Incorporating geopolitical risk analysis into your portfolio management process

There is no shortage of attention to geopolitical risk in financial market analysis. In 2018, higher trade tariffs and rising political uncertainty weighed heavily on investor sentiment. Geopolitical risk monitoring tools have emerged as key components of many research offerings.

Investor attention to geopolitical risk appears to be increasing. However, historical examination of investment concerns suggests that geopolitical risk has always been important. The question for investors is not whether geopolitical risk is a force for market change, but whether that force is relevant to their portfolios.

The question for investors is not whether geopolitical risk is a force for market change, but whether that force is relevant to their portfolios.

In some cases, the answer is an unambiguous yes. Agile portfolios with appropriate risk tolerance can take advantage of shifts—temporary or structural—brought on by geopolitical risk. For these portfolios, monitoring dislocations is an achievable and meaningful driver of alpha creation, where focused geopolitical risk analysis can reduce the impact and severity of adverse events and enhance the potential for upside growth.

For other investors, however, day-to-day conversations about geopolitical risk can be a drain on time and resources, with no realizable benefit to their investment process or return generation.

Geopolitical risk analysis plays a significant role in our asset allocation decisions, so we explored the different ways geopolitical developments can be leveraged. A series of interviews across asset managers, multinational corporations, and treasury departments revealed that best practices are based on transparent and consistent processes rather than highly technical methods.
Geopolitical Risk Analysis

Set goals
- Understand your objectives
- Recognize your exposure
- Assess the cost-benefit trade-offs
- Consider your quantitative focus

Build and resource a process
- Set clear expectations
- Establish buy-in
- Assign accountability
- Be honest about resourcing
- Engage clients

Integrate the components of a successful geopolitical risk management process
- Prioritize key risks
  - Consider the risk parameters
  - Assign priorities to risks
- Construct scenarios
  - Develop scenarios
  - Disrupt rote thinking
  - Get more mileage out of your scenarios
- Pressure test assumptions
  - Note your assumptions
  - Cultivate a diverse set of perspectives
  - Beware the armchair executive
- Track risks according to signposts
  - Focus on policy, not politics
  - Keep an eye on early warning signs
  - Don’t let market attention influence your risk prioritization
  - Monitor and react to key risks

Mitigate risks and capitalize on opportunities
- Protect on the downside
  - In a portfolio
  - In an organization
- Capture upside
  - In a portfolio
  - In an organization
Set goals

The first question for portfolio managers considering geopolitical risk analysis is: “Does geopolitical risk matter to my portfolio management team?” The question appears simplistic at first since extreme geopolitical risk could have an impact on any portfolio, no matter the investment process deployed. However, this question isn’t about the possibility of impact, it’s about whether any amount of focus on geopolitical risk is worth your team’s time. With geopolitical risk a focal point of news headlines, it’s no surprise that conversations about geopolitical risk are taking place every day—in meetings about asset allocation processes and in business lunches. Awareness of key geopolitical developments has become a prerequisite for informed decision-making.

But the omnipresence of geopolitical conversations does not necessarily make geopolitical analysis an organizational priority. Investment teams can spend substantial time and effort understanding geopolitical risk and its impact on financial markets, without a clear understanding of the impact on their portfolios or methods by which they can mitigate that risk.

Understand your objectives. Consider where the usefulness of geopolitical risk analysis begins and ends. Will efforts be rewarded with meaningful improvement in results?

For many funds, particularly those with a top-down management approach, assessing and monitoring geopolitical risk will have a meaningful impact on performance. This impact can be felt directly via security prices or indirectly via market sentiment or sector impacts.

Others may adjust their focus on geopolitical risk based on factors incidental to the portfolio management process. Perhaps they are striving to build brand image by producing thought leadership pieces on key risks. Maybe their sales and networking strategy depends on conferences that require them to be up-to-date on key risk factors as conversation starters. Managing internal executive requests and responding to company inquiries are also common activities requiring some level of geopolitical risk literacy.

The omnipresence of geopolitical conversations does not necessarily make geopolitical analysis an organizational priority.

