Political Risk and Emerging Market Investing

Taking macro-political factors into account in a portfolio

A REPORT BY EURASIA GROUP AND NIKKO ASSET MANAGEMENT

Executive Summary

1. Macro-political risks in emerging markets have increased since the 2008-2009 Global Financial Crisis, reflecting the growing importance of top-down analysis in managing emerging market portfolios.
2. Given the increasing frequency and intensity of political/economic crises, a more systematic method of measuring political risk and evaluating its impact on market prices is required for emerging markets.
3. A central thesis of investing in emerging markets assets is that given volatility and dispersion in these markets, there are better opportunities for risk-adjusted returns through a multi-asset approach. This is true except in times of heightened political risk, where assets become highly correlated.
4. We advocate a "three pillar" approach to emerging markets: investing in a broader range of asset classes, top-down, dynamic management of risk allocation to these countries/asset classes, and explicitly incorporating a systematic measure of political risk and its impact on emerging market assets.

SECTION ONE: MANAGING MACRO-POLITICAL RISK IN EMERGING MARKETS

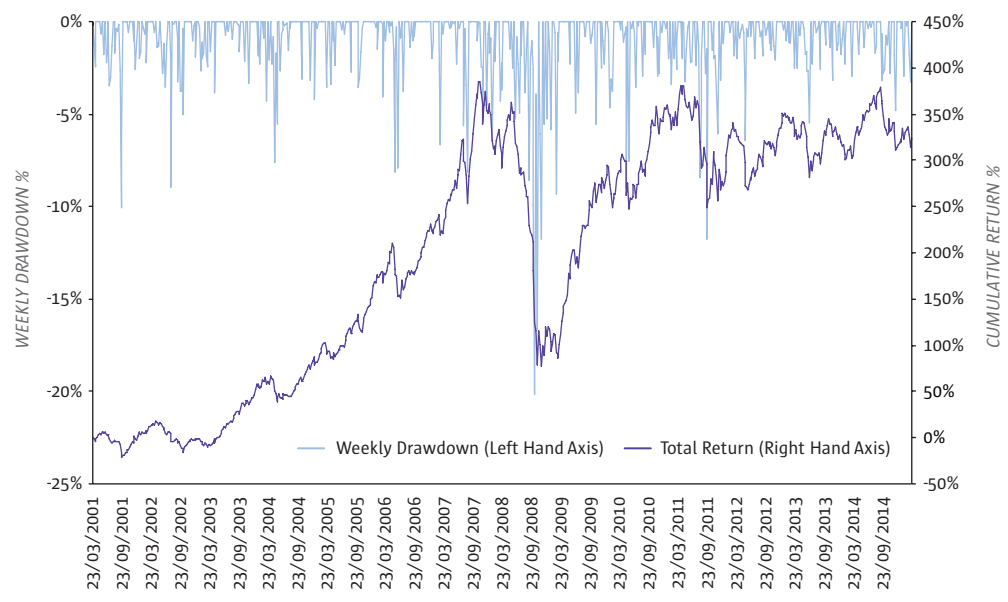
- Macro-political risk is increasing as a result of structural shifts in the international balance of political and economic power, with the US less willing/able to provide global leadership, but no real alternatives emerging to take its place.
- Rather than the "de-coupling" of emerging markets and developed markets often discussed after the 2008-2009 Global Financial Crisis, macro factors – such as US monetary policy – are actually having a greater role in driving tail risk in emerging markets.
- A top-down approach, incorporating systematic measurement of political risk, can potentially deliver better results than traditional bottom-up processes.

The rise of macro-political risk

Over the last 25 years, emerging market equities have outperformed developed market equities by 3.3% p.a. These higher returns came at the expense of substantially higher risk. The annualised volatility of emerging market equity returns was 23% p.a. In comparison, developed market equities had much lower volatility of 15% p.a. Higher risk was accepted as a necessary pre-condition for enjoying the higher returns provided by emerging markets. More recently, investors have begun to question whether they will be adequately compensated for this higher risk. Concern is growing on two fronts:

i) The frequency of market shocks is resulting in more frequent drawdowns;

Fig.1 Weekly drawdowns for emerging market equities 2001–2014 *Source: Nikko Asset Management Research*



ii) The source of the risk is changing from diversifiable idiosyncratic or stock-specific risk to non-diversifiable macro-political risk.

Nikko Asset Management, in order to address the concerns regarding the rise of macro-political risk, has conducted our own in-depth research to further understand the changing complexion of risks in emerging markets and their impact on assets. The research suggests the frequency of market shocks is increasing in emerging markets.

