

# POLITICALLY

The investment industry is not equipped to understand the impact of global political instability, says one expert on political risk. What can investors do?

BY MAHA KHAN PHILLIPS



# MOTIVATED

Investors with assets in Egypt woke up to some unwelcome news in May. As if it weren't enough that markets had tumbled since political unrest began in January, a court had annulled a 2006 deal to sell the country's historic Omar Effendi department store chain to the Saudi firm Al-Anwal United Trade Company.

Omar Effendi, a well-known store with branches across the country, was sold for 589.5 million Egyptian pounds as part of a privatization plan. For the buyers, the contract was done and dusted, even though former president Hosni Mubarak's government had long been accused of selling the company too cheaply. After the revolution, Egypt's judiciary, flexing its muscles, simply reversed the decision to sell. Saudi investors were stunned. How safe were their other assets?

The Omar Effendi sale was not the only financial transaction in flux. The court's decision followed other rulings to scrap state land sales in which the state was found to have sold land directly at below-market prices. Casualties included Damac Properties, a Dubai-based developer with a multi-million-dollar investment in the country. In fact, Damac and its founder, Hussain Sajwani, were fined around US\$45 million, according to news reports. Sajwani, a United Arab Emirates national, was sentenced in absentia to five years in jail, and Egyptian tourism minister Zuheir Garranah was jailed for five years, in part because of the deal. Damac has taken Egypt to the International Centre for Settlement of Investment Disputes, calling the arrest "politically motivated."

Not surprisingly, Egypt's investment future is on shaky ground. The situation could not contrast any more starkly to circumstances a year ago, when Egypt had been considered one of the Next 11, identified by Goldman Sachs as having the potential (alongside BRIC countries) of becoming one of the world's largest economies in the 21st century. Now, investors simply want out. They have learned the hard way that a great deal of political change can occur in a very short amount of time.

## THE DANGERS OF COMPLACENCY

Why didn't anyone see this coming? One possible answer is that investors, investment professionals, and the finance industry as a whole are complacent about political risk. Mohamed Abdel-Hadi, CFA, founder and chief investment officer of London-based emerging markets hedge fund Holland Park Capital (and also an Egypt analyst), says political transition in the country had been discussed by

investors for the past five years but the discussions didn't amount to anything. "Political risk does not prevent investors from investing," he says. "The problem is that once everyone knows that political risk is there, they start to take it for granted. People say political risk has been factored into the share price. Then it turns around and bites you."

Kai Stuckenbrock, director of Standard and Poor's Europe, Middle East, and Africa (EMEA) sovereign ratings group in Frankfurt, Germany, agrees. "We try to capture these risks as systematically as we can, but it is not always easy to forecast. You can be aware of a risk, where some of the key drivers are well known and you have been worried about them for some time. But the point is, at what stage does this become an issue? Many of these countries have been stable for decades, even though the risks have been prevalent."

In fact, in its January 2011 report "Tunisia's Jasmine Revolution Is Adding to Political and Fiscal Risks in the MENA Region," Standard and Poor's warned its clients that Egypt shared the same risks that Tunisia exhibited, including a young population, high unemployment, and comparatively low income levels. What it could not tell its clients, however, is what the outcome of those factors would be. Nor could it specify the timing of events.

Analysts were slow to react to events in other countries after political upheaval in Tunisia because analysts tend to focus on detailed analysis rather than big-picture events, according to Colin McLean, FSIP, chief investment officer and managing director of SVM Asset Management in Edinburgh, Scotland. People tend to focus on the scenario that is most similar to one they've seen before rather than ones that are harder to understand.

In an article published in *Financial News*, McLean also warned that "the world stage has largely shrugged off Tunisia, Egypt, and Libya as bit players in the global economy. This seems a remarkably complacent and potentially dangerous view."

McLean argues that there are already signs that spare capacity in Saudi oil production may be limited, with the real shock in Saudi Arabia yet to come. Others agree, pointing to Bahrain, which is said to be a test case for Saudi Arabia's own political future.

