Philequity Corner (September 15, 2008)
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Politics & the Stock Market

Besides market risk, stock market investments are also exposed to political phenomena. Simply known as "political risk," it is defined as the risk of losing money due to changes that occur in a country's government or regulatory environment.

Examples of political risk

Acts of war, terrorism, and military coups are all extreme examples of political risk. Expropriation of assets by the government – or merely the threat of dictating business activities – can also have devastating effects on share prices.

In July, for example, harsh comments from Prime Minister Vladimir Putin on New York-listed mining firm Mechel wiped almost $63 billion off the Russian stock market in a week, according to the Russian daily St. Petersburg Times. Mechel, which was ordered to cut prices and supply long-term supply agreements for coking coal, has lost more than 50 percent of market value. Moreover, the Russian RTS Index has already lost 22 percent since it entered into a military conflict with Georgia just last month.

But political risk comes in many other forms. Other examples include: a change in the form of government (from democracy back to authoritarianism, and vice versa), a new president or prime minister, or a change in the country's ruling party. All of these changes can have a big impact on a country's economic environment and investor perceptions about a country's prospects.

In Malaysia, Anwar Ibrahim is back in the parliament as leader of the opposition. He has threatened to seize power on September 16 by securing the support of at least 30 defectors – a threat preempted by the ruling party by sending a third of its lawmakers to Taiwan last week for a study trip.

In Thailand, protestors against the current government of Prime Minister Samak Sundaravej, seized the Government House on August 26 and have held it hostage since. Samak, although he refused to resign, lost his job last week over constitutional ruling that found him guilty for moonlighting as a TV cooking host, a breach of the current charter. Samak was elected only on December 23, 2007 when democracy was restored in Thailand after being under a military-appointed government for 17 months.

Similarly, an escalation of political risk is facing Pakistan after the resignation of Pakistani President Pervez Musharraf in mid-August. Asif Ali Zardari, widower of the legendary former prime minister Benazir Bhutto, was sworn in last week as the new president of Pakistan. This is the 14th attempt on democracy by Pakistan which has seesawed between military dictatorships and elected governments since its founding in the partitioning of British India in 1947.

Not confined to the Philippines

Political problems are definitely not confined to the Philippines. While we have had our share of politically "risky" events (such as the Oakwood mutiny in 2003, the Hyatt 10 in 2005, and attempts and calls for President Arroyo's resignation), it is ironic that the strong control and influence of President Arroyo over the Lower House, the military, and the local governments are now proving to be beneficial for the Philippines. If not for the strong government of President

Arroyo, we would be in trouble and in political disarray like in Thailand, or have political uncertainty like in Malaysia.

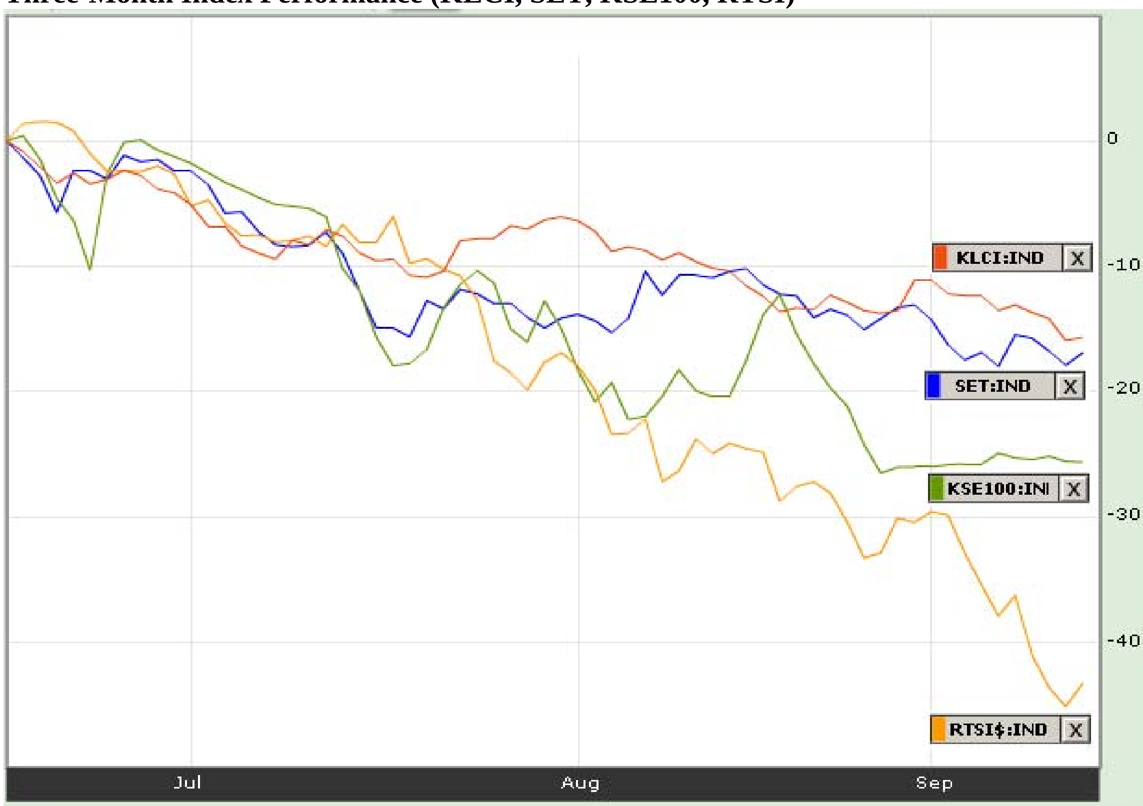
How investors react to political risk

Studies have shown that investors tend to overreact to political events in the short-term, while volatility dissipates in the long-run as discussed in *Resilience of Markets* (see Philequity Corner, July 24, 2006).

Clearly, those countries with heightened political risks have suffered amplified declines over the past three months. Russia's RTS Index, for example, plunged 43 percent over that period. Pakistan's KSE 100 Index dropped 26 percent. Meanwhile, Thailand's SET and Malaysia's KLCI declined 17 percent and 16 percent over the same period, respectively.

The Philippines' PSE Index, in contrast, is one percent higher than it was 3 months ago.

Three-Month Index Performance (KLCI, SET, KSE100, RTSI)



Source: Bloomberg

Managing political risk

Unlike economic or financial variables, political risk is more difficult to quantify. While it is possible calculate political risk "scores" or other quantitative-looking benchmarks (e.g. Transparency International's *Corruption Index* & Eurasia Group's *Geo-Political Risk Index*), it is important to remember that these are ultimately based on qualitative judgments.

The best way to go about managing political risk is to educate yourself. A good resource is the Economist's *Country Briefings*. These reports contain a wealth of information with regard to a country's government, politics and economy.

Another is to spread out your risks. Diversifying your international investments into a variety of regions and countries (and among several asset classes) would mitigate political risks even if your political risk calculations turn out to be off the mark.

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