

Will Brexit spark a much-needed market revaluation?

Markets globally have reacted negatively to the British having voted to leave the European Union (EU) after more than four decades. The night before the vote, UK betting markets reflected that the “remain” camp was heavily favored to win. In a 2015 speech titled, “Don’t be Surprised,” I wrote that “investing, like life, is highly unpredictable. There are surprises – some good, some bad.”¹ That speech seems all the more relevant today given global market volatility.²

“Brexit” falls into the bad surprise category as investors clearly had not priced such an event into the market and so it caused stocks around the world to decline. Those companies more exposed to the UK, such as those in the financial sector and more cyclical businesses, have been hit the hardest while safe havens, such as gold, have rallied. The UK market decline in dollar terms was actually far worse than in pounds thanks to the British currency having wilted 10% versus the dollar.

We didn’t have a compelling opinion in advance of the vote but what happens next is also unknown. Importantly, the referendum is not legally binding. In other words, the population voted for a divorce but it's up to the government to submit the papers. The UK government now needs to exercise Article 50 of the Treaty of Lisbon in order to secede from the bloc. With Prime Minister Cameron’s resignation effective this October, that leaves the submission to his successor, who may not file in 2016. There is even a small chance that Brexit may not even happen. But assuming the likelihood that the UK does leave the EU, the biggest question becomes what will a new agreement look like? It may not be too bad. What will the economic impact be on the UK and the EU and how might it spill over to the rest of the world? It certainly is a near-term economic suppressant but is it the beginning of deglobalization? Will other countries suffer populist revolts and seek to exit as well? We, like everyone else, simply can’t say for sure.

We *do* expect that there could be continued market weakness and volatility as the future begins to unfold, particularly given the lack of precedent for dissolution of such scale. Uncertainty breeds larger risk premia for stocks and other risk assets. UK voters have opted for the unknown and brought the rest of us along with them on a ride whose final destination, at least for now, is just a big question mark. If global stock markets were trading at 8x earnings, Brexit would have less of an impact. Unfortunately, that is not the case. When markets are priced for perfection (as they were), negative shocks have the greatest potential to create market disruption. Brexit might be the first step back to more appropriate valuations.

¹ <http://fpafunds.com/docs/special-commentaries/cfa-society-of-chicago-june-2015-final1.pdf?sfvrsn=2>

² From “Don’t be Surprised:

“Cycles, as true in investing as in life, have been with us since the beginning of time. So don’t be surprised at the ups and downs.”

“As the Roman philosopher Pliny the Elder noted two thousand years ago, ‘The only certainty is that nothing is certain.’ Or, as that modern-day philosopher Mike Tyson said, ‘Everyone has a plan ‘til they get punched in the mouth.’”

“Our long view and willingness to diverge from the crowd isn’t always the easy path as it may put us at odds with our peers and, more importantly, our investors. But it is our path. It is up to you to find yours. One should not be surprised by the actions of others. You can’t control broad investor behavior but you can control yours.”



Some investors are nervous holders looking for an excuse to sell so we may see further downside. What's more, it's not like the global economy is bolstering corporate profits, so a possibly overdue recession may hasten a decline. And, interest rates will not remain this low forever and certainly can't decline much more, eliminating another key underpinning of stock performance. As we've recited all too many times of late, equities are not cheap. We discussed all of this at our recent Investor's Day. The transcript can be found at http://www.fpafunds.com/docs/investor-day-presentations/2016_06_fpa-crescent-fund_id_transcript_final.pdf?sfvrsn=2.

Even when investing in pockets of value, it doesn't mean the rest of the world will immediately agree with you. That was evident recently with regards to our position in financials. As good of a value as we perceive them to be, the market sold them off in the wake of Brexit and that has contributed to our equity portfolio declining more than the market in this recent downturn. The financials we own have largely U.S. exposure and what business they conduct overseas is broad-based without disproportionate exposure to the UK. Nevertheless, their stock prices are volatile, causing our portfolio to do better than the market some days but worse on others. What happens on any given day doesn't matter; what does matter is the businesses' operating results while we own them and where these stocks are trading the day we sell them. We don't know how they will ultimately perform along the way or in the end, but low valuations - combined with historically strong balance sheets - give us a margin of safety that will hopefully protect our capital and then provide a return on it. The Federal Reserve published its annual stress tests the day before the Brexit vote and all of the companies we own, which were subject to the exam, fared favorably and were deemed strong enough to weather a severe economic meltdown without help from the U.S. government.³

