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Capital Management, LLC

Brexit

June 24, 2016

With the recent historic vote in the United Kingdom to leave the European Union, the OPCM Investment Team would like to share some important information and our views about the event, along with how the outcome may affect each asset class in your portfolio.

History: The precursor to the EU, the European Economic Community (EEC) was created in 1951. The UK joined in 1973. The citizens of the UK actually voted on a Brexit in 1975 – it failed miserably with 68% voting to stay. Now with the 52% vote to exit (Brexit) victory, there will be a two year negotiation with the EU (much of it having to do with trade). EU trade standards are incredibly important since the EU is the world’s largest trading bloc with 500+mm people.

Voter Turnout: Was 72%, higher than the general election and higher than expected. No clear timetable for the UK leaving, but negotiations around the formal terms of the exit may extend until at least Jan 1, 2019. Other miscellaneous poll data: 18-24yr old: 75% voted Remain, 25-49: 56% voted Remain, 50-64: 44% voted Remain, 65+: 39% voted Remain. 66% of “Leave” voters didn’t graduate from college while 71% of “Remain” voters graduated with a college degree.

Political: Prime Minister David Cameron announced his resignation after the vote and will leave office in October. Now the question is whether Conservatives can maintain a majority in parliament going forward. Likely a matter of time before Scotland calls for another referendum. Another issue to watch will be other major European countries that have seen recent rise in “Eurosceptic” politicians (namely France and Spain). Key elections: Germany and France in 2017.

Economic: UK GDP has been tracking around 1.5% and will likely slow down pretty noticeably from here (some estimates have pegged Brexit as a 1%-2% drag on GDP over the next 12-18 months). Bank of England will likely lean towards easing now – if conditions weaken significantly, quantitative easing could be initiated. This view will likely be balanced by any potential inflationary effects a significantly weaker GBP may cause. Negotiations between the UK and EU members around trade could last for several years; however, until formal plans are set the UK’s existing trade arrangements will remain in place. Of importance, UK will have reduced access to the EU market given the “Leave” side’s mandate of national control over their borders and laws. Non-EU countries that are part of the EEA (European Economic Area) like Switzerland and Norway enjoy the trade benefits of being an EU member, yet they are allowed those economic benefits because they have adopted numerous EU-member regulations and have endorsed free movement of EU citizens. One of the larger headwinds for growth going forward will be reduced foreign investment in the UK economy. Business investment had already turned down in the quarters leading up to this vote and this will likely accelerate any pullback. The UK may also see a sizeable impact to their labor force as 80% of the net increase in their workforce since 2004 has come from non-UK nationals.

“Remain” vs. “Leave” Arguments: The Vote Leave campaign argued that the EU costs the UK £350 million (\$500 million) per week, or almost £20 billion (\$28 billion) per year—money the group says could go towards the National Health Service or building new schools. Britain Stronger in Europe says that the numbers fail to include a rebate of £100 million (\$141 million) a week and EU spending in the UK, after which the net cost is much lower, at £5.7 billion per year (\$8 billion). Britain Stronger in Europe also highlights the benefits to being part of the EU’s single market (including free movement of labor, capital, goods, and services) and say stepping out of it would be a costly mistake that could cause an economic slowdown, job losses, and financial instability for years to come. Vote Leave asserts that the UK would keep trading with the remaining 27 EU countries in accordance with the Norwegian model, World Trade Organization rules, or other trade guidelines. They also say that leaving would allow them to negotiate free trade agreements with





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countries such as China, US, and India. The Vote Leave campaign wants to regain control over UK's borders and take back powers from EU institutions. It says EU regulations harm UK businesses and are created by unelected bureaucrats. Britain Stronger in Europe accepts a minor loss of sovereignty in return for free and fair trade among the EU member states. It also highlights that the unelected bureaucrats include UK citizens and claim it is easier to influence rules and regulations from inside the EU.

Impact on OPCM Portfolios: It is probably no surprise that the biggest selloffs today are in UK and Western European equities. Here are our opinions regarding the effect on our asset classes:

Domestic Equities: The overall exposure to the UK in the S&P 500 is relatively minimal – just under 3%. Broader European sales exposure is approximately 6%-8%. Going forward, we would expect ongoing volatility in UK and European equity markets but expect the impact to the S&P 500 to be more limited in scope and duration. We own a number of companies that have literally zero exposure to the UK.

Foreign Equities: Relative to our benchmark, we are approximately 5% underweight UK equities and around 12% underweight Western European equities. We are looking to add to India on potential further weakness, as India is less fundamentally affected by the Brexit versus the rest of the globe. We continue to like our relative overweight to Emerging Market countries which we believe will outperform their Developed Market peers during this period of uncertainty as the UK navigates its exit from the EU.

Natural Resources: The Brexit's resulting dollar strength should pressure natural resources initially. Natural Resources should continue to be volatile primarily due to concerns around any potential deterioration to commodity demand caused by the Brexit, as well as any continued moves in foreign exchange rates (particularly the USD). Going forward we will use any irrational market moves to initiate positions on our watch list with a particular emphasis on companies with minimal UK/EU revenue exposure.

Real Estate: International REITs will be pressured near term on concerns about the Brexit impact to local economies while domestic REIT's should hold up better as investors focus on their yield advantage and the healthier US economic backdrop. Of our five main positions, three have zero exposure to the UK or EU. CBG (CBRE Group, Inc) does generate some revenue from the UK, and RWX (SPDR Dow Jones International Real Estate ETF) is 30% EU with 15% UK. Overall OPCM is approximately 90% positioned in the US.

Alternative investments: As typically occurs in the Alts asset class, the holdings should move in different directions. Our long dollar position is up strongly today, while our private equity position is down strongly. Our short US Treasury position will slightly offset the gains seen in the fixed income asset class.

Fixed Income: Yields in treasury (and other global) bonds should continue to compress in the interim, as should higher quality corporate bond yields. The result is higher prices (better returns) in fixed income, although shopping for new bonds to replace recent maturities will be a challenge.

Cash: As you know, our cash levels have varied from 12-15% in July-2015, to under 5% in Feb-2016, to about 10% today.

The OPCM Investment Team

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