The Shifting Geopolitical Landscape: Perspective from Behavioural Finance

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The Shifting Geopolitical Landscape

- The market's response:
  A behavioral lens
- Challenges for conventional risk management methods
- Expanding the risk management toolkit

IIC 2024

In the search for market-beating returns, institutional investors are facing a shifting geopolitical landscape …

… [Speakers will] reckon with the aftermath of a highly anticipated U.S. presidential election … and challenges faced by institutional investors.

The Market's Response: A Behavioral Lens

ACADIAN

GEOPOLITICAL SHOCKS: WHAT TO EXPECT FROM THE UNEXPECTED

JULY 2017

While "buy when there is blood in the streets" has become axiomatic investing advice, surprisingly, there has been almost no systematic research that sheds light on this centuries-old maxim. What is the best course of action after a market shock? Creating and analyzing a large data set of unexpected geopolitical events, we begin to explore this question. The initial evidence suggests that, absent a view regarding the idiosyncrasies of a particular event, the most effective strategy is to stay the course.

OVERVIEW

Geopolitical shocks present unique uncertainty for investment managers. What is the proper course of action once an unforeseen event occurs? Quickly exit exposed positions, do nothing, or double down? Unfortunately, there is a dearth of rigorous research to guide asset owners and managers regarding the investment impact of geopolitical events. Most discussion is anecdotal, reflecting the difficulties of empirical work on the subject.

To start with, there is no industry standard reference dataset of relevant shocks, their attributes, and the associated market reaction—so we created our own. Through a procedure that combined parsing of unstructured data, natural language processing, and manual screening, we identified and characterized a sample of more than 2,600 events affecting 72 countries from 1928-2015.

Studying reactions to these events, we find no evidence to suggest that investors are better off selling[1] when shocks occur (Figure 1). This remains true even for severe events, defined as shocks that caused the worst 30 percent of declines. The analysis suggests that for a diversified investor who has no view regarding the idiosyncrasies of a particular circumstance, the best course of action is to stay the course.[2]

FIGURE 1

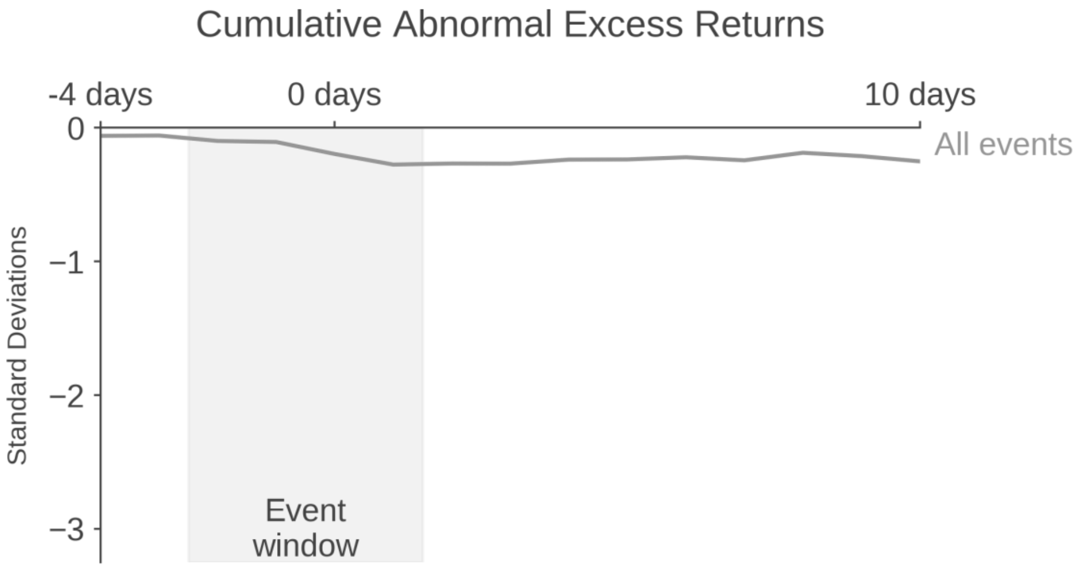
Returns from a case study of selected geopolitical events (1928-2015)*

Local market returns (in USD) starting four trading days prior to an event. Standardized abnormal returns are daily returns less the market's prior 120-day average return and divided by its prior 120-day volatility. High-severity events are defined as having cumulative losses during the event window (t-2 through t+1) in the worst 30% of the sample.

