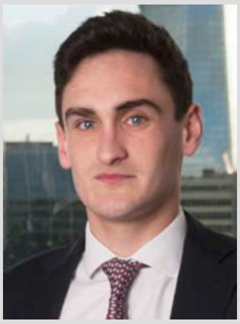
eQ investors **Strategy*Insights***

Brexit – March 2016

1. Executive summary



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It is very difficult to determine what the consequence of a Brexit would be in the long term because no one can know what the UK-EU relationship will look like in such a scenario. Hence all analyses on the subject are highly speculative and therein lays the biggest certainty on this subject: it is rife with uncertainty.

What is clear is that the UK is currently very tied into Europe. UK exports to the EU represented 13% of Gross Domestic Product (GDP) in 2014. Financial services are a particularly significant export to the EU, made easier by "passporting" (a rule that allows financial institutions to provide their services across Europe without the need to establish offices in each jurisdiction), so we feel these would be especially vulnerable in the event of a Brexit.

We have positioned our portfolios to protect investors from the potential risks surrounding a leave vote

We do not currently believe that a leave vote is a probable outcome. However, in that unlikely event, we do believe the market implications could be quite negative in the short to medium term at least due to the heightened uncertainty about the position of the UK in Europe and on the global political stage. Therefore we have positioned our portfolios accordingly to reflect these views and protect investors:

Sterling

- Outlook – We expect weakness and an increase in volatility, due mainly to weakening foreign direct investment. Some of this has already occurred, but there is risk of further weakness.
- EQ Action – Over the last several months we have taken steps to diversify our currency exposure. We hope this will reduce portfolio downside risk in the case of rising Brexit concerns.

Equities

- Outlook – We expect some weakness in UK equities to reflect added uncertainty around our relationship with the EU. Financial services and manufacturers with European trade links are likely to be some of the worst hit sectors.
- EQ Action – We are underweight in UK equities relative to our peers and do not plan to increase this allocation at least until Brexit concerns are alleviated.

Fixed income

- Outlook – Credit rating agencies have expressed concern about Brexit, with Moody's saying "a decision to leave the EU would be credit negative for the UK economy". This could increase the yield on UK government bonds. We expect UK corporate bonds would also be subject to higher yields in the short term. Over the longer term, there is an uncertain benefit to be gained by larger companies from their foreign earnings that could eventually outweigh any losses.
- EQ Action – We remain underweight in UK fixed income.

Commercial property

- Outlook – The UK commercial property market is very international and some of this investment could fall away in the event of a Brexit. We are already seeing large outflows from property funds which could be an ominous sign of things to come.
- EQ Action – We are reducing our exposure to UK commercial property to neutral from overweight.

2. What is the industry saying?

There has been a lot written about Brexit. We have reviewed many of the more detailed pieces and provide a short summary below:

The short term risks of a 'Brexit' vote are easier to articulate than the longer term benefits

Capital Economics – Overall neutral/hopeful on Brexit

- Focus is predominantly on the long term where they argue the effect is likely to be small.
- Positives derive from reduced regulation and ability to strike our own trade deals.
- Negatives are access to the single market, damage to the city and a loss of investment.

Goldman Sachs – Overall negative on Brexit

- Long run economic consequence of Brexit is negative but concede that it's hard to really predict given uncertainty of UK-EU Deal.
- Fear that negotiations would take longer than the suggested 2 years despite obvious benefits to both sides. They cite the EU-US Transatlantic Trade and Investment Partnership as a parallel mutually beneficial very lengthy negotiation.
- Concerned that investment would be much damaged in negotiation period which would have a material negative effect on UK GDP.

Deutsche Bank – Overall negative on Brexit

- Exit negotiations likely to be difficult due to EU desire to strike a balance between ensuring continued strong UK-EU trade while sending out message to other members that departure comes at a cost.
- Delayed investment to have negative affect on UK GDP in lead up to and just after vote.
- Sterling likely to be negatively affected due to vulnerability to UK fiscal and capital account deficit. A weak Sterling could help balance the current account but will damage foreign investment which has helped support it for some time.
- Combining changes in valuations and earnings they estimate a 15% downside for UK equities in the event of a Brexit.

