# ELGETHUN CAPITAL MANAGEMENT

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Yesterday, British citizens voted 52-48 to exit the European Union (EU). Here are some FAQs about the vote and exit:

**What is the EU:** The EU is a 28-country economic experiment started in the 1950s by Belgium, France, West Germany, Italy, Luxembourg and the Netherlands[1]. The intention was to promote trade, employment, capital investment and economic growth. Other countries joined over time and today 19 of the 28 countries share a common currency (euro). The EU is the largest economy in the world (if counted as one) with $18.5 trillion in GDP (US GDP is 2nd at $17.9 trillion[2]).

**Why did the UK vote:** Prime Minister David Cameron promised a referendum vote in 2013 if he won the 2015 election.

**Why does the vote matter:** The UK is the second largest economy in the EU (behind Germany) making up nearly 21% of EU GDP. The UK would be the first country to exit the EU, which could lead other countries to opt out, destabilizing the economy.

**Is it binding:** No. The Vote is nonbinding, but it's unlikely the UK would act contrary to the popular vote.

**Timing for exit:** The UK will remain an EU member until its formal exit is negotiated, which will likely take more than two years. There could be contentious negotiations and the EU needs to approve the exit.

**Impact:** No one knows the ultimate impact, given the UK is the first county to exit the EU. The UK will undoubtedly be impacted the most and other EU countries will certainly be interested in exit terms, trade agreements, and timing. Capital investment and employment could slow in the UK as multinational firms decide to hold-off on new plant and equipment and adding employees during the exit process. Long-term we don't expect negative effects from "Brexit" to significantly impact the US economy or US businesses (with the exception of those with large UK exposure). We do, however, expect increased volatility, which we welcome.

**What are we doing:** We will continue to focus on owning solid assets at attractive prices, as usual. During periods of volatility, understanding what you own, why, and the intrinsic value is paramount to making the correct decision. When margin calls, hedge funds, and algorithmic trades flood the market and prices swing violently, we are able to patiently wait for opportunities knowing we've prepared for turbulent times and stress-tested our portfolio. We have more than 20% cash in our equity allocations which will allow for opportunistic purchases should attractively-priced assets surface. Remember, our 20% cash allocation was purely a result of high valuations, not a call on global cataclysmic events. We don't consider a 3% equity drop significant, but we'll be looking for opportunities should they arise in the coming weeks.

Our UK equity exposure is less than 5%, consisting of stakes in BP and Rolls-Royce. Rolls could benefit from a cheaper currency given 80% of its sales are outside the UK, while most costs are in the UK. We also like the sticky nature of long-term service contracts on jet engines and national defense contracts.

**Summary:** The move to exit will probably hurt the UK economy, especially during the interim exit period. The UK economy represents less than 4% of world GDP, so even if the UK economy slows significantly, the global impact will be minimal. However, if the decision to leave encourages other EU countries to exit the EU, it would certainly weaken Europe. We're not macroeconomic forecasters (thank God) and we'll focus on the things in our control. We'll be patient and steadfast in our pursuit to preserve capital, while looking for opportunities.

Sincerely yours,

John

24 June 2016

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[1] http://www.telegraph.co.uk/news/2016/06/20/what-is-the-eu-why-was-it-created-and-when-was-it-formed1/
[2] https://www.google.com/#q=us+gdp; https://www.google.com/#q=european+union+gdp