Fig.1 shows the weekly drawdowns experienced by investors in emerging market equities since 2001. The greater clustering of the bars towards the right side of the chart shows the increasing severity and frequency of market corrections during, and since, the financial crisis.

From the perspective of long-term investors, drawdown risk becomes an even greater concern when markets are range-bound, as opposed to a secular uptrend. Fig.1 shows two very different return profiles for emerging market equities, pre and post the global financial crisis. In the period prior, the market recovered from each drawdown to move a leg higher. More recently though, range-bound markets imply that even drawdowns of similar magnitude and frequency have become significantly more damaging.

Even though emerging markets have matured as investment destinations, their vulnerability to shocks has only increased. In Fig.2 we isolate the 30 worst weekly drawdowns over the last 15 years. Drawdowns experienced during, and since, the crises are shaded in purple. These outnumber drawdowns prior to the crisis by two times – i.e., 20 out of the worst 30 drawdowns have occurred since the onset of the financial crisis. The magnitude has been larger in the more recent past as compared to the early part of the last decade.

This analysis not only validates our concern regarding the greater frequency and severity of market shocks, but also highlights the changing nature of emerging market risks. As correlations across securities and asset classes rise during such stress events, the perceived safety of portfolio diversification becomes an increasingly less effective way to manage portfolio risk. Hence the primary source of portfolio risk moves from diversifiable, idiosyncratic or stock-specific risk to non-diversifiable, macro-political risk.

To understand the changing nature of macro-political risk, we constructed an emerging market multi-asset portfolio and assessed the change in contribution to risk from different asset classes over time. The portfolio consisted of an equally weighted allocation to emerging market equities, emerging market hard currency bonds and emerging market local currency bonds (currency was disaggregated and treated as a stand-alone risk). The results are shown in Fig.3.

Before 2008, the equity portion (largest source of stock-specific risk) contributed the lion's share of portfolio volatility – roughly 70%, compared to 20% from currency and about 10% from the bond

portion. It is not surprising that bonds and currency added more to portfolio risk during the 2008 crisis, reflecting perceptions of higher top-down risk. However, it is surprising that currency and bond volatility (the largest sources of macro-political risk) have remained elevated since the crisis, currently comprising more than 50% of portfolio volatility. These findings coincide with those of the Eurasia Group, described later and shown in their political risk index measure for frontier, developed and emerging markets. There are many potential reasons for this change; among these, Eurasia Group's research highlights the following:

- Declining global leadership from the US and no alternative emerging to take its place;
- Growing emerging market powers with varying political systems have led to divergent global interests;
- The greater integration of emerging markets as part of the global economy and hence their increasing sensitivity to exogenous macro-political/ economic shocks.

No resolution to these contributing factors appears likely in the short term, and macro-political risk likely will continue to play a central role in the outcomes for emerging market portfolios. A top-down investment approach to managing emerging market portfolios, as opposed to the more traditional bottom-up processes, may well be a superior approach.

A top-down approach to emerging markets

A top-down investment approach for managing emerging market portfolios recognises both the increasing importance of macro-political risk on emerging market asset returns as well as the rapid evolution of capital markets across many of the larger emerging countries. Nikko Asset Management's position is that a top-down approach should consist of three key pillars:

i) Broadening the investment opportunity set from just equities to multiple asset classes (equities, local currency bonds, hard currency debt and FX) to add additional sources of returns and lower overall portfolio risk;
ii) Dynamic management of risk allocations to these asset classes (and to their building blocks such as Indian equities and Brazilian bonds) to protect downside risk;
iii) A systematic methodology for measuring and quantifying political risk and its potential effects on emerging market asset outcomes.

Creating an investment process that focuses on these three pillars positions an investor to accommodate the changing nature of emerging market investment risk and its impact on portfolios.

Fig.2 Weekly drawdowns for emerging market equities 2001-2014 *Source: Nikko Asset Management Research*

