Brexit: What does Vanguard think?

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Key highlights

- The vote will have a significant impact on the U.K. and European economies, with global implications, but the effects may be years in the making.
- The most immediate ramifications will be continued uncertainty and political change in the United Kingdom.
- The IMF projects U.K. GDP could be more than 1% lower by 2021 under its most favorable scenario.
- Given that it may take several years for the specifics to play out, each of which may rattle the markets, the best protection is broad diversification.

On June 23, in a long-anticipated, widely reported referendum in the United Kingdom, voters chose to leave the European Union.

The debate over whether to stay or leave (which became known as Brexit) began not long after the United Kingdom joined the E.U. in 1973. It finally culminated in this decision—a momentous one for the United Kingdom, Europe, and beyond, given that the United Kingdom is a global financial center and the world's fifth-largest economy. And the E.U., a union of 28 states, includes four of the world's seven largest developed economies.

Near-term ramifications

This vote will have a significant global economic impact. But because the referendum result itself is not a binding decision, it will take considerable time before that impact is fully felt. In the interim, uncertainty will persist.

First, the result needs to be incorporated into an Act of Parliament in the United Kingdom. Under the terms of the Lisbon Treaty (part of the E.U.'s governing framework), the United Kingdom will then give formal notice to the E.U. After that, negotiations will begin on the actual exit terms. Those negotiations can span two years and may be extended further.

The most immediate ramification, meanwhile, will be political change in the United Kingdom.

Market volatility and investor uncertainty

Most financial markets, especially stock markets, don't like uncertainty. In the weeks leading up to the vote, speculation about the outcome triggered increased market volatility—especially for most assets denominated in British pounds.

Some studies have suggested that Brexit could lead the already weaker pound to weaken further against other major currencies, perhaps by as much as about 20%. On the face of it, this outlook might tempt investors to avoid sterling-denominated assets.

Of course, Vanguard discourages market-timing moves, and by now, much of this effect is already priced into asset values. And even if declines in U.K. stocks, for example, haven't been fully priced in, keep in mind that Brexit will affect global markets, with a likely decrease in the value of riskier assets such as stocks. So avoiding or reducing U.K. exposure might not achieve the desired result.

Implications for the U.K. economy

Estimates of how Brexit will affect the U.K. economy range widely; some are positive, but the majority are negative. A key assumption in any Brexit scenario is what happens to trade agreements. The E.U. is the United Kingdom's largest trading partner, receiving about half of all U.K. exports. Upon leaving the E.U., the United Kingdom will lose its automatic right to the favorable trade terms that E.U. membership bestows.

The International Monetary Fund (IMF), for example, projects that U.K. gross domestic product could drop more than 1% by 2021 under its most favorable scenario, which assumes the United Kingdom will retain access to the E.U. market. Under a less optimistic scenario, the IMF projects that GDP could drop more than 4%.

Concern about Brexit has already led businesses to put hiring and spending plans on hold, and it has decreased merger and acquisition activity. Less favorable trade terms could also discourage foreign investment in the United Kingdom by firms that might otherwise seek a U.K. presence to access European customers.

Immigration policy has been one of the major issues in the Brexit debate. Although it will still be possible after Brexit for E.U. citizens to work in the United Kingdom, such decisions are likely to rest with the U.K. government—in contrast to currently unrestricted access.

Suffice it to say that a whole host of new U.K. regulatory frameworks would need to be developed to conduct business and trade in a post-E.U. world.

Implications for investors

Given that it may take several years for the specifics of Brexit to play out, and markets may be rattled as plans take shape, investors' best protection is to hold a portfolio that is diversified across asset classes and regions. You can read more about the benefits of global diversification in *Global equities: Balancing home bias and diversification* at advisors.vanguard.com.

In Vanguard's diversified balanced funds, such as our Target Retirement Funds, we will continue to maintain global exposures that are consistent with the funds' investment objectives and policies.

Although it is certainly worthwhile to keep abreast of global events such as the Brexit referendum, we caution investors against making tactical or short-term changes to their portfolios. Instead, we recommend following Vanguard's four core investment principles: Create clear, appropriate goals; develop a suitable asset allocation using broadly diversified funds; minimize cost; and maintain perspective and long-term discipline.

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