

# The case for mitigating autocratic risk in institutional portfolios

By Yves Choueifaty, Tristan Froidure and Axel Cabrol

TOBAM explores in this paper the impact of authoritarian regimes on portfolio performance, identifies an 'autocracy risk factor', and proposes ways to reduce exposure to this risk factor with the aim of improving risk-adjusted returns.

Studies from authoritative organizations such as the V-Dem Institute and Freedom House consistently show that democracy has been on the decline for nearly two decades. The V-Dem Institute notably claims that 'the level of democracy experienced by the average global citizen in 2022 has regressed to levels not seen since 1986', before the dissolution of the Soviet Union. As a result, a large portion of the global population now lives under autocratic regimes.

## Investments in companies based in autocratic nations do not create long-term value.

Why should this trend concern investors? Evidence strongly suggests that, in contrast to democracies, which tend to support economic growth, autocracies are generally harmful to both business and economic environments. This relationship is exemplified by the influential work of Acemoglu et al. (2019).

In his widely cited 2005 paper, "The Limits of Financial Globalization," René Stulz challenged the notion of 'country irrelevance' – the idea that 'asset prices, portfolios, and firm financial policies are independent of national borders'. Through thorough empirical analysis, he demonstrated that this theory does not hold, especially in autocratic regimes. In these environments, for instance, weaker property rights and the influence of corporate or government insiders raise the costs and risks for foreign investors, even in the absence of formal capital controls.

## It is not sufficient to merely divest from autocracies.

Additionally, Lin et al. (2019) show that US multinationals experience a significant decline in value when property rights weaken in countries where they have substantial operations. This has two key implications. First, we can observe the impact of autocratic policies on US investments that affect property rights. Second, simply divesting from companies listed in these autocratic countries is inadequate to shield a portfolio from adverse effects originating from autocracies. In fact, it is crucial to evaluate and actively manage the indirect exposure to autocratic regimes of firms listed in democratic countries to mitigate any risk arising from these regimes.

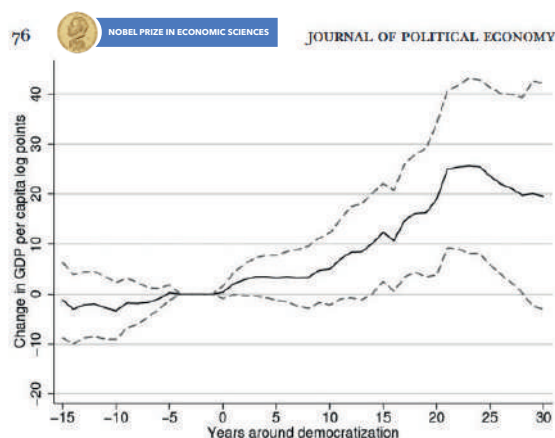
A striking example is that following Russia's invasion of Ukraine, foreign investments in companies listed in Russia were marked down to zero. These losses could have been avoided by steering clear of direct exposure to autocratic countries.

However, this is not the full picture. According to Yale University CELL, over a thousand companies listed outside of Russia have scaled back operations there after the invasion. Their combined contribution to Russia's GDP was \$600 billion. With a very conservative valuation of one-time revenue plus capex, and assuming an optimistic markdown of 50%, this equates to \$300 billion in investment losses – more than the total value of Western investors' holdings in listed Russian stocks. While Russia has been removed from Global Emerging Market Indices, China is currently a major concern for investors. This is evident in the growing interest in the EM ex-China and World ex-China benchmarks.

Since we can observe the effects of autocracies on democratic firms using extensive data, quantitative methods enable us to measure the impact of autocracies on each corporation listed in democratic countries. This, in turn, allows us to determine the Authoritarian Exposure (AE) of each democratic firm and identify a corresponding autocracy risk factor.

TOBAM's research has shown that a subset of firms listed in developed markets has significant exposure to authoritarian regime countries, even if it is 'indirect' in nature. Given the growing economic influence of autocracies, this issue has become too important to ignore for investors worldwide. To illustrate the impact of autocratic exposures on listed equities from developed countries, we constructed quintile portfolios of stocks ranked according to their AE and analyzed their performance over the past decade.

