#TMS2013: 'Country Risk', the art of coping with Foreign Markets

The progressive loss of control over the effects of decisions and actions in relation to economic and financial markets due to the increasing complexity of international operations and, in particular, increasing interdependency between economic variables and political variables, and the increasing weight of the latter – makes it essential and urgent to try to evaluate adverse effects, due to political events, of such decisions and initiatives. The analysis of political risk addresses this and seeks to minimize these effects. For global institutional investors seeking to manage portfolio risk, political risk now deserves more of their attention as governments have been called to intervene much more directly in the economies of rich and poor countries.

The analysis of political risk can highlight, through the use of given indicators, certain trends and market opportunities that economic indicators reveal more slowly. The analysis of political risk is also intended to highlight the importance that political structures and processes have on the major strategic decisions, including economic ones.

The evolution of economic and geo-political scenarios affects industrial and financial assets. That's why every time that a company engages in foreign investment, it must also take these into account. The monitoring of "country risk" has become increasingly important in light of recent events. Just think of the events of the Arab Spring and Egypt to realize how even countries considered to be generally predictable are not exempt from political risks. Political risk also often encompasses corruption, expropriation, and terrorism, as seen recently in Indonesia. This basket of uncertainties is important to understand, not just from the perspective of the direct stakeholders, the company owners and shareholders, but also for fund managers assessing the countries entering developing markets.

Political risk is perhaps the most important consideration of the more general analysis of ‘country risk’, and often serves as a substitute. Even as most people can understand what country risk represents at an ‘instinctive’ level, it is more difficult to define its various nuances. It is certainly related to the risk of insolvency of public and private entities, linked to a specific geographic area of □□origin and independent of their will. It is also the risk related to the origin of a particular investment or financial instrument, which are dependent on political, economic and social variables. Therefore, corporations interested in investing beyond their borders inevitably consider the essential elements of country risks in order to assess the viability of doing business in a given region. While some of the cited elements can be analyzed with quantifiable tools, especially in emerging markets, such data simply frame what is a far more complex and colorful picture comprising many dynamics. Former US Secretary of Defense Donald Rumsfeld described it best as “the known unknowns”, a definition that actually makes more sense than it should.

Country risk can be broken down into four general categories that have an impact on expected return of an investment or outcome of a project, as described in Duncan H. Meldrum’s paper “Country Risk and Foreign Direct Investment”, which is considered a standard in the methodology for Country Risk Assessment.

1. **Political Risk**. This refers to a whole range of non-economic events related to political factors and it is the least quantifiable and most unpredictable. It can refers to events of great impact such as conflicts, as well as shifts in the direction of economic policy as in

the case of expropriation and nationalization related to institutional changes and unilateral acts of governments. These risks are difficult to predict and are especially relevant in the mining and resources sector. Political Risk are subject to a number of influences stemming from the both the grass roots and the leadership. There are a number of examples from the past two years that have reminded investors of problems related to political risk in emerging economies, not the least of which has been the series of massive anti-establishment protests, described as the 'Arab Spring', which has forced a major re-assessment of risks in the Middle East and North Africa. It is not just the fear of political violence that concerns investors; indeed, protests such as those orchestrated by the Save Malaysia Stop Lynas (SMSL), have been exploited by political opposition, politicizing the granting of an operating license for the Lynas LAMP rare earth processing plant issue into an election issue.

2. **Sovereign.** The term "sovereign risk" refers to the ability or the willingness of a sovereign debtor to meet payment obligations. It therefore concerns the actual availability of resources and the reputation and the presence of and/or previous debt restructuring.
3. **Credit Risk.** Credit risk refers in more detail to the economic decisions of the various countries that affect growth rates, the degree of openness of the economy and exchange rates. We can include the risks related to authorities' decisions to adopt restrictions on capital movements, on the repatriation of dividends and profits in this category as well. Exchange rate risk is also included – that is the unexpected fluctuation of exchange rate or the sudden abandonment of a fixed rate for a variable one. These are very important in the mining sector as noted by Vale SA in its recent experience with the Rio Horizonte potash project in Argentina. In extreme cases, the risk can be related to

a state running out of foreign exchange reserves, forcing it to unilaterally adopt restrictions on payments to foreign countries and investors.

4. **Position or regional risk.** This is the risk stemming from the contagion of a given ideological or political trend due to its proximity to neighboring countries or similar economies (such as the PIGS or BRICS) in their typicality or vulnerability. The events of the ‘Arab Spring’ are a classic case as are the shared risks in the former Soviet Republics, known as the ‘Stans’ or even of South Korea, Japan and China due to the actions of North Korea.

