

ASSET ALLOCATION
AHEAD OF THE CURVE

Pricing the decline of democracy

- Democracy is in retreat, as shown by various measures
- Portfolio exposure to autocratic regimes negatively affects long-term returns
- The ‘tyranny risk factor’ appears to be independent from other risk factors

YVES CHOUEIFATY

History does not progress in a linear way. Science, democracy, technology, arts, the economy and any other type of evolutive process advance and recede in chaotic movements, even though they ineluctably move towards progress. Those recessions and pull-backs often go unnoticed at first, at least to the casual observer. And yet, they end up profoundly sanctioned by all stakeholders including the economy, financial markets and investors.

One of these recessions has grabbed our full attention at TOBAM. It can be boiled down to a single sinister headline: Democracy is receding. This is something that has significant implications for investors.

The decline of democracy

After the fall of the Berlin Wall in 1989, intellectuals predicted that liberal democracy would spread around the world, with the arc of history bending towards freedom. Political scientist Francis Fukuyama heralded “the end of history” and asserted that liberal democracy would be “the final form of human government”.

Academics and researchers, who were globally tracking the fortunes of democracy, confirmed what was obvious: democracy was spreading around the world, boosted by an all-powerful West. But the trend eventually shifted and democracy started losing ground at an accelerating pace.

Today, the most authoritative sources, whether it's the University of Gothenburg's V-Dem Institute, political advocacy group Freedom House or others, agree that democracy has been in retreat. The V-Dem Institute has even asserted that “the level of democracy enjoyed by the average global citizen in 2022 is down to 1986 levels”, preceding the collapse of the Soviet Union (see figure). The vast majority of humanity is now living under autocratic rule.

Importance to investors

This trend should be of interest to investors, given the ample evidence that autocracy is very bad for business and the economy and therefore extremely dangerous for



Yves Chouiefaty

investors. Autocratic regimes compromise economic performance, trample property rights and act erratically. They end up corrupt and use propaganda to mask their economic underperformance. They attack their neighbours and foster global instability. By definition, in their territories reigns arbitrariness, alongside economic irrationality.

Many studies prove the high correlation between freedom and prosperity. Similarly, there is plenty of academic research that shows that autocratic countries wipe out profits in the end, despite potential periods of economic growth.

When exposed to ‘tyranny’, your portfolio is exposed to a reverse J-curve: you can make money investing in an autocratic country for a while. Over the long term, the outcome

is rarely positive. Had you invested in Nazi Germany in the early 1930s, you would have experienced amazing returns – until you would have lost everything, including your soul.

The most recent reverse J-curve was in Russia; a gifted investor could have made profits in Russia until they lost everything after the 2022 invasion of Ukraine.

Mitigating risk

If you are trying to mitigate the dangers of tyranny in a portfolio, it is paramount to realise that it is not enough to avoid companies listed in autocratic countries. You also need to measure the exposure to the ‘tyranny risk factor’ of companies listed in democratic countries and take this exposure into account.

According to Yale University, more than a thousand companies listed outside of Russia had to close their business operations there after the invasion of Ukraine, resulting in more

than \$240bn (€228bn) in losses – much more than what western investors owned in Russian stocks. Most of the exposure to the disastrous effects of tyranny is indirect.

Data is abundant and widely available. Because, as asset managers, we can't be the arbiters of which countries are democracies or not, we have pulled data from the most authoritative sources and enlisted the support of external experts to decide on the borderline cases.

Using data-processing techniques and our quantitative expertise, we have identified and isolated a tyranny risk factor. We have then measured stock by stock the exposure to this risk for every single corporation listed in democratic countries. Finally, we have set out to quantify how the risk of democratic recession impacts investors.

Our four main findings are that there is a tyranny risk factor that is rewarded negatively over time. We also found that most of the exposure – about 75% for a standard portfolio – to this factor is indirect. A further interesting finding is that this risk factor appears to be independent from other risk drivers.

This approach allowed us to build a dynamic equity portfolio that is almost fully immune to autocratic countries, directly and indirectly. The back testing, which was independently conducted, is highly compelling. By protecting our investors from the exposure to the authoritarian risk factor, we can durably outperform the market and cushion against the big downturns triggered by geopolitical instability.

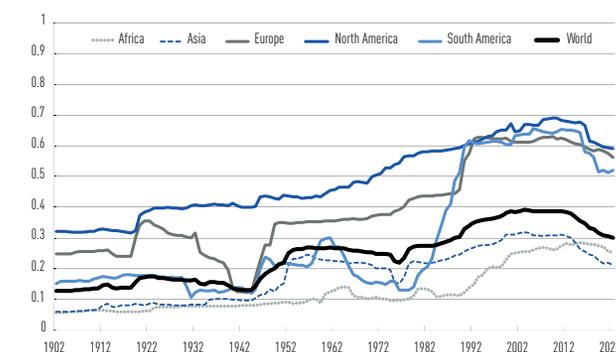
Freedom and dignity are powerful aspirations and their influence means that in all likelihood democracy will ultimately prevail. However, there is clear evidence that democracy is under threat. Freedom House suggests that there has been a 16-year trend of decline in democratic principles and freedom in countries across the world, with 38% of the global population now living in countries that are not free. Given the sizeable implications of this financially, it is critical that we are able to effectively protect investors from the steep economic cost of tyranny.

Yves Chouiefaty is president and CIO at TOBAM

“A gifted investor could have made profits in Russia until they lost everything after the 2022 invasion of Ukraine”

Democracy is back to 1986 levels

V-Dem liberal democracy index (average value, population weighted)



Source: V-Dem Institute