Eventually

Economist Insights

Geopolitical events such as the UK referendum on EU membership are troublesome for investors. What is the best way to react? Be brave by taking a position beforehand? Be nimble by reacting to market movements after? Or stay calm and just ride the volatility? So much depends on whether investors feel they have any insights, but even more depends on the incentives facing the investment decision-maker.

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Geopolitical events have always been a challenge for investors, but on occasion many events can overlap or occur close together. This Thursday there is the UK referendum on EU membership, on Sunday there are the Spanish elections, and, not to forget, the upcoming spectre of the US election.

How can an investor deal with these sorts of geopolitical events? They do not fit nicely on any kind of normal statistical distribution of the kind most people learn about and use. The very bifurcated impacts of some events make the usual approaches to valuing asset prices more troublesome. Consider the potential impact of the UK referendum on the British pound. The market expects the currency to rally on a vote to remain in the EU and to sell off sharply on a vote to leave. Taking the probability-weighted average of the two would give you a number somewhere around the middle - but this middle value is exactly the value that we know is most unlikely.

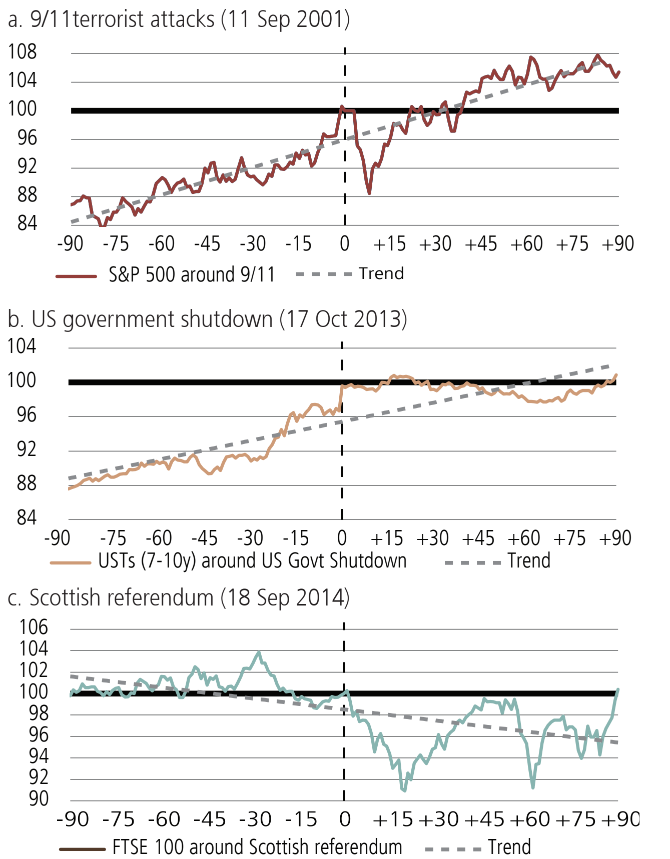
Most investors have already made the single most important decision on how to handle geopolitical events: their asset allocation decision. Is your portfolio heavily weighted towards developed market government bonds? One can surmise that you have decided to take a cautious approach to geopolitical risk. Are you holding a substantial amount of equities or emerging market debt? Then you are placing a bet that the geopolitical risks will not significantly disrupt your portfolio or investment strategy. Since investors rarely shift their investment preferences radically, most will find that their exposure to geopolitical risk is baked in.

But when you consider the complexity in making a choice, you might decide that you are not too bothered: it is all too difficult and there is nothing to be done. This may sound like a cop out, but it is actually a perfectly valid approach. When you start making decisions where you have no insight to give you an edge, you are no longer investing: you are gambling. Sometimes doing nothing is not a bad decision.

Look back at a few geopolitical events. Some of these could be seen in advance (the Scottish referendum in 2014), some as they evolved (the US government shutdown in 2013), and some could not be foreseen at all (9/11 terrorist attack).

Chart: Zen and the art of portfolio maintenance

Total return index of selected assets around selected geopolitical events, days before and after event (t0=100)



Source: Thomson Reuters DataStream, Bank of American Merrill Lynch, UBS Asset Management

If you take a long enough time horizon, asset prices eventually get back to their previous trend (chart). And this need not necessarily be a very long time, it could be a matter of months.

So there is something to be said for this passive approach, which is very similar to the idea of value investing. But it takes patience, nerves and a willingness to suffer mark-to-market losses. The drawdowns on some of the events in Chart 1 were up to 12% relative to trend before they recovered.

What if you think you do have a special insight about the likely outcome? Maybe you trust your judgment and analysis more than the market, or you have uncovered additional information the market does not have (for example, there are reports of hedge funds conducting private polling on the UK referendum). How do you actually take an active position?

With bifurcated events like the UK referendum on EU membership, you still face the binary payoff outcomes. You can go fully long or fully short an asset, but in some cases taking this kind of position has negative carry. For example, perhaps your view is that the US election will be bad for Treasuries. You could sell your Treasuries and buy gold, but gold has no yield so your view costs you money to express.

The obvious way for investors to deal with geopolitical risks is through derivatives. Derivatives can protect from tail risks without such a high cost. The problem is that many investors are more scared of derivatives than they are of geopolitical events. This comes from a legacy of some investors using derivatives to add, rather than reduce, risk. Many such trades did not work out well (especially during the financial crisis).

How do investors go about finding the right derivatives? First, they need to quantify the risks (to decide how much protection to buy). Second, they need to identify the asset classes most likely to be hit. Third, remember that when a crisis hits, traditional asset class correlations can go into reverse. Fourth, be careful who you buy your derivatives from: buying protection against Greek sovereign default from a Greek bank is putting all your eggs in the same basket.

For those who do not want to buy derivatives, or who do not have a strong enough view to want to place a bet, there is one more approach. A striking lesson from the charts above is that the market tends to overshoot. As everyone rushes for the exit to dump their risky assets (or rushes for the entrance to buy safe assets), there is a sudden imbalance between demand and supply and the low liquidity makes prices swing wildly. If you are brave enough to take the other side of the trade, you should be able to benefit from the subsequent rebalancing.

This sounds like a nice easy win, but it is notoriously difficult to pick the bottom. And sometimes the price does not revert, either because the effect is permanent or because something else happens. Take for example the value of the Russian RUB, where the currency weakened following the crisis in the Ukraine, but never recovered because the currency was subsequently hit by the drop in oil prices. Then there are also the crises that we have never experienced and therefore have no frame of reference. What about a major cyberattack on the banking system; how would we know when the market reaction is right?

The other challenge is the reputational risk for investors. Suppose you manage a pension fund, and you were considering whether to hold on to or sell your Italian government bonds during the sovereign crisis. If you held on to them, you would have made about 50% return over the next 5 years. And maybe you expected that. If you are right, you will gain some credit. But if you are wrong, all your trustees will say that "it was obvious" and you will be fired with your reputation in ruins. The downside outweighs the upside, so you are better off selling. As Keynes said: "worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally".

When considering how to invest around geopolitical events, the active approach is being fearful when everyone else is being brave (taking out insurance). The reactive approach is being brave when everyone else is fearful. While the passive approach is being calm when everyone else is brave, and calm when everyone else is fearful.

None of these approaches are easy to explain to others. The passive approach looks like you are doing nothing. The active approach looks like you are giving up performance. And the reactive approach looks like you are crazy for going against the crowd. There are no easy wins.