

A TACIT THOUGHT

WEEKLY INSIGHTS AND VIEWS

**5 May
2017**

At Tacit, late in 2016 we began to think differently about international exposure in portfolios for UK investors. After many years when international diversification reduced the overall volatility (a measure of risk) of a Sterling portfolio, we began to question if the events of 2016 could change the behaviour of portfolios as UK investors know them. Could it be that the aggressive fall in the exchange rate (as shown below) would change the behaviour of overseas assets and actually make them more risky in the hands of a UK investor?



Source: Barclays Capital

Now, we remind readers that we do not forecast, but, we are big believers in mean reversion and as currencies are valued relative to each other (not in isolation), they tend to show signs of mean reversion. The strength of any turnaround is driven by the extent of pessimism/optimism prevailing at any point in time. A measure of pessimism would be the short positions held in aggregate by market traders for example. An example of optimism might be the belief in the policies of the new President of the United States!

Now, this is not a technical or political piece, in fact quite the opposite. When everyone is pessimistic on the outlook for a currency, traders use this currency to borrow and invest the proceeds in other assets to generate a positive return (or carry). When that currency is your home currency, such as the Pound, a change in sentiment can lead to an abrupt rise in your currency which in turn devalues any holdings you may have in overseas assets. This is relevant here because these unforeseen circumstances will increase the day to day risk of portfolio with overseas exposure. The more the exposure, the higher the volatility of a portfolio through this phase.

No back testing or hedging strategy can insure against the current environment in our view and we must understand that there are consequences of the sharp fall in Sterling that go beyond the simple analysis carried out by most investors. Rigid asset allocation structures built up over the past decades by most of our peers will perversely likely increase risks rather than manage or lower them for clients.

Returns during April illustrate that a rising Pound will impact returns from overseas assets and if it coincides with falling equity markets, UK investors could experience losses that would historically have been mitigated by a falling Pound.

CONTACT DETAILS

t: +44(0)203 051 6450

e: info@tacitim.com

w: www.tacitim.com

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