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Building Capacity for Geopolitical Risk Analysis

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Political events continue to make news and influence markets across the globe. Every day there are numerous news stories about political decisions that have a significant impact on asset prices and business performance. Understanding geopolitical risk can help Sovereign Wealth Funds (SWFs) and other institutional investors avoid costly investment mistakes and allow them to take advantage of opportunities that they might not otherwise recognize. This paper will lay out some of the major issues related to developing geopolitical risk analysis capabilities.

While there are clear benefits from using geopolitical analysts to inform investment decisions, many financial firms and institutional investors do not use them. According to a survey in 2011 that asked financial firms from around the world how they dealt with various types of risks, the most common methods to deal with geopolitical risk were: diversify investments across more countries (59%), increase research before new investment (47%), avoid investments in certain countries (45%), decrease the size

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of investments in risky countries (39%), and diversify investments over more industries (27%). The increased use of political risk analysts came in sixth place with 26%.ⁱ Diversifying investments can be a sound method to deal with political risk but it is important that institutional investors understand the political risk correlations between countries when making investment decisions. Similarly, avoiding investments in certain countries can leave money on the table and may be unnecessary (or even counterproductive) if other investments in the firm's portfolio are not strongly correlated to the geopolitical risks in a country of concern.

The fact that geopolitical analysts are not used by more institutional investors is likely due to several factors. First, geopolitical risk is complex and the causal relationships are difficult to determine. The number of factors that affect political decisions is often quite large and it can be difficult to understand the interaction of the many variables that influence a political outcome. This complexity likely leads senior managers to rely on other techniques they understand better (such as diversification, purchasing political risk insurance, or adding a risk premium to the required rate of return) instead of using geopolitical analysis. Most geopolitical assessment methods are subjective and qualitative not quantitative, while many financial professions are more comfortable with quantitative analysis and complex models than qualitative assessments. Furthermore, many political risk analysts do not have business backgrounds and it is hard for them to put their analysis into language that managers and traders can use to develop trading strategies. Another factor that likely limits the use of political risk analysis by financial firms and investment funds is the fact that there are no standard methodologies or well established industry best practices for assessing the many diverse types of geopolitical risk. This means that institutional investors need to spend time and energy vetting potential geopolitical risk consultants before hiring them.

Benefits of Geopolitical Risk Analysis

SWFs and other institutional investors spend a lot of time on economic research and financial analysis but they often slight systematic approaches to geopolitical risks. There are a number of important benefits for senior managers that use geopolitical risk analysis to inform their investment strategies. As Dr. Ashby Monk noted recently in his *Avenue of Giants* blog, there are several ways in which geopolitical analysts could help senior managers. By including political risk in the risk budgeting process, investors can better understand downside risks and be able to better diversify their investments.ⁱⁱ Geopolitical analysts can also support scenario planning to highlight how political crises could affect certain asset prices.ⁱⁱⁱ Political risk analysis can help with asset selection (determine the ‘safest’ access point to get exposure to a region or asset) and performance attribution (how much of the overall performance is coming from the geopolitical risks being incurred by portfolio managers).^{iv} To expand on these points, one of the main benefits of political risk analysis is to highlight issues and possible events that have not been taken into account through other risk assessment mechanisms. The other important benefit from good political risk analysis is the proper pricing of risk. With a better understanding of the investment environment and the actual risk of each asset, senior managers will have a more accurate understanding of how much risk is in their portfolio and where the geopolitical risks are located. As a result, they will be able to adjust their investments to match the fund or institution’s risk tolerance.

Geopolitical Risk and the Risk Analysis Process

In order to develop an effective geopolitical risk analysis capability, it is important to understand what geopolitical risk is and the elements of geopolitical risk analysis. Geopolitical risk is any event that can directly or indirectly alter the value of an economic asset.^v This definition is quite broad but it is important for investors to understand all the ways that political risks can affect an investment and not just focus on those events that make the news. Political risk includes everything from government

actions (expropriations and breaches of contract, discriminatory taxation) to geopolitical events (international wars, terrorism) and social-economic changes that can lead to social unrest.^{vi} Geopolitical risks range from the apparent but ignored or overlooked (such as announcements about regulatory changes), to the hidden but discoverable (supply chain and sourcing issues for multinational corporations), to the truly unexpected (extremely unlikely events and black swans).

The geopolitical risk analysis process is similar to other risk assessment and mitigation processes that financial firms and institutional investors use. Geopolitical risk analysis consists of four parts – identification of the geopolitical risks that could affect the investments, forecasts or the assessment of likely outcomes (and parameters for losses), recommendations for mitigation of downside risks (and the development of strategies to benefit from geopolitical opportunities), and monitoring the situation to identify changes in the geopolitical environment.

The first step in geopolitical risk analysis is identifying potential geopolitical risks. This is commonly done through risk mapping which identifies different types of geopolitical risks that could affect an investment and the impact that this risk could have on the performance of the asset. A rough estimate of the likelihood or probability of the event occurring is sometimes included on a risk map but that factor should really be included in the second step of the process.

Geopolitical risks can be broken down by different level. These generally include:

- Global-level geopolitical risks are those that would have a global impact and affect countries in different regions. International terrorism events or acts such as hypothetically an Israeli attack on Iran's nuclear facilities would be considered global-level political risks because they could have a major impact on asset prices and economic growth around the world.