Why consider geopolitical risk analysis?

Monitor impact on portfolio performance. Improve non-portfolio processes, such as brand building, networking, and insights generation.

Each of these objectives is legitimate, but merits varying levels of effort from an investment team, depending on its core competencies, investment process, and resources. Recognizing and clarifying your goals can help a team assign the appropriate resources to meet them. For instance, leverage synergies among team members to help assign responsibilities, and ignore issues that may be interesting, but which do not meet goals.

Recognize your exposure. Thoroughly assess your portfolio’s vulnerability to geopolitical risk. Exposure is not always as straightforward as searching for a country name in a portfolio. For example, U.S. companies listed on U.S. indices may have substantial international sales exposure and are therefore impacted by currency volatility. Decomposing country returns in real estate or other alternative portfolios can be even more opaque.
Investment teams do not need to be overly meticulous in this exercise. Even high-level inputs can help in assessing the cost-benefit trade-off of geopolitical risk management activities. For example, teams may find that country exposures are too interconnected, and that assessing geopolitical impacts on the portfolio is best done at the sector level. By contrast, the team could find that top-down risk assessment is necessary, but at a global rather than country-level of analysis.

Assess the cost-benefit trade-offs. Consider the benefit of geopolitical risk analysis relative to other organizational and team workflow. Geopolitical risk analysis can quickly become an extensive undertaking, so it’s important to know up front how much of the team’s total time is worth allocating to the effort. Good process can minimize scope creep, but it can’t do everything. Understanding how much effort to allocate to a project will enable the team to set realistic goals and a suitable process.

Consider your quantitative focus. The increasingly complex nature of investment management has encouraged the development of more sophisticated risk management techniques. Quantitative tools are essential in some environments, providing analysts with necessary tools for measuring and managing risk.

Geopolitical risk analysis can be—but is not always—served by these tools. Accurate and timely data is not available for many countries. Risks do not always develop as anticipated, making quantitative sign-posting an arduous challenge without adequate payoff. Even the most sophisticated quantitative portfolios use thematic overlays rather than extensive quantitative methods for tracking geopolitical scenarios.

As a team proceeds to build and resource a process for geopolitical risk management, it should consider the balance between quantitative and qualitative methods. Sometimes simple scenarios, enhanced by quantitative measurement and pressure testing, are the most powerful tools for meeting objectives.

Build and resource a process

Once you have decided whether to incorporate geopolitical risk awareness into your portfolio management process, focus on how to do that. The process does not need to be complicated, but it does need to be structured and consistent. Checking a few basic boxes will ensure that no matter what the risk, your team can address it effectively.

Set clear expectations. Tell your team how much you expect geopolitical risk analysis to impact their portfolio management process. For some portfolios, an all-in focus on external threats may be appropriate. For others, this would spread analysts too thin.

Be clear about rules of engagement:

- How often should key risks be discussed—and in what forum?
- How frequently should the team monitor risks or models?
- What inputs and outputs should they maintain?

Transparent expectations help to minimize wasted time and distraction.
Establish buy-in. Both the team and management need to be on board with the objectives and proposed plan. Whether a team is starting from scratch or implementing changes to an existing process, gaining organizational support will improve results.

Every team has a different management structure and means of ensuring engagement. Consider hosting group or individual brainstorming sessions to gather input for process changes, ensuring you get on-the-ground, actionable input. The upfront time investment is likely worthwhile to ensure good-faith buy-in.

Process changes may also require a team to inform or establish buy-in with senior management. This should be incorporated early in the decision-making process, with set check-ins included accordingly.

Assign accountability. Consider how geopolitical risk analysis, monitoring, and management fits into your team’s goals. Clear accountability should be assigned to the analytic process, asset allocation decisions, and execution of decisions.

Responsibility matrices are one simple but comprehensive way to clarify roles and responsibilities. For example, break down a task into who should be responsible, accountable, consulted, or informed about a decision or process. Responsibility implies upkeep and management of required tasks. Accountability requires process management and upkeep; it may be the same person responsible for the task, or a manager overseeing many tasks. Consulted team members are those who should be available for trouble shooting or course correction. Those informed are usually senior management who should know the team’s projects’ basic status on some regular time interval.