1B: CUMULATIVE STANDARDIZED ABNORMAL RETURNS (%)

The Market’s Response: A Behavioral Lens

- Generally dispassionate



Local market returns (in USD) starting four trading days prior to an event. Standardized abnormal returns are daily returns less the market’s prior 120-day average return and divided by its prior 120-day volatility. Date Range: 1931-2015. Ex-ante high severity events are those expected to impact markets based on a manual review of information likely available at the time of the event. Results reflect filtering of events with overlapping windows. Sources: Acadian, Global Financial Data and publicly available blogs and wikis. Returns are of the major local exchanges where each event occurred. Past results are not indicative of future results. For further details about the data sample, see Geopolitical Shocks: What to Expect from the Unexpected, Acadian, 2017. Every investment program has an opportunity for loss as well as profits. For illustrative purposes only.

The Market's Response: A Behavioral Lens

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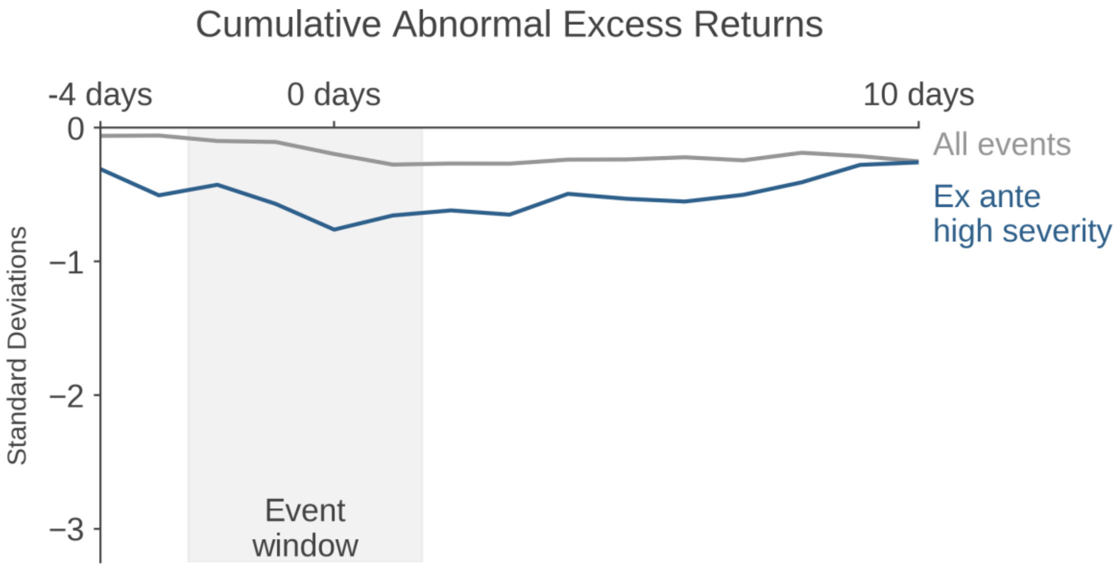