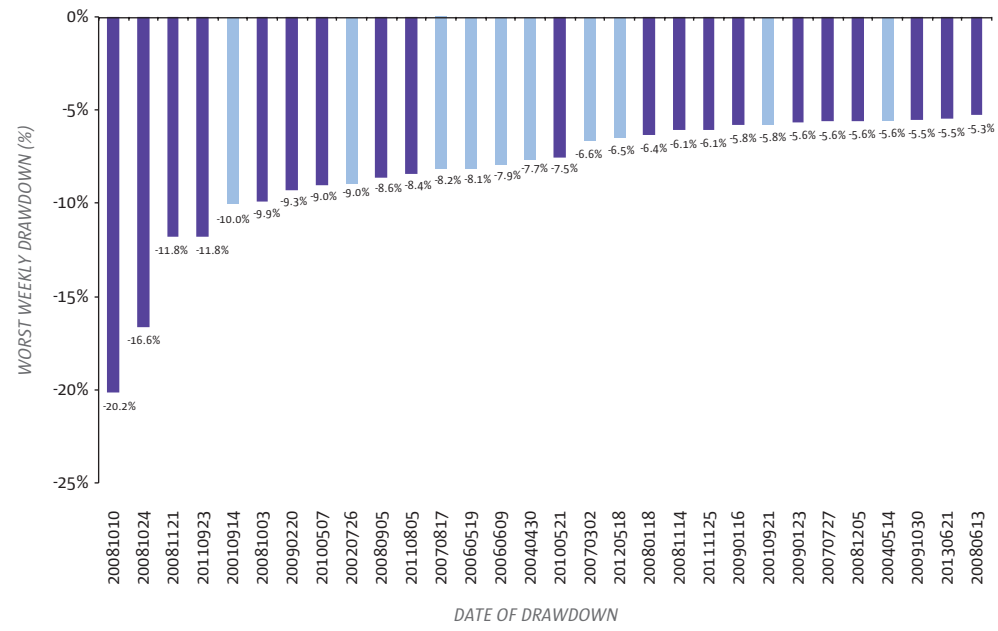
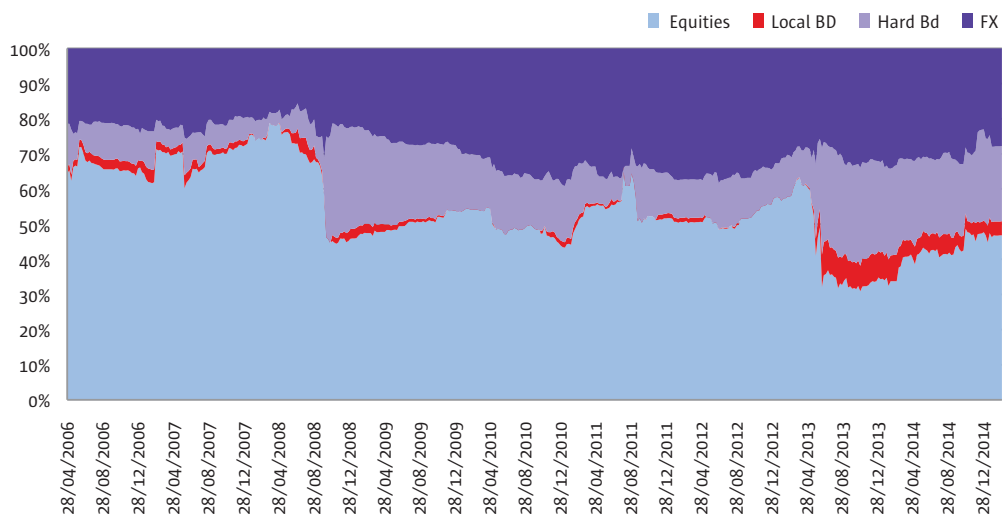


Fig.3 Risk allocation: all assets *Source: Nikko Asset Management Research*



Pillar 1

The benefits of broadening the investment universe can be shown through simple returns analysis of the equally weighted emerging market portfolio (equities, local and hard currency bonds) mentioned earlier. As can be seen in Fig.4 *(see over)*, this portfolio slightly underperformed emerging market equities since 2002, but outperformed both hard and local currency bonds.