For some organizations, team goals focus on portfolio performance, and it can be difficult to gauge how an extra hour of time spent on geopolitical risk analysis pays off. Teams should design their goals and incentives in a way that clarifies those tradeoffs so that team members can make appropriate decisions on a day-to-day basis.

Be honest about resourcing. It is possible, even likely, that your team will require more analytic attention to geopolitical risk than it has capacity or skill to manage. If that’s the case, the team should be open about that mismatch. Differentiate “must-have” inputs from “nice-to-have” analysis, and candidly consider how good the internal analysis is, while seeking to acquire external research inputs to fill gaps where a comparative advantage does not exist.

Engage clients. Determine whether client engagement is required, beneficial, or appropriate. At the end of the day, the purpose of assessing and monitoring geopolitical risk is to improve portfolio performance and the overall client experience. Communicating process changes to investors could be required.

For financial advisors, this step likely fits into your regular investment policy and risk tolerance conversations. How much risk should your client bear? How much are they willing to bear? When clients want to discuss major geopolitical themes, remind them of their overall risk tolerance and how key threats impact portfolio construction.

Is client engagement required, beneficial, or appropriate?

How much risk is your client willing to bear?
Integrate the components of a successful geopolitical risk management process

There is no one-size-fits-all approach to geopolitical risk management. But tactics to work smarter—not harder—can be extremely valuable for keeping an investment team focused.

PRIORITIZE KEY RISKS

Sensational news headlines do not always align with an increase in risk to your portfolios. To avoid spending unnecessary resources, take the time to prioritize any risks upfront and identify what might make those priorities change. Confidence in your process helps investment teams to stick to their plans.

Consider the risk parameters. Begin prioritizing risks by determining the factors against which you will assess them. Best practice suggests using “likelihood” and “impact” to determine priorities—focusing more resources on those risks that are more likely to cause meaningful impact on the portfolio. However, any of the parameters below may help in refining a list of priorities.

Assign priorities to risks. Once you have identified your risk assessment parameters, evaluate each risk systematically against the parameters to generate a ranking of key risks, according to their importance to the portfolio. This is unlikely to be entirely straightforward. Some risks might impact an organization financially through asset class impacts. Others could affect an organization through effects to the investment team, processes, or systems. Some risks are impossible to plan for; others are difficult to consider because their externalities are ambiguous.

Given the complex nature of risks, categories of prioritization can be helpful. Classifying risks as small, large, structural, or irrelevant can help to determine what kinds of resources should be dedicated to managing those risks, and over what timeline.

Risk parameters

✓ Likelihood. How likely is this risk to occur? Interval likelihoods can be used (percentages) or simple, ordinal likelihoods (low, medium, high) depending on the precision required.

✓ Impact. How much does the risk matter to the portfolio? Is it a persistent tail risk, or a short-term shock? How are markets likely to recover once the event has taken place? This parameter can be considered numerically [a potential risk amount determined by models such as simulations or value at risk (VaR), a statistic that measures and quantifies the level of financial risk within a firm, portfolio, or position over a specific time frame] or ordinarily (low, medium, high). For consistent analysis, the same measurement style should be used across all risks.

✓ Actionability. If the risk does occur, can anything be done about it? If algorithms will be reacting to the risk, can an investor afford not to do anything? If preparation or reaction is outside the team’s control, resources may be better spent making the case for firm-wide focus rather than spending internal resources preparing for that risk. However, if the risk is important, it should be addressed immediately by the team instead of being forgotten.

✓ Speed. Consider how quickly a risk could impact the portfolio. Swift impact may require enhanced, up front analysis to allow for quick reaction. Slower impact may warrant lower prioritization.