- Country-level risks are those that affect all of the businesses in a particular country. These risks are important for major direct investments in particular countries and portfolio investments in companies that have major exposure to specific countries. This level of risk focuses on government stability and likely policy decisions, as well as socio-cultural factors, that could influence economic growth and political stability in the future.
- Firm or operational-level geopolitical risks are those that only affect a specific industry or firm within a country. This level of risk is normally harder to identify and requires a more thorough understanding of national, state and local politics. Argentina's decision to renationalize the oil industry is an example of firm-level geopolitical risk.

The second step in geopolitical risk analysis is analyzing the identified risks and forecasting outcomes. The type of investment (direct or portfolio), investment duration, availability of information and level of uncertainty will influence the method of analysis that will be most appropriate for the specific geopolitical risk. Naturally, geopolitical risks with a limited set of outcomes and a short duration are the easiest to forecast while those with higher levels of uncertainty and longer timeframes are more difficult to predict. The most common frameworks for geopolitical analysis risk include:

- Scenario development which can identify a set of expected outcomes and leading indicators that can point toward how an issue will be resolved;
- Country Stability Analysis (also called Country Risk Reports) which quantify social and political factors to determine a country risk rating;
- Expert analysis based on history and theory.

Additionally, some geopolitical risk consulting firms have contacts with government officials or former officials that can provide insights into government decision-making. These firms may be able to provide some useful information but SWFs and institutional investors should be wary of claims that they will be

able to provide timely 'insider' information. Other methods of analysis that can be useful in geopolitical analysis include the use of game theory and aggregating forecasts from a variety of sources. Geopolitical consultants should understand the various methodologies that can be used to assess political risk and be able to apply the most appropriate methodology to the risk being assessed. For example, there is a lot of history and well established political science theory that support our understanding of revolutions and rebellions. Assessing the turmoil in North Africa from a political science and historical perspective may lead to better insights and forecasts than those derived from a complex scenario. Similarly, game theory analysis may produce better insights and forecasts than foreign policy expert analysis when assessing possible Israeli actions to stop Iran's nuclear program.

The third step in geopolitical risk analysis is identifying ways to mitigate geopolitical risks and take advantage of politically driven opportunities. A good geopolitical risk consultant will have a solid understanding of finance and economics and be able to develop appropriate mitigation strategies with an institutional investor's senior manager and his investment team. Risk mitigation strategies will depend on the level of geopolitical risk that is acceptable for individual investments and how those risks are correlated with other geopolitical risks across the SWF or institutional investor's entire portfolio.

The most common methods for managing and mitigating geopolitical risks include:

- Diversifying investments across more countries;
- Diversifying investments in more industries or asset classes;
- Increasing hurdle rate for certain projects;
- Developing warning system(s) that will identify when to increase or decrease investments in certain markets;
- Increasing agility to make tactical investments in reaction to changes in the political environment;

- Developing alliances which can spreading risk among partners ;
- Shaping the environment through corporate diplomacy activities;
- Purchasing political risk insurance ;
- Hedging currencies and commodities;
- Using derivatives and other financial instruments as hedging vehicles.

The final step in geopolitical analysis is monitoring the identified geopolitical risks and the factors that could change the analysis and forecasts. Political situations will continually evolve (sometimes dramatically in as little as a few hours) and new information could change the expected outcomes. Continuous, systematic data gathering and application of geopolitical risk assessment methodologies is necessary to limit the likelihood that senior managers will be surprised by unanticipated events which could adversely impact their investments.

Developing Geopolitical Risk Capabilities

Most institutional investors that invest globally should have a geopolitical risk analysis capability that identifies geopolitical risks, assesses those risks, develops strategies to mitigate the risk or take advantage of opportunities, and monitors the international environment for possible changes that could affect the risks. This capability can be in-house staff or provided by external consultants. The size and composition of the geopolitical risk analysis unit will depend on the size of the investments, investment strategy of the institution, geographic location of investments, and management structure. Regardless of how this capability is developed, it is extremely important that the geopolitical risk analysis be incorporated into the institutional investor's regular risk and investment decision-making processes. This will help ensure that the wide variety of geopolitical risks are highlighted and taken into account when investment decisions are made. In addition, there should also be a regular review process in place to assess the geopolitical risk analysts' performance.

Institutional investors should understand that there is large number of firms and individuals offering services related geopolitical risk; the quality of these analyses will vary widely. As institutional investors seek to develop structured programs of geopolitical risk analysis and expand and strengthen capabilities in this critical risk function, a key consideration will be: the use of external expertise vs the build-out of in-house capacity. In both cases the focus must be on understanding the firm's risk profile and the specific role of geopolitical risk analysis in that process and to effectively isolate and communicate these risks to senior management.

ⁱ Gordon Bodnar, John Graham, Campbell Harvey, Richard Marston, "Managing Risk Management," 55, available at <http://ssrn.com/abstract=1787144>

ⁱⁱ Ashby Monk, "Now Hiring: Geopolitical Analysts," *Avenue of Giants blog, Institutional Investor*, May 8, 2012, accessed May 10, 2012.

ⁱⁱⁱ *Ibid.*

^{iv} *Ibid.*

^v Ian Bremmer and Preston Keat, *The Fat Tail: The Power of Political Knowledge for Strategic Investing* (New York: Oxford University Press, 2009), 9.

^{vi} *Ibid.*, 10.