

Value investing in a politically charged environment

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Alan Thompson, CFA, provides some insight on how to assess political risk, and incorporate this into a value based approach to investing.

The post-Thatcher political consensus in the UK has broken down, and political risks are growing. Under the distant days of Tony Blair, political consensus supported EU membership, and both major parties appeared to reach an uneasy compromise, accepting Bank of England independence on monetary policy and a market-based economy.

The government's role was confined to regulation and protecting vulnerable members of society. Fast forward to 2016, and the situation has changed markedly, with the UK set to leave the EU and the appointment of Jeremy Corbyn as leader of the Labour party, a former left-wing backbencher who voted 428 times against the Labour governments of 1997 to 2010. Back too is the old politics of populism, with the Conservative party introducing foreign worker lists and the Labour party promising nationalisation and the ever popular printing of money.

GLOBAL UNCERTAINTY

Political uncertainty has also increased globally with the star of *The Apprentice*, Donald Trump, becoming President-elect. The Trump win has installed the first President with no elected-office experience since Herbert Hoover in 1928, highlighting the breakdown of trust between the governed and the political elite in the United States. Turning to Europe, politicians and the public alike appear increasingly fractured and unable to resolve migration from Syria, Muslim extremism, or to stand together in the face of a resurgent Russia. The bare-chested Bear is again strutting around Eastern Europe and the Middle East, sabre rattling with military exercises in Kaliningrad and cancelling weapons deals on the decommissioning of weapons grade plutonium with the US.

The ratcheting up of political uncertainty is undoubtedly concerning, and the world sadly appears more unstable than it did 20 years ago. But political risk is nothing new. The Julio-Claudian dynasty debased the Roman currency as far back as 27 BC, for example.

Indeed just taking the 20th century as an example, the UK went through two World Wars, marches by Moseley's Black shirts, the 1926 general strike, the Suez Crisis, two oil price shocks and the Cuban Missile Crisis with the real risk that the Cold War could have turned "hot". On this basis, the present level of political risks appears significantly lower than many of the challenges that our parents and grandparents endured. But taking the current situation and projecting that forward is

Executive summary

- Recognising shortcomings and limitations of economic and political forecasts is a challenge for all analysts, as nothing can be gained through overconfidence except the prospect of financial losses.
- Free riding or acquiring information from the behaviour of others can lead to information cascades, where individuals observe the actions of others and blindly follow despite being in possession of evidence to the contrary.
- The political risk from pension reform or higher inflation is far too high, and is not compensated by a suitable margin of safety.

fraught with difficulties. Would political scientists in the 1950s have forecast the collapse of Communism and reunification of Europe? Or would they have anticipated the continued spread of the Communist ideology, given the post-war electoral success of socialist governments in Western Europe, and the perceived technological superiority of Sputnik and the Soviet Missile programme? Recognising shortcomings and limitations of economic and political forecasts is a challenge for all analysts, as nothing can be gained through overconfidence except the prospect of financial losses.

THE POLITICAL RESEARCH CONUNDRUM

Eugene Fama's efficient-market hypothesis (1965) argues that assessing political risk will not lead to superior returns for investors. Instead competition amongst traders will on average ensure that information is reflected in market prices, and although markets are not infallible, profit opportunities will be rare and fleeting. But if investors en masse adopt a free riding/a lazy man's approach and shun research, it leads to a paradox of how a market can be efficient when it is suboptimum for any individual to engage in research (Grossman and Stiglitz, 1980). Free riding or acquiring information from the behaviour of others can also lead to information cascades,

whereby individuals observe the actions of others and blindly follow despite being in possession of evidence to the contrary (Bikhchandani, Hirshleifer, and Welch, 1992).

The formation of asset price bubbles directs investment into projects which are inefficient for society, and can prove costly for investors in the inevitable market correction. More positively, the formation of financial bubbles allows investors that conduct their own research and have the courage of their conviction and the possibility of outperforming in the longer term.