## CONTAGION EFFECT

Despite such hazards, many investors say managing political risk simply isn't a priority. "We didn't have any

money in Egypt anyway,” says one U.K.-based pension fund manager. Tim Hodgson, ASIP, senior investment consultant at Towers Watson in London, observes that many investors feel events in the Middle East are not important because of the size of their exposures. “They may only have 2 percent of their portfolio in emerging markets, and 1.5 percent of that would be in Egypt. The problem is that this could trigger something big, like water and food shortages, and forewarned is forearmed.”

Other investors contend that the Arab Spring was a “black swan” event and thus not something that could have crossed their radar beforehand.

Such thinking irks Pippa Malmgren, president and founder of the Canonbury Group and Principalis Asset Management. “This argument that political upheaval is a black swan and totally unpredictable and something you can’t be held responsible for is just nonsense,” says Malmgren, who also previously served as special assistant to the president on the U.S. National Economic Council. “We argued for many months that food inflation and

energy inflation would cause issues in emerging markets. We saw the first signs in Mozambique, and everyone said, ‘Why should we care about Mozambique?’ The answer is, ‘We care because food and energy inflation hits the most vulnerable first.’”

Malmgren, who spoke about geopolitics at the CFA Institute annual conference held in Edinburgh, Scotland, this past May, says investors who ignore the contagion effect of political events do so at their own peril. She argues that investors have simply forgotten about the “peace dividend” that has been in place for the past 25 years since the fall of the Berlin Wall. But all this is changing. “We’ve had 25–30 years of a world where volatility was flat and falling and growth was rising, and in that environment, you don’t pay attention to this stuff. But when volatility comes back, politics moves to center stage.”

The real culprit, she believes, is food inflation. “Tiananmen Square didn’t happen one day out of the blue; it happened when there was 14 percent inflation. Inflation has become the catalyst, the spark that makes people want change.”

## POLITICAL RISK INSURANCE

As geopolitical risk in markets comes into the spotlight, so does political risk insurance. There are many providers of political risk insurance, from large international organizations to smaller stand-alone entities. For the first time, these organizations are seeing interest from institutional investors.

One such provider is the MultiLateral Investment Guarantee Agency (MIGA), the political risk insurance arm of the World Bank, whose mission is to spur developmentally sustainable foreign direct investments in developing countries. “The situation in MENA (Middle East and North Africa) has refocused a lot of people on the area of political risk but also political risk insurance,” says Edith Quintrell, director of operations at MIGA. “Having a plan in place, and having thought about political risk before an investment is made, is very important.” MIGA insures against currency transfer restrictions, expropriation, war and civil disturbances, breach of contract, and failure to honor sovereign financial obligations.

Quintrell says private equity firms have been interested in taking insurance, particularly in Africa. MIGA does not make guarantees about indirect or liquid investments, such as stocks, meaning that institutional investors are less likely to take out insurance, unless they are making direct acquisitions.

Paul Barbour, CFA, senior risk analyst at MIGA, explains that the organization rates each country in terms of risk based on a certain set of metrics, estimating the probability of an event occurring. “In the past, political risk may have been

considered too expensive, but it is now considered better value for money.”

In general, fees for insurance are transaction driven, depending on the amount, coverage, and tenor of coverage. Getting coverage against expropriation, currency inconvertibility, political violence, and breach of contract for a power plant in a place considered risky could cost 2 percent per annum over 15 years, while getting expropriation for only two years in a less-risky place with a less-risky investment could cost perhaps 0.5 percent per year.

Daniel Wagner, managing director of Country Risk Solutions, the political risk and advisory service provider, says that short-term trade transactions may or may not be expensive, based on a wide range of factors, such as the sensitive nature of the goods, prior experience trading in the country, and whether sanctions are about to be imposed on the country or not. “It is all very transaction specific,” he says.

