Benefits of autocratic risk mitigation

This article examines the impact of authoritarian regimes on portfolio performance, identifies an 'autocracy risk factor', and proposes to mitigate exposure to this risk factor for enhanced risk-adjusted returns.

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Recent analyses by authoritative sources such as the V-Dem Institute and Freedom House consistently show that democracy has been in retreat for almost two decades. The V-Dem Institute notably asserts that 'the level of democracy enjoyed by the average global citizen in 2022 has regressed to levels last seen in 1986', prior to the dissolution of the Soviet Union. As a result, a significant portion of the global population now lives under autocratic regimes.

Autocracies do not generate long-term value

Why should this trend concern investors? Evidence strongly suggests that, unlike democracies, which tend to foster economic growth, autocracies are generally detrimental to both business and economic environments. This relationship is supported for instance by the seminal work[1] of Acemoglu et al. (2019).

In his widely cited 2005 paper, 'The Limits of Financial Globalization,' René Stulz[2] challenged the notion of 'country irrelevance' – the idea that 'asset prices, portfolios, and firm financial policies are independent of national borders'. Through rigorous empirical analysis, he showed that this theory does not hold up, particularly in autocratic regimes. In these environments, for example, weaker property rights and the influence of corporate or government insiders increase the costs and risks for foreign investors, even in the absence of formal capital controls.

Divesting from autocracies is not enough

In addition, Lin et al. (2019)[3] show that US multinationals experience a significant decline in value when property rights deteriorate in countries where they have significant operations.

This has two important implications. First, we can observe how US investments are affected by autocratic rules affecting property rights. Second, simply divesting from companies listed in these autocratic countries is insufficient to protect a portfolio from adverse changes originating from autocracies. Indeed, it is crucial to assess and actively manage the indirect exposure to autocratic regimes of firms listed in democratic countries in order to mitigate any type of risk arising from these regimes.

A striking example is that following Ukraine's invasion, foreign investments in companies listed in Russia were marked down to zero. These losses could have been prevented by avoiding direct exposure to autocratic countries.

This is not the whole story. According to Yale University CELI[4], over a thousand companies listed outside of Russia have curtailed operations there after the invasion. Their estimated contribution to Russia's GDP was $ 600 billion. Assuming a very conservative valuation of one time revenue plus capex, and an optimistic mark-down of 50%[5], leads to $ 300 billion in investment losses – exceeding the overall value of western investors' holdings in listed Russian stocks.

While Russia has been excluded from Global Emerging Market Indices, China is currently a country of significant concern to investors. This is evidenced by the recent interest generated by the EM ex-China and World ex-China benchmarks.

Since we can observe how democratic firms are affected by autocratic countries using the wealth of data available, quantitative techniques allow us to measure the impact of autocracies on each corporation listed in democratic countries. This leads in turn to determine the authoritarian exposure (AE) of each democratic firm, while identifying a corresponding autocracy risk factor in the process.

Our research has shown that a subset of firms listed in developed markets exhibit significant exposure to authoritarian regime countries, even if 'indirect' by nature. Given the rise in autocracies' economic influence, this issue has become too significant to be ignored by investors worldwide.

FIGURE 1: GDP AROUND A REVERSAL
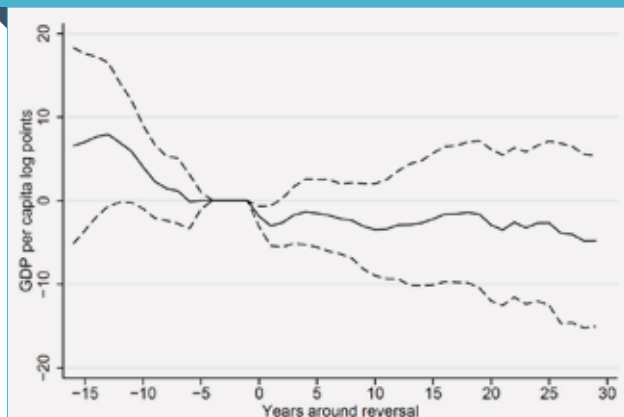
Source: Acemoglu et al. (2019) The solid line plots the estimated average effect on GDP per capita on countries that experienced a reversal (years 0) from democracy. The dashed lines represent the 95 percent confidence interval.

