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BREXIT IS A LINE IN THE SAND FOR FINANCIAL STOCKS

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Brexit is a game changer. The British decision to leave the European Union (EU) is a real negative development for financial stocks, especially those that are positively affected by rising interest rates.

There is a broad spectrum, however, in terms of how Brexit will impact different financial stocks. The biggest losers from Brexit are the stocks that needed interest rates to move up in order to improve earnings and returns. Prior to the Brexit referendum, I had assumed a slow multiyear process of U.S. interest rate normalization. Now even that seemingly conservative assumption appears optimistic. We are likely to see further quantitative easing among central banks outside the U.S., which will push rates lower globally, strengthen the dollar, and limit the Federal Reserve's ability to increase interest rates. The impact on bank profitability could be substantial.

The UK and EU banks have been hit hard following Brexit, as they are the most clearly affected, and the odds of a recession in the UK and EU have increased substantially. The political and economic uncertainty will likely impact consumer and business spending. Further, with a number of other elections coming up over the next couple of years in EU member countries, there is the risk that Brexit will act as a precedent for others.

The good news, however, is that the global financial system is far stronger than it was in 2008. Banks have taken significant steps to strengthen their balance sheets in the wake of the financial crisis as regulatory requirements increased and stress tests became the norm. Accordingly, I worry less about Brexit's risk of creating financial contagion.

In the absence of such systemic risk, the material decline of some of the U.S.-based global banks and brokers has created a buying opportunity. We have been able to add to many of our highest-conviction names, including banks and capital market-related holdings, which our investment team thinks are well positioned to manage through an uncertain environment regardless of where interest rates go. We have been stress-testing balance sheets and thinking about what the outlook for profit and loss is under this new reality.

In Europe, my initial moves have been to add to positions in some of the higher-quality European financial services companies that were hit hard following the Brexit vote. In 2008, I learned that in periods of fear, the market will sniff out any balance sheet weakness and force companies to raise cash. We are, therefore, looking at financial companies with large excess capital positions that will support their operations even if earnings per share estimates are lowered to deal with a new reality. As always, I continue to look for the idiosyncratic turnaround stories of companies with strong managements.

The winners in the post-Brexit world are likely to be stock exchanges (which benefit from higher volatility), the residential mortgage industry (lower rates should drive home price appreciation and a new refinance boom), and real estate investment trusts (lower rates increase the value of underlying assets). As always, my goal is to position our portfolio to outperform over the long term regardless of the economic backdrop. As a result,

I continue to focus on stocks for which we feel we have an information advantage and that are significantly underpriced for any multitude of reasons, including controversy, complexity, or investment horizon. This bottom-up approach leads to a well-balanced portfolio, with many companies that fall into the “winners” group and others that we believe the market is incorrectly (or shortsightedly) putting into the “losers” group.

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