Wagner argues that investors have relied too much on written information and on big institutions that “don’t get their hands in the daily grind which is involved in uncovering intelligence. They make phone calls; they aren’t on the ground themselves. They don’t have their fingers on the pulse.”

In his view, investors need to have a more active orientation toward risk. “It is a little too late to do anything about it after the horse has left the barn,” he says. “Investors need to anticipate as well as react.”

Malmgren also worries that a whole generation of investment professionals today have not experienced inflation during their careers. As a result, the investment industry is not equipped to understand the impact of global political instability.

For example, emerging markets are suffering from inflation that is higher than official figures. “In China, inflation is closer to 10 percent [than official figures of 5 percent], and in India and Bangladesh, the cost of a chili has gone up 300 percent. That’s why workers in emerging markets are fermenting. It is about unfairness in their society.”

Investors who think this has nothing to do with them should think again. Oil prices are going up, and manufacturing facilities are moving back to the United States, rather than being outsourced to cheaper markets. Fifteen of the largest companies in the United States have been buying all their supplies three months in advance to protect against future cost rises, says Malmgren, and Cadbury–Kraft recently announced that it was going to take two squares off one of its chocolate bars rather than raise prices, a sure indication, argues Malmgren, of the rising cost of cocoa, sugar, and milk.

Politics will affect how the problem of government debt in the eurozone and the United States is resolved and whether defaults will occur because politicians will come under pressure from the public. “This is definitely not just an emerging markets issue,” says Malmgren. “It is the explanation as to why Obama might not get elected again and why we have a hung parliament in the United Kingdom. The pressure of [government] debt burdens on households in the West is giving rise to third parties in politics as people look for alternative solutions,” she argues.

### **PUBLIC POLICY**

Investment consultants Towers Watson agree that political risk cannot be considered only from the point of view of emerging markets. In the firm’s March 2010 report “Public Policy: Where to From Here?” author Tim Hodgson argues that political ideology makes a big difference to the future. The current and projected size of fiscal deficits is unsustainable, as is the likely trajectory of public debt-to-GDP ratios, for example. Researchers at the Bank for International Settlements have projected future public debt burdens more than 30 years in order to de-emphasize fiscal policy and highlight the maturing of unfunded liabilities. According to the Towers Watson analysis, assuming

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ANDREW DRAKE, CFA

no adjustments are made to promised benefits, the public debt-to-GDP ratio for the United Kingdom would exceed 500 percent by 2040. For the United States, it would be around 450 percent. “The interest burden of this debt would exceed 25 percent and 20 percent of GDP for the two countries, respectively, or about 100 percent of the revenue you would expect to raise through taxation,” writes Hodgson in the report.

To work out what the future might hold, the consultancy advises that investors should understand which policies are plausible, take a view on

how likely different options are, and think about how the other parties will react and adapt to policy changes. Hodgson’s report continues, “The size and trajectory of both fiscal and public debt cause us to believe that public policy choices are now, and will remain, for the foreseeable future, extremely important. Governments have the power to hinder or nurture economic growth, to liberate or constrain private sector activity, as well as apportion pain unequally through the system.”

Agreeing with this assessment, Richard Phillipson, director of institutional consulting in the Dubai office of advisory company Investit, points out that politics is part of the risk premium of markets. “Political risk is not just an issue for emerging markets; think Australian commodities or U.K. oil and taxation or the acceptable profitability of essentially monopoly utilities. Firms in developed markets are governed by regulation. Regulation is arrived at by a political process. Banks can be everybody’s darling, making the loans that make people feel rich and then paying their taxes ... and then not. At another level, money can lose value from politically expedient inflation.”

### **FORECASTING POLITICAL RISK**

So where does that leave investment professionals who want to understand the impact of geopolitics on portfolios? For Hodgson, the answer is simple. “We can’t do anything about them, but we do need to know what our response will be if events happen.”

