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Brexit and Valuation Revisited

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What are we to make of the market gyrations of the last week of June 2016?

The Dow Jones Industrial Average was down 868 points over the two days following the Brexit vote, causing a decline in wealth in the hundreds of billions of dollars collectively, and then up 828 points over the next four days, causing an increase in wealth of almost the same amount. The FTSE 100 – an index that tracks the 100 largest companies on the London Stock Exchange – erased its post-Brexit fall in just two days, enjoying its best day in five years and ending up at a two-month high. The VIX, a measure of fear in the market, shot up to 26 from 15, and then was back down to 15 only five days later.

These market reactions to Brexit make now a good time to remind ourselves of the function of the global financial markets, which is to try to value the future earning power of corporations all over the world. This valuation in turn is a function of the cash flows of these corporations, the expected future growth in these cash flows, and the required rate of return on these cash flows. The larger the cash flows, the higher the expected growth rate, and the greater certainty there is about these numbers, the higher the value the market will place on these companies.

Moreover, when the market is more certain about its performance of this function, the less volatile it will be. Take a large company like GE, as an example. Analysts pour over its financial statements; they see that there has been, on average, a steady growth rate over the past 20 years; they know the terms of their long-term contacts with customers; they know the business inside and out. There is still plenty of uncertainty, since we are dealing with the future, but the market can make a reasonable judgment about GE's future cash flows given the known facts.

Now, take an event like Brexit. The unprecedented nature of this event discombobulated the thousands of analysts and investors who follow the markets on a daily basis. First, market participants reacted as if we were headed for a major crisis; then, they acted as if it was all much to do about nothing. How does an analyst value an event like this? It requires that they be able to forecast an endless number of highly complex, unprecedented variables that will take many years to reveal their effects, perhaps like a giant decision tree of our worst nightmares.

While finance has aspirations to being a science, the truth is it is as much art as science, and probably more art than science. The imprecision of the field can be seen in the poor stock analyst trying to answer this question for his research report on, as another example, The Royal Bank of Scotland (RBS): what will be the effect of Brexit on world-wide GDP, the future value of the pound, and the future cash flows of RBS? What will be the effect if Scotland, where RBS is headquartered, makes good on its threat to leave the United Kingdom? Or if Brexit creates a domino effect within the EU, leading to its breakup? On the other hand, could the opposite occur, as argued by Gideon Rachman in the Financial Times (see insert) and Brexit never happens because the Brits, either sooner or later, step back from this decision. These contingencies and many more are all possible but, without a crystal ball, unpredictable.

So, this leaves us with a question – what was rational – the 868 point drop in the Dow during the two days after the Brexit vote – or the 828 point rise during the next four days?. The two-day drop was either a panic or a rational re-pricing of assets. And the four-day gain was either more "irrational enthusiasm" or the rational re-pricing of assets. We will only know the answer to this question in the rear-view mirror, after events have unfolded, and the Brexit drama has concluded one way or another at a date that is likely many years in the future.

As we said in our email note of June 27th:

> PMA has taught for almost 35 years that an investor can control only what it can control, since it cannot control the future. PMA investor portfolios control the risk of its portfolios BEFORE the unexpected occurs. That portfolio risk control is what we have done for 35 years. How? All of PMA portfolios are diversified over asset class and regions with portfolio managers whom we have met and investigated. Our managers take the least amount of risk consistent with their expected returns and seek to weather down-markets better than those managers who take great risk for greater return. Our managers will make individual security selection dependent on current market conditions.
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> Unexpected financial events have occurred before over a PMA client's experience, in 1987, 2000-2003, 2008 and other times. It is not a new experience. Our advice to clients then and now is not to make significant portfolio changes during periods of great uncertainty and volatility.

That was good advice on June 27th. It was good advice during the credit crisis of 2008 and the tech bubble of 1999. It's good advice today.