The importance of political risk and some of its recent and most noteworthy manifestations will be addressed by the #TMS2013 Panel D: *Geopolitical Risk and why it Matters: the rising tensions between China and Japan, US policy, and much more…* will be moderated by Al Shefsky, BA, JD, President, CEO & Director, Pele Mountain Resources Inc. Alan Shefsky B.A., J.D.President & Director Pele Mountain Resources Inc. Al Shefsky has been President, CEO and a director of Pele Mountain Resources since founding the Company in 1996. He has provided leadership and vision in the acquisition of the Eco Ridge Mine Rare Earths & Uranium project, his recruitment of a world class technical team with decades of experience in the Elliot Lake mining camp, and the advancement of the project to its current pre-development stage. Mr. Shefsky holds a Bachelor’s Degree in Economics from the University of Western Ontario and a Juris Doctor degree from Pepperdine University School of Law.

David Abraham, Senior Fellow – Institute for the Analysis of Global Security. David S. Abraham is a strategist in the natural resource sector with experience in business, the non-profit sector and government. He has assessed geopolitical and economic risk at Lehman Brothers and Sempra Commodities and also oversaw federal oil, gas and coal, and foreign assistance programs while at the White House Office of Management and Budget from 2003-07. During his career, David worked in various advisory and management capacities in several emerging market countries.

Dr. Michael Berry, Ph.D – Discovery Investing Dr. Michael Berry is a pioneer in the emerging field of “discovery investing”. He researches and writes on companies that focus on discovery in natural resources, high technology and biotech. Previously, he successfully managed small and mid cap value funds for Heartland Advisors and Kemper Scudder. He publishes Morning Notes by Michael A. Berry, Ph.D. The notes discuss geopolitics and their effect on capital markets.

Alessandro Bruno, Sr. Editor, ProEdgeWire. Alessandro Bruno holds a Bachelor of Arts Degree in Near Eastern Studies, a Master’s Degree in Middle East Studies and has completed Doctoral coursework in Middle East Politics at the University of Toronto. Alessandro has worked for the United Nations in Libya and specialized in Middle Eastern, African, and South American affairs with a focus on strategic political and economic development especially in the oil, gas and mineral resources sectors. He has been published extensively and is a frequent guest on television news programs including the BBC, SunTv CBC and CTV. Alessandro has lived and worked abroad and can communicate in a number of languages including Italian, Spanish, French, German, Arabic and a little Russian and Persian among others.

Byron King, Editor, Outstanding Investments, Energy & Scarcity Investor
Agora Financial. A Harvard-trained geologist and former aide to the United States Chief of Naval Operations, Byron King is Agora Financial’s resident oil and energy expert and editor. This “old rock hound” uses his expertise and connections in global resource industries to bring the very best opportunities in energy, mining and precious metals. Byron has made frequent appearances in mainstream media such as The

Washington Post, MSN Money, Marketwatch.com, Fox Business News, CNBC's Squawk Box, Larry Kudlow, Glenn Beck and PBS Newshour.

Eric Margolis, Award-winning, Internationally Syndicated Columnist Eric S. Margolis is an American-born journalist and writer. For 27 years, ending in 2010, he was a contributing editor to the Toronto Sun chain of newspapers, writing mainly about the Middle East, South Asia and Islam. He contributes to the Huffington Post and appears frequently on Canadian television broadcasts, as well as on CNN. A multinational, he holds residences in New York, Paris, and Banff, Canada. Margolis is the owner of Canadian vitamin manufacturer Jamieson Laboratories. Eric Margolis holds degrees from the Edmund A. Walsh School of Foreign Service at Georgetown University, the University of Geneva, and New York University. During the Vietnam War he enlisted in the U.S. Army.

Political risk factors are inversely proportionate to investors' knowledge about a country, which depends heavily on transparency by the nation under consideration. Companies and institutional investors intending to invest for the long run should do their best to assess the subjective and non-quantitative elements that can be thought of as political risk. Corporations in some sectors, such as oil and gas or mining, pay considerable attention to these factors, given that they must enter into negotiations with government entities for rights to the resources that bring them to a developing country. They know that political risk in many developing countries can entail nationalism that puts them at a disadvantage.

Understanding political risk gives advantages in analyzing the behavior of particular stocks, as political climate affects factors as diverse as sanctions, national budget deficits or surpluses and aid flows. Ultimately, developing formulas and tools to study political risk as precisely as possible helps investors find the best strategies for approaching profitable investments in emerging markets.