# CONSISTENT RETURNS IN A CHANGING WORLD:
## MANAGING POLITICAL RISK ACROSS DEVELOPED MARKET EQUITIES

Justin Wells, strategist in the global equities team at Old Mutual Global Investors, argues that political risk needs to be taken seriously by investors and that consistent returns are difficult to find by making macro bets.

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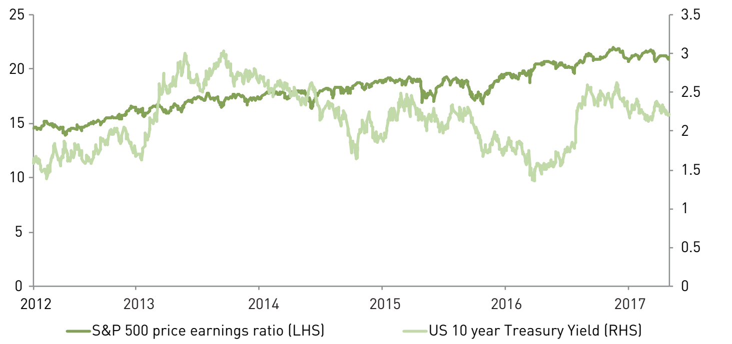
A powerful cocktail of economic headwinds, disparities in income between rich and poor, polarisation in beliefs and sporadic 'lone wolf' terrorist attacks has conspired to destabilise the political landscape across much of the developed world. Recent elections and referenda have had unforeseen results. Anti-establishment sentiment has flourished. Over recent years political risk has become accentuated, and has arguably not been so acute for a generation. Many of today's active equity managers investing in developed markets have not faced the challenge of managing such specific political risks before in their investment careers.

For some time now markets have relied on the central bank put, that is, the belief that central banks would always be able to step in to avert a crisis. Belief in central banks' omnipotence has propped up markets during times of elevated risk. It may be that investors have become desensitised to risk, numbed by years of accommodative policy by central banks. Certainly, conventional metrics of market volatility are at record lows.

A warning note is sounded by the bond market. While the price earnings ratio of US equities has continued upwards, bond yields have fallen this year (see chart), as investors have become sceptical about the potential for fiscal stimulus and higher rates in the US.

### Different stories told by US bonds and equities




Yields have fallen again while the S&P 500 price earnings ratio forges ahead
*Source: Bloomberg, as at 14 August 2017*

### Managing risk in practice

The binary nature of the outcomes associated with political instability has the potential to wrong foot many active equity managers, and undermine the consistency of the return structure. We remain resolute in our belief that forecasting future binary events leads to inconsistent returns.

Rather than trying to predict political outcomes, our approach is to focus on market state, here and now. We do not allocate our risk budget to anticipating binary outcomes, which may or may not play out. Instead our approach is reactive. We observe the effect the big issues are having on the state of the market itself. Our approach to the current elevated policy uncertainty is to react to how it is impacting the market, and not to try to predict the direction of travel. More precisely, we try to understand which stock selection techniques will be most effective in the current market environment. In seeking to determine the current market environment we are not forecasting macro. Instead we are trying to understand the type of stocks which will outperform in the environment here and now. With that in mind, our conviction is less on an individual stock level, and more around what investment style is suited to the current market environment in which we find ourselves.