BlackRock – Overall negative on Brexit

- Newly independent UK would have reduced leverage to negotiate new trade deals.
- EU would be weaker without UK as it would lose a major budget contributor, a leading voice for free markets and a global financial centre.
- Sterling to be worst hit due to potential worsening of UK capital and fiscal deficits. This could trigger UK credit downgrades which would increase gilt yields.
- Domestically focused small and mid-cap UK equities to underperform large caps as Sterling depreciates, providing a foreign earnings boost for large caps. London property market to suffer as there could be a fall in office demand based on the UK's access to the single market.

AXA Investment Managers – Overall negative on Brexit

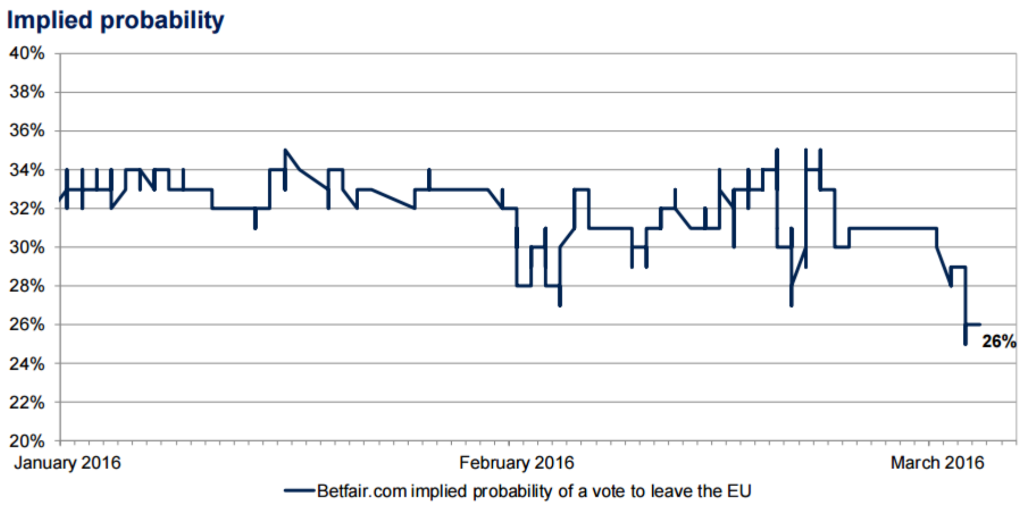
- Estimate a leave vote would reduce potential GDP by 2% - 7% over the next 15 years.
- Dubious about how high a priority a UK trade deal will be with foreign countries. The vast number of deals required could cause the renegotiation process to take some time.
- Material negative impact on financial services due to restriction of access to EU.
- Outcomes very dependent on the deal that the UK gets with the EU.

So, overall other firms are fairly concerned about a leave vote. There are several clear short term risks to Brexit with longer term benefits being unclear and hard to measure.

3. Our current view

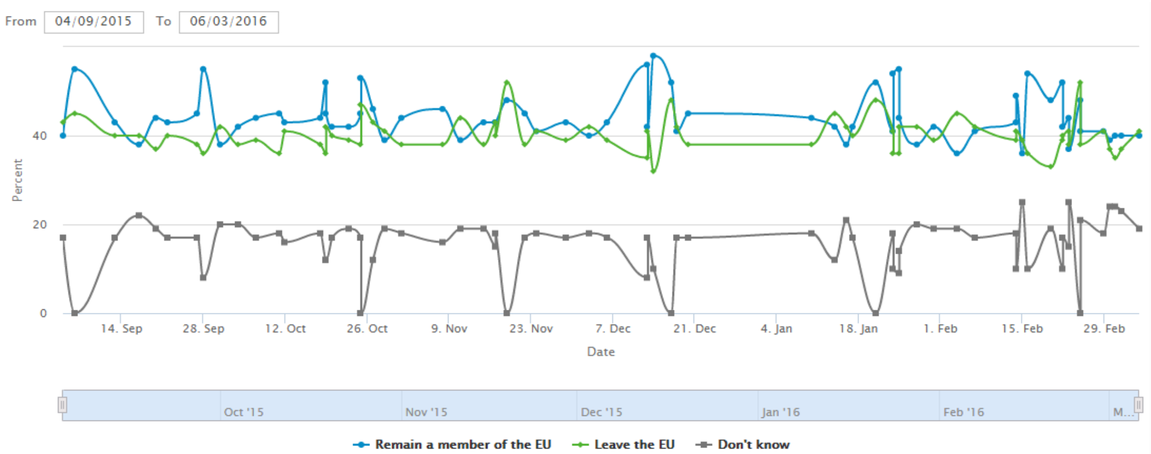
We view Brexit as a low probability event with quite a negative consequence (in the short and medium term). There are two ways of judging this probability: the polls and the bookies!