✓ Optics. If an organization is brand-conscious or publishes regular research, a lack of conversation around some risks could be perceived as neglect.
CONSTRUCT SCENARIOS

Geopolitical risks seldom develop in linear fashion, making it difficult to monitor and address their progress. However, deploying an approach that includes scenario building and signposting can provide focus and direction. Scenario planning should lead to actions that will mitigate risks or capture opportunities. If no risk is evident, scenarios should at least help clean up the risk management process.

Scenario planning should lead to actions that will mitigate risks or capture opportunities. If no risk is evident, scenarios should at least help clean up the risk management process.

Develop scenarios. Scenario analysis is the process of evaluating portfolio outcomes across potential circumstances or states of the world. Scenarios help teams to understand where they stand vis-à-vis a risk that might cause them to change their behavior. Scenario analysis can strengthen a team’s conviction about its prioritization and calls-to-action, thereby helping it to make good choices at opportune moments.

Qualitative Scenario Development

1. Develop base case scenario for an event
2. Determine highest likelihood outcome for the risk
3. Evaluate if the risk is a persistent tail risk or short-term shock
4. Identify market recoverability options
5. Repeat process using alternate futures for key risks

Quantitative Scenario Development

1. Develop base case scenario for an event
2. Calculate if portfolio is sensitive to one key factor, such as: interest rates, asset price, or exchange rate
3. OR
4. Use circumstances from extreme events to help build quantitative tests for portfolio resilience

Scenarios can take the form of qualitative analysis, quantitative measurement, or both. A simple framework for qualitative scenario building begins with a base case for the event. What is the highest likelihood outcome for the risk? How likely is that outcome in the first place? From there, you can consider upside and downside scenarios. Is it a persistent tail risk or a short-term shock? How are markets likely to recover once the event has taken place? Considering alternate futures for key risks will drive more precise perspective around what constitutes key developments in the most important risks.

Quantitative scenarios can vary widely by sophistication. One form of a simple quantitative scenario is a stylized scenario, in which portfolio sensitivity is measured against one key factor relevant to the portfolio, such as: interest rates, asset price, or exchange rate. Another involves using circumstances from extreme events to help build quantitative tests for portfolio resilience. However, it’s important to have reasonable ambitions. Quantitative scenarios can be complicated due to the secondary and linked impacts of geopolitical risks to securities in the portfolio.

It is useful to note that good scenario building can prompt you to alter your risk prioritization.
Disrupt rote thinking. Without a proper space to be creative, an investment team is likely to end up with a list of scenarios that others are already considering—the “known unknowns.” Good scenarios require pushing the team outside of its comfort zone to determine what its “unknown unknowns” might look like.

For an investment team to be creative, it must establish the appropriate environment for a constructive mindset. There are many ways to do this. For example, “heaven and hell” exercises, in which you consider the best and worst possible conditions for key risks, can help to push a team beyond considering only the more likely circumstances it is accustomed to.

You can go as deep or as shallow in these exercises as the process requires. Even a gentle push towards the less obvious scenarios will improve a team’s results in the following analytic steps.

Get more mileage out of your scenarios. Once key scenarios to monitor have been identified, that work can be leveraged to change an investment team’s mindset around how it monitors risk. So, how does a team incorporate risk scenario development into its everyday thinking? Some organizations take their scenarios very seriously, posting them throughout the office. Others promote focus by requiring team members to tie any geopolitical risk management conversation or article-sharing back to the scenarios themselves. Leveraging day-to-day work in this way creates analytic synergies and helps to improve scenario formation in future rounds.

PRESSURE TEST ASSUMPTIONS

Identifying and pressure testing the assumptions underpinning any analysis performed is one of the most overlooked, but most important steps in the geopolitical risk management process. It requires process, inclusiveness, and outreach—all of which can be time-consuming.

It is also one of the most rewarding parts of any process. From an analytical perspective, this series of steps equips a team to identify its weaknesses and track its progress. It can improve a team’s aptitude for uncovering blind spots. From a portfolio management perspective, it keeps the team from making tactical allocation errors caused by risks that are gaining headline share, but not developing.