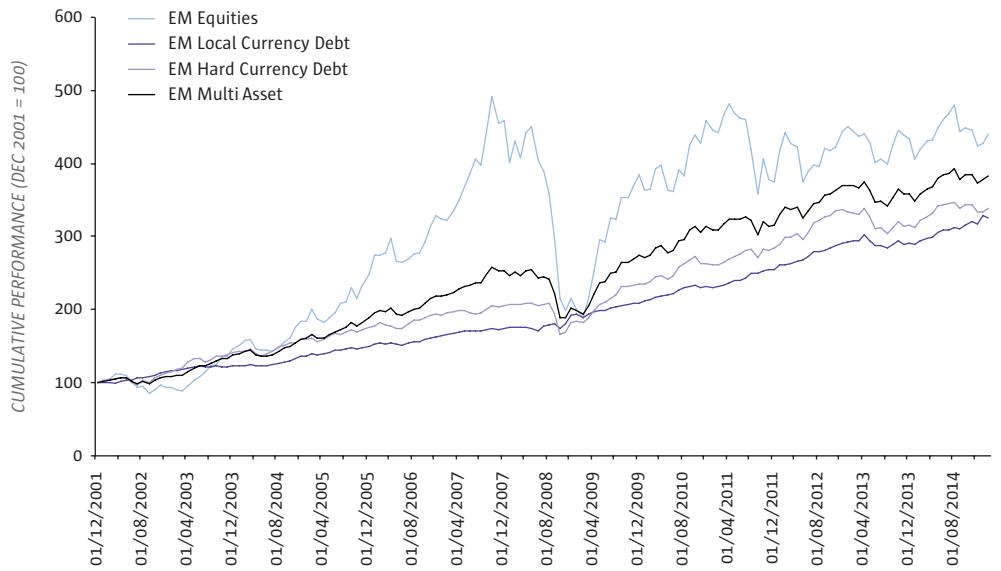
However, the benefits of a broader investment universe played out by significantly reducing the risk. The volatility of the equally weighted portfolio was about half that of emerging market equities over the period, and the drawdown in 2008 was only 20% compared to a 53% loss for emerging market equities.

Pillar 2

To maximise the benefits of a broader investment universe, it is important for a top-down approach to dynamically manage the portfolio's risk allocation. Investment risk premiums are not static, and given the expectation that emerging market assets will

Fig.4 Relative performance of representative emerging market multi-asset portfolio versus other asset classes

Source: Nikko Asset Management Research



continue to be impacted by growing macro-political risks, an investment process needs to be able to handle the changing nature of emerging market asset risk premiums.

Nikko Asset Management employs a disciplined approach to dynamic risk allocation. Rather than use traditional market benchmarks, all assets in which we invest need to earn their way into the portfolios. The asset must display attractive characteristics, based on proprietary models, of one or more of the following: attractive valuations; positive momentum; or supportive macro-political dynamics.

Pillar 3

Quantifying macro-political risk and measuring its potential impact on emerging market asset prices is a difficult undertaking. To address this, Nikko Asset Management collaborates with Eurasia Group, utilising their systematic methodology for quantifying political risk and embedding the results in the investment process. The following section describes in detail how Eurasia Group measures political risk.

SECTION TWO: POLITICAL RISK AND ASSET PRICES

- Political risk is an important driver of emerging market returns. However, it is difficult to measure and its impact on asset prices is underappreciated and poorly understood.
- Eurasia Group has developed a systematic approach to measure political risk and apply it in an asset-pricing framework to better understand the links between politics and market prices.
- Macro-political trends – including more frequently and rapidly transmitted shocks – are increasing the need for incorporating a systematic approach to political risk into emerging market portfolio management.

As described above, political risk is a key driver of emerging market returns. However, it is challenging to measure and formally incorporate into the investment process, and its effects on asset prices generally are under-appreciated by investors. To address this gap, Eurasia has developed a systematic approach to measuring political risk, which forms Pillar 3 of the investment approach described above. In this section we discuss why political risk matters to emerging market asset prices and what factors are driving the increasing influence of political risk, and how Eurasia has implemented a methodical approach to assessing political risk, which is embedded in the Nikko Asset Management investment process.

Why political risk matters – key drivers

There is evidence of significant relationships between political risk factors and returns across various asset classes, in areas such as equity index volatility, bond spreads, formed risk premia between spot and forward FX rates, and CDS spreads. Research also shows that political effects are especially important in the emerging markets. In particular, there are five main factors explaining why politics matters so much for asset prices in emerging markets:

- *Institutional capacity to manage shocks.* Political institutions, government strength, and the relationships between societies and their governments place important constraints on the ability of governments to manage adverse internal and external economic shocks. This can take the form of institutional constraints on fiscal and monetary policy responses to economic contractions, emergency legislation and crisis management, and economic reform.
- *Policy uncertainty*. Most fundamentally, politics create uncertainty about future policies, which in turn affects expected levels of economic activity (growth) and profitability through their impact on investment, taxes, consumer and business confidence, and the price and availability of credit, among other channels. Asset prices, of course, are sensitive to actual policy changes, but also to "headline risk" around elections and other signals of potential future changes to policy.
- *Competition and operating environment*. Politics determines the rules of the game for producers and consumers – setting the level and form of competition and market orientation or "openness" within an economy. The competitive environment, in turn, directly affects both the value of firms and the volatility of the operating environment – which are both reflected in asset prices. Moreover, politics can drive uncertainty around a firm's ability to physically operate and can materially impact levels of production (through supply chain, legal, judicial, and other risks).
- *Sovereign creditworthiness.* Politics and policy choices directly impact the ability and willingness of governments and state-owned enterprises to pay debt.
- *Market structure can amplify political shocks.* Unanticipated political shifts can cause large and very fast shifts in desired portfolio balances, resulting in large price adjustments. Being able to adjust early to political signals can significantly help investors in emerging markets manage their downside risk.

