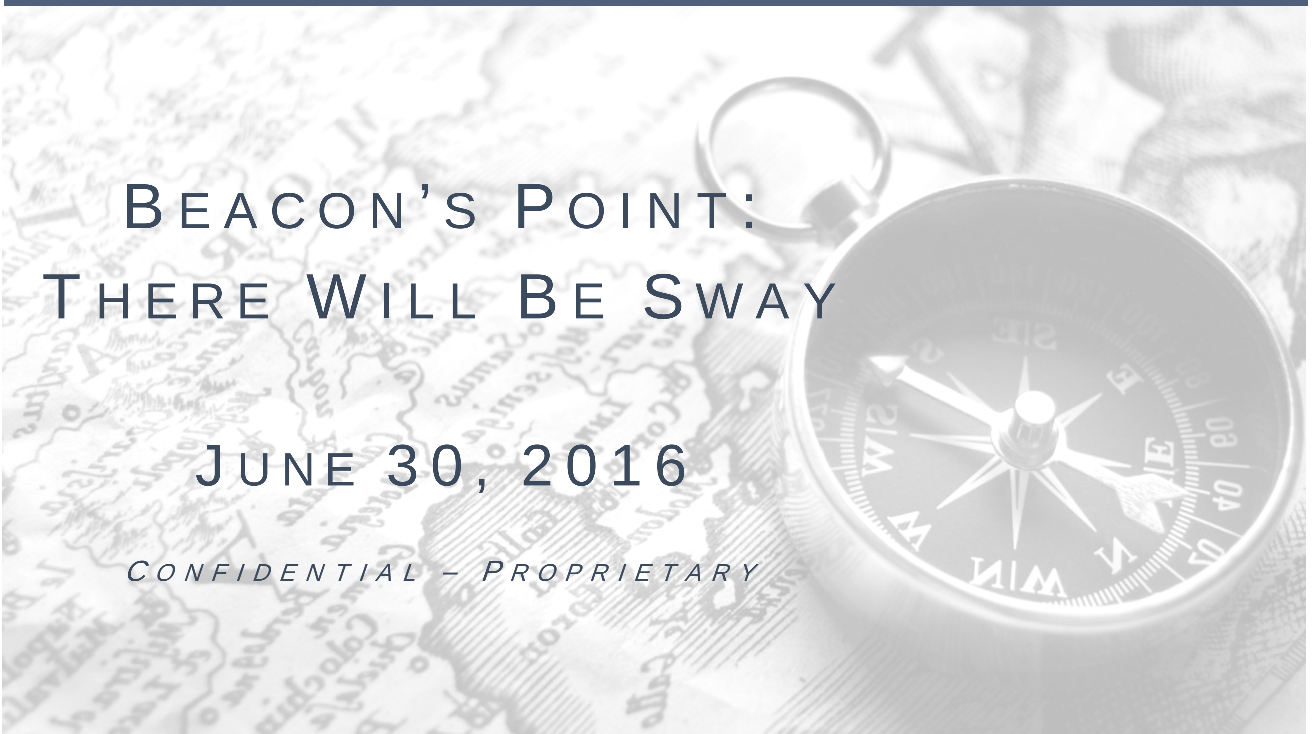
BEACON POINTE



BEACON'S POINT: THERE WILL BE SWAY

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There Will Be Sway

Ascending a mountain by tram is a memorable experience. The swinging can be strong and nauseating, especially in inclement weather. The standard warning "There will be sway" often comes through the loudspeakers with no time to brace oneself for the rough ride. Yet we make the trip again and again because it is the only way to get to the top of the mountain where the views are breathtaking. The key to overcoming the inevitable sense of panic and queasiness is being prepared, having the right mindset, and keeping an eye on the final destination.

Investing in financial markets can be equally challenging. A seemingly orderly up-trending market can quickly morph into a violent correction with little advance notice. Even long-term investors start focusing on short-term performance and may question past portfolio decisions that were made with conviction. There is, naturally, a temptation to abandon one's discipline and change course. In such circumstances, action is more comfortable than inaction. Occasionally, a recalibration of the plan is a prudent choice – for instance, if an investor had overestimated the level of risk tolerance appropriate for his or her portfolio. More often, however, the optimal – though by no means easy – decision is to accept volatility but remain committed to a thoughtfully designed long-term investment strategy. Jumping off the tram mid-way to the top of the mountain is, for obvious reasons, not a good solution.