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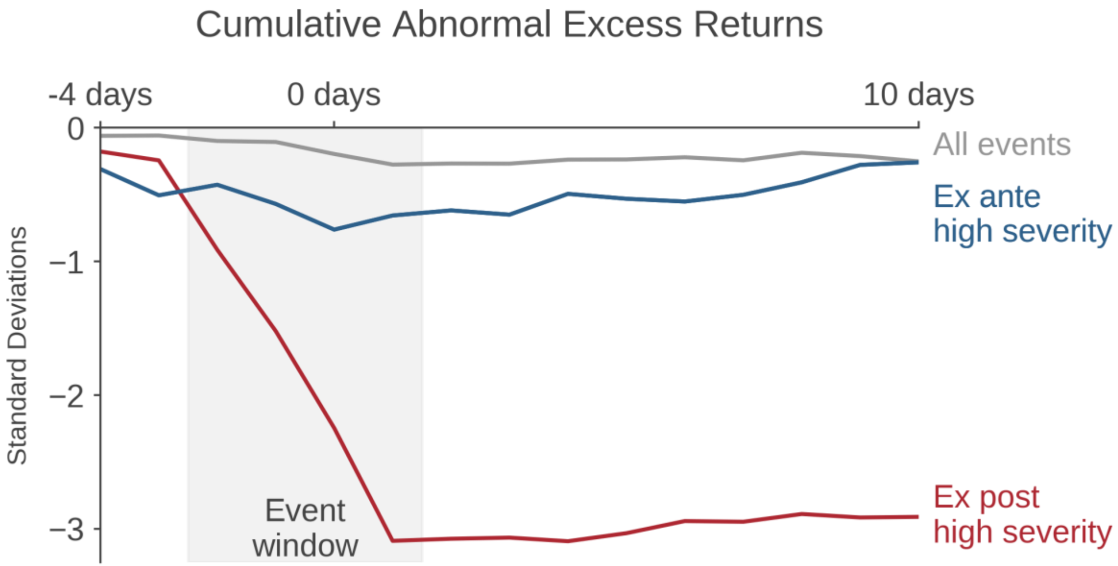
The Market's Response: A Behavioral Lens

- Generally dispassionate
- Largely unbiased



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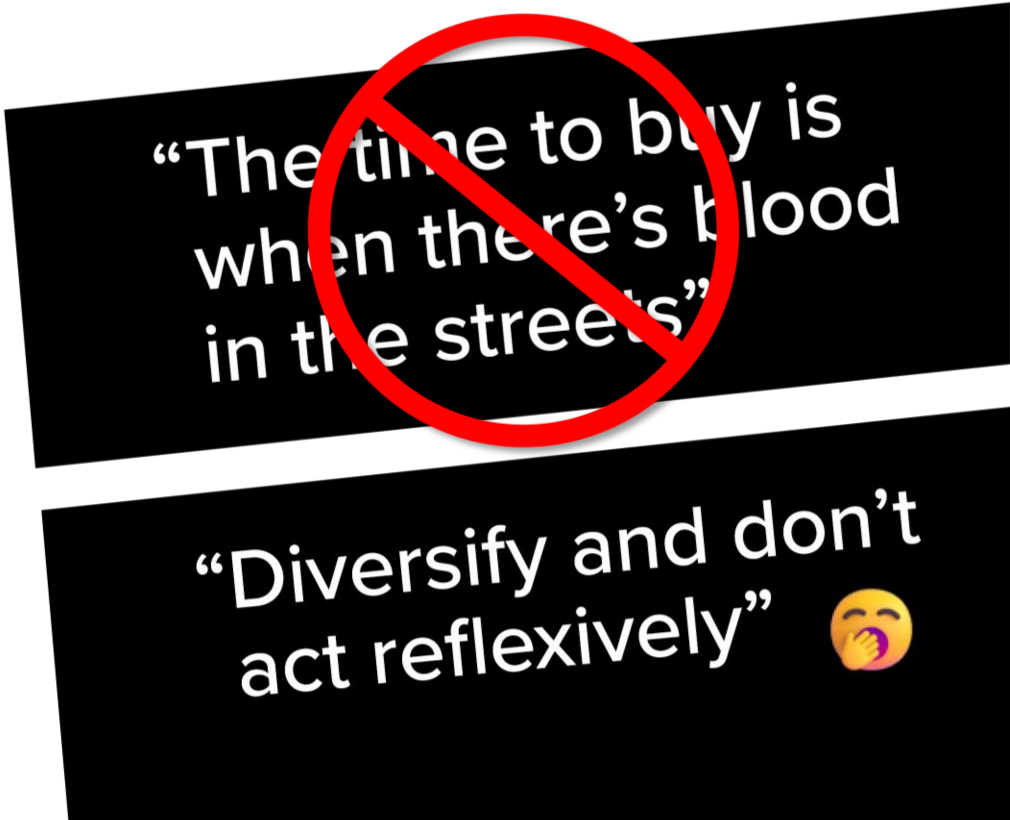