How to measure political risk

While politics is clearly a major contributor to tail risk in emerging markets portfolios, the challenge is in defining and quantifying how these political forces interact with the market to gain insight into their effect on returns. In modelling the effects of political risk, the first key challenge is definition. Often, political risk means different things in different contexts. The second major challenge is developing a systematic method for measuring the political risk. Eurasia Group defines political risk along four main parameters: political stability, social stability, security (in terms of internal and external threats), and economic stability (both short and long-term). These aspects are discussed in more depth below.

Measuring variables such as political risk is methodically difficult. No direct metrics of political

risk exist. Moreover, the few "off-the-shelf" measures across countries are low-frequency (usually updated annually), making them impractical for use in comparing against time-series returns on asset prices. Because there are few tools for measuring political risk, or estimating how it is priced across countries and asset classes, investors tend to fall back on ad hoc measures and generally purely qualitative approaches.

As outlined in the description of Pillar Three, to overcome this gap Eurasia Group has developed a systematic methodology for measuring political risk and using it as a signal for top-down country allocation decisions across asset classes. Three important parts of this framework are:

1. Country scores that capture current levels of political stability (the Global Political Risk Index);
2. Formal assessments of the future outlook of political stability and its impact on the business environment (political trajectories);
3. Asset pricing models that estimate the interaction between political risk and market prices.

The Global Political Risk Index (GPRI)

Eurasia Group's Global Political Risk Index (GPRI) presents a relative measure of country-level state stability, defined as the stability of the regime and the government. The regime is the set of rules that establish the institutions of the state, define the powers of those institutions, and condition interactions between the state and society. The government controls the executive institution of the regime.

The GPRI assigns quantitative scores to countries, expressed on a scale of 1–100, with higher numbers corresponding to lower levels of risk. Based on these scores, the GPRI also produces ordinal rankings of the countries.

The GPRI includes four category scores: Government, Society, Security, and Economy. Each of these categories contributes to the degree of state stability that a country has, as each can influence the legitimacy of the current regime and government.

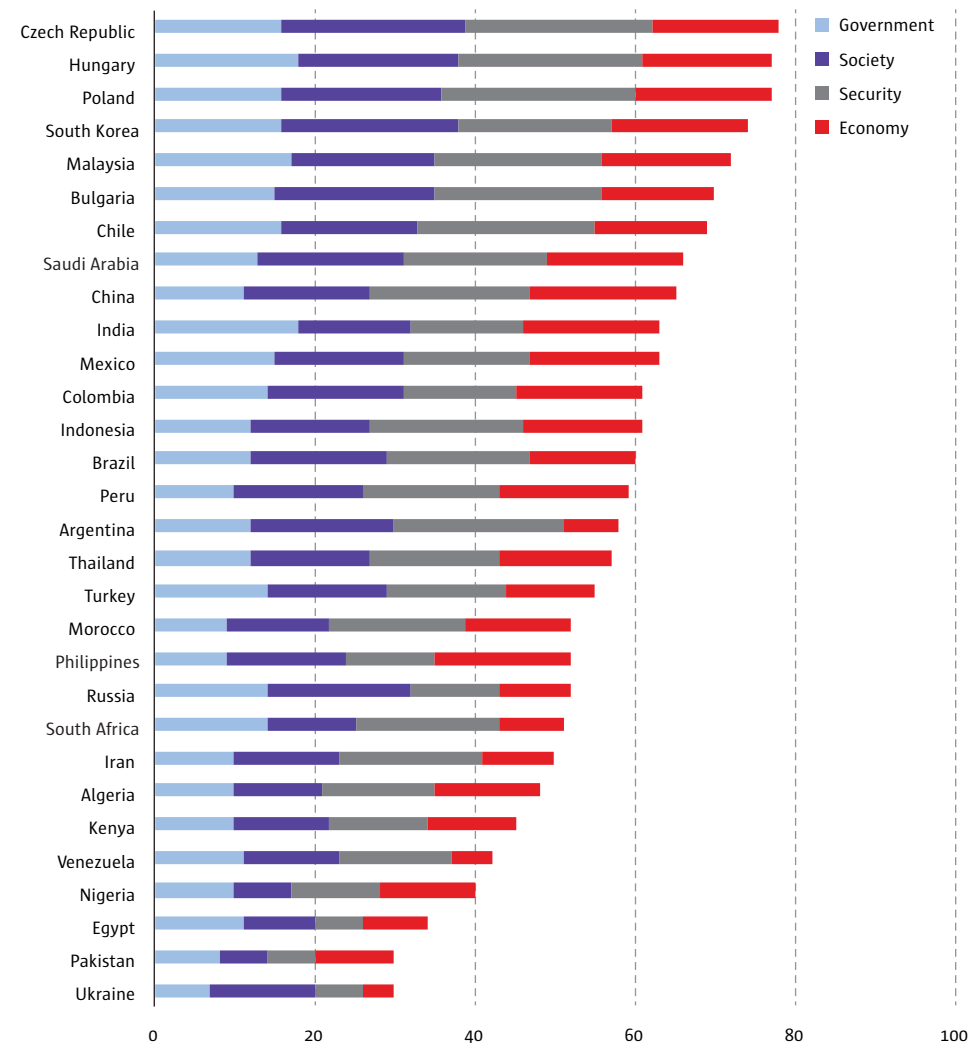
- The Government score captures state stability by measuring the strength and durability of the regime and the government through factors including the cohesiveness of the government and the opposition, the degree to which the government has popular support, and the strength and transparency of government institutions.
- The Society score captures the presence and intensity of, and the potential for, social conflict that creates risks to state stability. Factors include income inequality, ethnic/class conflict, urban population growth rates, and issues that can arise from poor government service provision, such as high infant mortality and low literacy rates.
- The Security score captures state stability as influenced by internal and external security risks, including factors such as military spending, terrorism, domestic and inter-state armed conflict, and security alliances.
- The Economy score captures state stability by aggregating the risks of short-term and long-term economic instability. Short-term factors include economic performance and government finances, while long-term factors take in the structure of the economy and the environment for the private sector.