Bookmakers are attaching a much lower probability to a leave vote at around 25% versus a stay vote at around 75%. This is in stark contrast to the polls which suggest the odds are close to even.



Source: Betfair.com, Schroders Data Insights Team. 4 March 2016

The chart below shows the results of 69 polls, from www.whatukthinks.org. Given how poor polls were at predicting the 2015 general election and the Scottish referendum, it is understandable that the numbers below are treated with a degree of scepticism. What is particularly interesting is that while the results are currently very close, around 20% of people are currently undecided.



We believe this 20% of people who are undecided or not intending to vote will gravitate towards "remain" as we move towards to referendum date. History tells us that in every major referendum over the past 40 years, voting has been in favour of retaining the status quo or for a "progressive" rather than "regressive" action[1].

[1] The UK & EU: Exit Emergency, Deutsche Bank Research, 12/02/16

4. Market implications of a 'leave' vote

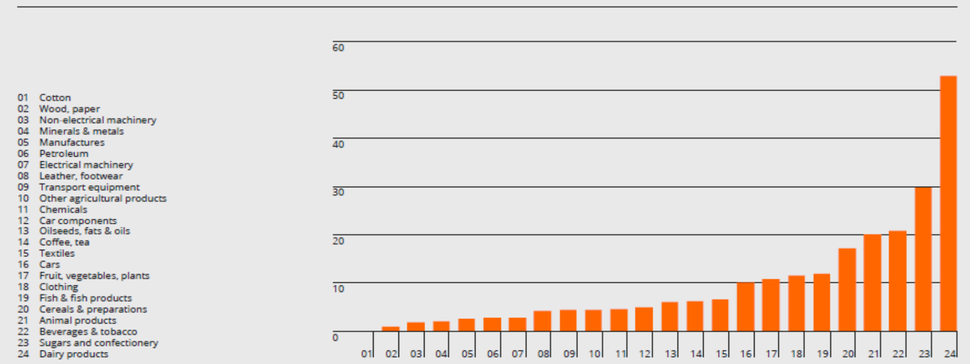
There are a few key features of the UK economy and market that must be understood before an assessment of the potential market impact can be undertaken.

In 2014, exports accounted for around 28% of UK GDP and of this, the EU represented about 45%; the UK's largest trading partner. The UK was a net importer of goods to the tune of £80bn and was a net exporter of services to the tune of £21bn with the EU[2] in 2014. We estimate around 75% of the UK's services exports to the EU are attributable to the financial services sector[3]. Much of this is reliant on the ability to "passport" these services across the EU, which would probably require negotiation in the event of Brexit. The manufacturing sector would also be adversely affected as exports to the EU would have to continue to comply with regulation and could potentially be subjected to a tariff.

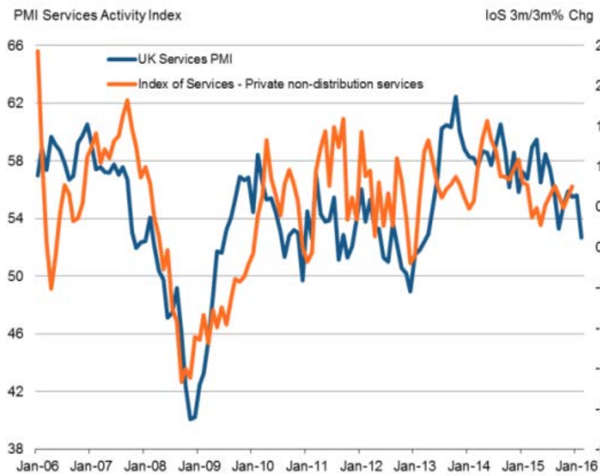
This section looks at the key areas of the markets which would be most likely to be affected by a 'leave' vote

Some of these effects may be offset by the devaluation in Sterling, boosting export competitiveness. The chart below from Capital Economics highlights the range of tariffs charged on imports to the EU.

