The Risks Ahead, Including Geopolitics

Why is Risk a Challenge and an Opportunity?

Investors are always walking the tight rope of risk. But aiming for accurate predictions around risk is a fool’s game. So rather than predict, we prepare. The perception of risk can greatly impact market sentiment, often creating opportunities, too. We seek to understand both sides of the coin.

Key Takeaways

- Investor sentiment appears skittish as we enter 2024, with the convergence of headline risks.
- A short-list of current risks includes two wars, a potential recession, the upcoming U.K. and U.S. elections, political infighting, increasing signs of defaults (from a very low base) and the continued threat of inflation; to name a few.
- Risks are ever-present and come in different forms, but they are all important. The way we respond differs. We should also acknowledge the risks that aren’t yet known.
- The three techniques we can use to fight risks are: a) true diversification, with offsetting positions, b) thoughtful sizing of opportunities arising from external shocks, and c) ongoing analysis on what is priced in.
- Lean into the noise, reframing risk as opportunity. If we see cheaper prices in the market, it can create potential buying opportunities. In today’s market, that means taking advantage of higher government bond yields, banks, and sensible emerging market exposure.
- Conversely, some of the worst investing environments come off the back of no perceived risk.
- Remember, markets experience ups and downs - the recent volatility is considered normal in a historical context.

Turning Ideas into Actions for 2024

The Key is a Robust Portfolio

We like longer-term bonds more than we have in a decade, but we are prepared for surprises, which is why short-duration bonds still factor into our portfolio construction.

Focus on Sizing

Increasing return prospects within fixed income make it a more compelling opportunity but select equity market opportunities still offer more attractive returns.

Risk Creates Opportunity

Some of our favourite opportunities — banks, emerging markets — carry high headline risks. We size these exposures carefully and assess offsets — healthcare, utilities — to create robustness.

Today's Risks Feel Elevated, So What Really Matters?

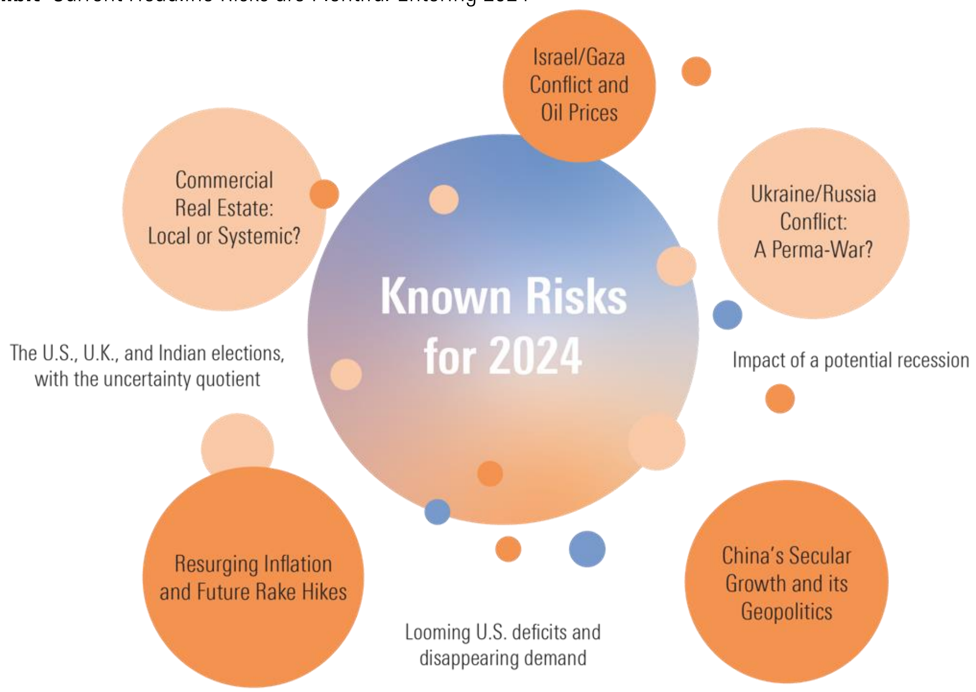
The current market conditions highlight several significant challenges for investors. The key at this juncture is accepting the reality of market risks while not becoming unnerved by them. It's easy to lose one's bearings amidst the continuous stream of market news and speculation, dubbed as "black swan hunting". As investors, it is critical to discern this noise from facts, focusing on long-term investment strategies rather than panic-induced decisions sparked by temporary market fluctuations. If anything, lean into the volatility and reframe nervousness as excitement for opportunities.