Political trajectories

Eurasia Group's political trajectories are forward-looking, directional assessments of how politics will affect a country's business environment — defined as the overall economic and investment climate — over the next six months and two years. Trajectories are calculated based on an analyst survey across five political dimensions: government stability/cohesion, social stability, security, economic policy, and investment policy — and are intended to capture the future outlook for politics and its effect on the business environment.

Trajectories are assigned by Eurasia Group's country analysts through a structured methodology that converts a series of qualitative inputs into an overall quantitative score. To assign trajectories, analysts evaluate each country's outlook across the five key political dimensions noted previously. Analysts then evaluate the impact of each outlook on the country's macro business environment, weighted by the relative importance of each dimension in generating political risks and opportunity. The qualitative inputs are translated into a raw score.

Fig.5 Global Political Risk Index (GPRI) *Source: Eurasia Group*

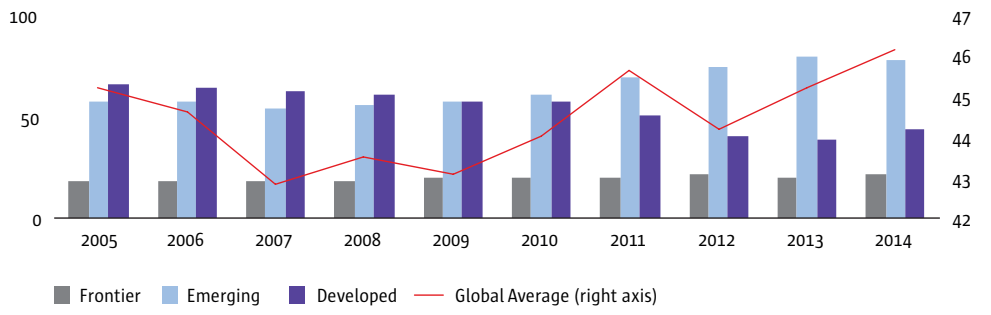


Eurasia Group has applied these political risk variables in empirical work using a time series of 22 emerging market equity returns and bond spreads since 2005. Returns and spreads first are regressed against a set of macro and market fundamental variables; the time series of political stability is then introduced into the regressions to see how it improves the ability to explain the variation in returns and bond spreads. Key findings of this work include:

- For equity markets, incorporating a political risk measure meaningfully improves our ability to explain differences in market returns between countries compared to a model of equity market fundamentals alone.
- Measures of political risk are generally uncorrelated with equity market fundamentals, suggesting that political risk provides independent leverage in explaining why equity returns vary across countries.
- Adding the GPRI as a political risk factor to a macro-equity factor model (including earnings growth, equity risk premia, and price-to-book ratios) raises the ability to explain the variation of returns between countries by roughly 18%.
- We find similar results with emerging market bond spreads: incorporating a formal measure of political risk meaningfully improves our ability to explain differences in bond spreads – both between countries and within countries over time – compared to macro and credit fundamentals alone.
- Adding political risk to a macro factor model (GDP growth, current account balance, short-term interest rates, and the government's budget balance) raises the ability to explain the between-country variation in spreads by roughly 11% (and also improves the ability to explain why spreads move within a country over time).

