



Equities

Political Risk in Emerging and Developed Markets

May 1, 1996

The often-observed link between dramatic political events and large market moves suggests that political risk can affect stock returns. Quantifying that risk is difficult, however, because the evidence of its systematic impact on stock returns is largely anecdotal. In this article, we provide direct evidence on this issue by exploiting analyst estimates of political risk.

First, we show that changes in political risk have a larger impact on returns in emerging markets than in developed markets. In emerging markets, political risk changes represent an economically and statistically significant determinant of stock returns. Average returns in emerging markets experiencing political risk upgrades exceed those of markets experiencing increased political risk downgrades by approximately 11% a quarter. There is no statistically significant difference between average returns in developed markets experiencing political risk upgrades and those experiencing political risk downgrades.

Second, we document a global convergence in political risk. During the past 10 years, emerging markets have become politically safer and developed markets have become riskier. If this trend continues, the differential impact of political risk in emerging versus developed markets may narrow.

These results suggest several prescriptions. In emerging markets, if one can forecast changes in political risk, one can forecast stock returns. Therefore, emerging market analysts are well advised to devote considerable resources to forecasting political risk changes. In developed markets, political risk is less important.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC ("AQR") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither

AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.