Assessing Country Risk in a World of Uncertainty

By Mona ElNaggar

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Our Managers' Global Reach. As TIFF scours the globe in search of the best investment teams, we increasingly find ourselves casting the net farther afield while keeping one foot firmly planted on US soil. Typically, at least some of the commitments in our private equity and realty and resources funds are to non-US fund managers. Drilling down to examine the non-US category, we find widening diversification. Certainly the historical bias has been toward Western Europe. However, we have been increasingly stepping into emerging markets.

Macro View. Each country in which we invest comes with its own set of risks. While we are not "macro" investors who make a call on a market and invest accordingly, it is essential that we take the macro environment into account and not "miss the forest for the trees" by focusing on the manager in isolation. A great strategy executed by a strong team can be completely overwhelmed if they are operating in an environment that is inherently unstable or at risk. So how do we assess the risk associated with a particular country or region, and how much weight is that risk given in our allocation decision-making? The manager's ability to make investment decisions against a backdrop of relative certainty is important, so we need to assess the political, legal, and financial systems of a country.

Political System. We have a clear bias toward democracies. This is not a neo-conservative view of the world. It is just that government decisions in a democracy are more transparent, more open to debate, and signaled sooner before being made into law, allowing a private investment professional to adjust accordingly rather than be taken by surprise. That is not to say that democracies are devoid of surprises. Indeed, many a hedge fund was taken by surprise when the US and UK suddenly barred short selling of financial stocks in September 2008. However, the relative transparency and accountability of the democratic decision-making process gives us comfort. Another factor is the stability of the political system. That does not mean stability of a particular political party or regime – the uprisings across North Africa and the Middle East have exposed the fallacy of relying on that type of "stability." Rather, the stability that matters is the populace's confidence in the political system and its adaptability – i.e., when the leader or party currently in power becomes unpopular, change can and does happen in an orderly fashion.

Legal System. A second category of macro factors is the rule of law. Is due process followed? Are the courts free of political interference? Are property rights clear and enforceable? While we hope that investments always go well, things can and do go wrong, so we want to know that our managers have a clear path to redress any injustice. An important factor within the rule of law is whether foreign investors' rights differ from those of domestic investors. That is important because our managers often form offshore funds for tax structuring reasons. Hence, even though the principals of the fund might be domestic nationals, the fund, and therefore the ownership of the underlying assets, is often considered to be foreign. If foreign owners are second-class citizens in terms of rights, that is a clear sign of danger for us as LPs.

Financial System. Any single investor is part of an entire financial system that will also impact the value of the investment. How available is credit and how much is absorbed by the government as opposed to the private sector? A government that is heavily indebted is detrimental in many ways – it can drive up the cost of borrowing or drive down the availability of credit for the private sector. How stable is the currency? Our members are US dollar-based investors, so we are very attuned to fluctuations in the currencies of our investments. In a relatively stable currency environment, we would expect that the investment skills of the managers we employ would be the greater differential in returns. However, investing with a manager who operates in a country with a highly unstable currency can make returns volatile for reasons that have nothing to do with that manager's investing prowess, a situation we prefer to avoid. Another factor that cannot be overlooked is the ease with which capital can be extracted from the country. It is very easy to put money to work. It is sometimes a lot harder to get it back. We try not to make it harder still by investing in countries that exercise capital controls in an arbitrary fashion to suit inflation or exchange rate targets. That is one of the biggest risks we see today with investing in China, for instance, which is obsessive about the renminbi and is not averse to using capital flow restrictions to exercise control in the market. Currently, China's focus appears to be primarily on limiting in-flows as it seeks to dampen inflation, but that could easily switch back to limiting repatriation of profits, something the regime has also done in the past.

Fluid Analysis, Asset Specific. Our assessment of country risk is far from static. As shown by events such as the 2011 Arab uprisings, the political situation in a country or region can turn on a dime. Similarly, a currency viewed as a reserve currency can suddenly be put at risk. Witness the euro's instability in the wake of debt crises in Greece, Ireland, Portugal, and potentially in the much larger economies of Italy and Spain. And closer to home, investors took a treacherous mid-summer journey as they sought to discern whether the US – and therefore the global economy – would be weakened by the political impasse over Washington's debt ceiling and deficit reduction plans. We are constantly reassessing country risk with an eye on the long term. Indeed, as private investments are long-term commitments, we tend to be far more conservative about country risk than one might be with a more liquid instrument, such as public equities. Hence, a country that might get the nod for our marketable investments or or absolute return program might be avoided for private investments.

Perception vs. Reality. Importantly, the gap between perceived and actual risk can be a great source of profit. One of our managers acquires and develops assets in the energy, natural resources, and commodities sectors. Because the team seeks value dislocation opportunities where misperceptions of risk affect pricing, the manager expects to acquire its portfolio at costs well below the forward price curve for a given commodity. The team's strong belief is that misperceptions of risk are magnified in non-North American markets in general and some emerging markets in particular – the result being the potential for higher risk-adjusted returns. More than just value dislocations, however, are the demand forces in the developing world. With global demand for commodities and energy increasing, this manager, for example, has invested in parts of Asia, South America, and Africa. Similarly, powerful demographic trends have allowed another of our managers to invest with confidence across Africa, with a particular focus on sub-Saharan Africa. With high levels of economic growth, favorable demographics, political stability, and improving leadership supporting an emerging, urbanizing, and modernizing middle class, Africa seems to be fertile ground for investment. However, there is a marked perception/reality mismatch for this continent, which many investors still view as a basket case. For instance, the World Bank's latest Worldwide Governance Indicators rated the political stability of Rwanda ahead of China and India, while that African nation's pro-business government has helped drive 8.8% year-on-year GDP growth since 1994. Yet we would bet most readers thought of the Hutu-Tutsi conflict as soon as they read the word "Rwanda." While a history of episodic strife has been unfortunate (to say the least) for Africa, it is fortunate for us as investors when others fail to realize how much has changed. We love to invest where capital is scarce.

Risk/Reward Equation. To be sure, we constantly feel the heavy weight of our obligations to our members and understand that private investing is not all about maximizing returns. Indeed, we have probably sacrificed some potential returns in the short run by studiously avoiding committing to managers that operated in environments where the country risk made us ill at ease, such as Russia and China. We have to exercise judgment every day and avoid knee-jerk reactions, as we are dealing with long-term commitments. Some bets are more easily taken than others – for example, that Europe will sort out its debt crisis versus that China will at all times respect foreign property ownership rights on par with domestic property rights. However, most decisions are taken in a world of shades of gray. We cannot promise that we will always be right, but we can promise that our relentless focus is on the risk/reward equation for every manager, including the state of the markets and political systems in which they operate, and that we will aim only to take calculated risks that will be adequately rewarded. ■