The Market's Response: A Behavioral Lens

- Generally dispassionate
- Largely unbiased
- Struggles with uncertainty

Challenges for Conventional Risk Management Methods

- Heterogeneity

Challenges for Conventional Risk Management Methods

- Heterogeneity
- Complexity
- Transience

Wagner, Alexander F., Richard J. Zeckhauser, Alexandre Ziegler, "Company stock reactions to the 2016 election shock: Trump, taxes and trade." Journal of Financial Economics 130, no. 2 (2018): 428-451.

Expanding the Risk Management Toolkit

CHOOSE A REPRESENTATIVE LONG-SHORT BASKET


ACADIAN ASSET MANAGEMENT

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Measuring Macro Event Risks to Active Equity Portfolios

September 2024

- The tight U.S. presidential race offers a timely reminder of the risk that macro events can pose to active equity strategies.
- Unfortunately, conventional risk modeling tools don't offer investors much insight into portfolio-level exposures to such catalysts.
- In this paper, we demonstrate a practical methodology to help investors measure and inform management of macro event-related risks using "winner-loser" baskets published by sell-side analysts and other subject-matter experts.

Anticipatable macro events, such as the upcoming U.S. presidential election, can generate considerable stock market volatility and widely varying impacts over the cross section of returns. Unfortunately, while the style factors in traditional risk models pick up on changes in volatilities and correlations produced by sustained macro trends, they do not well-capture risks associated with events and other shorter-term macro phenomena. In this paper, we demonstrate a practical method to supplement the predictions of multi-factor risk models, which allows investors to measure and, therefore, to reduce equity portfolio exposures to transient macro risks.

"Winner-Loser" Baskets as Macro Event Factors

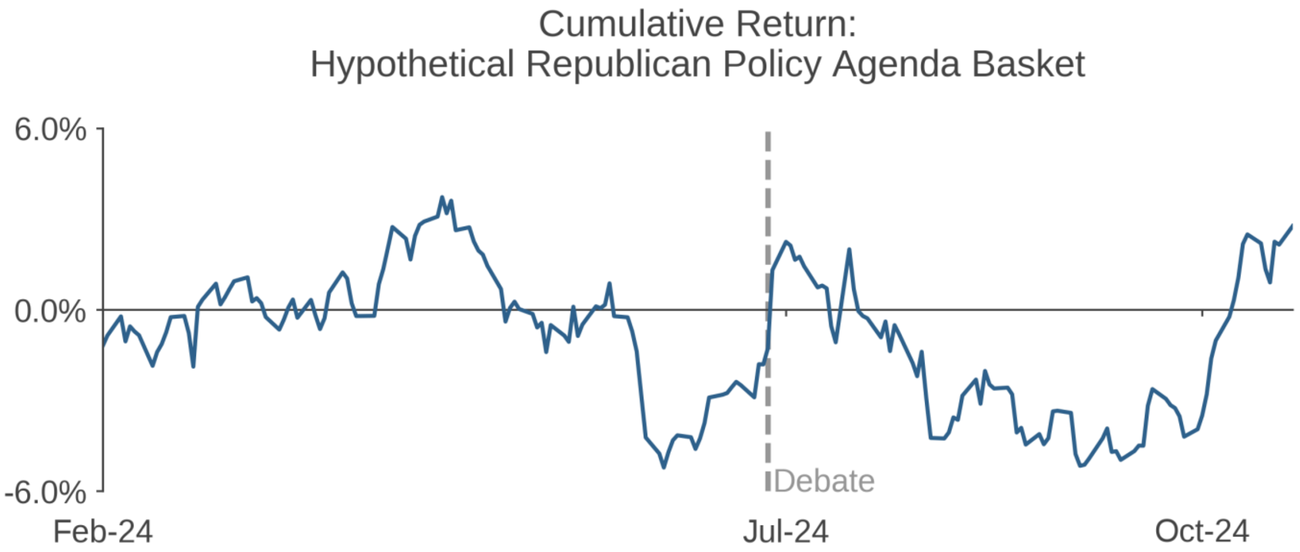
Sell-side equity analysts and other subject-matter experts often publish winner and loser stock baskets in association with upcoming macro events. These baskets represent companies that the analysts expect to outperform and underperform depending on how circumstances play out. The transmission mechanisms between events and markets may be multifaceted and complex, perhaps involving shifts in demand for products and services, new regulations, and supply-chain disruptions, just to name a few possible channels.