As we stand on the precipice of 2024, it is crucial for us as investors to harness the power of behavioural science in maneuvering through the risks that lie in the landscape of economy and geopolitics. As a starting point, let's collectively agree that uncertainty is always present, with at times terrifying headlines dominating our collective consciousness. Nevertheless, equities, which make up the lion's share of most investors' portfolios, have managed to return 7.4% per year after inflation over the trailing 100 years (S&P 500 total real return, annualised), allowing investors to compound returns despite two world wars, the cold war, a global pandemic, and a range of local economic crises. That shift in perspective, from the narrow "what just happened" to the broader "how do market cycles evolve" is key in helping imperfect decision makers choose wisely in the face of irreducible uncertainty.

The Market Hates Uncertainty and Negative Surprises

The resilience of the broader markets may be cold comfort as we look at the litany of *known* risks facing us at the start of 2024, particularly for those with shorter investment time horizons. The sampling below are top of mind for us.

Exhibit Current Headline Risks are Plentiful Entering 2024



Source: Morningstar Investment Management. Risks assessed as of 15 November 2023. For illustrative purposes only.

This collection of concerns is daunting, but it's worth remembering that not every risk requires a whole new portfolio to survive its realisation. A well calibrated portfolio—a collection of global equities, fixed income across a range of maturities, and, at least for our part, carefully selected hedged strategies designed to limit overall interest rate risk—should weather external shocks fairly well.

In other words, we can build robust portfolios that can hold up to a variety of different eventualities; we don't have to have a crystal ball to know what is going to happen next. Rather we can build portfolios that find and protect value over a wide range of "what if's". In fact, to the extent an external shock causes sudden negative sentiment, we likely would consider the price dislocation an opportunity. That was the case during COVID, for example. Recall that in March 2020, global equities crashed in unison, while liquidity concerns froze bond markets, including the U.S. Treasury market, which is known as a global safe haven.

As the pandemic developed and lockdowns ensued, we had no greater foresight than anyone else on the range of potential outcomes. What we did know was that asset prices were getting crushed far beyond our estimates of normalised fair value. As a result, our portfolio managers around the globe added risk—equities (for example, energy stocks), high-yield bonds, emerging-markets bonds, and more—as quickly as we could. The rest is history. After a 22% correction between February 20, 2020 and April 7, 2020, global equity markets rallied tremendously. Despite the massive loss, the Morningstar Global Markets Index managed a 16% return for 2020 in its entirety.

Using Techniques to Manage Portfolio Risks

Of course, not every external shock follows the COVID path. Some really do impair cash flows, meaning that the fair value of the asset permanently deteriorates. A recent, extreme example? Russian equities in the wake of the Ukraine Invasion.

In other instances, a portfolio may not be as well calibrated as the investor thinks. Perhaps that's because a position wasn't sized correctly given all its risks, or the underlying fundamentals of an offsetting position wasn't fully understood.

Of course, none of that matters if it's possible to predict with certainty both the risk and the ensuing market impact. However, we argue that's near to impossible. Think about the most momentous events in recent market history. COVID and lockdowns. Global inflation. Aggressive central bank policy. Few of these developments were_predicted accurately ahead of time, and if a particular investor was able to call one risk, he or she was unable to predict the rest.

With an appreciation for uncertainty firmly in mind, we believe the best approach to managing external shocks—geopolitical or otherwise—is ongoing fundamental asset class analysis and careful portfolio construction. So, with these two tools firmly in hand, we'll walk through the 2024 risks we've identified. Rather than guessing at probabilities certain to be wrong, we will articulate the expected impact of these risks, any opportunities that could emerge, and potential offsets we believe could mitigate possible damage.