To simply illustrate the impact of autocratic exposures on listed equities from developed countries, we constructed quintile portfolios of stocks ranked according to their AE and investigated their performances over the last ten years.

Key Findings

This analysis of world developed firms yields three critical insights:

1. **Risk reduction with performance enhancement:** Divesting from the top 20% of stocks with the highest autocratic exposure would have improved performance while reducing overall portfolio risk, as measured by realized volatility. Notably, the Sharpe ratios of the quintile portfolios decrease from 0.5 for the first quintile (Q1) to 0.05 for the last quintile (Q5) as authoritarian exposure increases and is associated with lower returns.

2. **Authoritarian risk reduction comes with discarding junk stocks:** The table regression coefficients of each AE quantile portfolio show that the highly significant and negative exposure to quality stocks of Q5 decreases significantly with a reduction in authoritarian risk. This indicates that reducing authoritarian exposure is also associated with less exposure to junk stocks.

3. **Independent authoritarian risk factor with negative risk premium:** The low R^2 values from the regressions suggest the existence of a risk factor tied to the reduction of authoritarian risk, independent of other factors. Portfolio Q5 hedged with Q1 provides a simple authoritarian factor proxy, whose large negative unexplained performance points to the presence of a negative premium.

Overall, our findings suggest that investors can construct portfolios with low exposure to authoritarian regimes without compromising their potential to capture long-term risk premia. Quite the opposite. In fact, such portfolios may enhance risk-adjusted returns by avoiding the negatively rewarded 'autocratic risk factor' and while discarding stocks with 'junk' characteristics.

Conclusion

In summary, shielding investors from indirect exposure to the authoritarian risk factor has led to better outcomes, while arguably providing better protection against economic shocks triggered by geopolitical instability. Investors can proactively safeguard themselves against the economic costs imposed by autocratic regimes. ■

1. Acemoglu, Naidu, Restrepo and Robinson, 2019. Democracy does cause growth. Journal of political economy.
2. René Stulz is a respected figure in the field of finance and the holder of the Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University.
3. Lin, Mihov, Sanz and Stoyanova, 2019. Property rights institutions, foreign investment, and the valuation of multinational firms. Journal of Financial Economics.
4. https://www.yalerussianbusinessretreat.com/
5. Renault had to sell its 68% stake in Russia's biggest carmaker for 100 kopecks.

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FIGURE 2: PERFORMANCE & EXPOSURES ACROSS AE SORTED QUINTILE PORTFOLIOS

Performances	Q1: lowest AE	Q2	Q3	Q4	Q5: highest AE	Q5-Q1
Annualized return	8.9%	6.6%	3.4%	1.7%	1.2%	-6.9%
Vol	17.4%	18.0%	19.4%	21.4%	22.6%	13.5%
Sharpe ratio	0.51	0.37	0.18	0.08	0.05	-0.51
Excess return regression coefficients						
Market	+1%	+5%	+10%*	+14%*	+15%*	+13%*
SMB	-29%*	-21%*	-11%	-5%	+6%	+35%*
HML	-14%*	+6%	+11%*	+14%*	+19%*	+33%*
UMD	+9%*	+8%	+8.3%	+5%	+7%	-1.7%
QMJ	+9%	-5%	-20%*	-38%*	-51%*	-60%*
BAB	-6%	-2%	1%	-2%	-17%*	-11%
R^2	14%	5%	10%	18%	26%	35%

Source: TOBAM, Bloomberg, AQR.

Stocks within the Bloomberg World Developed Index were ranked every month according to their AE. We then constructed quintile portfolios of AE-sorted stocks, weighted by market capitalization. Portfolios were controlled each month for their past one-year volatility and rebalanced so that they were fully invested on average from April 2014 to April 2024.
Regression Coefficients are shown in % to improve readability. Factors Size (SMB), Value (HML), Momentum (UMD), Quality (QMJ) and Betting against Beta (BAB) are those of AQR's Global universe, and the associated Risk-Free rate has been used to compute Sharpe Ratios. * Indicates that the estimated coefficient is different from zero with a probability of 99%.