Typically, winner and loser baskets comprise only limited sets of companies whose linkages to an event are most apparent. Nevertheless, we can extrapolate information from even narrow selections to inform estimates of event risk across much broader investment universes. In developing confidence in the resulting predictions, what matters is the reliability of the basket as an instrument to track market expectations regarding the likelihood and consequences of the event. If we can establish that confidence based on a combination of intuition and analysis, then we can apply the long-short basket to estimate portfolios' active exposures to the upcoming event in question.

Figure 1: Cumulative Returns of Hypothetical "Winner-Loser" Republican Policy Agenda Baskets

Expanding the Risk Management Toolkit

CHOOSE A REPRESENTATIVE LONG-SHORT BASKET



Source: Acadian based on index returns from Bloomberg. Hypothetical Republican Policy Agenda Basket is constructed from Goldman Sachs GSXUREPL and GSXUREPS indexes, beta adjusted, as described in Measuring Macro Event Risks to active Equity Portfolios, Acadian, 2024. It is not possible to invest in any index. The above does not represent investment returns generated by actual trading or an actual portfolio. Hypothetical results are not indicative of actual future results. Investors have the opportunity for losses as well as profits. For illustrative purposes only.

Expanding the Risk Management Toolkit

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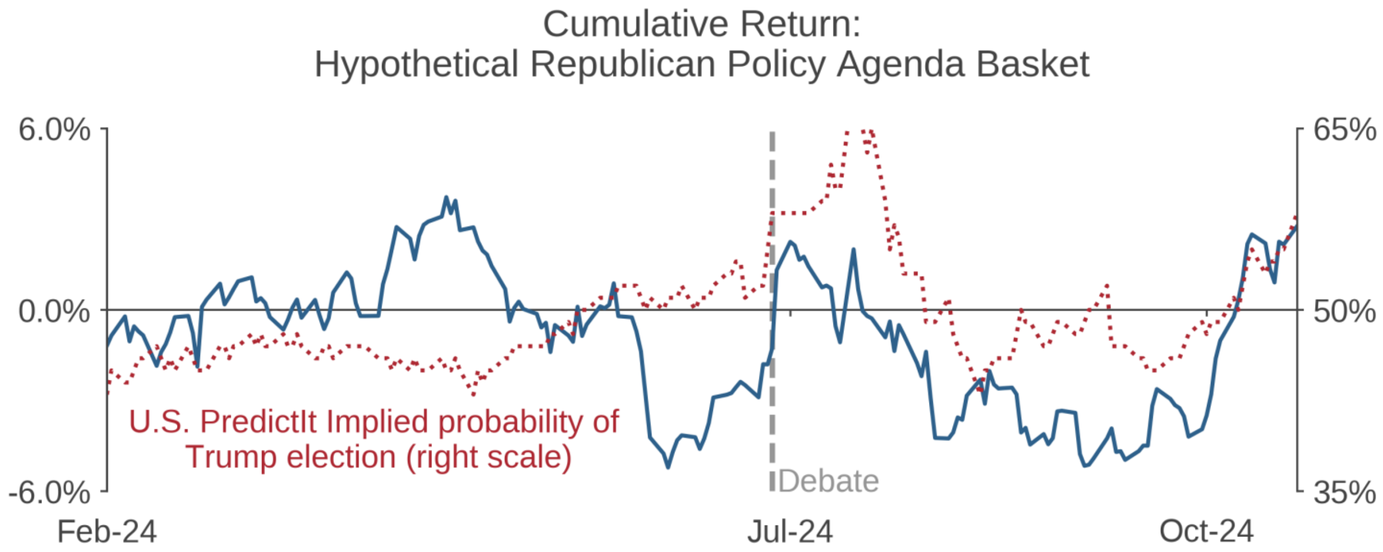

