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BEFORE AND AFTER THE VOTE: THE BENEFIT OF A BALANCED APPROACH

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Managing global fixed income portfolios often translates into finding the right balance of risk and protecting investors against adverse outcomes. In the month running up to the European Union referendum on 23 June, it became clear to our investment team that volatility would rise and that the cost of insurance against that volatility was fairly cheap. While we did not necessarily predict a Leave vote, we saw the outcome as asymmetric: the potential downside impact of a Leave vote on the financial markets would be much greater than the upside response to a Remain. Our positioning therefore reflected this asymmetry so that in the end we benefited from the outcome.

At the same time, we implemented some positions that would have benefited from a Remain scenario. While we did not expect a Remain vote to trigger a major market rally, there was nevertheless a risk that the market would react more positively than expected, leading to a “melt up” in risk. While that might have benefited sectors such as emerging market debt and high yield corporates, a “risk on” scenario would have been negative for core sectors such as government bonds and high grade corporates. This scenario never materialized, however, and the premium paid for these positions quickly lost its value after the referendum.

Looking to the future, the optimist’s view might be that a major risk event is out of the way; the initial market reaction was negative but that has eased somewhat; Article 50 may never be triggered; and the UK is a relatively small economy in the global context.

The pessimist’s view is that uncertainty is now much higher. We have moved from a “known unknown”, to an “unknown unknown”. This uncertainty will have a negative impact on factors such as sentiment, trade and capital investment across the world, with the risk that an already weak global growth environment may be tipped into recession.

In the immediate aftermath of the referendum, we reduced some of the positions that acted as risk hedges, but our stance still remains largely defensive. As risk assets have started to rally post Brexit, we expect to find opportunities to implement new hedges at attractive levels while at the same time investing in markets where fundamentals are attractive. It might be possible that the cheapest downside protection could be found outside Europe now. As the consequences of the Brexit vote develop and are better understood, we actually see merit in selectively buying European risk and using the US market to neutralize some of the market beta of our portfolios.

Away from Brexit, the world is still not an altogether stable place. China is still a concern. U.S. and Italian politics will gain focus as we move into the Autumn, with a referendum on constitutional reform in Italy expected in the second half of the year and the US election due in November. Ultimately, central banks have limited power to intervene, and the summer months are usually characterized by reduced liquidity, so keeping the right balance of risk remains a prevailing theme in our portfolios.

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