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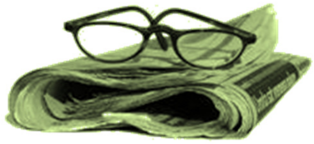


Understanding "Brexit"

What does this mean for the South African Investor and how should Retirement Fund Trustees react?

Introduction

A referendum was held in the United Kingdom on Thursday 23 June 2016, to decide whether the United Kingdom should leave or remain in the European Union ("EU").

The leave-vote won by 52% to 48%.

The immediate aftermath of this somewhat surprising result saw stock markets stumbling, currencies weakening and investor's grappling with what to do next.

In this paper we aim to provide more background to the European Union, what the exit of the United Kingdom means and give some insights on how retirement fund trustees should behave in these uncertain times.

Background to the EU

Establishment of the EU

The EU grew out of a desire for peace in a war-torn and divided continent. Five years after World War II ended, France and Germany came up with a plan to ensure their two countries would never go to war against each other again. The result was a deal signed by six nations (Belgium, France, West Germany, Italy, Luxembourg and the Netherlands) to pool their coal and steel resources in 1950 in the form of the European Coal and Steel Community ("ECSC").

Seven years later, a treaty signed in Rome by the same six nations created the European Economic Community ("EEC") - the foundation of today's EU.

The EU was established under its current name in 1993 following the Maastricht Treaty.

Since then the community has grown in size because of the accession of new member states.

The latest major amendment to the constitutional basis of the EU, the Treaty of Lisbon, came into force in 2009.

The main purpose of the EU is to operate a single market, which allows free movement of goods, capital, services and people between member states.

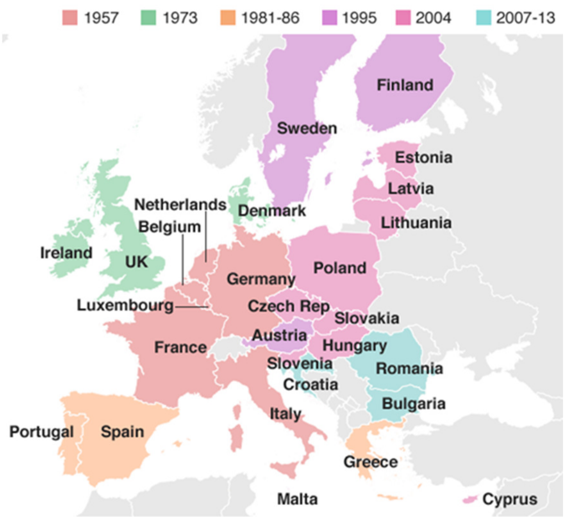
The 28 member states within the EU include Austria, Belgium, Bulgaria, Croatia, the Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom ("UK").

The European Economic Area ("EEA") includes EU countries and also Iceland, Liechtenstein and Norway. It allows them to be part of the EU's single market.

Switzerland is neither an EU nor an EEA member but is part of the single market - this means Swiss nationals have the same rights to live and work in the UK as other EEA nationals.

The total population of EU member states was 507.4 million in January2014 and at that date the economy of the EU generated a GDP (nominal) of around €14.303 trillion according to the International Monetary Fund, making it arguably the largest economy in the world if treated as the economy of a single country.

The map below details the current members of the EU and when they joined.



The UK and the EU

The UK withdrew from the early talks that lead to the Rome Treaty in 1957. When the UK tried to join the European Common Market in 1963 in attempt to revive its flagging economy, the French President at the time, Charles de Gaulle vetoed their application.

It was only in 1973 that the UK was allowed to join the EEC and some people immediately argued that it should pull out.

The last UK referendum on the question was held in 1975 and passed by a margin of 2-to-1. Prime Minister John Major's government almost fell in 1993 when some of his party's lawmakers voted against him over the signing of the Maastricht Treaty, which expanded cooperation and created the EU. The same Euroscepticism kept Britain from adopting the single currency when it was launched in 1999.

The EU added eight eastern European countries in 2004, triggering a wave of immigration that strained public services. In England and Wales, the share of foreign-born residents swelled to 13.4% of the population by 2011, roughly double the level in 1991.

In recent years, people have been lured from other EU states by Britain's economy, which had been growing at twice the pace of the Euro zone. The UK is the second-biggest EU country by economic output and the third-largest by population, after Germany and France. There's still a queue of countries waiting to join the bloc.

UK Prime Minister, David Cameron pledged to hold a referendum before the end of 2017 on continued EU participation after rising Euro-scepticism fed support for the anti-EU UK Independence Party, which won 13% of the vote in the 2015 general election.