Last week's Brexit vote caused a much bigger "sway" than market prognosticators had expected. As soon as the results of the UK referendum were announced, risk assets sold off meaningfully while perceived safe havens outperformed. The vote was as close as anticipated, but ultimately the outcome surprised global investors and concerns about the potential fallout implications for the European Union mounted. These concerns are largely legitimate – after all, the United Kingdom is the second largest economy (behind Germany and ahead of France) in the Union. In its absence, other members will have to step up and contribute more in order to make United Europe work. If we were thinking in basketball terms – which we often do – this is a predicament as difficult as the Lakers found themselves in after losing Shaquille O'Neal to the Miami Heat in 2004. Kobe Bryant was still there, of course, as were some other promising players, but everyone (even the most ardent fans) wondered if the team could be successful without its diesel. As we now know, the Lakers organization was able to adapt and rebuild a strong core around Kobe, winning two more championships post-upheaval.

While a similar eventual triumph for the European Union is hard to envision, we nevertheless believe that what lies ahead is persistent uncertainty and prolonged volatility rather than catastrophic financial destruction. Mohammed El Erian, formerly of PIMCO and currently an advisor to Allianz, made the following comments on Friday: "It can be a significant financial shock [but] the good news: This is not Lehman. This is not a payment and settlement crisis that results in a sudden stop for the global economy. It is a shock to the institutional set-up. It will cause some major financial moves…" In other words, there will be "sway" but the tram is unlikely to fall off the rails or cables, as the case may be.

With the constantly evolving situation, the specific immediate and longer-term Brexit implications are still unknown, but we offer a few observations:

- The final tally showed that 52% of voters wanted the U.K. to leave the European Union. The currency reacted quickly – sterling fell 11% to a 30-year low against the U.S. dollar. The major European stock indices also retreated meaningfully on the news. Oil weakened and gold gained ground. Risk aversion is definitely back on top of investors' minds.

- The main economic impact should be felt in the U.K. through changes to investment flows and domestic consumption. Prime Minister David Cameron announced that he will step down in October. The Conservative Party will now look for a new leader; the U.K. will also likely need to plan for general elections before the end of 2016.

- The vote may open the door for a possible unification of Northern Ireland and the Republic of Ireland as well as a potential second Scottish independence referendum (the first one took place in 2014). Some market observers believe that, if the decision to leave the EU is upheld, the U.K. may cease to exist as a unitary state.

- There is a risk that the outcome of the Brexit vote will embolden nationalist politicians to seek similar referendums elsewhere in Europe. Furthermore, the political landscape in non-EU developed countries, including the U.S., may shift further towards polarization and populism. The upcoming elections in the U.S. add another layer of uncertainty to the geopolitical, global economic, and financial markets outlook.

- Policymakers around the world can, and are likely to, pursue further monetary easing (asset purchases or currency interventions) as a way to mitigate the risk of destabilization in the system. This also implies a lower probability of rate increases by the Federal Reserve in 2016.

- The U.K. would be breaking new ground if it separates itself from the European Union. This has not been done before and the logistics of the process will certainly be complex and difficult. The vote itself is not legally binding; formal withdrawal requires an act of Parliament. It is expected that, once Britain initiates exit negotiations, it will take at least two years (as specified under Article 50 of the Lisbon Treaty) to account for all of the state's obligation and determine its future relations with the union. The British government has an incentive to delay the start of the two-year window in order to gain valuable time for a negotiation plan preparation.

- A potential positive outcome would be the development of a stable, functional relationship between the U.K. and the EU modeled on Switzerland and Norway. Both countries are not members of the European Union but maintain strong links with the rest of Europe. However, this is far from a certain result, as the EU will likely be a tough counterpart in the negotiation process. There are far too many unknowns at this point so a wait-and-see approach is necessary.