Exhibit Our Approach to Handling New Risks as We Enter 2024

Risk	Impact	Nature of Risk	Potential Opportunity	Offsetting Positions
Commercial Real Estate Crash	Regional bank write-downs	Cash Flow Impairment: Banks	Oversold regional banks	
Expanding Middle Eastern Conflict	Energy market disruption	Oil price shocks, which, in turn, could increase recession risk for vulnerable economies		Cheaply priced energy assets like U.S. MLPs and European energy
Prolonged Ukraine/Russia Conflict	Energy/food market disruption, European economic pressure	Food or oil price shocks, which, in turn, could increase recession risk for vulnerable economies		Cheaply priced energy assets like U.S. MLPs and European energy
China's Secular Growth Crash	Stagnating or collapsing Chinese economy	Cash Flow Impairment: Chinese Equities, Heightened recession risk for trade partners	Oversold Chinese Technology Equities	
China/U.S. Conflict	Rapid reshoring, global economic uncertainty	Global equity volatility		Long-term, high-quality government bonds
Resurging Inflation	Higher interest rates, falling corporate earnings, heightened recession risk	Equity and fixed income volatility		Short-term, high-quality government bonds & hedged alternatives
Developed Market Sovereign Deficits	Increased term premium (investors demanding higher long-term yields)	Cash flow impairment: Longer-term yields reset higher, price loss		Cash, hedged alternatives
U.K. and U.S. Contested Election	Political uncertainty	Short-term equity volatility		Long-term, high-quality government bonds

Source: Morningstar Investment Management. Risks assessed as of 15 November 2023. For illustrative purposes only.

A review of this list shows two consistent themes. First, we believe most of these risks result in volatility, but don't necessarily change future return expectations, which means that in many instances, price dislocation that results from these events could be a broad-based buying opportunity.

Second, we tend to look to high-quality government bonds to hedge geopolitical risk. Why? It's a relative safety proposition. Geopolitical events don't consistently cause equity market sell-offs, but when they do, we find more often than not that government bonds—particularly long in duration, but at times short-duration bonds as well—provide an offset.

Elections and Risk Management

As we approach the elections in 2024, the two primary questions for investors revolve around fiscal responsibility and the impact of potential policy changes. The direction the wind blows on these issues could determine the course of the market.

As we've observed from prior similar "event risk", the uncertainty of the moment tends to cause sell-offs in so-called risk assets—equities and corporate bonds as two prime examples. Meanwhile, government bonds tend to act as a store of value because the long-term financial stability of the government aren't necessarily in play.

Exhibit The Impact of Major Global Events, With Short-Term Equity Moves

20 Major Market Events	Date	1-Month	6-Month	1-Year
Russian invades Ukraine	24/02/2022	7.1%	-1.2%	-4.4%
U.S. leaves Afghanistan	30/08/2021	-4.4%	-2.3%	-10.3%
Brexit	24/06/2016	3.1%	8.3%	17.8%
Russia takeover of Crimea	20/02/2014	2.5%	9.7%	0.6%
Lehman collapse	15/09/2008	-27.3%	-38.6%	-13.6%
Bear Stearns collapse	14/03/2008	1.1%	-3.8%	-41.0%
London subway attack	05/07/2005	2.8%	7.6%	8.4%
Iraq war	20/03/2003	2.4%	19.6%	29.2%
9/11	11/09/2001	0.6%	7.7%	-15.5%
Russia currency default	17/08/1998	-4.0%	16.0%	28.2%
Asian Financial Crisis	08/10/1997	-5.5%	13.0%	-0.9%
World Trade Center bombing	26/02/1993	1.4%	5.7%	8.3%
Iraq invasion of Kuwait	02/08/1990	-8.9%	-1.7%	12.8%
1987 Crash	19/10/1987	-21.5%	-18.4%	-10.6%
Nixon resignation	09/08/1974	-8.6%	6.0%	17.3%
Yom Kippur War	06/10/1973	0.2%	-11.7%	-38.9%
Six-Day War	05/06/1967	3.3%	7.5%	13.5%
JFK assassination	22/11/1963	6.8%	6.8%	23.2%
North Korea invades South Korea	25/06/1950	-10.0%	4.1%	11.7%
Pearl Harbor Attack	07/12/1941	-1.0%	-6.5%	4.3%
	Average	**-3.0%**	**1.4%**	**2.0%**
	Median	**0.4%**	**5.9%**	**6.3%**
	% Time Positive	**55.0%**	**60.0%**	**60.0%**

