Dynamic Portfolio Manager Brexit Commentaries

June 24, 2016

In what is described as a historic and generational event, the U.K. has voted to leave the European Union. It becomes the first major country to decide to leave the bloc. As the geopolitical and economic impacts unfold, global financial markets have already reacted. Our portfolio managers provide their initial assessment.

Oscar Belaiche

This was definitely an unanticipated event where the financial markets and the odds makers were wrong. We have little direct exposure to Europe and the one U.K.-based utility security owned in Dynamic Strategic Yield Fund and also held in Dynamic Global Infrastructure Fund and other funds is up for the day and fully hedged versus the British pound. Securities we own are high quality with strong balance sheets and more predictable earnings so we are looking at this as a buying opportunity and indeed are selectively buying today.

We believe this event will reduce the likelihood of interest rate increases in the U.S., with the probability of a Fed Funds rate increase in December 2016 dropping from 50% to 8.5% overnight, and may put a damper on global economic growth.

Jason Gibbs

The most important thing in volatile times is sticking to a time tested process. We own quality businesses that deliver essential services. Dividends from these companies will continue to be paid and continue to grow. There have always been macro events that cause tumult, and there will be more in the future. The world is resilient and ultimately adapts and moves on. As always, those that stick to the process and focus on company specific fundamentals will win in the end.

Eric Benner

Global capital markets and local betting markets alike were sharply surprised by yesterday's 52% to 48% outcome in favour of the U.K. leaving the European Union. The market's reaction has been severe but mostly rational, with both the pound and U.K./European equity markets falling sharply on political and economic uncertainties, and U.K., U.S. and most global bonds rallying just as sharply on the assumption that central banks will respond vigorously to those uncertainties.

Within the U.K. and Europe, equity market reaction was starkly divergent for cyclical versus defensive sectors and for domestic versus global businesses. Once again, investing in quality businesses has proven to be a strong defense against macro uncertainty, as high quality businesses with global exposures were down modestly or even up slightly in local terms, driven by their resilient earnings which are actually bolstered by declines in the pound and euro. Meanwhile, cyclical businesses with significant European exposures were down sharply, with U.K./European financials leading the way at -10% or worse.

With the market's reaction more or less as expected along cyclical and defensive lines in general, our focus continues to be on identifying which specific high quality businesses offer the best bargains, both now and as the political and economic after-shocks play out in the coming months.

Tom Dicker
U.K. and European real estate stocks were down violently overnight which has had a negative impact on Dynamic Global Real Estate Fund. U.K. stocks comprised about 6.8% and European stocks were 4.4% of the Fund as of yesterday's close.

We have already seen a large move off the bottom and we do believe this is a market over-reaction in the face of uncertainty. We expect values to normalize over the coming weeks as more clarity emerges in the political situation in Europe. Canadian and U.S. real estate stocks' reactions have been much more mixed with many actually up on the day so far. For real estate stocks, uncertainty in the economy has been partly offset by lower bond yields and a general move into safe assets.

While this volatility is painful in the short run we will use it as an opportunity to add high quality real estate to the portfolio. In this moment of maximum uncertainty, staying the course is key.

Damian Hoang
In Dynamic Premium Yield Fund, we have de minimis exposure to European equities. In general, we were defensively positioned heading into this unexpected risk-off event—with around 50% of the Fund's assets partially hedged using index puts (we buy these puts for portfolio protection) and a high-teens cash buffer. In addition, even after today's sell-off, the large majority of the written cash secured puts in the Fund are still out of the money by an average of 6.5% (our margin of safety). The rest of the portfolio consists of less than 30% long equity exposure of which approximately 10% is overwritten with covered calls.

With the VIX spiking almost 50% to around 26, premiums have become very attractive. We are taking this opportunity to deploy selectively into high quality companies at compelling valuations by writing puts with an extra margin of safety.

John Harris
Dynamic Alternative Yield Fund has a small percentage of its assets in U.K. real estate and European infrastructure. These investments were fully hedged as to currency. Additionally, although we anticipated that “remain” would prevail, we had portfolio hedges in place which have helped mitigate the drawdown today. We have been buyers on the weakness today.