Frameworks for determining fundamental value require an explicit forecast of the political and economic environment. This central forecast has an almost zero percent probability of occurring, but is necessary as a building block for the determination of fundamental value. Feeding a forecast of the political and economic environment allows teams to compare investments across asset classes on a like-for-like basis. Having screened for assets which have a higher intrinsic value than the prevailing market price, an assessment of the accompanying uncertainty must be conducted which includes company fundamentals along with political and economic risks.

Political risk in democratic countries is assessed on the basis of the institutions and mechanisms of government. An individual politician can certainly behave rashly or without conducting sufficient research, but there are sufficient checks and balances, either explicitly or implicitly, in most democratic countries that there is only a limited discretion for any person. In the UK, the executive branch of government is held to account by: the House of Commons, House of Lords, an independent judiciary and an independent Bank of England, which along with Sir Humphrey's civil service (the fictional character from the television show, *Yes Prime Minister*), and the underlying economic drivers constrain any hot headedness, while also allowing reform. These checks and balances are arguably why markets had little reaction to the surprise Trump victory, as reforms have increasingly required 60 votes in the Senate to prevent filibusters, and hence the 54 Republicans will have to co-operate across party lines.

The situation is, of course, markedly different in non-democratic countries, without the constraints of power, and often missing the channels for dissenters to voice legitimate grievances. There, the investor needs a far higher expected return. History has shown that investing in dictatorships or countries with state-controlled capitalism has a higher level of uncertainty, with risks of expropriation, economic mismanagement, war, revolution or simply the ending of the rule of law. Russia and Zimbabwe are clear cases, whereas more pertinently the lack of political reform in China is a smouldering risk, and Turkey appears to be on the road to authoritarianism with the dismantling of pluralist institutions. But political risk also encompasses government regulations, which proliferate in every sector of the modern economy and generally dominate geopolitical risks at least in the developed world.

INVESTMENTS

Applying this investment process requires that investors are willing to “walk away” and seek out new opportunities when current prospects have insufficient margins of safety. But fund managers have only marginal amounts of discretion because of rigid fund mandates, short-term benchmarking, and the attractiveness of fee income to fund management businesses. For example, consider the investors who purchased the 50-year gilt on 30th August 2016, which yielded just 1.1%. It's difficult to believe that this is little more than a false market created by political risk/pension regulation, and value-based investors would do best to avoid it. Demand is determined by pension legislation and the Bank of England's quantitative easing programme, while supply is controlled by the Debt Management Office, an agency of the UK Treasury, which has combined to create an almost “herd like” run into long-dated gilts by defined benefit pension funds. The problem is that this is a suboptimum outcome for everyone, with companies facing ever larger pension contributions, and current employees are being forced onto money purchase schemes. Members of defined benefit schemes are arguably better off with a cash equivalent sum. The only party to gain from the current setup is the government, which is enjoying artificially lower borrowing rates and is reducing the power of markets to monitor fiscal discipline. Growing pension deficits across the corporate sector increases the likelihood of pension reform, and value investors should shun this market. The political risk from pension reform or higher inflation is far too high, and is not compensated by a suitable margin of safety.

Benjamin Graham applied a 'margin of safety' to his approach. Purchasing assets when their intrinsic value is substantially higher than their price limits the downside risk to investors of any purchase, and acknowledges the lack of perfect foresight with regard to both company fundamentals along with economic and political forecasts. ■

Biography



Alan Thompson, CFA, holds a masters degree from the University of Dundee and won the Alfred Marshall prize in Applied Economics, prior to joining the Bank of England. He has worked in both the Bank of England's markets, and monetary analysis departments, and was sponsored to complete a masters degree at the University College London. In 2006, Alan joined Scottish Widows Investment Partnership, holding posts in real estate, and international bonds, prior to becoming the international economist in the Global Strategy team. In 2015, he was appointed lecturer in economics and finance at Dundee Business School.