Fig.6 The global economy's exposure to political risk has increased since the 2008-2009 financial crisis

Source: Eurasia Group, IMF World Economic Outlook



The growing need for a systematic approach on political risk

While macro-political conflicts continue to dominate the headlines (Russia-Ukraine, ISIS, Syria, Iraq) and have added a general degree of uncertainty and volatility to markets, in general, they have been viewed as local, contained conflicts. We forecast that the frequency and intensity of macro-political crises are likely to increase given the current structural shifts in the international balance of political and economic power.

The United States is less willing and able to provide global leadership, but no alternatives have yet emerged to take the place of the US. Traditional American allies are distracted by domestic issues and less aligned. Emerging market countries have become powerful enough to block global initiatives, but not so powerful (or coordinated) that they can offer their own alternatives. A growing China, a declining Russia, and many emerging markets with competing priorities and widely varying political systems are leading to more major powers with more divergent interests.

> "In times of crisis the correlation between debt and equity assets in an emerging market country or region can become much more highly correlated, and benefits from dispersion reduced dramatically."

The world has entered a period of "macro-political creative destruction," with important consequences for the global economy. The effects from heightened political risk spilling over into emerging markets will require investors to take a more systematic consideration of the transmission of political risk. As Fig.6 shows, Eurasia's GPRI index reflects the decline in macro-political stability that has accompanied these structural shifts in the macro-political order post 2008-2009 – and in particular elevated risks for emerging markets. This indicator presents a composite global measure of political risk – which takes country-level assessments of political stability and aggregates them using GDP (at PPP) weights – and shows a marked increase in the global economy's exposure to political risk over the past several years, as illustrated in Fig.6.

The example of India and Brazil, and the impact of the elections on their subsequent different policy responses to macro-political economic challenges, such as the tapering of quantitative easing by the US (referred to as the "taper tantrum"), demonstrates the increased sensitivity of emerging markets to exogenous shocks. Because this political risk is contributing even more heavily to market prices, the need to incorporate a systematic approach to measuring political signals into emerging market portfolio management has increased.

SECTION THREE: LINKING POLITICAL RISK MEASUREMENT WITH EMERGING MARKET MULTI-ASSET MANAGEMENT

- Diversification benefits between investing in emerging markets and developed markets have declined over recent years, as both are now more tightly integrated into the global economy and sensitive to similar macro-political shocks.
- Diversification benefits between asset classes within emerging market countries also decline markedly during times of crises, as political risk tends to drive correlation of all assets higher.
- This emphasises the need to be able to interpret early political risk signals, and incorporate these into top-down country allocation decisions.

The linkage between political analysis and portfolio management

As noted in the first section, the growth of local currency bonds and other asset classes within emerging markets now provides the investor with

multiple sources of excess returns. The higher volatility of this broader range of emerging market assets has been seen as providing an opportunity to generate better risk-adjusted returns. A number of emerging market multi-asset funds launched post the 2008-2009 crisis. Many of these were premised on the popular view that developed and emerging markets would "decouple," and emerging markets were entering a period of relative autonomous growth from developed markets. However, as illustrated earlier, far from decoupling and being driven more by endogenous bottom-up growth factors, emerging markets have actually become more sensitive to top-down macro factors and the similar macro-political shocks that affect developing markets. Rather than a bottom-up view, what is now required is a better understanding of the linkages between macro-political events, emerging market policy responses, and how these are transmitted to asset prices.

Another problem with the premise that a multi-asset approach to emerging markets benefits because of the dispersion between emerging market asset classes is that this assumption doesn't hold true during political crises, which are becoming more frequent.

As Table 1 illustrates, in times of crisis the correlation between debt and equity assets in an emerging market country or region can become much more highly correlated, and benefits from dispersion reduced dramatically.

