BREXIT: An investor's guide

Brexit continues to provide an uncertain backdrop for investment decisions as the clock ticks down to the UK's official departure from the European Union. Alliance Trust Savings' Sara Wilson considers the facts and how, under the circumstances, investors might best position themselves.

Investment markets recovered quickly from the bout of volatility that immediately followed the result of the June 2016 referendum, with a weaker Sterling boosting FTSE stocks where the bulk of their earnings comes from outside the UK.

But as I write this, some two and a half years later, investors are still uncertain as to how the UK's trade relationship with the EU will look after 29 March 2019, when the UK is scheduled to leave the EU. Yes, we do now have a draft withdrawal agreement on the table, but whether it will pass successfully through the UK Parliament is still anyone's guess.

Developments may mean things have become clearer by the time you read this, but here we've put together our thoughts on some of the questions that may be on your mind.

If there's a 'no deal' outcome, what would this mean?

Under the terms of the draft withdrawal agreement there will be a transitional period between 29 March 2019 and the end of 2020 to smooth the way while we negotiate our future relationship with the EU. If we reject that deal and haven't got a Plan B, we simply crash out of the EU on 29 March 2019 with no transitional arrangements in place. When it comes to trade, the UK would have to revert to World Trade Organisation (WTO) rules when dealing with the remaining EU 27 nations.

It's possible a no-deal Brexit could boost the FTSE in the short-term since the FTSE traditionally has an inverse relationship with Sterling. The pound fell sharply in September when the prospect of a no-deal Brexit scenario seemed to increase, and again in mid-November when it became clear that Theresa May's draft deal may struggle to gain Parliamentary approval. However, the ensuing disruption to trade and other areas of daily life of crashing out of the EU with no deal seems highly likely to have a negative impact on certain companies and industries.

What impact would a no-deal Brexit have on interest rates?

One possibility is that the Bank of England, which has raised interest rates twice over the past 12 months (from 0.25% to 0.75%), could respond to this outcome by cutting them again. However, Bank

of England Governor Mark Carney has commented that house prices could fall by as much as 35% over three years in a worst-case scenario, which could cause a more severe weakening of Sterling and force the Bank to increase interest rates[1].

Ultimately, monetary policy will be dictated by events, what the Bank considers the greatest threat to the economy and how it acts to mitigate it.

What's the difference between 'no-deal' and a so-called 'hard Brexit'?

The main one is that with a 'hard Brexit' there would be a withdrawal agreement and transitional arrangements in place to smooth our way to a new relationship with the EU, but that new relationship would ultimately leave the UK outside both the single market and the customs union, trading with the EU 27 on WTO terms.

The International Monetary Fund has predicted that the UK would lose up to 4% of national income in the event of a hard Brexit (compared to a loss of up to 1.5% for the EU)[2]. However, in practice, based on the draft withdrawal agreement and accompanying Political Declaration, this option now appears less likely than a 'softer' form of Brexit.

What does the November 2018 draft deal involve, and what is 'softer' about it?

Broadly speaking, the draft withdrawal agreement means we'll continue to follow EU rules and regulations for the period of the transition. And, up until 1 July 2020, we'll also have a one-off option to extend that transition for a limited period. This represents a 'softer' Brexit as it means existing trade arrangements with Europe will continue whilst we negotiate the detail of our long-term future relationship with the remaining EU 27 countries based on the Political Declaration.

However, during the transition, since we'll officially have left the EU, we'll no longer have a say on how EU rules and regulations continue to be developed even though we'll be subject to them. This, and some other key elements in the draft deal, such as the proposals around border and customs arrangements between Ireland and Northern Ireland, makes it controversial. There appear to be some serious challenges ahead for Theresa May and her government when it comes to securing approval from the UK Parliament.

Is there still a chance Brexit won't actually happen?

The 'softer Brexit' represented by Theresa May's draft deal would allow continued access for trade, but it's also ramped up what was already growing demand for a referendum on the terms of the withdrawal agreement, highlighted by October's People's Vote March in central London.

The possibility of another referendum keeps alive the idea – however slim it may seem – of the UK staying in the EU after all.

So, with all that in mind, what should investors do?

As always, what is right for you will depend on your personal circumstances so nothing said here can be taken as a recommendation. But there are two general practical points you may find it helpful to bear in mind.

First, the ongoing uncertainty might tempt some investors into making decisions based on what they predict might or might not happen. Yet investment decisions driven by emotions as opposed to hard facts very rarely work out well. While it might feel logical to sell out as markets start to fall, even short spells out of the market can significantly erode any long-term returns because you can then miss out on the gains from any following rebound.

You might also miss out on specific opportunities, such as being able to buy into investment trusts at discounts to their net asset value. Recent research by Winterflood, for example, found half of UK equity investment trusts trading at discounts wider than their 10-year average, with the Brexit-related uncertainty a contributing factor[3].

Second, diversification is typically a helpful strategy. Spreading your investments across different asset classes, sectors and global regions can go a long way to managing the risk in your portfolio while still giving you the potential to both capture opportunities and enjoy long-term benefits from remaining invested.

If you're at all unsure whether your portfolio is effectively diversified, you may benefit from seeking professional financial advice. Alliance Trust Savings can't give you advice. ■

1. Independent – No-deal Brexit may force interest rate rise, says Bank of England governor Mark Carney – 14 September 2018.
2. Guardian – The IMF is right: hard Brexit is an international threat. 22 July 2018.
3. FT – UK investment trust discounts widen since Brexit vote. 19 October 2018.

Sara Wilson

Head of Platform Proposition
Alliance Trust Savings Limited

Sara joined Alliance Trust Savings in March 2013 as Head of Platform Proposition, taking on responsibility for the products and investment choice available on the platform. Previously, she worked for Standard Life as International Proposition Manager. Before moving to Scotland, Sara worked for Xansa, a technology outsourcing company. She received a BA Honours in International Business from the University of Teesside and a Post Graduate Diploma in Marketing at Napier University, Edinburgh.

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