Frontier Advisors

How global political dynamics and economic shifts are impacting investment decisions

Investors face a challenge understanding the impact geopolitical upheaval and the macroeconomic environment will have on their portfolios, but good governance and investment frameworks can help manage the downside risk.

They are issues that are becoming increasingly common with the best funds able to take major events, such as the GFC, pandemic, and Russia's invasion of Ukraine, in their stride.

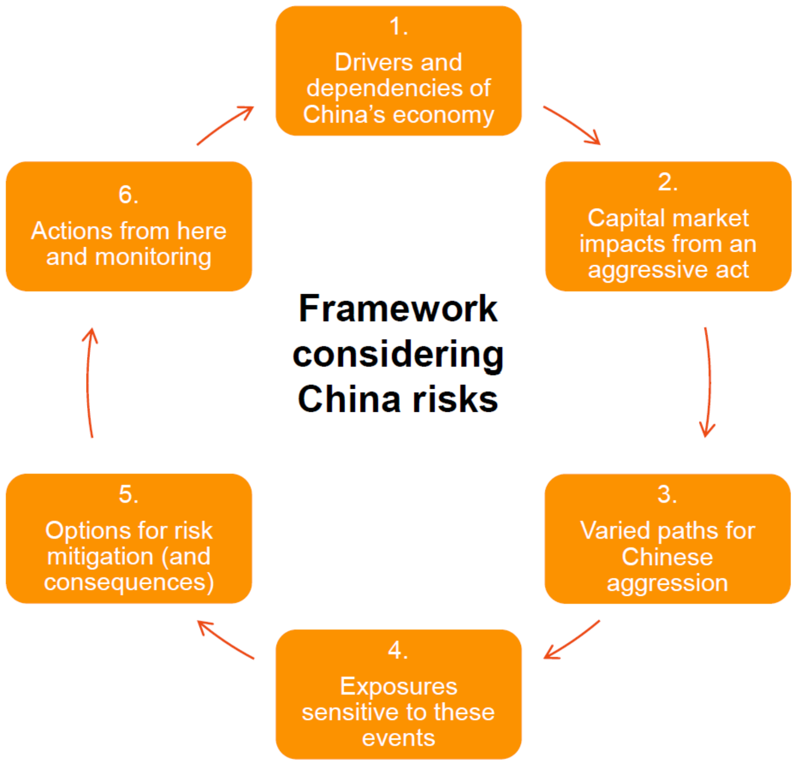
"They knew where the risks were and what they could do about it," Paul Newfield, Director of Research and Specialist Services, Frontier Advisors, said. "They knew what risks they couldn't act on after the event had occurred and they also knew where they could potentially pursue opportunities."

Setting up a sensible investment framework to consider these political and macro risks – which then feeds into the investment strategy – is crucial before geopolitical events occur.

Sonya Sawtell-Rickson, CIO, HESTA, said the unified policy reaction to the Russian-Ukraine event prompted the fund to review its exposure to China, which is facing issues such as poor demographics, a property crisis, and deteriorating global relationships.

"What we basically did was take all of that work, develop stress tests on the back of it, and that led us to also put in place new constraints. So**,** less exposure – definitely less liquid exposures – and changing our forward return expectations and earnings expectations in our capital market assumptions. You want to make sure you're looping it all together in a way that's cohesive."

Sensible frameworks and work before potential events are necessary



Andrew Fisher, Head of Investment Strategy, Australian Retirement Trust, said the Russia-Ukraine invasion occurred on the same weekend the Fund merged (from Sunsuper and QSuper) while Brisbane, where the fund is based, was beset by floods.

“We had a really unique conversation on that Monday and that actually led us to divest from Russia before we were told to divest. I think to the question about governance, sometimes it's better to be lucky than good… but it's amazing how often you seem to be lucky if you have really good governance.

“The question we asked ourselves was, ‘If that's the decision right now, would you go and buy Russian stock right now at the depressed valuations?’ If the answer is ‘no’, why are we still holding it.”

He said making decisions quickly was important given markets now moved far more quickly than they did during the GFC.

Sawtell-Rickson said scenario analysis capturing all possibilities was difficult, with HESTA using it more as an overlay.

“Our process tends to be more grounded in quantitative metrics and process. We think that gives us a really great discipline.”

Fisher said geopolitics was not a competitive advantage for the $280 billion fund.

“We have some competitive advantages, but being smarter than the market on every geopolitical outcome is not really one of them. Being large is a competitive advantage. We see ourselves providing liquidity to markets.”

As well as geopolitical events and risks, Frontier has also identified climate change and its systemic impact on economy and investments, as well as a higher interest rate regime, as three key areas driving portfolios over the medium to longer term and where funds should build resilience.

Fisher said a climate stress test looks similar to a geopolitical stress test, but “nobody retaliates against a storm”.

“So, unless a genuine hot conflict between the US and China erupts here, I would say in most cases, geopolitical noise we're likely to essentially treat as a natural disaster-type scenario that is likely to bounce back.”

Newfield said nimbleness was of extreme importance and risk was not symmetric.

“If you've got an incumbent holding that is already in your portfolio that could have a deleterious impact on your members, downside risk is really when good governance and nimbleness matters. And it matters a lot.”

Fisher said commodities weren’t a particularly logical long-term strategic investment given rising productivity should make them easier to extract from the ground, but geopolitical risk and de-globalisation could change that. Fisher went on to say:

“Commodities are actually quite a reasonable hedge for all that geopolitical risk because if we are moving into a world where we are perhaps not going to see the productivity dividend that was had for the last 25-plus years, and some of that gets challenged, commodities are a fairly natural hedge against it.”

Frontier has a central pathway for future returns which looks reasonable. However, it does recommend considering resiliency (which is managing the size of downside risks) and it expects some options for rebalancing portfolios. It also recommends investors:

- Review their portfolios from the ground up and select areas of geopolitical concern (and do the deep dive work).
- Consider different economic regimes, as well as asset classes/investments which protect against downside scenarios and higher inflation.
- Monitor geopolitical risks (which Frontier does in its market review work).

More information can be found in Frontier’s Look Forward for clients. If you want a more detailed discussion, contact Paul Newfield, Director of Research and Specialist Services, Frontier Advisors, at pnewfield@frontieradvisors.com.au.