Andrew Drake, CFA, managing director at investment advisers P-Solve in London, argues that no scenario, no matter how extreme, should be disregarded when forecasting. “Loss of capital tends to come either from huge market shocks or economic regime change,” he says. “Trying to factor in the political influence on this is an interesting one. There are some political scenarios that have occurred that we would never have dreamed up

12 months ago. So, while we look at what the likely scenarios will be, we also look at the most extreme scenarios, which we don't expect to happen. In those extreme scenarios, how can we make sure we are protected so we don't lose all our chips?"

Towers Watson points out that most risks will be hard to hedge. For example, hedging the breakup of the euro may involve the use of credit default swaps contracts, which introduce different risks. Adding food and water exposure to a portfolio may hedge climate change but might "run the risk of confiscation in precisely the circumstances in which they become most valuable."

For his part, Phillipson suggests a checklist, much like the ones used by pilots and health care professionals. "Pilots go through their checklists, whether they have flown the flight right before or not," he says. "The reason you have checklists is that everyone considers things more if they have happened recently. Drivers who have just seen a speeding motorist booked do slow down. If you have a checklist, then when the saliency of an issue declines, you don't forget that you still have to check it off your list."

Towers Watson gives each risk a probability, ranging from "low" to "very low" and "very, very low." Each risk also has an impact category: "high" implies a significant impact on most asset and liability values; "medium," a material impact on some values; and "low," an impact on a few values where the significance could vary.

Others believe nothing is completely unexpected. Carolyn Williams, head of thought leadership at the Institute of Risk Management in London, points out that a tsunami hitting Japan was not a completely unexpected event. "It is about looking at your dependencies around the world," she says. "Look at where you are exposed. The cause of the disruption, whether it is political changes or natural disasters or terrorist attacks, is not as important."

Similarly, investors in the Karachi Stock Exchange (KSE) should have been aware that there was a likelihood that Osama bin Laden would be found in Pakistan at some point, say analysts there. Pakistani stocks declined on the day bin Laden was killed over worry that international aid could be delayed.

Malmgren says a plethora of information is available to help investment professionals understand big-picture risk. But sometimes information isn't enough to make a difference. McLean, for example, suggests that people should react faster after big events. "So, in Egypt, even when there was information, there was an unwillingness

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to see complete change." He would like to see larger, bulge-bracket brokers expand on their analysis. "If they did more scenario analysis and tried to put us alongside some of the emerging markets' political risk, integrating it more into their day-to-day research, that would be helpful," he says. "There is also probably a role for having more output and more written in terms of political risks."

#### GETTING THE MESSAGE

The problem is not a lack of informed political analysts. Whether provided by

advisory firms, retired diplomats, or international organizations, research is out there. Investment professionals could be working harder to integrate these issues into their analysis, according to Daniel Wagner, managing director of Country Risk Solutions, the U.S.-based political risk and insurance advisory firm. "When you talk about hedge funds, private equity firms, and asset managers, then you are talking about smart people," he says. "They think that they know everything. The challenge, for them and for people outside, is to encourage them to think that maybe they don't know everything. They have sophisticated tools for risk. The question is: Is there a value-add to be had from speaking to someone on the outside? Someone who doesn't have skin in the game?"

In his view, a lot of portfolio managers get caught in a trap of overconfidence and rely too heavily on the tools that they use. "Who knows what opportunity costs there are in not having considered an alternative approach?" he says. "In general, portfolio managers are very comfortable with numbers. I'm not sure they are as comfortable with *qualitative* risk management. My view is that utilizing the best mechanism of qualitative and quantitative methods will have the best result."

He may be right, but political risk is still a long way away from being a mainstream concern. Malmgren suggests that in Asia, where some countries are buying their way out of political upheaval through wage hikes, political pressure may be mounting now. Vietnam could be the next Tunisia, she suggests, and though China may be able to resist pressures, "the Chinese are extremely worried about inflation because in their history, it has always been a catalyst for political unrest." And if China faces serious political instability in the future, political risk will climb up the priority ladder in a hurry. **■**

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