Figure 12: EU tariffs by selected sectors (% 2013)
Source: World Trade Organization, Capital Economics



Given the magnitude of exposure to Europe, we believe Brexit would also affect consumer and business confidence which, in turn, is likely to hamper consumer spending and postpone or divert domestic and foreign investment[4]. We have started to see this with the weakest UK Services Purchasing Managers' Index ("PMI") survey in three years in February (chart on right). Firms cited concerns about Brexit, market volatility and weak economic growth for the lack of confidence.



Sources: Markit, ONS

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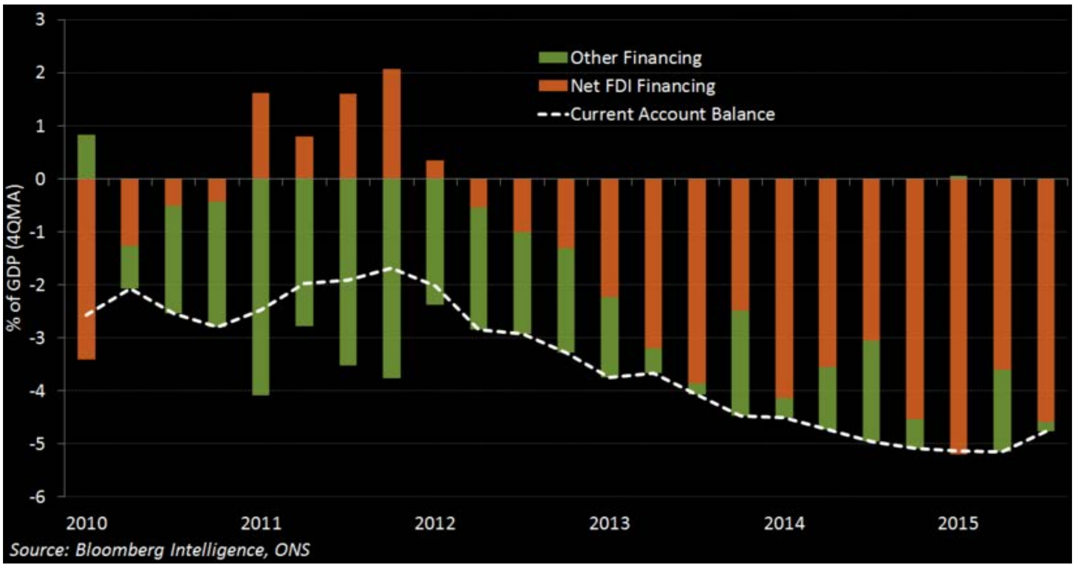
[2] ONS, Balance of Payments Q3 2015
[3] The Economic Impact of 'Brexit', Woodford Investment Management and Capital Economics
[4] Brexit: The uncertainty shock of leaving the EU, Goldman Sachs, 04/03/16

Below we discuss potential market implications by asset class, focusing on the short and medium term. In the long term, we believe the UK economy and assets would adapt and recover, but at significant cost.

4.1 Currency

Sterling Negative – Sterling weakness would be the most obvious impact of a Brexit vote. The chart below highlights the impact that Brexit discussions are already having. The UK currently runs a current account deficit of 4.67% of GDP[5]. We have run a current account deficit since the 1980's but the recent deterioration is primarily due to falling net income, caused by falling profitability of UK corporates abroad[6].

The UK benefits from significant net foreign direct investment (FDI) flows. FDI flows help to balance the current account deficit as it means that foreign investors need to sell foreign currency to buy sterling to invest in the UK. This, in turn, keeps supply and demand for Sterling balanced. Given the uncertainty surrounding the UK's access to the EU market for at least a few years, a reduction in new FDI flows is likely. This could upset the balance and cause a significant sell off in Sterling. An Ernst and Young survey conducted last spring confirms this point. They reported that 70% of firms questioned felt that access to the single market was important for the attractiveness of the UK as an investment proposition. In addition, 30% of firms questioned said that they'd freeze or cut investment until the outcome of the referendum was known[7].



Source: Bloomberg Intelligence, ONS

Euro Negative – While not as significant as the risk to Sterling, uncertainty created about the future of the EU in the event of Brexit would likely be negative for the Euro. This would likely negate some of the benefit the UK would gain from a weakening Sterling but not ease any uncertainty.

