Summary
• Few would have predicted the UK embarking on divorce proceedings with the European Union, Donald Trump sitting in the top job at the White House and Prime Minister Theresa May taking over from David Cameron and then failing to get the landslide majority she and everyone else expected in a new election.
• However, in mid-June, the so-called fear gauge, the VIX, closed just a shade above its lowest level ever of 9.75, which was 23 years ago. The one exception was the British pound where the BPVIX rose slightly to around 8.64 due to political uncertainty over the start of the Brexit negotiations and failure of the Tory government to form a majority government.
• Investors are not immune but the response with every event has softened. There were big moves after Brexit, but then the Trump election caused less significant dislocations, while stock markets did not plummet in the recent UK elections, although they did have an impact on sterling. Political risk has moved much higher on political agendas.
• While corporate bonds have been remarkably resilient to political uncertainty over recent years, changes in currency, interest rate and inflation expectations have impacted pension funds.
• Pension funds are advised to strategically build portfolios that are weighted towards better-rewarded risks such as diversified credit exposure across public and private markets, and away from interest rate, currency and economic risk.

The right direction

Lynn Strongin Dodds looks at how political risk can affect pension funds and the strategies that should be put in place to combat this

Political risk is nothing new, but few institutional investors would have predicted last year that 2017 would see the UK embarking on divorce proceedings with the European Union, Donald Trump sitting in the top job at the White House and Prime Minister Theresa May taking over from David Cameron and then failing to get the landslide majority she and everyone else expected in a new election.

A relative calm?

What is perhaps even more surprising is that in many cases the fallout from these unexpected events has been short lived, which might help explain why today market volatility is near record lows. In fact, in mid-June, the so-called fear gauge, the VIX, closed just a shade above its lowest level of 9.75, 23 years ago, The one exception was the British pound where the BPVIX rose slightly to around 8.64 due to political uncertainty over the start of the Brexit negotiations and failure of the Tory government to form a majority government.

One reason for the general relative calm may be the law of diminishing returns. As Aspect Capital senior product manager Chris Reeve puts it: "I wouldn't say investors are immune but it seems that the response with every event has softened. There were big moves after Brexit, but then the Trump election caused less significant dislocations, while stock markets did not plummet in the recent UK elections, although they did have an impact on sterling."

This does not mean though that investors are sanguine and for many, political risk has moved much higher on their agenda, according to a recent poll of 100 of its clients conducted by Royal London Asset Management. Around 38 per cent cited the potential failure of Donald Trump to deliver on his proposed economic reforms as the biggest threat, while 22 per cent expressed concerns over Brexit and a eurozone crisis.

Janus Henderson head of multi-asset Paul O'Connor also believes that 2016 saw the return of political risk as a greater influence than in the past three decades where monetary policy, the fight against inflation and inequality were the main themes.

"One of the key difference today than in the past is that the succession of events are much closer together than historically," Rathbones Investment Management investment director Samantha Boyd states.

"In a relatively short space of time we have seen the referendum and elections in the US, France and the most recent one in the UK. The result is that politics is playing a much greater part in terms of where markets are moving, while stock specific and company fundamentals are taking more of a back seat."

Another change is that reactions to political events have been particularly counterintuitive, according to Aviva Investors head of investment strategy, global investment solutions John J Dewey.

"Even predicting the political outcome correctly could have led to an incorrect assessment of the behaviour of markets," he adds.

For example, Dewey notes that while equities and corporate bonds have been remarkably resilient to political uncertainty over recent years, changes in currency, interest rate and inflation expectations have impacted pension funds. "For UK pension funds, the fall in sterling after Brexit provided a boost to unhedged overseas asset exposure," he says. "Over time, it has increased inflation, inflating the cost of short-term, inflation-linked liabilities."

Diversification

Despite being "in a new era where political risk is here to stay, that does not need to be viewed negatively because it also brings opportunities", says O'Connor. "I would say that one of the best defences is to be globally diversified in order to be insulated against any of these risks but also have the ability to react dynamically and use these big swings to your advantage."

O'Conner is far from alone. "One of the most important things is to design a portfolio that weathers all events," J.P. Morgan Asset Management global head of multi-asset strategy John Bilton says.

"The starting point is to have a core thesis and then to think carefully about levels of risk, and any hedges to put in place. For example, if you believe that Europe is going to go through a period of uncertainty over an election, then it is more appropriate to moderate exposures to European risk, rather than to try to specifically position for the event itself.

However, Bilton adds that "if seeking a hedge against an extreme tail event – eg the possibility of the euro breaking up – then think about how this hedge would work if it were ever needed. So in this example look for US dollar liquidity and a hedge that doesn't settle in euros".

Dewey also advocates strategically building portfolios that are weighted towards better rewarded risks, such as diversified credit exposure across public and private markets, and away from interest rate, currency and economic risks. "The latter are better undertaken in a highly-diversified, multi-asset strategy," he adds. "High-quality private assets have a track record of resilience in volatile markets, while offering illiquidity premia and diversified credit premia."

More to come

Looking ahead, investors will have to contend with the German election in September, followed by the Italians going to the polls later in the year or in early 2018. There is also of course trying to predict Trump's next move. "Trump is a wild card and if he is able to get his tax cuts and fiscal stimulus passed, this will be negative for fixed income assets but positive for equities," BlueBay Asset Management fund manager Mark Bathgate says.

"If this was the case then I would keep some of the portfolio at the more liquid end, such as interest rates futures, just in case you have to adjust quickly."

If recent history is any guide, Brooks Macdonald Group fund manager Niall O'Connor also recommends not making big bets on these upcoming binary events.

"What we have done with our Defensive Capital Fund is to hold more cash, reduce currency exposure and sell riskier assets in favour of buying more out of the money put options," he says. "There may be less captured on the upside but we are more protected on the downside. There is a fear of missing out in the current low volatility environment but you do not want to be lulled into taking bigger risks when the political risks and valuations are too high."

Whichever direction is taken, all managers should continue to bolster their risk management frameworks. "Pension funds have become much more sophisticated in risk modelling and stress testing," Invesco head of UK institutional sales and service Hugh Ferrand comments. "There is recognition within the fund management industry of the importance of modelling the portfolio for each circumstance, whether it be another eurozone crisis, China going bust or US Treasuries rising by 300 basis points. If the outcomes are not acceptable and the portfolio does not react in an acceptable way under these conditions, then the fund manager needs to change the ideas."

Fund managers are also advised tonot only hold their nerve when the lead up to an event but also when the risk is evaporating. Take the French elections."There was an audible sigh of relief but then people started buying bonds that they would not have touched months earlier but at 100 to 200 basis points narrower," M&G head of institutional portfolio management David Lloyd mentions. "These were not French borrowers or in sectors that would have benefited from the election but only because the political risk had dropped."

Conducting more in-depth and granular research could help provide better insights into the political ramifications for a country, its corporates and markets. "If you want to debone a country you look at the economic conditions and then the skeleton around it," Pioneer Investments head of global asset allocation research Monica Defend says.

"The most fragile countries will be the most impacted by political risk and visa versa for the stronger ones. This helps explains why volatility faded in the short term in Europe after Brexit and while it lasted much longer in Brazil."

Written by Lynn Strongin Dodds, a freelance journalist