TRANSCRIPT

Analytics Risk Summit London 2024

Creating frameworks for geopolitical risks

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So geopolitical risk actually has returned as a key risk impacting investment risk and return.

It's actually cited as one of the most, if not the most important concern on top of mind for investors today.

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Now, investors today, if you think about it in terms of geopolitics, everyone talks about it, but I think they lack a consistent framework to actually think about how to measure, manage and monitor geopolitical risk.

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Now, even before we get into that, let's take a step back in terms of how do we define geopolitical risk.

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And it's funny that geopolitical risk is different to different people.

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So you might get a different answer depending on who you ask.

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And the reality is that it is actually very loosely defined today.

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So, simply put, you know, many will tell you that geopolitical risk is about the challenges and opportunities that you face when you invest in foreign markets.

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Now that definition is very limited because it ignores economic exposures.

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Your domestic portfolio could also be exposed to geopolitical risk.

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Now, there are others who extend the definition of geopolitical risk to include other types of risks, such as risk related to climate change or AI, for example.

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And the thought there is that, you know, if countries cannot align and come together, then these risks actually may be really material and we may realize these risks and you know, which is one school of thought, but there is the other school of thought that we are actually clubbing all these risks together.

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And once you start clubbing a bunch of risks together, how do you really isolate what is driving your portfolio risk and return?

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So investors are really thinking about geopolitical risk.

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But I think the challenge is that they do lack a systematic framework to think about it and to assess it.

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And what MSCI has tried to do is really address the gap here and really provide a framework to be able to measure, manage and monitor geopolitical risk and to keep the, you know, the framework intuitive and simple what we have done is think about the investment horizon because geopolitical risk can vary depending on your time frame.

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And we've really taken this approach to bucket the framework into three categories.

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So there's a short-term investment horizon, there's a medium-term investment horizon and there's a long-term investment horizon.

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Now in the short-term, what we see is that when there's a spike in geopolitical risk, markets do, you know, react in a riskier fashion, but that doesn't last that long, and the recovery can be fairly quick.

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So then we go to the medium-term.

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And in the medium term, what we see is that there are companies that are more sensitive to geopolitical risk versus others. Geopolitical risk can, for some companies, to actually make changes to their business model, and make actually fundamental changes to how they operate.

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Now this can impact investor behavior, it can impact asset prices as everyone's anticipating on these companies to change.

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So it really depends on which sector you are in, which country you are in.

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But the medium term can be quite important because it can really differentiate companies on how they react to geopolitical risk.

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And this is again an area of work that that we are thinking through a lot more significantly.

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And then you go on to the long-term where you know, geopolitical risk can impact, you know, GDP growth and inflation and as a result of long-term capital market assumptions.

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And how do you think about that?

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How do you think about the equity risk premium that comes in?

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So those are things also that investors are grappling with and MSCI is trying to address that using our research.

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So what geopolitical risk has really done, or geopolitics has really done is create economic blocks across the world.

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And simply put, these are countries that like each other, trust each other and want to do business with each other.

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And you know, this rewiring of the global economy has impacted everyone, has created winners and losers as far as countries are concerned, as far as investment opportunities are concerned.

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Now a lot of countries have done - had made a lot of effort to actually shore up their supply chain, right?

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But I think the biggest impact has been on emerging markets where we see this, where we see the difference and we see an even further fragmentation of emerging markets.

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Now on the flip side, it's also made investors allocate differently to emerging markets.

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One of the most important things that we've seen is the exclusion or the separation of China from emerging markets as investors think about allocating to emerging markets.

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And this is because, you know, in some cases they want to manage the risk differently because they think the risk of China is different from the rest of emerging markets.

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And in some cases, investors have actually reduced the allocation to China.

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Now MSCI specifically has launched something called a next-generation emerging markets model that actually uses this dual structure of carving out China from the rest of emerging markets, because we want to, you know, showcase that actually the risk drivers of those two blocks are different, which will help investors eventually manage that risk better.

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So MSCI plays an objective voice when it comes to helping investors navigate such challenges.

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You know, I could go on with a long list, but I think the two main areas I want to focus on is the emerging markets model that we talked about earlier with the dual structure to be able to measure the risk of emerging markets excluding China and then the risk of China separately.

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And the second one is the geopolitical risk framework.

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And you know, there it's an important aspect because depending on which time horizon you are, there are different tools and different pieces of research that can really help you navigate that environment.

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So in the short term, you know, you could think about MSCI's stress testing and scenario analysis tools to figure out what is the impact of a certain geopolitical event or a shock to my portfolio.

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In the medium term, you could use MSCI's data sets such as geospatial data and which really determines where a company's assets are located, as well as MSCI's economic exposure data, which showcases where a company's revenues are coming from, to really determine where are those risks and opportunities in terms of geopolitics.

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And this will really help to differentiate between a certain group of companies versus others and determine which ones are more sensitive to geopolitics versus not.

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There's also a lot of work that we are doing to think about other metrics that can actually measure the sensitivity of companies to geopolitical risk.

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And now in the long-term, you know, geopolitics obviously can impact GDP in terms of lower growth, in terms of higher inflation and capital market assumptions.

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And you know, we are thinking about ways in which our macro finance model can actually help address some of these implications.

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When I think about the future of risk management and analytics, you know, it boils down to two things, which is data and transparency.

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The investment landscape has become extremely complex and clean granular data and robust tools and solutions are absolutely essential to be able to figure out the why and the how.

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And MSCI actually has a pivotal role in this changing landscape.

About MSCI

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