- Meanwhile, the sell-off in global risk assets, while painful, offers a silver lining in the form of better buying opportunities for active investment managers. The result of indiscriminate price weakness is fundamentally strong securities trading at compelling discounts to their intrinsic values. U.S. and Asia markets would be only marginally affected by a U.K. exit from the EU; in the U.K., export-oriented companies could benefit from a cheaper currency; and emerging markets – already pricing in a significant slowdown and lower growth prospects – may be poised for a period of outperformance. Active managers will have the ability to add value in this environment.

Needless to say, there is a long way ahead before all the issues are sorted out. The obvious question for investors is what to do now. As discussed at the beginning of this Beacon's Point, we believe that the patient and diligent execution of a prudently designed investment strategy is the best course. The benefits of staying invested have been discussed on the pages of Beacon's Point several times in the past but are worth revisiting during periods of heightened volatility. Crisis events are certainly not a new market phenomenon – there have been and will be points in time when fear overshadows rational thinking, resulting in extreme short-term market gyrations. History has shown that, with the benefit of time, investors are able to digest the new information, evaluate the real-world implications of the event, and adjust to the risks and opportunities presented by the current environment. Research from Putnam Investments, included in the table below, highlights similar episodes over the last 80 years. On average, U.S. stocks lost 10% during the crisis event, but recovered nicely over the subsequent periods. Patience and an unwavering investment discipline enable successful long-term investors to stomach the volatility, stay the course, and accomplish their financial goals.

CRISIS AND RECOVERY: HOW THE S&P 500 INDEX PERFORMED DURING AND AFTER HISTORIC EVENTS

			S&P 500 percentage of gain/loss after last reaction date			
Event	Event reaction dates	Percent of gain/loss during event	1 month later	1 year later	5 years later	10 years later
Fall of France	5/09/40 – 6/22/40	-16.9%	0.7%	5.0%	15.7%	13.2%
Attack on Pearl Harbor	12/06/41 – 12/10/41	-7.5	2.1	15.8	18.0	17.1
Outbreak of Korean War	6/23/50 – 7/13/50	-12.2	10.2	42.2	27.7	18.5
Eisenhower heart attack	9/23/55 – 9/26/55	-6.6	-0.5	11.9	8.4	11.5
Cuban Missile Crisis	8/23/62 – 10/23/62	-9.9	15.5	41.1	15.8	11.1
Kennedy assassination	11/21/63 – 11/22/63	-2.8	7.0	27.8	12.4	7.0
U.S. attacks Cambodia	4/29/70 – 5/26/70	-15.0	6.4	49.0	9.3	9.3
Nixon resigns	8/09/74 – 8/29/74	-13.4	-6.8	30.2	14.6	14.6
U.S.S.R. invades Afghanistan	12/24/79 – 1/03/80	-1.8	9.9	36.5	15.0	18.0
U.S. invades Grenada	10/24/83 – 11/07/83	-2.1	2.8	9.4	15.9	15.0
1987 stock market crash	10/02/87 – 10/19/87	-31.5	7.1	27.7	17.0	18.9
U.S. invades Panama	12/15/89 – 12/20/89	-2.1	-0.9	-0.2	9.3	18.2
Gulf War ultimatum	12/24/90 – 1/16/91	-4.0	17.2	36.6	17.3	18.0
Gorbachev coup	8/16/91 – 8/19/91	-2.3	3.2	14.5	15.2	14.3
Collapse of Long-Term Capital Management	8/28/98 – 9/09/98	-2.0	-2.0	35.8	1.8	3.7
September 11 terrorist attacks	9/10/01 – 9/21/01	-11.6	11.3	-11.1	8.3	3.9
U.S. invades Iraq	3/18/03 – 3/31/03	-2.1	8.2	35.1	11.3	8.5
Collapse of Lehman Brothers	9/05/08 – 11/20/08	-39.1	18.3	48.8	21.5	–
Mean gain/loss		-10.2	6.1	25.3	14.1	13.0
Median gain/loss		-7.1	6.7	29.0	15.1	14.3

Source: Putnam Investments

Please feel free to call Beacon Pointe should you need additional information or have any questions.