



BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 30 June 2016



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Fund manager

Predictions that a Brexit vote would precipitate sharp falls in risky asset prices proved unfounded in June as global equities emerged from post-referendum turbulence to post gains of 8.79% in sterling for the quarter. The gains were fuelled by sterling weakness as the dollar, yen and euro rose 7.52%, 17.79% and 4.82% respectively against the pound. The rally extended beyond the quarter end, with US shares rising to record highs in early July.

Interest rate expectations adjusted swiftly following the surprise Brexit decision as the prospect of monetary tightening receded. Weak May US employment data and downward revisions to data for the two preceding months had already pushed bond yields lower. UK gilts gained 6.18% over the quarter as yields hit historic lows. In some Brompton investment strategies, profits were taken on longer-dated gilts and other government bonds. All strategies posted significant gains for the quarter thanks to currency movements and falling government bond yields.

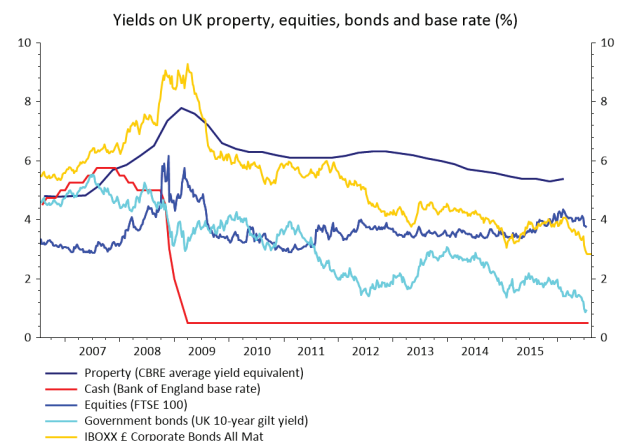
The falls in global equities and sterling the day after the vote provided a buying opportunity, with a sterling-hedged investment in a global equity fund added to the strategies. A sterling-hedged investment in a Japanese equity fund was also added to some higher-risk strategies. These investments should benefit from recoveries in equity markets and the pound. In some lower-risk strategies, the Brompton investment team took advantage of market weakness to add to clients' existing investments in the 3i Infrastructure investment trust because its portfolio of defensive, income-producing assets should produce attractive and stable returns in a low interest rate environment as well as increasing portfolio diversification.

The referendum result proved particularly challenging for the UK commercial property market. A number of property funds suspended dealing or imposed dilution levies on transactions to reflect the difficulty of selling illiquid assets at speed. Clients' investments in UK commercial property were reduced earlier this year but I do not believe the circumstances post-Brexit warrant selling the remaining investments at substantial discounts to net asset value. The UK economy may weaken in the short term as a result of weaker capital spending trends but the property sector is not as a whole suffering from over-capacity. Bank lending to developers has been restrained since

the credit crisis and demand and supply appear close to equilibrium other than in retail, where internet shopping has led to structural decline. The property funds in which clients are invested have low or no holdings in this sector.

Over the longer term, the pound's fall should improve competitiveness, supporting the economy as a whole and property in particular. Industrial properties may even benefit from Brexit as sterling's fall fuels exports. When greater political clarity is restored, overseas investors may consider UK property attractive because it is cheaper to them following sterling's fall. The prospects for City offices are, however, more uncertain because London could be rendered less attractive as a financial centre by an unfavourable Brexit settlement with the European Union.

Following the referendum, the receding prospect of UK and US interest rate rises and falls in gilt and US treasury yields increased the attractiveness of many higher-yielding investments. Property typically performs well in such an environment because rental income accounts for a high proportion of the asset class's returns, as shown in the chart below. As a result of Brexit, however, the political uncertainties may outweigh these attractions for the time being.



Oil prices recovered 27.81% in sterling over the quarter as US oil output declined further, bringing supply and demand closer to equilibrium. Financial distress among US shale producers may also have convinced Saudi Arabia and other Opec countries that higher oil prices would not immediately lead to a recovery in US output. The recoveries in prices for oil and other commodities, the receding prospect of US



Quarterly review (continued)

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interest rate rises and some respite from dollar strength contributed to rises in emerging market equities and bonds. Equities in Asia excluding Japan and emerging markets gained 11.90% and 13.34% in June in sterling, leaving them 8.07% and 8.38% higher respectively over the quarter. The recoveries in oil-producing countries such as Brazil and Russia were even greater. Brazilian equities rose 30.11% in sterling in June, leaving quarterly gains at 22.50%.

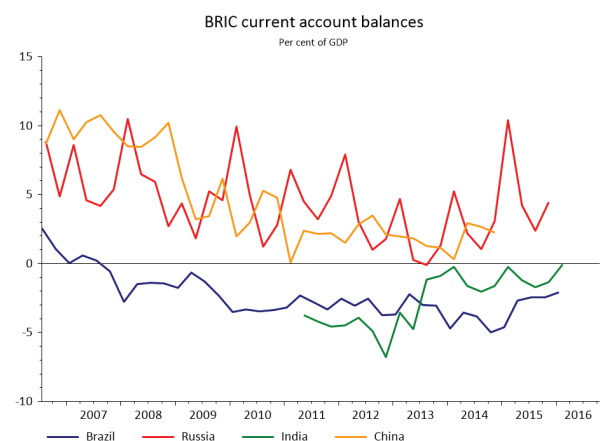
Brompton's investment strategies added or significantly increased their holdings in emerging market equities and bonds in early 2016. This decision contributed to gains made by all strategies during the quarter. The investment team bought exchange-traded funds (ETFs) alongside actively-managed funds because the more defensive positioning of active managers after years of underperformance from the asset class would mean a recovery would initially be more fully captured by ETFs. This generally proved to be the case because most of the ETFs had significant holdings in markets such as Brazil as well as China, South Korea, Taiwan and India.

Over the coming months, political events such as the US presidential election will influence returns for the rest of 2016. The investment team will adopt a similar approach to such events as during the Brexit campaign, utilising the benefit of diversification across a range of assets. The team will not take a view on the outcome, then position portfolios to benefit disproportionately from one particular result. Instead, the approach will be to look for investments that could perform well whatever the outcome.

In December 2015, when the Federal Reserve raised interest rates for the first time since the credit crisis, many commentators expected a swift succession of rises during the course of 2016. In the event, the Fed

did not tighten monetary policy during the first half of the year. It was possible in early July that the pendulum had swung too far the other way and that investors had become too sanguine that rates would remain lower for longer. June's employment data were stronger than expected after May's weak data. Following the Brexit shock, it would be easy to forget the US is close to full employment and recent commodity price rises may soon be manifest in inflation data. In consequence, I will look for opportunities to take profits following recent gains but I remain positive overall because central banks in aggregate are still easing their monetary policies. In Japan, for example, further policy action may come shortly following the endorsement of the prime minister, Shinzō Abe, in recent elections.

Emerging market equities may recover further given their low relative valuations. Improvements in the current account balances of many developing economies, as shown in the chart below, may also underpin recoveries in their currencies and their local bond markets, particularly when measured in sterling, which could weaken further if Brexit talks prove difficult. There is also further capacity for monetary easing, with India likely to cut interest rates if food inflation eases following the monsoon season.



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