Michael McHugh, Domenic Bellissimo, Dan Yungblut & Bill Kim
The British referendum result was unexpected by the global community. The immediate impact has been a material increase in the price of safe haven assets and fall in other deemed riskier assets. Our initial assessment is that the near term impact on the global economy will be minor and will produce additional or extended monetary stimulus. The longer-term impact appears to be political as other countries within the EU face internal resistance to membership and an overall shift towards nationalism. The initial market response has been a partial retracement of the initial risk-off reaction in the market.

Within our bond mandates our short portfolio duration muted the immediate price appreciation following the decline in yields overnight. Breakeven spreads fell impairing the performance of real return bonds. The overall high quality lower duration of our corporate bond holdings served to insulate that part of the portfolio to the risk in credit spreads.

In the days ahead we will further examine the economic, policy and business consequences to gauge the potential impact on the fixed income markets. We anticipate that the increased volatility will create opportunities to add to existing positions, including higher quality corporate issuers and to possibly implement derivative strategies that would aid in facilitating our investment strategies.

Marc-André Gaudreau
Following the historic Brexit vote and the market reaction, the Credit Team believe that the increased uncertainty and volatility in the markets will create attractive investment opportunities over the next few months. We believe that the 2-year negotiation period along with the upcoming U.S. election will require very accommodative Central Banks policies. This Brexit shock, combined with low global economic growth, is increasing the probability of financial contagion.

The team’s various Dynamic funds have been positioned defensively for several months with high cash levels (~20% for the credit funds and ~10% for Dynamic Preferred Yield Class) and a focus on higher quality issuers. In addition, we purchased credit portfolio insurance earlier this year to help protect from market shocks such as this. None of the funds hold securities of European financials. As we move forward and credit premiums increase and financial contagion eases, we expect to gradually add to selected issuers and unwind some portfolio hedging (sell credit portfolio insurance) at attractive levels.

Christine Horoyski
While the decision for Britain to exit the European Union was unexpected, our portfolios are defensively positioned and should benefit as investors flee to safer areas of the market during this turbulent time. We hold long duration government bonds for safety, corporate bonds for value, and are hedged against our major foreign currency exposures. We do not have any direct exposure to European bonds and do not anticipate adding any to our portfolios in the near future. Bonds are key beneficiaries during risk off moves in the capital market and our fixed income portfolios are designed to be a core fixed income solution for investors and focus on delivering a total return approach while serving as a parachute for investors during periods of volatility and uncertainty.

Noah Blackstein
Dynamic Power Global Growth Class and Dynamic Power American Growth Fund have minimal exposure to the U.K., and Europe remains a low weighting in our portfolios as well. This is not due to any reasons related to Brexit or issues in Europe but rather due to our inability to find securities in Europe that meet our investment criteria. Our main country weightings in Dynamic Power Global Growth Class are skewed towards the U.S. and Asia which come as a result of our bottom-up stock selection process.

When we look at Britain leaving the European Union (EU), it's difficult to say how things will play out in the long-run, as investors will often shoot first and ask questions later. This process of Britain leaving has been long and drawn out, and it will take time to see how this eventually unfolds. We see the impact on the U.S. economy of Britain leaving the EU as being de minimis; however, the reaction of the markets is not something we can control. It's difficult to determine when or what stocks will get caught up in massive waves of selling due to investors panicking.

The only thing that tends to go up in markets such as these is correlations. We cannot predict the price movement of stocks in other companies even if they have nothing to do with the U.K. or Europe. In the meantime, our focus remains on the fundamental outlooks of the companies we own. Our goal is to continue to find companies with the best outlook and the best opportunity going forward. We want to own companies that will continue to grow regardless. In certain cases we are hopeful that any sell-off that occurs will provide us with an opportunity to add to certain positions in our portfolios.

Robert Cohen
Surprise, surprise, Brexit is here. While this might be the canary in the coal mine for the demise of the Euro, Britain will be adjusting toward Brexit for the next 2-3 years. The instantaneous market reaction doesn't surprise us as investors are moving toward safe-havens such as gold. Our investment philosophy, however, is to stick with the exact same companies that we would have owned with or without Brexit. We believe in investing for the long-term.