In the past, the UK has chosen to opt out of some key EU decisions, like the single currency or Euro and the Schengen Treaty, which relaxed border controls. Prime Minister David Cameron wanted Britain to stay in the EU, if certain changes are made to the rules - including lower benefits paid to migrants and greater protection for states not in the Euro zone.

Critics believed Britain was being held back by the EU, gets little in return for the money it pays in and would be better taking back control of its borders.

The UK Referendum Results and its Aftermath

Voters supported the split by a margin of 52% to 48% after a rancorous 10-week campaign that divided the nation. This marks the beginning for the negotiations for the exit strategy. Unfortunately, this adds yet again to uncertainty in the global and local investment markets.

The immediate aftermath of the results saw turmoil on most major markets and currencies, which included:

- The result prompted Prime Minister David Cameron, who had pushed for the UK to remain in the 28-nation bloc, to say he'll resign by October.
- The vote jolted financial markets, sending the UK. currency tumbling by 9% to the US dollar - its lowest level since 1985.
- The Rand plummeted in the wake of the news, but recovered somewhat, by the close of the following business day.
- The political turmoil included Scotland's devolved government paving the way for a new referendum on breaking away from the UK so it can remain part of the EU. Northern Ireland politicians have also raised this as a possible outcome.

Impact of Brexit

The UK will have two years to negotiate the mechanics and terms of an exit once it takes the legal steps to leave the bloc, with talks to unwind agreements in areas as diverse as fishing quotas, financial services legislation and health and safety standards.

Cameron had warned that a withdrawal would trigger a recession and a decade of uncertainty for jobs, trade and the broader economy.

Advocates of a split, including the country's leading tabloid newspapers and Boris Johnson, the popular former mayor of London, argued for Britain to leave the EU to regain control of its laws and slow a larger-than-expected influx of immigrants.

Because the free movement of citizens is a basic tenet of EU law, leaving the bloc is the only sure way to stem the flow.

The exact extent of the impact for world economies remain uncertain at this stage. The multitude of scenarios were largely influenced by the revised treaties entered into by the UK with the EU and other trading partners. As this is the first such exit from the EU, there is no precedent and as a result much uncertainty remains.

It should be noted that the exit is a very complex process – both financially and legally and whilst reference is made to a two-year period for the exit, it may well take much longer for all components of the exit and new trade agreements to be finalised.

Key short term issues that are clear at this stage include:

- Uncertainty is likely to continue for the unforeseeable future, in particular as UK negotiates its exit from the EU. This is because the full extent of the economic impact of this exit is not yet clearly understood.
- The governor of the Bank of England assured the investment market that the Bank of England was ready for the unfolding uncertainty and it's prepared to take whatever measure it deems appropriate to cushion the economy of the UK.
- It is believed in the market that the exit will see the UK economy contracting in the near future. As a result, the statement above has seen the market pricing in a cut in interest rate by the Bank of England before the end of this calendar year.

The long term effects of the exit remains unknown and only time will inform the investor community of the full impact of the exit, in particular the negotiations that will unfold in the near future.

Key long term considerations include:

- The UK has for some time been seen as the financial capital of the EU. This is likely to change, as Brexit may well remove the free flow of capital from the UK across the EU.

- The UK economy has for some time been rated AAA. Some commentators believe that Brexit may cause a downgrade in this rating. This in itself will have significant consequences for the UK economy, and if it materialises, a recession may be on the cards for the UK.
- South Africa is likely to be affected in the same direction as the UK, due to the two countries' extensive trade relations and financial market connectivity.
- Economic growth has been lagging across the world. Brexit is likely to exacerbate this and as a result, we expect central banks across the world to delay interest rate hikes in a response to ongoing slow growth.
- Brexit will create uncertainty around the future of SA's trade agreements with the UK as the latter exits the EU. This will likely put SA's export growth and extended current account deficit at risk. Domestic sentiment is also likely to be negatively affected by the Brexit and could do further damage to the country's already-fragile growth outlook.

What should Boards of Trustees do?

Long term investing requires discipline to the investment philosophy and the investment strategy. In addition, Boards of Trustees must act with due care and diligence when dealing with Pension or Provident Fund investments.

Investing in an uncertain investment market requires a dedicated skill. Therefore, Boards of Trustees should refrain from emotional tactical decisions aimed at avoiding the current volatility and uncertainty created by Brexit.

Boards of Trustees should seek answers to the question, "Is the Fund's current investment strategy and philosophy robust enough to withstand the current uncertainty?"

This should be done in consultation with the Fund's Investment Consultant.

Sources:

1. www.bloomberg.com
2. www.bbc.co.uk
3. www.telegraph.co.uk
4. www.historylearningsite.co.uk

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