Note your assumptions. Geopolitical risk can seem fluid; assumptions and views change in small increments with each research piece and news article being read. For this reason, it is useful to note and track all assumptions at each research meeting. Additionally, documenting and regularly revisiting assumptions can facilitate the signposting process. This step not only allows for a more seamless tracking of the team’s thought process, but also ensures consistency of view across the team.

Cultivate a diverse set of perspectives. Many organizations strive to build diverse teams. But ensuring dialogue and pressure testing assumptions can be more challenging in practice. As a first step, consider the team’s background. What are its analytic strengths? Where might there be gaps in knowledge or experience? Identifying those strengths and weaknesses allows research teams to ask stronger questions through research meetings, ensuring that any missing perspective is captured through outreach or further research.

For example, if your team has access to resources or views from different regions, consider testing the assumptions and prioritizations with them. Geopolitical risks are often international or even global in nature. It’s worth mentioning that the prioritization of these risks may differ by location as well.

Identify where the team may be susceptible to group-think, or reluctant to challenge a key personality. Implementing a round-robin approach in research meetings, or a pre-meeting survey for quieter teams, can aid in extracting views from more introverted team members.

Rely on your network, conferences, or other teams within the organization to get a second pair of eyes on the frameworks.
and prioritization. Not all feedback will be implemented, but it will help to build conviction around the team’s views and process.

**Beware the armchair executive.** One of the most cited drags on fund resources is the over-participation of leadership in geopolitical risk discussions. Busy executives often raise headline risks or ideas to stoke creativity or to ensure comprehensive analysis. But the fire drills that these inputs often cause can derail an otherwise well-structured process. Good executive buy-in throughout the geopolitical risk management process will help to allocate everyone’s time more effectively. Keep leadership abreast of key assumptions, priority risks, and signposts, thus allowing them to channel their impulses and to pressure test team workflow.

**TRACK RISKS ACCORDING TO SIGNPOSTS**

Many organizations prioritize key risks but do not identify ways to determine whether the likelihood of a given risk is increasing or decreasing. This is a mistake. If the risk is important to the organization, then it’s equally important to understand how it is progressing. Is the risk unfolding? What might happen next?

Signposts are a useful exercise in tracking the development of top risks. Good signposts are anchored in the key assumptions made up front around a scenario, and mark whether a scenario is materializing. Consider qualitative (events or statements) as well as quantitative (economic or financial market indicator) signposts and share them across the team. If a signpost is triggered, the team should be held accountable for determining what it means for the portfolio. If signposts are quantified and automated, ensure that the traders are aligned on next steps as well.

**Focus on policy, not politics.** Identifying the right signposts can require some trial and error. A basic rule of thumb for distinguishing signal from noise is the distinction between politics and policy. Political developments can serve as meaningful signposts, as they can indicate a change in the risk’s likelihood or pace. However, analysts are frequently knocked off course by following political developments that do not necessarily indicate a change in real economic or business outcomes.

**Keep an eye on early warning signs.** Some combinations of economic and financial market circumstances serve as strong warnings of potential trouble. For example, high inflation and deteriorating employment can signal political unrest. A pegged currency and rapidly declining export value (particularly for commodities exporters) can prompt a change in exchange rate policy. Often, particularly for emerging markets, these signposts will change before official data is released. If a portfolio relies on country-level economic conditions, data screens should be used to help identify any red flags early.

**Don’t let market attention influence your risk prioritization.** If a high-impact risk fades from market attention, it should still be monitored until deemed to have little to no impact on the portfolio. Markets can be distracted, but opportunities can arise and be taken advantage of by simply remaining watchful.

**Monitor and react to key risks.** Resilience to unexpected change relies on end-to-end processes that allow for rapid course correction. Identifying signposts should equip a team to be able to differentiate signal from noise and react when signposts flash red. For instance, when the market environment moves to either risk-on or risk-off, it’s important to identify what actions should be taken next or communications made.
Mitigate risks and capitalize on opportunities

An efficient, effective geopolitical risk management process helps to illuminate risks and opportunities, despite widespread uncertainty. However, risk identification and tracking can only take you so far. It is up to you to act on the intelligence when the time comes. Risk response can be stress-inducing, limiting creativity at the time when it is needed most.