Today, within the first 24 hours of the Brexit vote, over half of the equities in the portfolio are up over 5% and the gold price is up about 6.25%, or CAD$100/oz to CAD$1700/oz, which we expect will continue to enhance fund performance. We anticipate that the market will settle down over the coming days, and then the focus will be on the question of the future of the rest of the Eurozone. Probably a topic that will be debated for years to come, but we don't expect another shoe to drop in the near-term. Nevertheless, long-term this is a stark reminder of the problems in the fiat currency system amidst the backdrop of negative real interest rates, quantitative easing, extraordinary debt/GDP ratios and massive government budget deficits all the while the central banks running out of tools to fix things with. This is probably an opportune time to remind investors why they should own some gold at all times – events like Brexit can happen quickly and it's better to be in the asset class than scrambling around trying to time the markets. We feel that the focus of our portfolio is investing in the best-in-class companies across the board from producers to advanced exploration, with a goal of giving investors an optimal risk-reward to the asset class. We remain highly concentrated and are excited with the prospects of the companies that we own, which are only enhanced by the higher gold price but are not reliant on the higher gold price to be successful.

David L. Fingold

We like to say that the reason we are conservative investors is because we do not know when there will be bumps in the road. It is unclear to what extent the events surrounding the Brexit vote are a bump in the road. That will likely be sorted out by the markets over the course of the next week or longer. The reason why we are conservative is because when you do hit a bump in the road, you pick yourself up, brush yourself off, and you move on. A conservative investor need not worry about interruptions from time to time. We are invested in businesses that are undervalued, that are growing, that have strong balance sheets, and have dividend growth. We expect that all of the companies we own will be profitable investments if we are patient. We don't own any companies which would either have benefitted or have been hurt by a Remain or Leave outcome from the referendum. We own one company within Britain in our Global Dividend fund. 90% of their sales are generated outside of the United Kingdom.

We believe that investors still have an obsession with macroeconomics and that is causing investors to focus on noise rather than focusing on the quality companies that they could be investing in. The impact of macroeconomics that we saw during the global financial crisis is likely the high point of our lives. We have been calling that "peak macro". Macro influences on single stock returns have been falling. Our recommendation is that investors should spend less time watching television or reading newspapers, and a lot more time focusing on whether or not they have invested in good businesses with good prospects and solid financials. There is no question that if you allow these events to give you post-traumatic stress disorder and react to any major macro developments, it may cause you to take your eye off the ball of proper investing.

Alex Lane & Stephan Smith

Obviously the Brexit “leave” vote is very negative however with a narrow margin it creates greater uncertainty. Also, in terms of an actual economic impact it will likely take two years to actually resolve the exit mechanism. What we had done to protect our investments in our portfolios in the short term prior to the vote was to hedge all British pound exposure even though a lot of our companies in the portfolios are not impacted in terms of their operations. Now given a Brexit verdict we are looking at each individual name to assess potential impacts and will be adjusting the portfolios accordingly.

Dana Love

Our initial response is to view this as an opportunity to upgrade our portfolios and take advantage of the volatility we’ve seen earlier today, either by adding to existing positions in high quality companies which we already own or going to our ‘wishlist’ to find great companies who are in attractive industries and are now trading at attractive valuations. There are great companies around the world whose products and services are in no less demand today than they were before the polls closed in the U.K. yesterday. The only difference for many of them is that they are now more attractive to buy as a long-term investment.

Only hindsight will be able to tell us how long this volatility will last and the extent of the trauma inflicted. In situations like this the typical historical pattern of the past 25 years would have the central banks around the world intervening to help avert crises and bring calm to markets. The big question is if the central bankers have any bullets left to tackle this event that given the incredible amounts of monetary stimulus pumped into the system since the 2008-09 financial crisis. Even unconventional tools and policies may have reached their effective limit.

