Philequity Corner (April 9, 2007)
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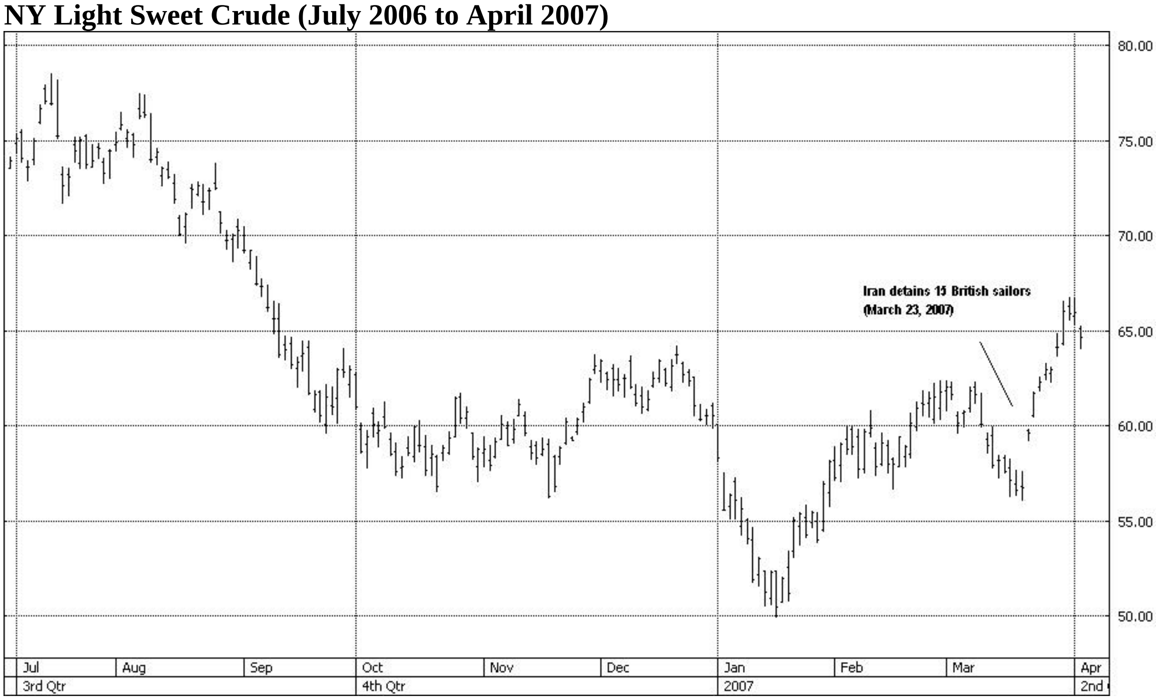
Coping with geopolitical risks

After dipping to $50 per barrel in mid-January, oil prices is back above $60 per barrel again following the coldest February in the US for 30 years, refinery outages, OPEC output cuts and geopolitics. Oil surged as high a $68 per barrel in late March over supply concerns from the Gulf, particularly from Iran which remained at odds with the U.N. over its nuclear program. The tensions were further compounded by Iran's detention of 15 British sailors last March 23.

Even though prices eased off with the release of the sailors last week, tensions continue to remain high as the U.N. Security Council have tightened sanctions against Iran, prompting a partial suspension of talks between Iran and the U.N. atomic agency and rekindling worries of a possible military confrontation.

In this article, we'll discuss how investors can prepare for this worst case scenario, however remote the possibility.

NY Light Sweet Crude (July 2006 to April 2007)



Source: Technistock

The case when history does not repeat itself

In a previous article titled The Resilience of Man and the Markets (see The Philippine Star, July 24, 2006), we showed that while unfolding geopolitical events are impossible to predict and difficult to factor into a short-term investment strategy, history tells us (as in the case of the Pearl Harbor bombing, the Cuban missile crisis, the Kennedy assassination, etc.) that the markets are quick to recover from these non-economic catastrophic events. Just as in the case last year, when North Korea tested long-range missiles and skirmishes between Israel and Lebanon escalated, the markets eventually weighted down the risks versus the long-term economic fundaments, and ultimately recovered.

However, one may argue that history does not always repeat itself, that in a rare case, the unexpected may happen. This is what Nassim Nicholas Taleb termed as "the rare event fallacy." In his book, Fooled by Randomness, Taleb said, "*Sometimes market data becomes a simple trap; it shows you the opposite of its nature, simply to get you to invest in the security and mismanage your risks*."

In a similar way, this is what most investors and businesses bitterly experienced in 1997, when the peso which then traded in a tight band against the US dollar during the previous years, unexpectedly experienced a sharp, sudden and brutal devaluation.

How then do we guard our investments if the Iran situation escalates? What should we do to protect our portfolio against this low probability but decisively high impact scenario? The answer lies in asset allocation.

Managing risks thru asset allocation

Simply put, asset allocation is a way of spreading your investments across various asset classes such as cash, bonds and stocks (see our article Investment Basics: Asset Allocation, The Philippine Star, March 12, 2007 issue).

This concept had its beginnings in 1952, when Nobel Laureate Harry Markowittz, then a young graduate studying operations research at the University of Chicago demonstrated mathematically, why putting all your eggs in one basket is an unacceptably risky strategy. It was his position that portfolio risk could be reduced and the expected rate of return improved if highly uncorrelated investments or those that didn't move together were combined.

Later on, a study by Brinson, Hood and Beebower in 1986 supported Markowitz's conclusions. The study concluded that market timing (the ability of a manager to consistently time the market) and security selection (the ability to pick the right securities) had an inconsequential impact on portfolio performance. Asset allocation accounted for over 90 percent of the impact on performance.

Ibbotson and Kaplan studied the same issue and published their results the Financial Analysts Journal in 2000. Their results essentially confirmed the 1986 study: 88 percent of the performance of pension funds was attributable to asset allocation.

Preparing a properly balanced portfolio

In a rare case that the Iran conflict escalates to a military confrontation, stock markets would certainly suffer across the board as oil prices and risk aversion increases. But for those investors with global portfolios, the simplest way to hedge against these geopolitical risks and be protected against rising oil prices is to be long the commodity itself via futures contracts. Another option is to buy a commodity ETF like the US Oil

Fund (symbol: USO), the Oil Services Trust (symbol: OIH) or even individual stocks outright.

Among domestic companies, the beneficiaries of higher oil prices are the following:

- Petron Corp (PCOR) – the country's biggest oil refiner. Petron stands to benefit from any resulting rise in domestic pump prices especially if it maintains oil inventories at lower prices.
- Petroenergy Resources Corporation (PERC). The company is currently the only locally listed company that offers a pure play oil production. It owns a stake in a consortium operating several oil wells in Gabon, Africa. .
- PNOC-EDC – The biggest geothermal energy producer in the country, PNOC-EDC provides an interesting play for the growing number of investors seeking for companies engaged in the production of alternative energy.
- Chemrez Technologies Inc (COAT) – a producer of biodiesel, COAT should also benefit from positive sentiment as rising oil prices will once again bring to fore governments efforts at promoting the use of biofuels.

A properly balanced portfolio, for example, would have a 5 percent to 10 percent allocation in commodity-based stocks, including energy producers. So if the price of oil spikes, the rise in share prices of the energy stocks will cushion any blows from the other components of the portfolio.

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