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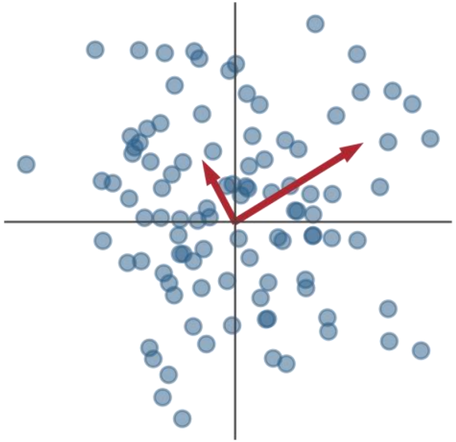
Expanding the Risk Management Toolkit

CHOOSE A REPRESENTATIVE LONG-SHORT BASKET → ESTIMATE STOCK EXPOSURES TO THE THEME

In predicting risk associated with macro catalysts, use a “short-term,” “statistical” risk model.

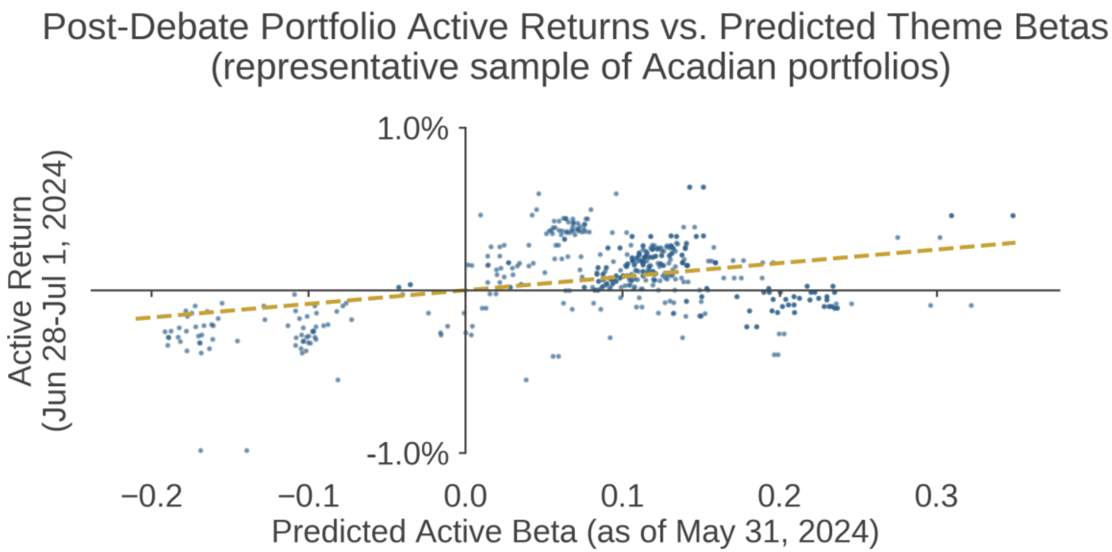
Statistical Risk Models Infer the Risk Factors



Source: Acadian. For illustrative purposes only.

Expanding the Risk Management Toolkit

CHOOSE A REPRESENTATIVE LONG-SHORT BASKET → ESTIMATE STOCK EXPOSURES TO THE THEME → AGGREGATE TO THE PORTFOLIO LEVEL



Source: Acadian. Portfolio performance is gross of fee. Past performance is not indicative of future results. Investors have the opportunity for losses as well as profits. For illustrative purposes only.

Takeaways: A Systematic *In* Action Plan

- Diversify
- Don’t react reflexively
- Expand your risk management toolkit

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