Fight or flight...

Two of our analysts debate the impact that war in Ukraine could have on investors' portfolios...

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It's easy to be glib about war until it starts. In 1983 Stanislav Petrov was the one man standing between the world and a nuclear conflagration. When the Soviet early-warning system picked up a (non-existent) pre-emptive nuclear strike, Stanislav, colonel in the Soviet Air Defence Forces, was on duty. His order was to immediately retaliate in the event of any attack, which the Soviets believed to be a real threat given the tensions of the time. His decision to ignore his orders and wait to hear confirmation prevented, most likely, a series of tit for tat nuclear strikes which could have killed millions. The stakes are not so high in Ukraine – probably. But the mutual distrust and the mind games are the same. Assuming war is imminent – as it would be foolish to assume otherwise – we ask whether investors should be repositioning for the fall-out.

This will all blow over – Thomas McMahon

Putin's aims in Ukraine are likely to be limited, rather like the first incursion in 2014. His whole strategy is about taking as much as he can without actually triggering a full-throated response from NATO. In his eyes, NATO's – or the West's – weakness and unwillingness to fight is his opportunity, and there is a line he can't cross. As a result, I would expect any conflict to look a lot like the first attack in 2014, focused on areas of Russian influence and creating an attritional situation that saps power and legitimacy from the Ukrainian government. What happened in markets in 2014 could therefore be a reasonable guide.

The Russian incursion came in February, and it was disastrous for the Russian market and economy. The MSCI Russia Index ended the year down 43% in sterling terms, most of this due to a collapse in the currency. In local terms, the market was down 13%. However, the MSCI ACWI was up 10.6% for sterling investors. Global markets shrugged off the conflict, which may well have encouraged the West to make a rather limited response. For all our principles, our economic interests often drive policy, and they lie in keeping any conflict limited in scope. This is perhaps even more true now than then, thanks to the cost-of-living crisis, which is likely to become more and more significant to politics as the year goes on.

In fact, it could well be that the conflict throws up a buying opportunity in energy-related stocks and perhaps others in Russia. If you had bought into the market in December 2014, near the relative lows, you would have outperformed the MSCI AWI by around 20% since, even after the recent sell-off as tensions rise. One way to be prepared to take advantage of another such opportunity would be to allocate to **Barings Emerging EMEA Opportunities (BEMO)**. BEMO has the flexibility to invest in Russia, which is one of the major markets in its benchmark, but equally to avoid it and bide time in other markets. In particular, the ability to buy Saudi oil companies could prove beneficial if Gazprom, Rosneft and companions suffer sanctions or become temporarily uninvestable. A riskier play could be to look for an opportunity to by JPMorgan Russian, which currently sits on a 12% discount. Given the potential for military action to hit the Russian market, this trust could suffer initially, but if investors manage to time an entry point after the market has absorbed the hit, long-term returns could be good as they have been since the last conflict.

Overall I do not think investors should be shifting into a defensive stance out of fear of an attack on Ukraine. More pertinent reasons to be cautious include the high level of inflation which could start to negatively impact consumer spending and the

Analysts:

John Dowie

economic recovery, and how markets will absorb higher interest rates, particularly in high duration sectors. At the margin, any conflict could reduce the willingness of central banks to raise rates, as they may worry about any economic fallout. However, the current inflationary situation is probably at the stage where central bankers will feel compelled to act. Remaining invested in portfolios with a lower beta to growth could be wise, with one such example being **AVI Global (AGT)**. AGT invests in idiosyncratic opportunities around the world where the managers believe there to be value opportunities. This doesn't mean they avoid growth sectors like technology, but they look for situations where the price isn't reflecting the value in the company. This is likely to offset or override any negative impact from rising interest rates to the companies' valuations.

This will all blow up – John Dowie

Wars have unpredictable and unintended consequences and can escalate all too easily. In this case, escalation could occur because both sides may not be willing to back down, each for their own reasons. The US leadership will be keenly aware that after the humiliating retreat from Afghanistan, China will once more be observing a test of American resolve. The US establishment may decide to intervene in Ukraine to cool Xi Jinping's ambitions with regard to Taiwan.

For Russia, the stakes are even higher. Without naturally defensible borders the primary strategic goal of the Russian state is to maintain build a sphere of influence that acts as a buffer zone between Russia and the Western powers. If Ukraine joins NATO, the last of the buffer zone between the militaries of the West and the Russian heartland will be removed, and as Putin has made clear, this is absolutely unacceptable. Whereas many commentators in the West seem to interpret this as the bluster of a megalomaniacal dictator, it is in fact entirely consistent with centuries of Russian foreign policy and a mindset shaped by a history of multiple devastating invasions – a mindset that US and UK leaders seem unable to grasp, themselves being raised in nations and cultures made safe by oceans.

Now, all this being said, a serious conflict is still the less likely scenario, the reluctance of nuclear-armed powers to confront one another hopefully providing enough incentive for cooler heads to prevail. So, what is an investor to do? A land war in Europe could have immense repercussions: an energy crisis in Europe as gas supplies are cut off, panic selling in markets, and political upheavals as the NATO alliance is sorely tested (Germany is deeply reluctant to clash with Russia). Does this mean an investor should sell everything and bunker down? Or simply carry on and hope for the best? The problem with the former is that an investor will be abandoning their financial plan for an unlikely outcome. The issue with the latter is that if Russian tanks do roll over the border, what is the likelihood any given investor will keep a cool head and not panic whilst watching their portfolio take losses?

Fortunately, there is a solution for dealing with unlikely but potentially bad outcomes: insurance. **Ruffer Investment Company (RICA)** and **BH Macro (BHMG)** are two strategies that have had insurance-like characteristics to date (of course, there is no guarantee that these trusts will protect a portfolio in the event of future market stress, be it related to the outbreak of war or not). BHMG is a hedge fund strategy that seeks asymmetrical payoffs from unlikely but extreme events whilst limiting its maximum losses. This creates a return profile that can deliver strong returns during market selloffs. For example, in March 2020, BHMG returned c. 18% when the MSCI World Index was down c. 11%. RICA is explicitly designed to avoid losses over one-year rolling periods and invests in tail-risk insurance strategies, gold and government bonds as defensive assets and has a multi-decadal track record of preserving investor capital during difficult market conditions. I think by including these types of holdings in a portfolio, an investor can feel prepared for the worst without having to abandon their overall portfolio positioning.

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