Brexit = head for the dollar?

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This at least appears to be the reaction of much of the market if we look at the performance of the likes of AB Inbev, Reckitt Benckiser, GlaxoSmithKline and Nestle. Even the previously much maligned HSBC has managed to strongly outperform both its local market and sector and keep pace with the wider market in euro terms. The one attribute all these stocks share is that they have little reliance on the UK for earnings and indeed make a significant amount of their profits in US dollars or US dollar-linked currencies.

Likewise, we have seen a significant sell-off in anything that fits within the dreaded financials sector – an area that our clients will have heard us talk a lot about. The banks sub-sector had its worst two-day move ever in the days following the referendum. Yes – worse than post the Lehman's collapse!

European banking sector worst 2-day moves (STOXX Europe 600 Banks Index)

Date	2-day % change
27/06/2016	-21.0%
20/01/2009	-14.8%
02/03/2009	-14.3%
27/10/2008	-14.0%
20/10/1987	-13.5%
07/10/2008	-12.5%
24/06/2016	-12.2%

Source: Bloomberg, 30 June 2016

What now for stock pickers?

Two questions we should then be asking ourselves:

1. If this is what 'the market is doing' then is it the right thing to do?
2. Should we be following?

The answer to both is in our opinion an emphatic no!

To answer the second question first – rarely has following the herd ever been the right thing for our clients. The answer to the first is more fundamental and goes to the heart of how we invest for our clients, and at a time of poor performance warrants further explanation.

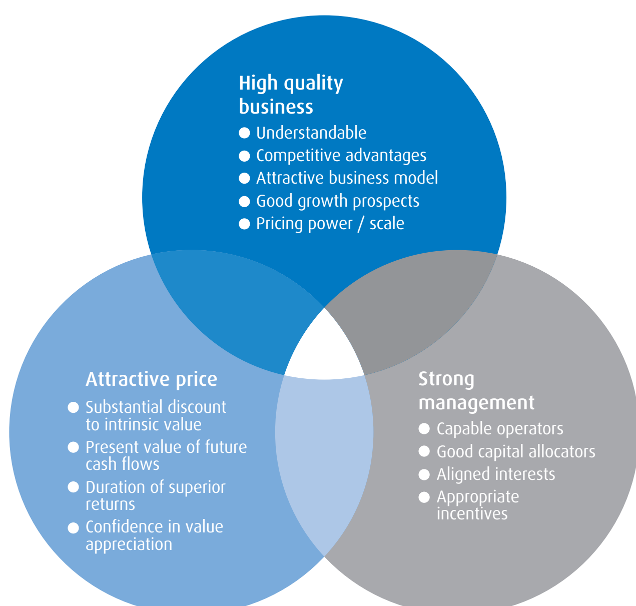
As to why investors have reacted this way the answer is clear; few expected or were positioned for such an outcome and with the rise in the markets in the days ahead of the referendum, extreme volatility was the result. For now all we know is that the world has changed, probably forever, and we do not know the impact that 'Brexit' will have on the UK or indeed the European economies longer term.

> "Markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises"
>
> **Howard Marks**

Time to take advantage

In times of such uncertainty it is perhaps understandable why investors want to shelter in large, liquid US dollar earners. As long-term investors, however, we disagree and believe that we should be taking advantage of the volatility and much lower prices to buy into the good quality long-term winners that are currently tainted by either the sector in which they operate or the country in which they make their money.

To explain in more detail we need to look again at our investment philosophy.



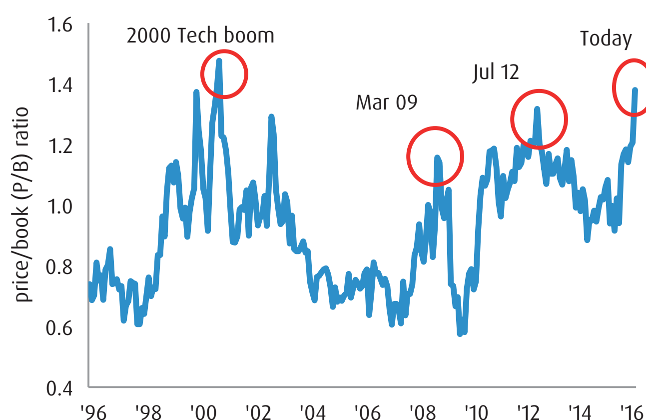
The issue we have with recent share price moves is the complete lack of discrimination being shown in terms of quality. AB Inbev, Reckitt Benckiser and Nestle are all high quality businesses but we have seen even stronger moves from BP, ENI and Anglo American, in fact anything exposed to dollar-denominated commodity earnings. Presumably the impact that dollar strength will have on the economies of the predominantly emerging market consumers of commodities is something to think about later!

However, we do want to buy good businesses so does the former group make sense?

This is where we come to the second tenet of our investment process: valuation. We have a strong belief that the price we pay is the biggest driver of returns for our clients and that it doesn't matter how good quality any asset is – if you pay too much you are unlikely to deliver good returns. If we think about the two groups above then perhaps one could argue that valuations in the latter group are attractive. Frankly we don't know (tell us the long term oil, iron ore, copper price and so on, and we might have an idea) and they certainly don't meet our threshold of quality. The first group does meet our quality criteria but is it a good use of clients' money to buy AB Inbev on 32 times this year's earnings or Reckitt Benckiser on 27 times, just because they are good businesses that make most of their money in dollars away from Europe? Again, our answer would be no.

Quality – but at what price?

Valuation Dispersion



Source: UBS Quant and European Equity Strategy, 11 February 2016

For a while now we have been explaining to investors that, in our view, those stocks universally accepted as 'quality' have become increasingly expensive with minimal margin of safety. As can be seen in the chart above, the valuation gap between cheap and expensive stocks is as wide as levels last seen in the 2000 'tech bubble'. We have felt that we could find better

Continued

value and quality in areas of the market shunned by many of our peers. For example, we do believe that, contrary to the views of many, we can find quality (and certainly value) in sectors such as banks through retail banks like DnB and ING, through insurers such as Prudential or Axa, and in cyclical businesses such as CRH. Clearly this has been a painful period for performance as we have been hit by the triple whammy of expensive quality continuing to outperform, oil and mining rising on the back of recovering dollar earnings, and weak performance from some of the names mentioned above.

A change of heart or a change of perspective?

Despite this and the current backdrop the question we always ask as we systematically review poor performers is: has anything changed in our long-term investment thesis? If the answer is no – which it often is – then we continue to hold our positions and accept the near-term volatility.

We are also increasingly asking ourselves whether there are other stocks in which we can now find extreme levels of value because they are perceived to be impacted by Brexit. Possibilities include UK retailers like Next and Kingfisher, housing exposed stocks such as Howdens and Grafton and the house-builders, and European financials in general.

Aiming for the same

Our aim remains the same: to buy into businesses that we believe are good quality and long-term winners based on our own research, not whatever the market may or may not believe at any point in time. Lastly, make sure that we do not pay too much for these businesses in order to minimise the risk of losing our clients' money in the long run.

We continue to believe that if we are unwavering in following our own process then we can deliver good returns for our clients, and that, in periods such as we find ourselves in now, we should embrace the opportunities we find, not hide in the same stocks as the herd.

Ultimately, we want to keep reminding ourselves of Warren Buffett's maxim: "Be fearful when others are greedy, and greedy when others are fearful".

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