Source: Morningstar Direct, S&P500 Index. Data as of 31 October 2023. Data presented is indicative and for illustrative purposes only.

Dangers in Commercial Real Estate, Although We Still See Merit in Banks

As with most other investors, we see the potential for meaningful write-downs within the office space, in large part due to the changing work preferences in the wake of COVID.

We've attempted to identify the various touchpoints the broader economy has with commercial real estate, and while we see potential pain points for pensions, for example, we think most of the pain for public markets will be localised in regional banks.

Even here, though, we think the risk varies by bank, and, in at least some cases, is overdone. To manage the risk while taking advantage of the opportunity, we've carefully sized exposure to a collection of bank stocks, screening for commercial real estate exposure and avoiding companies that appear particularly exposed.

Here's the overarching takeaway for external risks in 2024: They exist, as they always do, but we believe the vast majority relate to volatility, and present as much opportunity as loss potential. The very essence of external shocks is their uncertainty, both in timing and magnitude.

Without question, many risks potentially have a higher probability than what's on this list, but we just don't know about them yet. It's with this uncertainty in mind that we think having a robustly constructed portfolio that considers the full range of outcomes is a critical component to investing success.

Valuation Risk is Often Ignored, But Really Matters

Overvaluation risk is a real problem that never features on the laundry list of what can go wrong. Everything has a price, with swings in perceived risk creating potential mispricing. No bad news? Likely elevated valuations. A lot of perceived risk? Possibility of attractive prices.

Some great companies have high valuations and need significant growth to deliver on market expectations. Said simply, they have no room for error or disappointment. Other markets are priced for a story of despair—for example, China equities—which only a little need to go right. Fundamentals matter especially with higher rates so investing where there is a valuation buffer or margin of safety is key for the years ahead. This is a story that we see play out again and again in markets.

Chinese Stocks are Perceived as Risky, but Upside Potential Exists

To be clear, we acknowledge the uncertainty that surrounds these markets, and we have no better clarity than others on how it will play out. To manage those concerns, we rely on scenario testing to determine our positioning:

- How much can we own, assuming the worst happens, without jeopardising our overall portfolio outcomes?
- Do we have overlapping exposure here that we don't see at first blush? How can we manage these risks?

Valuations are an underrated tool to shift the risk-to-reward in your favour. And where headline risks are plentiful, we often find tomorrow's golden opportunities.

New Risks, Consistent Approach

Patience and perspective are key in the world of investing. Before making any move, consider what is already priced in and how the markets have already adjusted. While risk might initially sound intimidating, it isn't always a bad thing. Risk can be a catalyst for opportunity if managed with care. After all, in the world of investments, risk not only creates a possibility of loss but also forges avenues for gain.

Risk and reward are different sides of the same coin and investors cannot expect outsized gains without taking on some risk. This does not feel intuitive as our brains are not wired for patience nor for eagerly embracing uncertainty. Histrionic headlines don't help. However, discipline and long-term perspective are never out of style and investing principles can payoff most handsomely during turbulent times.

While the risks we face as we enter 2024 are significant, they are not insurmountable. The keys are to stay calm, focus on the long term, sift through the noise, and apply robust risk management techniques. Remember, even in the face of risk, opportunity lies. Armed with a thorough understanding of the market, sound strategies, and a cool head, investors can not only weather the current market conditions but also find potential opportunities amidst them.

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