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Geopolitical Tensions Flare—What Investors Should Do

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Key Takeaways

» *The recent flare in U.S.-North Korean rhetoric understandably leaves investors wondering how to protect their portfolios against a potential military confrontation.*

» *Wars are difficult to predict, and reallocating a portfolio to address a particular risk can be expensive and can undermine the investor's long-term plan (if the event fails to occur). Even worse, a reallocation to one risk may expose the portfolio to other, unanticipated risks.*

What it May Mean for Investors

» *Fortunately, diversification is a step that can (at least partially) help to guard against political risks. Diversification already is part of our recommended long-term portfolio planning. We therefore advise investors to stay with their investment plans.*

U.S. and North Korean leaders exchanged threatening rhetoric this week, only weeks after reports that North Korea is evolving its missile technology with the eventual goal of reaching the continental U.S. with a nuclear warhead. While the North Korean threat is top-of-mind for many investors, financial markets have responded with a tepid pullback so far. In this report, we consider what might trigger greater market concern—but focus our advice on keeping perspective and preserving investment plans.

A War Is Difficult to Predict Accurately

While acknowledging the great potential devastation of a war, the probability that anyone can correctly predict the event and its timing seems low. The challenge is more difficult in that history may not provide a reliable pattern to follow. Past North Korean military provocations caused limited damage and typically subsided once new economic concessions were granted.

The threat of a nuclear weapon is certainly more serious than previous threats, but that threat also may increase the probability of a diplomatic solution. Despite their other policy differences, China and the U.S. both want regional stability in north Asia. China has been reluctant to pressure its Korean ally—but this week supported UN Security

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Council sanctions against North Korea, following Pyongyang's latest missile test launch. The more defiant North Korea grows, the more we believe that North Korea's closest ally (China) and greatest adversary (the U.S.) will collaborate to maintain regional stability. If one is well advised to keep one's friends close and one's enemies closer, a provocative military strategy seems to be the worst route for North Korea to take.

Keep Perspective: North Korea Is Not the Only Risk

Other global problems also pose threats to financial and commodity price gains, including renewed worries about a Eurozone breakup under some Italian election outcomes, Russian-supported separatism in Ukraine, spillovers from multiple conflicts in the Middle East, and terrorist attacks. Even though their potential impacts are not as immediate or dramatic as that of a new Korean war, these risks may have higher probabilities of disrupting markets in the coming months.

Quite understandably, though, investors are wondering how to protect their portfolios against a sizable military confrontation. If the rhetoric intensifies—or should a conflict break out on the Korean peninsula—the likely beneficiaries would be perceived risk havens like bonds and gold, and, possibly, the Swiss franc. In terms of U.S. companies, those least affected would likely be those with local supply chains.

A Diversified Portfolio May Be the Best Defense

Reallocating a given portfolio to try to protect against some combination of the above-listed risks likely would result in an allocation that is similar to our recommended portfolios, which not only diversify assets—but vary depending on the investor's unique risk and return objectives. Moreover, these portfolios typically accommodate the instruments or asset classes that historically have served as perceived risk havens: cash alternatives, bonds, commodities (including gold) and local companies from the U.S., Europe, and emerging economies (from all parts of the world). Diversification doesn't hedge against any one geopolitical risk, because the probabilities are dynamic and very difficult to predict. However, diversification provides the investor some flexibility to forego possibly complex and expensive hedges of a particular risk that may or may not be realized.

The process of diversifying should not neglect equities. The U.S. has faced a variety of geopolitical threats, and the U.S. equity market has a long track record of growing amid threats, including existential threats such as the Cuban Missile Crisis (1962). As Chart 1 illustrates, the equity markets also have dealt with other crises, from the Iran Hostage crisis (1979) to the stock market crash of 1987. We acknowledge the grave possibilities of the current North Korean threat. The most obvious way in which the risk could increase would be if North Korea tests another nuclear device or tests more long-range missiles. Yet, we also expect that additional provocations increase the pressure for a diplomatic solution. Thus, we do not see a reason to abandon investment plans. It is, however, important to periodically confirm that your investment plan continues to meet your risk profile and financial objectives.

