INVESTMENT ANALYSIS

POLITICS AND THE CALCULATED RISK
PUTTING TROUBLE-SPOTS IN THE PORTFOLIO

Recent events in Central Europe, South Africa and the Middle East have brought political-risk analysis (PRA) back into focus as a possible financial tool after languishing in the late 1980s. The discipline reached its heyday following the overthrow of the Shah of Iran in 1979, when oil companies and other multinationals collectively lost billions of investment dollars through failing to read the undercurrent of revolutionary change in that country.

Today, as companies once again prepare to do business with South Africa, or banks try to assess the implications of rapid political change in central Europe, or portfolio managers work out how best to alter asset allocations in light of the Gulf war, the business community must assess more seriously whether PRA is an indispensable investment tool in planning offshore investments, or an academic distraction with little part to play in the real (and very fast-changing) world.

The answer seems to be that it's a bit of both. Sceptics would argue that we have yet to find a political analyst anywhere in the world who predicted the “domino downfall” of communism in Central Europe, or the sudden wave of change in South Africa, making a mockery of political pundits and their investment skills. But that is like saying racing form guides are a waste of time because the occasional rank outsider scrambles home. If appropriate experts are consulted, the same probabilities apply to PRA as to any economic analysis.

The political-risk analyst Jeffrey Simon once noted: “It is tempting to want to believe that someone can tell you with certainty whether or not a specific event will happen, but this is rare indeed in most disciplines, especially the social sciences. Thus, any expectation that the new profession of political risk would be able to ‘predict’ revolutions was quickly dashed.”

In that light, this article looks at the circumstances in which PRA can play a useful role in assessing cost-of-capital/hurdle rate decisions, and the various means available to the manager in measuring that risk.

In the past, many companies have avoided the need for such analysis by investing only in so-called “safe” countries such as the US, Canada, the UK and the larger economies of Western Europe. However, such a strategy is flawed on a number of counts:

- All countries suffer from political risk—it’s just a matter of degree. For example, just as some US companies would have raised their investment hurdle rates on the election of the Whitlam government in 1972 (given the radical and inher-

By JAMES PARKER

Investment managers have good cause to be uneasy about the Middle East. But, with proper risk analysis, some other “unpopular” countries might be worth a closer look.

James Parker ASIA is a senior investment writer with Australian Business magazine and maintains a keen interest in political risk analysis.
ently unpredictable nature of its platform), Australian companies with investments in Britain should already be assessing whether any sort of risk premium is necessary to cover the policy outcomes of a Kinnock Labour victory in elections there due next year.

As the flow of capital becomes more widely spread and returns slow down in the more mature Western economies, companies with high growth aspirations (or fund managers wishing to remain ahead of the pack) will need to look further afield for investment opportunities, particularly (as companies such as BTR Nylex and Pacific Dunlop have found) in the prosperous but politically less stable nations of South-East Asia.

As an example, Indonesian banks are offering more than 23 per cent to prime borrowers. Most Australian financiers with surplus cash would argue that while on the surface the rate seems attractive, investing in Indonesia is “too difficult” or “too dangerous”. But just as managers factor in a foreign-exchange and economic risk when investing overseas, so it should be possible to calculate a premium necessary to take account of political risk as well. Should the three risk premiums, added to our own prime rate and extra transaction costs, still be less than 23 per cent, Indonesia might in fact become a pretty interesting place to place some surplus cash.

Finally, it should be remembered that certain events—such as the Gulf war—can affect all investments everywhere. The author’s experience (as he has written, “serious long-term quantitative analysis of this momentous event has so far largely been given way to subjective speculation based on frenzied interpretation of the most recent development.

To define political risk, it is necessary to distinguish between the terms uncertainty and risk. The former is a subjective term denoting doubt about a political environment and possible outcomes. Political risk involves the calculation of probability using quantitative input, making it, one hopes, a more objective measurement.

But the two are certainly linked. “When the international manager makes a probability judgment of an uncertain political event in a host country, he thereby converts a political uncertainty into a political risk. Hence, by converting uncertainties in the political environment to probability terms, political risk provides a mechanism for the objective evaluation of foreign investment climates.”

The other thing which needs to be pointed out is that different users of PRA will need to use differing models to achieve their analysis objectives. Companies planning to invest directly offshore or banks wanting to lend them money for such ventures need to add a single percentage premium to their required cost-of-capital/hurdle rate, one which encapsulates myriad political-risk variables. Fund managers, on the other hand, would look at various scenarios, the odds of each occurring, and the returns that would accrue from each outcome.

In both cases there exist models of varying complexity and subjectivity designed to achieve these ends, although the author contends that overly complicated or econometric models should be treated with scepticism, given the intrinsically qualitative nature of any data fed into them.

In a declining order of subjectivity, a number of PRA processes are described below:

Grand tours and old hands

The “grand tour” method involves having a senior manager, banker or fund manager visit the country in question and “check out” the political situation. As Rummel and Heenan note, this technique tends to suffer from an overdose of selective information. “Frequently, we have seen cases where company observers are briefed in form but in fact insulated from the political and economic realities of the country visited.”

Another problem is that such missions may well be carried out in tandem with other tasks such as assessing the ease of regulatory approvals, getting a feel for the country’s economic potential at both macro and micro levels, or searching out joint-venture partners. In none of these examples would the businessman be likely to encounter objective advice on foreign investment, and all would rob him of time needed to perform more detailed political analysis.

Although such a process is patiently inadequate when performed in isolation, many share and unit holders around the world would probably be horrified to know how often their funds have been spent on the basis of just such methodology.

