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Opinion

March 10, 2025

Investors beware: democracy is receding and it's bad for business

By Philippe Bolopion

German carmaker Volkswagen is one of many companies with exposure to China, with factories such as this in Anhui province © Qilai Shen/Bloomberg

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Portfolio performances risk being severely affected as autocracy rises

At a glance

- Last week's Economist Intelligence Unit Democracy Index for 2024 shows democracy is at a 19-year low
- Just 6.6 per cent of the world's population lives in a full democracy, down from 12.5 per cent 10 years ago
- Autocracy is bad for business. Conversely, investing in democracy is good for the bottom line and can also help starve autocratic regimes of the capital and resources they need to entrench their rule at home and undermine democracy abroad.

Global democracy just hit a new low. According to the Economist Intelligence Unit Democracy Index for 2024, published last week, at no point in the past 19 years has democracy ranked lower. "Just 6.6 per cent of the world's population now lives in a full democracy, down from 12.5

per cent 10 years ago," the report warns. "And a large share of the world's population — currently two in five people — lives under authoritarian rule."

"While autocracies seem to be gaining strength, as shown by the index trend since 2006, the world's democracies are struggling," says Joan Hoey, director for the Democracy Index.

Washington-based think-tank Freedom House has published similar findings, as has the Varieties of Democracy Institute at Gothenburg University. The latter warned last year that "the average level of democracy enjoyed by the average person in the world in 2023 is down to 1985-levels".

Over the past two decades, the rapid democratic progress enjoyed after the demise of the Soviet Union has been wiped out, making the world less free today than it was in 1989.

This prolonged democratic recession is bad news for the average citizen. In fact, it's an existential threat for anyone who believes in free societies, human rights and freedom.

But why should investors care? Because the performance of their portfolio risks being severely affected.

There is abundant evidence that autocracy is bad for business. Last November, the Nobel Prize in economic sciences was awarded to MIT economists Daron Acemoglu and Simon Johnson, along with the University of Chicago's James A. Robinson, for their work in demonstrating that strong political, economic and legal institutions are essential to a country's prosperity.

In 2019, Acemoglu published a seminal paper establishing that "democracy has a positive effect on GDP per capita" as it reduces social unrest and enables economic reforms through investments in education and healthcare. However, when a country experiences democratic decline, its GDP per capita decreases, with a negative impact on these same social and economic factors.

What is true at the macroeconomic level is also true at the stock level. Tobam's research shows that in the long term, companies exposed to autocratic regimes tend to offer inferior returns. In autocracies, corruption tends to flourish, expropriations cannot be challenged in the courts, and companies at the hands of government cronies benefit from unfair competitive advantages.

There are two ways in which companies can be exposed to autocratic regimes — directly, when they are headquartered in such countries or indirectly, when a company based in a democratic country has a significant part of its customers, suppliers or investors in a non-democratic state.

Making a portfolio authoritarian proof

Armed with this research and basic quantitative tools, it is possible to build portfolios that have minimal exposure to authoritarian countries. These portfolios will exhibit improved long-term returns, without demonstrating any biases to other known risk factors. They will also be more resilient in the face of increased geopolitical risk.

The elephant in the room here is China, the second-largest economy in the world and in the bottom 10 per cent in the V-Dem institute's democracy rankings.

Its regime is bent on undermining the idea of democracy. In the past two decades, China has propped up autocratic regimes or political parties around the world, through digital tools and economic inducements. And the country has been shown to try to influence elections, including in Australia and Canada.

In the past 15 years, China's share of global GDP has doubled to an amazing 18 per cent. Yet during that time, the performance of emerging markets, including China, delivered a 3.7 per cent annual return, versus a 3.5 per cent annualised return for emerging markets excluding

China. Despite China's spectacular economic growth, long-term investors have not been rewarded

Giving investors a solid compass

Today, the world is facing many uncertainties. Financial markets have already been roiled by the trade war threatened by the new US administration, and geopolitical risk is back with a vengeance.

In tumultuous times, investors need a solid compass. One thing the above research shows is that in the long run, democratic countries are likely to perform better. And companies that find a way to harness the enduring power of democracy will prosper, along with their shareholders.

Investing in democracy is not only good for the bottom line, it can also help starve autocratic regimes of the capital and resources they need to entrench their rule at home and undermine democracy abroad.

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