Putting Brexit in Perspective

A Risk Management Lesson

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While the United Kingdom's prospective departure from the European Union has caused significant trepidation for many investors over the past three years, Brexit's long-term impact on the average portfolio remains murky. Much of the volatility that permeated across markets in 2016 when Brexit was introduced ultimately proved fleeting. In many respects, investors reacted in an emotional and kneejerk manner to the U.K. referendum before ultimately settling down.

Three years later, most market participants are still trying to make sense of Brexit. The Securities and Exchange Commission's Jay Clayton punctuated this in a speech earlier this year, pointing out that the "potential adverse effects of Brexit are not well understood."

The fact is that market-moving events such as Brexit almost always arise over full cycles. At Swan, we believe it is foolhardy to try to time markets and make directional bets around these moments. It is prudent, however, to be mindful of the looming implications, because understanding where the market can go is an important aspect of defining, understanding and managing risk.

Unpacking Potential Impacts

Since the Brexit referendum first passed, there has been a slew of unanswered questions regarding how the U.K. will function from a regulatory and trade perspective with the rest of the European Union. This major unknown has been one of the prime reasons why economists are forecasting at least a 3-4% contraction in Britain's economy over the next 15 years – in August, the U.K. experienced its first contraction since the wake of the recession. A "hard" Brexit, which entails the U.K. withdrawing without trade or services agreements, is a scenario that could cause the economy to shrink by upwards of 10% over the same timeframe.

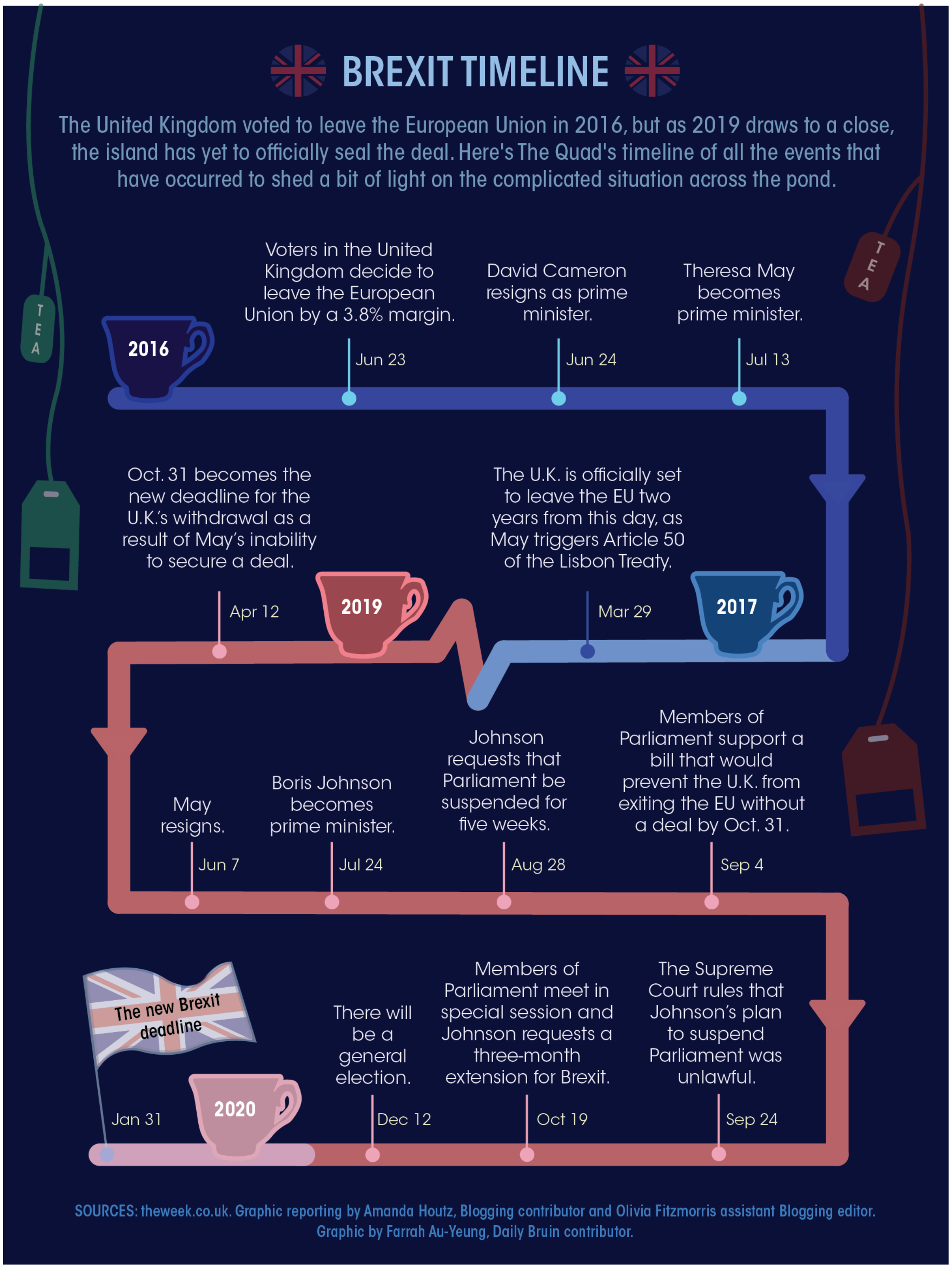
Given the U.K. is the world's fifth largest economy, any prolonged period of contraction will impact multinational corporations and risk assets linked to global consumption. Investors relying on Modern Portfolio Theory will likely feel the reverberations most. This has led the "smartest guys in the room" to share an array of hot takes lately about how to assume a defensive posture and increase portfolio allocations to purported safe havens such as cash, gold and non-risk assets. We have a much different view.

Redefining Risk Management

Every market cycle has at least one or two flashpoints that pose legitimate risks for investors. The 2011 debt ceiling crisis and 2016 elections are a couple of this cycle's biggest U.S. examples. But if you get caught up in the noise and pay too much attention to what the crowd is saying, these moments can be all the more regrettable.

At Swan, we have pioneered a proven, consistent investment process designed to mitigate downside risk over a full market cycle. Our Defined Risk Strategy maintains "always on" exposure to stocks via exchange-traded funds while significantly reducing risk using strategic put options. Importantly, this approach allows an investor to retain full-cycle exposure and potentially still capture income along the way through options trading. It is also a viable portfolio diversifier for investors who want to avoid trying to time markets amidst Brexit-style moments.

As the late innings of our historic ten-year bull market continue playing out, more macroeconomic issues and risks will likely pop up. Now is the time to think about a better, goals-based approach to navigating the next cycle. Our view is relying on a traditional portfolio of 60% stocks and 40% bonds is simply *embracing risk* rather than truly *managing risk*.



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