EQ Action: Over the course of the last few months we have been increasing our exposure to foreign currency assets, starting with an increased allocation to the US Dollar. Until recently we had invested in European and Japanese equity funds where the managers had mitigated the risk to fluctuations in the currency. We have since switched the Japanese holding in full and switched

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[5] Bloomberg
[6] Britain's current account deficit: it's much worse than you think, Deutsche Bank, 23/02/16
[7] 2015 UK attractiveness survey, EY

about half the European holding, giving us exposure to fluctuations in these currencies which provides some added protection for the portfolio in the event there are further falls in the value of Sterling.

4.2 Equity

Starting with European equities, our analysis shows the exposure of European companies to revenues earned in the UK is pretty low, less than 5% on average. Mostly, European companies earn their revenues from the European region at around 50% followed by the US and Asia at around 10-15% for large cap companies. Hence, in the event of Brexit, we believe there would be a sentiment based sell off, but fundamentally the outlook for European companies should not be too badly affected by in terms of UK revenue. There would be material contagion risk, however, if the market starts pricing for a breakup of the Eurozone. However, given the strong monetary policy support from the European Central Bank and the political resolve of Europe, we do not expect this to be a near term risk factor.

In terms of the UK, the picture is more nuanced. Large caps have a globally diverse source of revenues but the European region accounts for a very significant 25%. Asia, the US and UK next in line with around 20-25% each. Within this, the sectors most at risk are Consumer Discretionary, Energy, Financials, IT, Telecommunications and Utilities. Large caps may therefore suffer from European revenue declines more than mid and small caps. However, their foreign currency net earnings in all currencies would be boosted by a fall in value of Sterling.

In mid and small caps, the picture changes dramatically with the UK itself now being the largest source of revenues at around 45% - 60% (depending on the source of data) followed by Europe at around 15-20% and the US at 8-10%. From a sectoral perspective, it's a fairly even split except financials that are at most risk. However, we understand mid and small caps are heavily exposed to foreign currency costs, such as through importing goods from overseas, transportation costs being linked to the price of oil which is priced in US Dollars, etc. Hence in the short term there is a risk to their profitability due to a fall in value of Sterling. However, we expect the higher costs would only damage margins for a short period of time before ultimately being recouped through higher selling prices. So ultimately the consumer would pay for these higher costs through inflated prices.

EQ Action: Our selection of UK managers does have a greater bias towards mid and small cap companies but there remains around one third of their exposure which is to large caps. From a sectoral perspective, the biggest exposures are to consumer discretionary, industrials and financials. We are currently discussing positioning with our selected fund managers to understand any recent changes in light of Brexit risk. These discussions may lead us to adjust our positioning.

4.3 Fixed Income

Standard & Poors (S&P) and Moody's moved the UK to a negative outlook last year due to Brexit concerns with S&P stating, "a possible departure from the EU also raises questions about the financing of the economy's large twin deficits and high short-term external debt". Recently Moody's said "we consider it positive that the referendum will take place as soon as June, as a lengthy period of uncertainty on the part of firms and investors would damage the UK's economic growth prospects. That said, the outcome of the referendum remains wide open. In our view, a decision to leave the EU would be credit negative for the UK economy". A sovereign credit rating downgrade is quite probable if the UK leave the EU.

EQ Action: Our exposure to bonds is fairly low anyway and where we do hold exposure it is mostly through strategic bond funds where they have the flexibility to adapt their portfolios quickly. The exposure they do have is fairly well diversified outside the UK, although the UK remains the largest single country exposure. Their portfolios are mostly exposed to investment grade issuers, i.e. large cap companies, the UK and US governments.

Given discussion about the more international nature of large cap companies above, we think investment grade credit is least likely to suffer from material spread widening. In the event of Brexit, although at risk from potential credit rating cuts, we believe UK gilts would be the flight to safety asset for most UK investors while US Treasuries would enjoy the same status from institutional and international investors.

Hence we are comfortable with manager positioning here.

4.4 Commercial property

London accounts for 23% of European cross border commercial property investment and 40% of the world's top companies have London as their European headquarters. Paris, the next closest city has just 8%[8]. Some of this property investment, especially for financial services, is related to the UK's access to the single market. This source of demand could suffer in the event of Brexit and we have already observed an accelerated level of outflows from UK property funds over the last few months.

EQ Action: We have reduced our previous overweight position in this sector to a neutral position. We have focused the allocation with a manager whose greatest exposure is to properties outside London where we currently see lower risk in this scenario.