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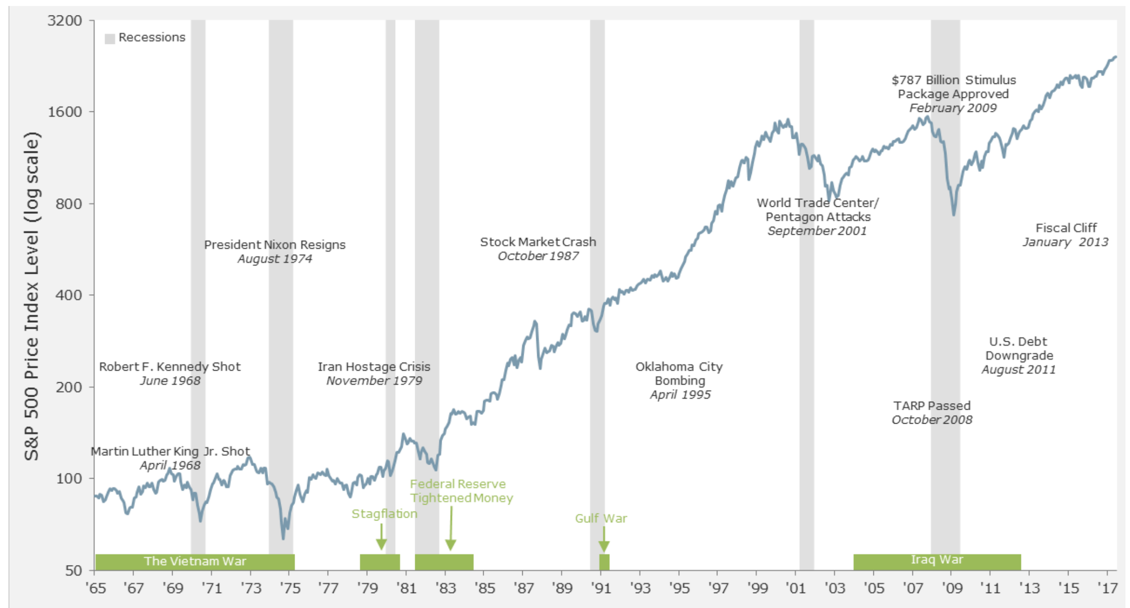
Chart 1. U.S. Markets Often Have Shown Resilience Despite Crisis Events



Sources: Wells Fargo Investment Institute; Bloomberg, Ned Davis Research. 6/30/2017. ***Past performance does not guarantee future results.*** *Equity performance represented by S&P 500 Index. An index is unmanaged and not available for direct investment.*

Focus on What Is Controllable

Our strongest conviction is that, while there are long-term risks here in the U.S. and elsewhere in the world, well-diversified investors should remain fully invested and stay focused on economic fundamentals and market valuations. Our tactical advice is designed to raise or lower risk in portfolios as opportunities and threats arise. Our current tactical positioning reflects our belief that a modest pullback is likely in the equity markets between now and the end of the year. Whether that pullback will arise from an intensification of the current geopolitical situation or from more mundane concerns about U.S. fiscal policy, central bank policy, or extended market valuations remains to be seen. In our opinion, investors are well served by taking a slightly defensive posture in their portfolios, through reducing high-yield bonds and developed-market bonds in favor of U.S. investment-grade bonds, by ensuring that risk-asset exposure (such as to equities) is aligned with strategic targets, and by reducing small-cap stocks and commodities in favor of REITs (Real Estate Investment Trusts) and hedge funds.

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Risks Considerations

Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Hedge funds are complex, speculative investment vehicles and are not suitable for all investors. They are generally open to qualified investors only and carry high costs, substantial risks, and may be highly volatile. There is often limited (or even non-existent) liquidity and a lack of transparency regarding the underlying assets. They do not represent a complete investment program. The investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as mutual funds. Investing in hedge funds may also involve tax consequences. Speak to your tax advisor before investing. Investors in funds of hedge funds will incur asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investment in a hedge fund involves the risks inherent in an investment in securities, as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, "junk" bonds and illiquid investments. There can be no assurances that a manager's strategy (hedging or otherwise) will be successful or that a manager will use these strategies with respect to all or any portion of a portfolio. Please carefully review the Private Placement Memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as other factors you should consider before investing.

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