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Factoring geopolitical risk into equity portfolios

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Experience is the panacea of equity investing as one learns so much through different investment cycles, and yet very few, if any, of these experienced investment professionals had managed money during a significant broad-based war. We now face managing money during two major localised wars, with the possibility of further escalation. Studying history and learning from it, as I have done, will certainly be beneficial in this new chapter we are going through. Investing is a multi-faceted discipline, and investors will need various tools in their armour over the next couple of years to navigate what is likely to be a challenging market environment.

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Some of the more traditional ways of understanding markets are well understood by us and our competitors, such as:

- Cycles do not persist; they evolve or mean-revert.
- Economic growth has its ebbs and flows.
- Competitive advantages are difficult to maintain in the long term.
- Culture is a key competitive advantage but needs to be maintained/evolved.
- Companies will pivot to growth opportunities naturally or regress.
- Industry structure and competitive intensity need to be well understood.
- Cash flow matters, persistence is important.
- Country dynamics are key, as are policy frameworks and the government's ability to enact economic growth.
- Debt needs to be carefully managed; balance sheets are not important until they are.
- Management is important, as is company structure and decision-making.
- Boards matter – the more diverse and skilled they are, the better, as external perspectives are critical.
- Capital allocation is key, with a preference for companies that can grow internally.

What is now required is an additional layer of skill to navigate the investment environment

Several issues are surfacing for which investment managers may be unprepared. An example is the rapid rise in interest rates globally. Most market participants expect interest pressures to subside over time as inflationary pressures ease. But what if they don't? There are several reasons to suggest that interest rates could be structurally higher for longer. The US bond market is certainly suggesting that. In my early days of investing, I was told the US$ 30-year yield on the bond market was the most important economic indicator to look at when investing. I have over time come to the same conclusion. So, if this important indicator is screaming 'Watch out!', should we ignore it? Other commentators argue that until recently, the US$ 30-year was around 3% for an extended period so why should it not revert? I am not saying there won't be a retracement when the US economy eventually goes into a recession. However, there are several factors that we need to consider when looking at the long-term inflation outlook:

- The globalisation theme has broken down. Capacity is being built closer to home – near-shoring or friend-shoring is taking place – which is at a structurally higher cost in many instances.
- Government debt levels across the world have been rising for a considerable time. Government is crowding out the private sector and indirectly increasing business costs. This will be inflationary in the long term.
- There has been a structural under-investment in commodity supply, accentuated by the role-players being hesitant to invest due to prior cycles where excess capacity was built. Higher prices on a sustainable basis are required to justify new capacity.
- The environmental agenda has necessitated new sources of supply at structurally higher cost as they are less efficient than traditional sources, particularly in the area of energy. As these new sources rise as a proportion of the mix, this will likely increase inflation.
- Conflict is rising globally in a general sense within country politics, across borders, between generations, etc. This tends to give rise to inflationary pressure over time.
- Regulatory influence is increasing, partly due to the rise of government in the global economy, which tends to increase the cost of doing business over time. Protectionism is also increasing as various countries look to protect local industry, often resulting in higher prices.

- China exported low inflation to the world over the past 30 years. By making their products available at a much lower cost than local producers this artificially depressed local inflation over a considerable period. It also closed a lot of manufacturing capacity outside of China. This is unsustainable in the long term. The world is slowly moving away from China as the pre-eminent supplier to the world. Inflation will follow.
- Higher funding costs once it develops some stickiness tend to moderate capital investment as new capacity requires a higher return. Weak competitors exit the market. Stronger players exhibit their pricing power by passing on inflationary increases, which become a virtuous circle until innovation arrives. This tends to result in inflation trending up over time.
- Inflation can be contained through innovation/efficiency gains. Unfortunately, the rate of innovation globally has been receding for some time. So, again, this is another catalyst that is not available to slow inflation – not to say indefinitely, but currently, this is the case.
- Artificially low-interest rates globally created an environment where capital was essentially 'free or very low relative to the natural rate of interest rates'. This created an environment to invest, creating inefficient capacity that is too costly to maintain/service at higher interest rates and will need to be retired. New, more efficient plant/equipment will be at a much higher cost from a capital and a maintenance perspective.
- Wars are inflationary. They tend to empower governments to spend. Defence budgets have been declining across significant economies as a percentage of GDP for an extended period as the world adjusted to peace and prosperity. Defence budgets will probably rise above in-country inflation, given rising conflicts globally.
- Initially, wars can potentially be deflationary if demand weakens dramatically, but then inflation resurfaces as replacement capacity is built. It's unclear where we are heading in this regard, although there are signs that the recent conflicts have resulted in structurally higher costs for Europe in the energy market. Risks are also evident in food production that must be carefully managed.
- The US dollar, as the reserve currency, has dictated liquidity flows. For a long time, the dollar has been strengthening against various currencies. Should economic growth weaken in the US, it will likely weaken the dollar, creating some inflationary pressure for US consumers.
- In developed markets, mainly, unemployment levels are low. A weaker outlook will create some slack in the system, although higher wages are likely even in a weaker economy. Staff need higher salaries as an incentive to work, where generational wealth has enabled early retirement and created bottlenecks in skilled areas.
- Government incentives globally, supporting part-time workers/the unemployed in mainly developed markets, have raised the barrier for the need to work. This requires businesses to incentivise through higher entry-level wages. This higher cost will need to be passed on to the market, creating inflationary pressures.