[8] Brexit: Big risk, little reward - Blackrock

4 Conclusion: what will decide the referendum?

While our view on the outcome of the referendum may well change, we are confident that these issues will remain at the heart of the debate:

4.1 Trade

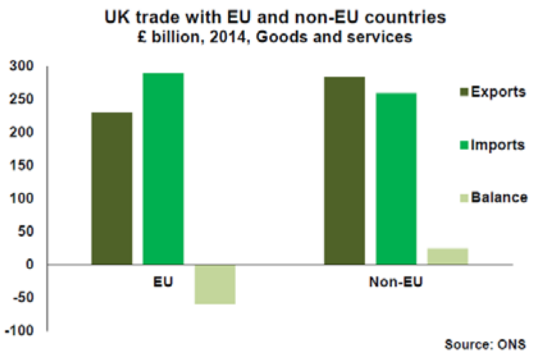
Our views on the key issues at the heart of the debate

Current situation: As a member of the EU, the UK can trade with other member states free of tariffs. However, the UK is not allowed to pursue it's own trade agreements.

What's the issue: The UK is bound by EU trade agreements. As a result, the UK cannot, as Switzerland have, strike a bilateral trade agreement with China. Instead, the UK has had to wait while the EU negotiate a trade deal with China; this has been underway for over a decade.

Our View: In 2014, exports accounted for around 28.4% of UK GDP[9]. The EU accounted for 45% of these exports[10] which equates to almost 13% (28.4% x 45%) of total UK output. This is a significant portion of GDP.

The UK ran a goods deficit of £80bn and a services surplus of £21bn with the EU[11] in 2014. This means that we are net importers of goods and net exporters of services. In 2013, the most recent data that we can source, the UK ran a £16.1bn financial services surplus, equivalent to 0.9% GDP[12]. Consequently, 75% of the UK's services surplus with the EU is attributable to our financial services sector.



UK trade with EU and non-EU countries 2014
Goods and services

	Exports		Imports		Balance
	£ billion	%	£ billion	%	£ billion
EU	230	45%	289	53%	-59
Non-EU	283	55%	259	47%	+24
Total	513	100%	548	100%	-34

Source: ONS Balance of Payments Statistical Bulletin, Tables B & C

As members of the EU, UK financial services enjoy good trade terms with other EU member states through 'passporting rights'[13]. These allow British institutions to sell into the rest of Europe without having to establish local offices. This relationship would likely form a key part of the exit negotiations and would be at risk of adverse terms.

The UK would need to negotiate drastically improved trade terms with the rest of the world to negate these potential downsides of a leave vote.

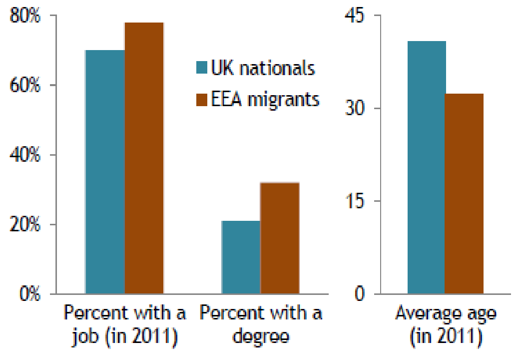
[9] World Bank, http://data.worldbank.org/indicator/NE.EXP.GNFS.ZS
[10] ONS Balance of Payments Statistical Bulletin
[11] ONS, Balance of Payments Q3 2015
[12] The Economic Impact of 'Brexit', Woodford Investment Management and Capital Economics
[13] https://www.the-fca.org.uk/passporting

4.2 Immigration

Current Situation: EU nationals do not require a visa to enter another member state, and no time limit is placed upon their stay.

What's the issue: Leave campaigners feel that we should have more control over UK immigration policy.

Our view: Contrary to popular opinion, EEA migrants are younger, better educated and more likely to be in work than UK natives. When one considers these demographical advantages, it is unintuitive to assume that these EEA migrants are a net cost to the economy. A House of Commons paper titled, 'Statistics on migrants and benefits' released in February 2016, contains analysis from the University of Oxford's Migration Observatory analysis of the Labour Force Survey which reinforces this point. As at Q1 2014 it shows that people born outside the UK accounted for 16.2% of the working age population but just 7.7% of working age population receiving out of work benefits[14].



Source: Dustmann and Frattini (2013)

In reality, it is extremely difficult to calculate exact costs and benefits to an economy of migration due to difficulties with attribution of costs and benefits.

