ESGCLARITY

Constructing portfolios that minimise exposure to autocratic regimes

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Weak investor protection is one reason assets could be priced differently across autocratic and democratic countries

The Russian invasion of Ukraine is the latest example of the risks associated with authoritarian regimes. The human losses in the conflict have been truly tragic. However, the implications of the conflict are also being felt in a variety of other ways, including financial. Following the invasion, more than 1,000 companies curtailed operations in Russia, at an estimated cost of $240bn for these global corporations.

This is something that investors, quite simply, cannot afford to ignore. Yet the relative peace and prosperity of recent decades have meant investors have

forgotten what the risk of tyranny is, and what it could imply for investments in countries or companies that have a significant exposure to such regimes.

There are multiple factors that make autocratic regimes a risk to investors, and the time has come to address this risk and provide investors with ways to tackle it in their portfolios.

Weak investor protection is one of the most important reasons why assets could be priced differently across autocratic and democratic countries.

Moreover, several studies show that investing into countries with decreasing political risks tends to be beneficial for investors. Average returns in emerging market countries with decreasing political risk exceed those of emerging market countries with increasing political risk. Political country risk is correlated with future equity returns and equity valuation measures. Autocratic countries also tend to have more volatile stock markets that cannot be explained by simple country risk, but are also related to the lower level of investor protection.

More economic freedom implies the potential for better economic conditions and improved property rights in a country and tends to have positive stock market effects.

There is ample evidence that highlights that freedom and governments that do not concentrate too much power in their hands are important prerequisites for long-term sustainable growth and an increase in wealth.

Portfolio construction

How, then, can investors practically construct portfolios to minimise exposure to these risks? Information here is clearly critical, with a lot of facets of each country’s practices needing to be assessed to understand the prospective risks associated with each. This includes considering how governments function, the level of political participation in each country, the robustness of their political processes, and their record on civil liberties.

But also important is the means of how investors assess this information in order to construct portfolios. Given the numerous differences between distinct countries and regimes, a rigorous and robust approach is needed to objectively

assess information. Only via such a structure can investors be sure that individual markets and securities are being correctly considered, with those with poor records or close ties to authoritarian regimes being excluded.

A final critical element when considering these issues is diversification. Crystal ball gazing and predicting the future is almost impossible and it is foolish to try. Very few, if any, of us would have predicted that Russia would have gone as far as to invade Ukraine, even when taking Putin's aggressive rhetoric into consideration. An ability therefore to be able to spread risk across a portfolio, thereby mitigating potential concentrations and volatility, is key to ensuring investors benefit full in a risk/reward context.

History shows that greater economic freedom results in improved economic and market dynamics, improving investment returns.

It would therefore seem that assessing the risk associated with authoritarian regimes, and how to manage that risk within investment portfolios, is becoming increasingly important and relevant to global equity investing.