Although most market sectors are in the red today, the financial sector has been particularly hard hit given the interconnectedness of the global economy and the fears of contagion. As a longer term theme in our portfolios we have maintained a significant underweight allocation to the financial sector based on a number of concerns including valuations, lack of transparency (particularly the larger banks), and the general difficulties of banking in an era of historically low interest rates. That being said we do own a few select companies in the financial sector, particularly those involved in the P&C insurance business that we believe to possess differentiated business models and prudent risk profiles.

Don Simpson

Global markets are selling off today on the news that Britain voted to leave the European Union in a national referendum. While this is not what we were expecting, we recognized that as we got closer to this date that this was a real possibility.

We only own one name listed in Europe, a REIT with high quality assets spread across Europe. While we have minimal direct exposure as a percentage of the funds, there are many businesses that we own with exposure to the U.K. and Europe. It is unclear how they will be impacted by any changes related to the referendum. What we do know is today's vote has created a lot of uncertainty in the market and the market does not like uncertainty. Today is not the day to be figuring out how much exposure we have to a no Brexit vote, but rather to find opportunities to buy high quality businesses that may be discarded as investors rush to the sidelines.

Volatility is certainly not fun, but it does create great long term opportunities to build wealth. The key for us is not to panic but rather to stick to our process of owning high quality businesses at attractive valuations.

Chuk Wong
News of Brexit is a shock but not a disaster for the world economy. When the dust settles, I think the economic implications for the U.K. and the rest of EU are likely less dramatic than what the current volatility of the financial markets is suggesting. There is reason to adjust our investments to reflect the new reality but there is no reason to be panicking.

The direct economic implications for the rest of the world including the U.S., China and Japan are relatively small but the second derivative impact could be significant due to the financial market linkages. For instance:

- Japanese yen levels of 90-100 per USD mean Abenomics is being unwound;
- Given that the global economy carries about US$250 trillion of debt (net), volatilities are imbedded in the global financial system.

The response of major Central Banks will be the key to financial asset stability in the near term. Central bankers have very little choice but to adopt a more aggressive stance to ease and to provide liquidity. The long-term political consequences of the U.K. leaving the EU could turn out to be far more significant as there will be questions over the entire EU project. The Eurozone needs to be restructured and Brexit will likely accelerate the process. The resulting rise in political uncertainly will likely last for some time.

Benjamin Zhan
This is a historical day for U.K. and for global markets. The process for the U.K. and the European Union to negotiate and rewrite the treaties is of unprecedented complexity. According to most analysts, it will take at least a few years to show any serious progress. From the business and policy perspectives, no meaningful change can be practically expected today, tomorrow or even the next few months. But from the capital markets standpoint, the damage is done and ramifications for Europe and global markets could be significant.

For the U.K., foreign capital will leave, the British pound will decline, inflation will rise, and productivity will decline. For Europe, investment decisions will be delayed, job creation will be slowed, and economic recovery will face a setback. Globally, a slowing Europe will no doubt have a negative impact on the already slow progress of the economy. In addition, this referendum opens the door for other European Union members to follow, which in turn can risk the very foundation of the European Union. With all the uncertainties ahead, it is understandable that many investors are selling, with MSCI Europe closing down 7.9% and FTSE 100 down 3.2%, while the British Pound plunged 7.5% and EURO declined 2.1% against USD.

For the near term, plunging currencies could have an immediate benefit to British and European exporting companies and tourism industries, whose costs are mostly Pound and Euro based, but with substantial revenues being derived from other parts of the world. In the longer run, the economic consequence for a more independent U.K. is not as a clear-cut as many believed, as the flexibility outside of the European Union can be used to the advantage of the British economy.

At the end of the day, what really matters for us as investors is the future return on our investments, and plunging stocks prices themselves are a sign that the market is doing its job to rebalance. While it is too early to be bottom fishing for the whole market, risk-return opportunities have become more obvious in some segments. It is our belief that when the market stabilizes, Dynamic European Value Fund will be very well positioned to benefit, as we have taken steps to prepare the portfolio since the beginning of the year. Capital markets seldom follow consensus predictions, and when the traffic is as one-way as it is today, it often pays to be a contrarian.

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