(UBS)

How can investors help defend themselves from geopolitical risks?

05 June 2024, 5:30 pm CEST, written by UBS Editorial Team

While global markets tend to recover relatively swiftly from most political or geopolitical shocks, investors are generally eager to mitigate volatility in their portfolios. Unfortunately, there is no one-size-fits-all hedge.

The perfect hedge would depend on the nature of the crisis, which is impossible to predict. Even so, investors can apply these general principles:

- **Diversify geographically.** Most geopolitical crises will impact some nations more than others, such as South Korea during North Korea's missile tests, or Russia and Ukraine during the current crisis. Since you cannot anticipate where the flare-up will happen, maintaining a geographically diverse portfolio is the favored basic hedge. Geographical diversification can be particularly important for investors based in emerging economies, where policy setbacks or conflicts can have a more severe and lasting effect on the home equity and fixed income markets, as well as the currency.

- **Consider some exposure to "safe-haven" assets.** These can include gold, the Swiss franc, US dollar, Japanese yen, US Treasuries, low-beta stocks, and select hedge fund strategies. However, this is not a static category. For example, if the political crisis threatens to radically boost energy prices and therefore inflation—but is unlikely to spark a recession—high-quality government bonds might not be the best source of protection, especially if yields are already low. But a selection of defensive investments—diversified in their own right—can help reduce volatility.

- **Explore hedges that have upside potential**, even if the crisis does not escalate. The optimal hedge is one that you expect to rise in value over the long term, even if the geopolitical crisis is resolved, but would outperform if the crisis escalates.

- **Keep a long-term focus.** Geopolitical risks seldom have more than a fleeting impact. So, we recommending avoiding getting caught up in any panic response and to not sell into the crisis. This should ensure you are well placed to benefit from the rebound. Political risks can capture market attention for anything from a few days or weeks, then disappear just as suddenly as they fade from the headlines. In addition, there is almost never a time when there is no potentially significant political crisis on the horizon, so put them in perspective.

- **Build a “buffer” against volatility.** When it comes to managing risk in your portfolio—whether from a geopolitical shock or another source—the priority is to make sure that your portfolio is designed so that short-term market volatility does not interrupt your ability to meet your goals. One solution is to build a Liquidity strategy by setting aside enough cash, bonds, and borrowing capacity to meet the next 3–5 years of cash flow needs from your invested assets. Historically, most diversified portfolios have fully recovered from even the worst market losses in 3–5 years, so the Liquidity strategy can provide you with the resources that you need to “wait out” the recovery of the rest of your portfolio. Being able to maintain your lifestyle and avoid the risk of locking in otherwise-temporary losses in your long-term investments can create a powerful buffer against geopolitical shocks, providing you with confidence and safety even if they become a more serious market disruption, such as a bear market.

- **Select hedge fund strategies can increase portfolio stability and diversification.** Due to their focus on risk management and downside mitigation, hedge funds have historically added differentiated returns in multi-asset portfolios, providing some protection against unexpected sell-offs and helping to reduce portfolio swings, especially during times of economic slowdown or recession. The path toward broader geopolitical uncertainty is likely to contribute to volatility, creating opportunities for hedge funds to generate alpha and potentially achieve higher returns. So, investors concerned about geopolitical and economic uncertainty can add exposure to hedge funds as part of a well-diversified portfolio.

For much more, see **Geopolitical risks: An investor's guide**.

Important information
As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.
© UBS 2024. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.
There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.