Correlations between asset classes within countries rise sharply leading up and in the immediate aftermath of major political risk events. This is true for both negative and positive political shocks. Table 1 provides a representative sample of major political risk events across the emerging markets over the past 15 years, from Vicente Fox's election as president in Mexico in 2000 (a positive political "shock") to the re-election of Dilma Rousseff (a more negative risk event) in October 2014. The sample includes elections, institutional crises (Turkey in 2001, Philippines in 2005), and government collapses (Argentina in 2001, Egypt in 2011, Ukraine in 2013). Some of these events were well anticipated, and others were not.

As Table 1 shows, major political risk events are associated with an increase in correlation between equities and sovereign bonds, suggesting that country-level asset prices are increasingly macro-driven around political events, and less so by asset class fundamentals. We develop a stylised estimate of intra-country asset correlation around political events by looking at the mean level of correlation across various times ahead of and following each of these events: correlations tend to rise meaningfully three to six months ahead of the event, peak in the 30 days prior, and subsequently "normalise" following the event.

Despite divergent election results, and subsequently diverging asset price performance, the evolution of asset class correlation followed a remarkably similar path in both cases. In India, equities and bonds were moderately correlated (0.36) six months ahead of the election and rose steadily ahead of the election, peaking (at 0.64) in the 30 days following the election; in the subsequent six months correlations steadily declined to fairly low levels (0.14).

Brazil too saw an increase in correlation ahead of the election, peaking at a high of 0.83 in the 90 days before the election, and subsequently declined – although still remaining at relatively high levels (0.68 six months out), likely reflecting still-high levels of political risk in Brazil.

A systematic framework for understanding political risk effectively helps to anticipate change in correlation and volatility for better top-down portfolio management. An investment process that evaluates valuation, momentum and macro inputs is significantly enhanced when political risk can be accurately measured and understood.

Conclusions

1. Instead of decoupling, the rapid evolution of capital markets means that emerging markets are becoming increasingly sensitive to macro-political shocks. This means that top-down analysis is increasingly important to emerging market portfolios.
2. The growing frequency of macro-political shocks and their impact on emerging market asset prices means that it is increasingly important to have a systematic approach to assessing political risk.
3. There is indeed a broader range of assets within emerging markets, offering greater opportunities for diversification and returns, which can be accessed through a multi-asset approach. However, in times of political crises, the dispersion between these assets declines, and the importance of dynamic top-down country and asset allocation becomes key in managing downside risk.
4. These approaches need to be incorporated into a multi-asset approach, which captures the increasingly broad sources of return within emerging markets, and dynamic asset allocation, which factors in macro risks, along with valuation and momentum, to be able to manage the significant downside volatility.
5. This proposition is recognised by Nikko AM and is evidenced in its partnership with Eurasia Group.

This article was drawn from a white paper produced by Eurasia Group and Nikko Asset Management. Contributors include: Alexander Kazan and Aditi Marisetti from Eurasia Group; Al Clark, Robert Samson, Tanuj Dutt, and Peter Knight from Nikko Asset Management. ***http://en.nikkoam.com/sp/eurasia***

Table 1 Asset correlations in emerging markets during political crises

Note: Highlighted cells show the peak period of aset class consolidation *Source: Eurasia Group*

Event	Country	Start date	Start -180	Start -90	Start -30	Start +30	Start +90	Start +180
Fox wins Presidency	Mexico	01-Dec-00	0.38	0.36	0.34	-0.58	-0.08	0.19
February institutional crisis	Turkey	22-Feb-01	0.52	0.82	0.72	0.84	0.79	0.71
President de La Rua forced out of office	Argentina	21-Dec-01	0.69	0.57	0.14	-0.51	-0.13	0.14
Lula's election	Brazil	27-Oct-02	0.84	0.80	0.86	0.92	0.89	0.78
Election rigging scandal and crisis	Philippines	01-Jun-05	0.36	0.33	0.34	0.60	0.57	0.32
Zuma election	South Africa	22-Apr-09	0.50	0.29	0.80	0.56	0.17	0.24
President Mubarak forced to resign	Egypt	11-Feb-11	0.21	0.24	0.61	0.50	0.33	0.36
Humala makes second round	Peru	10-Apr-11	0.32	0.18	0.04	0.72	0.47	0.50
Yanukovych flees to Russia	Ukraine	02-Nov-13	0.38	0.49	0.63	0.13	0.53	0.19
Modi election	India	26-May-14	0.36	0.60	0.64	0.39	0.20	0.14
Rousseff election	Brazil	26-Oct-14	0.45	0.83	0.71	0.57	0.68	--
AVERAGE			0.46	0.50	0.53	0.38	0.40	0.36