
Morningstar Investment Management Insights

Brexit Deadline Looming: What Matters for Portfolios & Investors

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Key Takeaways

- ▶ Political outcomes like Brexit are notoriously hard to navigate. How they affect your long-term goals may be impossible to foresee. This makes investing difficult, but it should never drive fear-driven action.
- ▶ If we can't understand how an event will affect fundamentals, we don't want to base investment decisions on it. You should instead think about the potential range of outcomes and navigate the risks with a long-term view.
- ▶ We offer five points for reframing political events in investors' minds to help them achieve their goals.

People love to talk about Brexit and investors can be tempted to trade based on expected outcomes. We believe the investment basis for this is weak — not because we don't see a strong connection between political developments and uncertainty, but because sound investing inevitably links back to company fundamentals. Benjamin Graham — considered the father of value investing — deemed investing in something you don't understand and can't analyse to be speculation. We agree. As long-term investors, politics doesn't play much of a role in how we view portfolio management. We want to know the range of possible outcomes and position accordingly, but we must resist speculating.

**For Financial Advisers and Their
Clients Using Our Portfolios**

Writing About Political Events

Much has already been said about the recent Brexit developments — before, during, and after each negotiation point. Even professional investors spilled a lot of ink (or pixels) exploring the possible outcomes and implications. We don't always write about these events as we don't want investors jumping at shadows. It's not that we ignore politics or don't want to share our thoughts; it's that we believe doing so may send the wrong message to investors.

Meeting your goals is a matter of being long-term investors rooted in fundamental facts — and believe you should think about Brexit this way too. Political events rarely fit into this equation, primarily for two reasons: their short-term nature and their unpredictability. For instance, whether Boris Johnson is successful in his vision for Brexit or it results in further political turmoil still carries a lot of unknowns. It makes great news fodder, but the clearest effects on markets tend to be short-lived. Also, it's hard enough to predict political outcomes. But to be useful, an investor's prediction must not only accurately capture an outcome but all that follows, too — how the market responds, and how policies or other changes stemming from the event may one day affect investment fundamentals.

A Suggestion for Reframing Brexit

As long-term investors, we encourage investors to reconsider how they view Brexit in line with their goals.

The following points may help:

- ▶ Don't react immediately to news (however certain or material).
- ▶ Don't try to anticipate market reaction — markets move faster than any investor and price-in anything fundamental immediately.
- ▶ Wait out the noise and wait for real change with policies or earnings implications.
- ▶ Be prepared to position against the herd; what is assumed as consensus does not always become reality.
- ▶ Volatility can be your friend by offering quality assets at cheaper prices than previously available.

At most times, we believe you should try to emulate great value investors, like Benjamin Graham or Warren Buffett, who would caution against investing in something you don't understand. Political events like Brexit can't be understood because of the indirect and tenuous connection it has on investment fundamentals. We therefore believe that when investors depart from long-term, fundamentally sound investment analysis, they can drift dangerously into speculation.

The Morningstar Investment Management Group View

At Morningstar Investment Management, we don't make investment decisions based on political events because the connection to fundamentals is weak. We urge investors to remember that over 70% of U.K. corporate revenues are derived offshore, so we do not need to predict the U.K. economy to know what might happen to U.K. stocks.

When it comes to execution, our process is intended to be robust and time-tested, accounting for risks like Brexit in a structured manner. This means our conviction (and the subsequent sizing decision) rests on four key pillars: 1) absolute valuations, or understanding how a security's or market's price compares to its underlying cash flows; 2) relative valuations, or understanding how the valuations compare to other global opportunities; 3) studying fundamental risk; and 4) observing contrarian indicators, or evidence that an investment is unloved (or overly loved) by the market.

Of course, we must acknowledge a wider range of potential outcomes than usual—impacting the sizing and risk management in our portfolios—but don't believe Brexit should otherwise affect your approach to achieving goals in meaningful way.

Soapboxes Aside

The point is that it's hard to connect pre-event analysis to post-event reality. And if the connection here is tenuous at best, then we might say we're operating in what statisticians call a "low-validity environment." Plainly put, it's what Mike Tyson was referring to when he said something¹ like, "Everybody has a plan until they get punched in the face."

So, it seems predictions for the Brexit deadline and beyond are bravely asserted, but once pundits—or investors—get hit in the face with the political change, they often need to reanalyse and reconstruct their

¹ This quote is often attributed to Tyson, but perhaps rarely fact-checked. It seems what Tyson actually said was, "Everybody has a plan until they get hit. Then, like a rat, they stop in fear and freeze." See also: <https://www.sun-sentinel.com/sports/fl-xpm-2012-11-09-sfl-mike-tyson-explains-one-of-his-most-famous-quotes-20121109-story.html>

theories. The effect is that political outcomes drive short-term, knee-jerk reactions in markets. Recall the predictions, even by at least one investment bank's researcher,² that a Donald Trump win in the 2016 U.S. election would cause calamity in markets—which it did globally overnight after the election, only to give way to considerable market gains since. ■■

Further information: Please contact your Financial Advisor for further information.

² <https://money.cnn.com/2016/11/04/investing/donald-trump-stock-drop-citi/index.html?iid=EL>

Since its original publication, this piece may have been edited to reflect the regulatory requirements of regions outside of the country it was originally published in.

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