The Crescent Fund's (the "Fund") portfolio of value investments (both equities and debt) should provide downside protection in a severe market downturn. The relatively small market price decline since the Brexit vote is more market noise than anything else. The Fund's 36% cash position provides additional protection in the portfolio and will be used when the inevitable opportunities arise to purchase good companies at cheap prices.⁴ Price declines have allowed us to put some capital to work but we are waiting and hoping for even better bargains. In the scheme of things, the market hasn't really declined all that much. As we've argued for the past couple of years, we believe the market has borrowed from future returns. Brexit may have sparked this recent market decline but it happened against a backdrop of historically high valuations. Should stocks really decline (unlike what's happened thus far) and/or high-yield bonds once again offer returns in the teens, we anticipate deploying our cash to buy up compelling bargains.

Despite the fact that the Fund doesn't have any direct exposure to UK-centric businesses, Brexit has had an impact on our portfolio but to date it's nothing more than should otherwise be expected and well within the range of what has transpired in similarly contentious periods in the past.⁵

³ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160623a1.pdf>

⁴ As of June 27, 2016

⁵ One difference versus the past is that 43% of the companies we own in our long equity portfolio are domiciled outside the U.S., totaling 29% of the fund's long equity exposure as of March 31, 2016. We have therefore introduced the MSCI ACWI as an additional benchmark.



It's our job to structure a portfolio that will do well over time but that seeks to avoid a permanent impairment of capital. Watching investments be marked down does not feel great in the moment but thankfully it's not the moment that counts. What matters is what happens over time when emotions carry no weight and facts prevail and those with staying power generally triumph.

Steven Romick
Co-Portfolio Manager, FPA Crescent Fund
June 28, 2016

Important Disclosures

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies and other matters of interest to the prospective investor. Please read this Prospectus carefully before investing. The Prospectus may be obtained by visiting the website at www.fpafunds.com, by calling toll-free, 1-800-982-4372, or by contacting the Fund in writing.

The views expressed herein and any forward-looking statements are as of the date of the publication and are those of the Portfolio Management Team. Future events or results may vary significantly from those expressed and are subject to change at any time in response to changing circumstances and industry developments. This information and data has been prepared from sources believed reliable, but the accuracy and completeness of the information cannot be guaranteed and is not a complete summary or statement of all available data.

Portfolio composition will change due to ongoing management of the Fund. The portfolio holdings as of the most recent quarter-end may be obtained at www.fpafunds.com.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. The Fund may purchase non-U.S. securities, including American Depositary Receipts (ADRs) and other depository receipts, which are subject to interest rate, currency exchange rate, economic and political risks; this may be enhanced when investing in emerging markets. Small and mid-cap stocks involve greater risks and they can fluctuate in price more than larger company stocks. Short-selling involves increased risks and transaction costs. You risk paying more for a security than you received from its sale.

Interest rate risk is when interest rates go up, the value of fixed income securities, such as bonds, typically go down and investors may lose principal value. Credit risk is the risk of loss of principal due to the issuer's failure to repay a loan. Generally, the lower the quality rating of a security, the greater the risk that the issuer will fail to pay interest fully and return principal in a timely manner. If an issuer defaults the security may lose some or all of its value. The return of principal in a bond investment is not guaranteed. Bonds have issuer, interest rate, inflation and credit risks. Lower rated bonds, callable bonds and other types of debt obligations involve greater risks. Mortgage-backed securities and asset-backed securities are subject to prepayment risk and the risk of default on the underlying mortgages or other assets.

Value stocks, including those selected by the portfolio managers for the Fund, are subject to the risks that their intrinsic value may never be realized by the market and that their prices may go down. In addition, value style investing may fall out of favor and underperform growth or other styles of investing during given periods. Securities selected by the portfolio managers using a value strategy may never reach their intrinsic value because the market fails to recognize what the portfolio managers consider to be the true business value or because the portfolio managers have misjudged those values.

Past performance is no guarantee of future results.

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