contango ASSET MANAGEMENT LIMITED

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HOW TO MANAGE POLITICAL RISK

Over the past few weeks, investors have been inundated by news of political risk. What is it? And how should investors manage it?

With potential political change on the horizon in Australia, the US, and the UK, it's a crucial time to consider the implications.

Political risk is the risk that an investment could suffer as a result of political change or instability. Instability can stem from changes in government, changes in legislation or from more extreme events such as a coup d'état.

Previously, political risk only mattered to investors in emerging markets. The main risk was usually forced nationalisation of assets, like gold mines in Africa, Oil assets in Venezuela, copper mines in Bougainville or corruption in approval processes.

A current example is in Brazil where President Rousseff has been accused of corruption, impeached by the senate, and must now stand aside while the trial takes place.

But what's new is that political risk is no longer confined to emerging markets. Rather, it has spread to developed markets and the core of the global financial system.

In the US, the global bond manager PIMCO recently listed a Trump presidency as a 'significant risk' and the Economist Intelligence Unit ranked it in its top 10 list of global risks, sandwiched between 'Grexit' and the rising threat of terrorism.

In Europe, the risk of 'Brexit', the UK voting to leave the European Union, has caused the sterling to drop over 8% from its 2015 highs. In addition, Europe is facing increasing political pressure to deal with the unprecedented wave of migration from the Middle East and Africa.

But a risk that hasn't caught the attention of the media to the same extent, but is critically important, is the potential for political instability in China.

The outlook for China is under pressure as the economy rebalances and de-levers. Previously, policymakers appeared to accept the fact that growth would slow as an inevitable consequence of the reform process. As the saying goes, short term pain for long term gain.

But beginning in early 2016, Chinese policymakers began to waver and we saw a confused and inconsistent approach to managing the economy. Whether this is a result of factional infighting or a deliberate decision, any policy uncertainty from the world's second largest economy is cause for concern.

How should investors manage political risk?

The easiest way to avoid political risk is, if possible, to sidestep it in the first place. This means allocating only a small portion of a portfolio to emerging markets or key problem countries.

But if the risk is more broadly spread, which I argue it now is, investors need to maintain a more defensive portfolio with a focus on income and not capital gains.

This means a higher allocation to cash and a more diversified equity portfolio with a focus on lower risk and high yielding stocks.

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