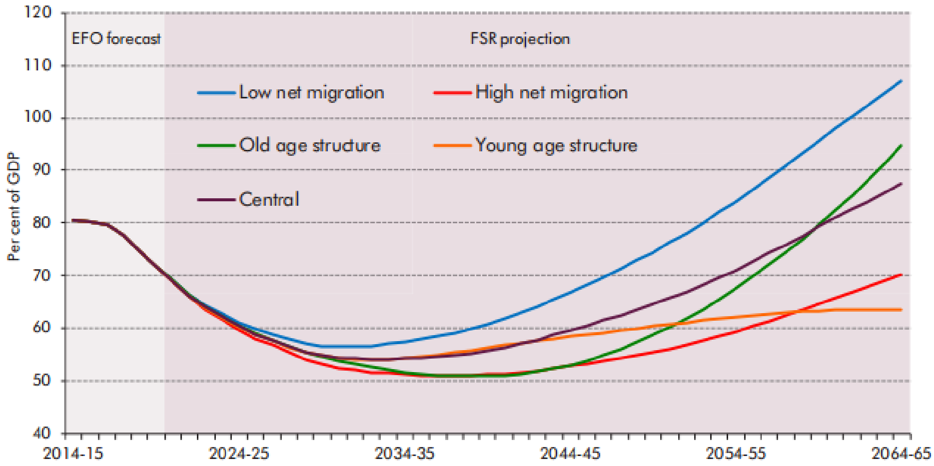
The opposite is true for total population where net immigration from the EU has accounted for 45% of population growth since 2004[15]. Workers produce more economic growth but inevitably put more pressure on housing and public services. These effects are observable; in 2015 EU immigration alone increased the size of the UK workforce by 0.5%[16]. Equally, we are seeing increased pressure on housing costs. Immigration is a contentious point but, fundamentally, we have an ageing population in the UK and we need young, tax paying migrants to help pay for us in the future. Consequently, housing and service shortage are issues that the UK government will need to face sooner or later.

A leave vote could reduce immigration to the UK, reduce investment and curtail exports. All of these would contribute to an increase the UK debt to GDP ratio. Immigration boosts GDP as EU migrants are more likely to be of working age and more likely to be in work. In addition, the UK's ageing native population mean without working age migrants we will see a smaller working population having to cover an increasingly large health bill. The government are likely to need to borrow to fund this gap. The chart overleaf shows the Office of Budgetary Responsibility estimation of the effect of immigration on UK debt to GDP.

[14] This analysis was presented in full in Madeleine Sumption's and William Allen's blog *"Migration and welfare benefits"* for Full Fact, 4 May 2015. Also see similar analysis from the Migration Advisory Committee's July 2014 report *Migration in low-skilled work*, p.265

[15] Migration Observatory, 'The impact of migration on UK population growth', 2012.

[16] Calculations using tables from the data section of Office for National Statistics, Migration Statistics Quarterly Report, August 2015 (Office for National Statistics, London), 2015



Source: OBR

4.3 Regulation

Current situation: All EU members are subject to significant regulation decided at EU level. The purpose of parts of this regulation is to facilitate ease of trade but, as with any blanket approach, some is more relevant to the UK than others.

What's the issue: Euro-sceptics argue that the majority of small and medium sized business don't trade with the EU but are subject to their regulation anyway; a needless cost. The hope is that, if the UK leave the EU, many corporates would be able to reduce their regulatory burden and increase productivity.

Our view: There is no doubt that many of the EU's regulations are costly. Open Europe, an independent think tank, estimate that the 100 most expensive EU rules cost £33bn. That is an unquestionably significant expense. The real debate is whether we would be able to significantly reduce this by leaving the EU. If we were to leave the EU but join the EEA, like Norway, the UK would be subject to 93 of the 100 costliest regulations at a cost of £31.4bn[17]. Switzerland also have to adopt many of the same regulations. Any change in regulation would also be dependent on the UK populace being willing to accept longer working hours, reduced holiday entitlement and repeal of measures taken to protect the environment.

EU regulations are a considerable expense to the UK economy, how many of these would remain post-Brexit would be entirely dependent on the outcome of negotiations. In reality, there is likely to be a high correlation between trade with the EU and regulatory burden. Specifically, the more trade we do (and do easily) with the EU the more of their regulation we will need to assume.

[17] http://openeurope.org.uk/intelligence/britain-and-the-eu/top-100-eu-rules-cost-britain-33-3bn/