**Key Findings:** This analysis of firms in developed countries yields three important insights:



Source: Acemoglu et al 2019, Journal of Political Economy

The solid line plots the estimated average effect on GDP per capita on countries that democratized (in log points), with a 95 percent confidence interval in dashed lines

### 1. Reduction with performance

**enhancement:** Divesting from the top 20% of stocks with the highest autocratic exposure would have improved performance while reducing overall portfolio risk, as measured by realized volatility. Notably, the Sharpe ratios of the quintile portfolios decrease from 0.5 for the first quintile (Q1) to 0.05 for the fifth quintile (Q5) as authoritarian exposure increases, which correlates with lower returns.

### 2. Authoritarian risk reduction is associated with avoiding low-quality stocks:

The regression coefficients of each AE quantile portfolio indicate that the significant and negative exposure to quality stocks in Q5 diminishes significantly when authoritarian risk is reduced. This suggests that reducing authoritarian exposure is also linked to a lower exposure to low-quality stocks.

### 3. Independent authoritarian risk factor with negative risk premium:

The low R<sup>2</sup> values from the regressions imply the existence of a risk factor associated with reducing authoritarian risk, independent of other factors. Portfolio Q5 hedged with Q1 provides a simple authoritarian factor proxy, whose large unexplained negative performance highlights the presence of a negative premium.

Overall, our findings suggest that investors can build portfolios with minimal exposure to authoritarian regimes without sacrificing their potential to capture long-term risk premia. On the contrary, such portfolios may enhance risk-adjusted returns by avoiding the negatively rewarded 'autocratic risk factor' and by eliminating stocks with poor characteristics.

## Conclusion

In conclusion, protecting investors from indirect exposure to the authoritarian risk factor has led to better outcomes while also providing stronger protection against economic shocks caused by geopolitical instability. Investors can proactively shield themselves from the economic costs imposed by autocratic regimes.

Sources:

- 1 Acemoglu, Naidu, Restrepo and Robinson, 2019. *Democracy does cause growth. Journal of political economy.*
- 2 René Stulz is a respected figure in the field of finance and the holder of the Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University.
- 3 Lin, Mihov, Sanz and Stoyanova, 2019. *Property rights institutions, foreign investment, and the valuation of multinational firms. Journal of Financial Economics.*
- 4 <https://www.yalerussianbusinessretreat.com/>
- 5 Renault had to sell its 68% stake in Russia's biggest carmaker for 100 kopecks.



**Yves Choueifaty**

President and CIO, TOBAM



**Tristan Froidure**

Head of Research, TOBAM



**Axel Cabrol**

Co-Deputy CIO, TOBAM

## PERFORMANCES & EXPOSURES ACROSS AE SORTED QUINTILE PORTFOLIOS

Performances	Q1: lowest AE	Q2	Q3	Q4	Q5: highest AE	Q5-Q1
Annualized return	8.9%	6.6%	3.4%	1.7%	1.2%	-6.9%
Vol	17.4%	18.0%	19.4%	21.4%	22.6%	13.5%
Sharpe ratio	0.51	0.37%	0.18	0.08	0.05	-0.51%
<b>Excess return regression coefficients</b>						
Market	+1%	+5%	+10%*	+14%*	+15%*	+13%*
SMB	-29%*	-21%*	-11%	-5%	+6%	+35%*
HML	-14%*	+6%	+11%*	+14%*	+19%*	+33%*
UMD	+9%*	+8%	+8.3%	+5%	+7%	+1.7%
QMJ	+9%	-5%	-20%*	-38%*	-51%*	-60%*
BAB	-6%	-2%	1%	-2%	-17%*	-11%
R <sup>2</sup>	14%	5%	10%	18%	26%	35%

Source: TOBAM, Bloomberg, AQR.

Stocks within the Bloomberg World Developed Index were ranked every month according to their AE. We then constructed quintile portfolios of AE-sorted stocks, weighted by market capitalization. Portfolios were controlled each month for their past one-year volatility and rebalanced so that they were fully invested on average from April 2014 to April 2024.

Regression Coefficients are shown in % to improve readability. Factors Size (SMB), Value (HML), Momentum (UMD), Quality (QMJ) and Betting against Beta (BAB) are those of AQR's Global universe, and the associated Risk-Free rate has been used to compute Sharpe Ratios.

\* Indicates that the estimated coefficient is different from zero with a probability of 99%.