In this context, what should we make of the current geopolitical landscape and the implications for equities? Also, if inflation is to be structurally higher over time, what are the implications for SA equities? What knowledge would the doyens of Liberty benefit from if they managed money through a war?

Rule no 1: don't lose capital. Capital can dissipate over time, gradually or quickly; both are a disaster. Diversified portfolios generally are more protected from stock-specific risk. In terms of geopolitics, I think the following is relevant:

- Think carefully about where your country sources food/energy/water from. If supply is disrupted, how easy is it to replace from a supply perspective? Are you sure? How internally self-sufficient are you as a country, not being dependent on external support?
- Where you operate from is essential. How advantaged is your country from a geographic positioning perspective? The more isolated and dependent on external supply you are as a country, the more vulnerable you may be in the long term. This is one consideration, although geographic positioning and a country's natural boundaries are also issues to consider.
- To whom is your country aligned? How strong is that bond? How dependable are they likely to be as a partner? What vulnerabilities do they have?
- How efficient is your government? We are experiencing an environment currently where government policy is being managed by party politics globally. Often, if there is no clear political majority, policy becomes less effective, while in more autocratic-led countries, ideology can shape the political agenda. Countries can be moving directionally towards more conflicted politics or more autocracy. Understanding politics helps ascertain how government as a role-player in the economy can shape economic policy in the future.
- Geopolitics is also shaping capital flows. The US has the deepest pool of capital for many reasons, but one of the most significant benefits the US has is controlling large capital through the dominance of the dollar as the world's reserve currency. Understanding demand for the dollar will provide insight into future liquidity in an environment where access to capital is getting more difficult. Understanding the construct of country-specific funding will be essential for all investors in the future.
- What do you as a country offer others? What is the source of your economy, how open is it, is it subsidised? How dependent are others on you as a supplier/manufacturer/producer/resource partner?
- How vulnerable are you in terms of military attack? How extensive is your military, and how geographically vulnerable are you in terms of antagonistic neighbours? How dependent are others on your capabilities?
- What is your nuclear capability? How advanced and broad-based is the military component of your country's nuclear arsenal? Protagonists will think twice before going to war with a country with significant nuclear capabilities, especially if their capabilities are not a threat or not developed sufficiently.

Having reflected on traditional cyclical factors, while also considering that the inflationary environment may be more challenging, and then having reflected on some geopolitical factors, let us now consider what we didn't learn through the past major investment cycles when it comes to learning from history with regard to wars. They say history is never the same concerning wars but that there are some similarities. Here are some considerations:

- Wars tend to constrain economic growth and divert capital away from traditional areas, particularly consumption.
- Wars can often be associated with some form of financial repression. Given the current state of the world, this is probably already taking place but could accelerate as inflation erodes purchasing power in a period of lower economic growth.
- Geographic winners/losers tend to be more accentuated in periods of war in a relative sense, although all lose out ultimately.
- Savings are depleted as capital is diverted.
- There is a significant erosion of a country's capital stock as productive capital is compromised and new capital is diverted towards uneconomic/military/government agendas.
- Cross-country support is hugely important. Wars are costly and require aligned partners who can provide capital and other requirements during periods when the warmongers are struggling economically.
- Wars are fought for different reasons and arise based on various other factors, although ideological wars are the worst, as pragmatism disappears.
- Demand for commodities rises, although less for demand-led infrastructure commodities and more for industrial/military-use commodities. Commodities exposed to consumption tend to suffer. A nuanced approach is required in selection.
- Debt levels in government typically rise. Debt levels are already elevated, and further pressure on the fiscus will constrain growth and challenge investors.
- Wars tend to have a dramatic impact on currencies. Currencies can weaken gradually or quickly, with a profound impact on domestic-orientated investors. Capital restrictions typically follow. Safe-haven assets like US treasuries and gold usually perform better.