PROTECT ON THE DOWNSIDE

In a portfolio:

- Develop sensitivity measures to guide buy/sell response when a geopolitical risk takes place. Begin by tracking a system of past events and see what happens when markets react. How long does the risk last? Which asset classes are most impacted?

- Equipped with this knowledge, you can identify which assets should be bought or sold if a risk event occurs. Then, signposts can be used to set buy and sell triggers for those assets. Leveraging a geopolitical risk management process can help improve trading operation discipline.

- When in doubt, diversify. It’s critical to recognize that diversification can dilute the strength of a position, but also protect an investor from adverse, unforeseen shocks. Know when giving up yield is worthwhile.

- As a component of any diversification strategy, you should consider where alternatives can bring alpha, while also providing less correlation to market beta.

- Maintain flexibility in the portfolio by having liquidity on hand and avoiding excessive leverage.

- Add hedges if they are cost-effective. Sometimes credit protection, for example, can be cheap relative to the potential impact of the risk. Options strategies are also useful for risks aligned with specific dates.

- Review currency exposure. Currency volatility is a key transmission mechanism of geopolitical events. It can manifest itself in portfolio volatility or in fluctuating home-currency earnings for multinational corporations.

In an organization:

- Assess the need for business continuity plans. Setting aside any regulatory requirements, consider whether basic processes and systems should be replicated, backed up, or otherwise protected against a major risk. Infrastructure should also be examined—lenders, counterparties, etc.—and key dependencies should be identified as those that can be jeopardized by an extreme event.

- Minimum standards need to be set with the companies and partners the organization works with. Standards for compliance, risk management, records maintenance, and/or communication could be vital in keeping risk management efforts intact.

- Consider your ancillary risks, such as the response to geopolitical risks that can have operational or reputational risk impacts that are just as important as the financial impacts of that risk.

- Buy insurance for extreme risks that could impact systems, relationships, or ability to do business.
CAPTURE UPSIDE

Risk management generally focuses on limiting downside risk, without enough emphasis on the upside opportunity that risks can bring.

In a portfolio:

- Maintain flexibility for buying opportunities. As in a downside scenario, having liquidity on hand allows portfolio managers to buy when external liquidity is low.
- Wait out the retail game. Particularly with the proliferation of technology, retail investors are active in markets and can be fickle investors as sentiment ebbs and flows. Hold steady and keep an eye out for upside opportunities when market dislocations occur.

In an organization:

- The sales team should be equipped with useful talking points related to risk. No matter the impact to the portfolio, consistent, smart analysis about key risks can build trust in the portfolio managers.
- Consider whether there is a marketing or public relations opportunity related to the risk. Do the portfolio managers or analysts have something useful to say in print or the news media? How should it be communicated, and to whom? Consistency is key. Speak to key risks and the process.

Closing thoughts

Effective incorporation of geopolitical risk analysis into any portfolio management process requires strong planning and strong execution. At the end of the day, balancing risk and reward is just as important as balancing effort and reward in a portfolio.

The interconnected nature of global financial markets means that we rely on international risk and return factors, even in local, country-biased portfolios. Developing clear goals for geopolitical risk management and building and resourcing a process to meet those goals is vital for meeting them.

Familiarizing yourself with the processes identified in this paper will help you be better equipped to make informed resourcing decisions and be better prepared to take advantage of geopolitical risk.
This material represents an assessment of the market environment as of a specific date; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any particular issuer/security.

The strategies discussed are strictly for illustrative and educational purposes and are not a recommendation, offer, or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any strategies discussed will be effective.

This material contains general information only and does not consider an individual’s financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial advisor before making an investment decision.

New York Life Investments is a service mark and name under which New York Life Investment Management LLC does business. New York Life Investments, an indirect subsidiary of New York Life Insurance Company, New York, New York 10010, provides investment advisory products and services. NYLIFE Distributors LLC is located at 30 Hudson Street, Jersey City, NJ 07302. NYLIFE Distributors LLC is a Member FINRA/SIPC.