In other cases, multinationals might seek expertise from “old hands” such as diplomats, academics, journalists or businesspeople with years of experience in the country or region. This is a more effective technique, but means the company must subjugate its own beliefs for those of contracted outsiders. Its success will depend largely on finding the right people to speak to. And depending on their fields, they may understand only part of the picture.

Comprehensive qualitative assessments

A better solution is to get a number of people both inside and outside the company to perform investment analysis in their area of expertise. Examples might include: market potential; GDP growth, forex stability, inflation and balance of trade, etc.; social conditions; tax laws; sources of political unrest; relations with neighbours and trade blocs.

However, the result, says Simon, can be “a vast amount of information for the corporate decision makers to digest, with no structure or consistency to the reports. Very little attempt is made to integrate the different functional reports, with the result being an overflow of information.” Another problem, particu-
Figure 1: Some Possible Middle East Scenarios

US Victory
C%

War
A%

Inconclusive
D%

Iraq victory
E%

Sanctions maintained
but gradually weaken.

Gradual weakening
of sanctions. Oil
price initially
high but
higher oil
production
maintained by OPEC
so that stock
piles overflow and
price declines. Oil
price stabilises around
$20-$25.

World growth
and inflation
OK.

World growth
and inflation
OK.

Iraq gets
support
F%

Sanctions
maintained
but gradually weaken.

Hostility and uncertainty
increase embroiling
other Gulf states. Possible
war on Israel. Oil
supplies curtailed and
price maintained above
$40.

1.5% fall in world
economic growth. 3% in
crease in inflation. Poor
investment returns.

1.5% fall in world
economic growth. 3% in
crease in inflation. Poor
investment returns.

Iraq muddles on
G%

Iraq negotiates
withdrawal from Kuwait
H%

Emir of Kuwait returns. Hussein probably deposed. But instability in ME remains with hostility to the US. Uncertainty and hostility lead to Saudi Arabia acceding to demands to lift in OPRC price from $21 to, say, $25.

Iraq's price for withdrawal includes OPEC commitment to higher oil price. Hussein wanted $25 at July OPEC meeting.

Key:
A+B=100
C+D+E=100
F+G+H=100

I=AxC, J=AxD, K=AxE
L=BxF, M=BxG, N=BxH

P=K+L
Q=J+M
R=I+N

Source: Rothschild Australia
Bayesian decision analysis and Delphi techniques

Both of these techniques lead to the formation of “decision trees” based on the probability of certain events occurring, and the subsequent probabilities of their outcomes.

For example, looking at the Soviet Union, we might argue that within the next 12 months we could see either (a) a change of government or (b) Gorbachev remaining in control. Once the probabilities of these two outcomes have been devised, we could then ask: if (a) is true, what are the probable scenarios arising out of it? This might lead us to: (a1) a popular uprising; (a2) a military coup; or (a3) the union breaking up as its various republics attempt secession, each with its own probability.

Assuming Gorbachev were to remain in control, possible options might then be: (b1) that “perestroika” is more aggressively followed; (b2) that communist hardliners entrench their positions, further slowing reform; or (b3) that the system muddles along in its current state of confusion.

The tree can extend as far as the expertise of its creators will allow, with each branch ultimately leading to one of a number of final conclusions, each with its own probability.

An excellent example (Figure 1), designed last August by fund manager Rothschild Australia, shows how to derive various investment alternatives flowing from the Gulf crisis. For the fund manager this is probably the best means of using PRA, as it allows investment returns to be directly compared with their underlying probability or risk. The question, of course, is who provides the input, and it is here that Bayesian analysis parts ways with the more recent Delphi technique.

Under the former, according to one definition, an individual’s “prior hunches, convictions, or information about the ‘state of nature’ (that is, significant events and circumstance) ought to be incorporated into his decision-making process in some systematic way.” The disadvantages of this are obvious, given that very few investors would possess in-depth knowledge of a foreign country’s affairs and characters, particularly at the “second tier”. And because probabilities are multiplied together each time a new branch is added (so that the sum continues to equal 100 per cent), any errors will be magnified as the number of outcomes grows.

The Delphi technique, first formulated in the 1950s, gains its outcomes and probabilities from polling a sufficient number of acknowledged experts and pooling their responses to a set series of questions. The method differs from standard polling procedures in that respondents are then shown the pooled answers to determine whether they agree with the “consensus” view or want to change their answers. The chief advantage is a much more finely tuned analysis; the more obvious disadvantages are that the process is cumbersome and (more important) slow. Diligent but hard-pressed fund managers will probably use a hybrid solution, polling a number of interested and easily accessible parties, and using pooled feedback.

Country risk/econometric models

The use of quantitative models to ascribe essentially qualitative political risk tendencies may seem paradoxical. Nonetheless, the practice has a firm following. Such models are especially useful for banks and export credit insurers who can analyse data such as GDP growth, inflation and debt-service ratios to come up with a political risk “score” for one country compared with another. Such scores can also be used to determine what political risk premium investors should add to their hurdle rates.

A number of organisations can provide corporates with both qualitative and quantitative data on political risk—Britain’s Business International (a subsidiary of the Economist) and the US’s Frost & Sullivan are two of the best-known specialists, each producing periodic forecasts over one and five years reports on almost every country in the world. Euromoney magazine also provides an annual “league table” of political risk.

The danger in relying too heavily on such reports is that the rapid pace of change in many countries (and also the increasing interdependence between nations) can quickly date the studies and render them at best incomplete or, at worst, highly inaccurate. The answer seems to lie in a combined approach, taking advantage of two or more methodologies in order to get as close as possible to the true picture. How deeply the manager wants to get into the analysis will then become a cost/benefit decision based on the amount of funds to be allocated to any particular country, and the relative risk perceived there.

NOTES


(3) ibid.