Considering all these factors, how do we best safeguard equity portfolios from geopolitical risks, considering the current environment?

- Diversify your investments, consider where the investments are based, with country-specific risk considered.
- Growth stocks tend to be more prone to earnings disappointments over time. Be wary of shares with high growth embedded in their valuations, especially technology shares.
- In a low-growth environment, a higher proportion of future returns may come from dividends. Higher dividend-paying shares are worth considering, although investors should ensure that the dividends will likely grow with inflation over time.
- Debt levels, as are funding costs are significantly elevated and rising. Be cautious of leveraged companies or those with unfunded liabilities. Credit-related companies like banks may be more vulnerable in an environment of deteriorating credit and weaker economic growth.

- Multinational companies will offer less country-specific risk and probably have access to more long-term capital. Preference should be given to companies whose products are more essential in an environment of potentially weaker consumption.
- If inflation is likely to remain higher for longer, with economic growth more challenged than what we have been used to, investors need to consider exposure to companies that lead in their sector, have a strong culture, and can out-compete weaker competitors. Judging that and what you pay for the companies that meet these criteria is difficult and probably the domain of professional investors.
- Consider companies in jurisdictions that are likely to benefit from a more conflicted world. New alliances are forming and are likely to benefit those companies operating in these advantaged countries. Mexico, for example, is currently benefiting from increased near-shoring by US companies, with government support.
- Asset allocation in this new world will be increasingly important to protect capital. Interest rates have increased significantly but may be higher in the future. A significant allocation to short-term interest-bearing investments is warranted even if tax and inflation erode their real returns. The relative attraction and certainty of fixed-interest products are likely to be at the detriment of allocation towards equities, which will create a great long-term entry point in equities at some point.
- Some allocation to gold – the physical product in some investment structure – is probably warranted. Gold shares should also be considered notwithstanding current elevated prices.
- Timing when to 'pick the bottom' from an entry point when investing in equities is a mug's game. Investors need to be long-term orientated and recognise that in the gloom, there are often the best entry points for investing. Investing with this framing bias helps avoid exiting at the bottom and buying at the top.

In summary, we are likely to go through a difficult patch now, with the US likely to enter a recession in 2024 and extended conflict weighing on returns in the short term, but we also recognise that this often presents itself as a great entry point for investors with a long-term orientation. Geopolitical risks will probably be somewhat elevated for some time and should be factored into investors' framework. Much of what I have learnt through various cycles remains relevant, although the tool kit needs to be expanded!

Glacier Research would like to thank Andrew Kingston for his contribution to this week's *Funds on Friday.*

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Andrew Kingston is a well-seasoned investment professional, with an extensive track record of 30 years in the industry. In October 2019 he was promoted to the role of co-head of Equities for Sanlam Investment Management (SIM), the active management business within Sanlam Investments. Currently he is Head of Equities of Sanlam Investments (SI). Andrew is also a key member of the core equity team at Sanlam Investments (SI).

Andrew joined Sanlam Investments in 1999 as an equity analyst and was promoted to Head of Equity Research in 2016, with his extensive research expertise primarily focused on industrials. Andrew also has a broad base of valuable portfolio management experience, having been portfolio manager for the SIM Industrial unit trust fund for the past 11 years. The track record of the fund resulted in a large, segregated fund being awarded to SIM in 2009, which has a long-term track record of outperformance. Under his vigilance, the Sanlam Industrial unit trust has also garnered several Raging Bull awards over the time the fund has been managed. In December 2015, this fund was recognised as the top performing domestic unit trust across all categories over a 10-year period.

Prior to joining Sanlam Investments, he worked at Liberty Asset Management from 1996 to 1998, as an investment analyst focusing on research.

Andrew is a qualified CFA, a CA(SA) and has a BCom G.Dip Acc from UCT where he was ranked within the top 10 in his class. He completed his articles at Ernst and Young.