MORNINGSTAR®

# The World Is Waking Up to Autocracy Risk Thanks to Russia, China

An interview with Perth Tolle, founder, Life & Liberty Indexes.

**Leslie Norton**
Mar 2, 2022

Professional investors have long argued that you have to look to China, and to a much lesser degree, Russia, when investing your money.

Obviously, they haven't looked at the Freedom 100 Emerging Markets ETF (FRDM), which excludes both.

Since its inception in 2019, the ETF has produced rip-roaring returns compared with other emerging markets funds and benchmarks. This year, with Russia's invasion of Ukraine continuing, the fund is down just 1.7%, just a quarter of the 7.3% decline for the emerging markets category.

We checked in with Perth Tolle, who founded the index on which the ETF is based. Tolle makes the case that countries where people enjoy personal and economic freedoms produce more sustainable growth and use their human and economic capital more efficiently. In the wake of Russia's invasion, such arguments make sense. To learn about "autocracy risk" and related issues, keep reading.

**Q: What kinds of risks does the lack of freedom pose?**
A: The world is waking up to autocracy risk, from [Russian President Vladimir] Putin, from Xi [Jinping, China's president]. We have Putin invading countries for no apparent reason. Last year, China carpet bombed the industries that had made them rich and the economic policies that allowed them to prosper, and went back to Maoist policies. [China tightened credit to the real-estate sector to rein in over indebtedness, and then imposed a regulatory crackdown on the internet sector, with Alibaba (BABA) losing nearly half of its market value in 2021.] China told these companies overnight, "You have to be a nonprofit now." When you see this kind of autocracy risk and the instant worldwide condemnation of the offending countries, maybe 40% in autocracies is not a great idea.

In 2021 our assets quadrupled because China carpet bombed their companies. A lot of emerging-markets funds were in the biggest Chinese companies like Alibaba and Tencent (TCEHY). The

Russia situation is similar to that. It's a wakeup call. It made investors realize that autocracy risk was a miscalculation.

**Q: What's the advantage of investing in freer countries?**
A: They have more sustainable growth, recover faster from drawdowns, and use their human and economic capital more efficiently. There is less capital flight. For example, China's One Child policy led to infanticide and forced abortions of 30 million girls in China. That's my generation. That had a profound impact on me. That's one of the things that made me realize that these policies matter for the future of the country.

**Q: What are your concerns about Russia today?**
A: I'm a lot less concerned about Russia now than before. I'm concerned about nuclear risk, but that's not something investments can help with. From an investment standpoint, the biggest concern is not Russia, which is 3% of most benchmarks, but China, which is more than 30% of most emerging markets indices. That's a huge concentration risk.

**Q: How did you create the index?**
A: We use quantitative third party personal and economic freedom metrics, from the Cato Institute, and the Fraser Institute, which are world-renowned econometricians. They compile a country score for each country based on 79 metrics of both personal AND economic freedoms, including variables like terrorism, trafficking, women's rights, freedom of media, freedom of assembly, shareholder rights, private property prices, sound monetary policy, freedom to trade internationally. These country scores are used to derive country weights. Our country weights are 100% freedom weighted. We give no consideration to market capitalization.

These freedom weightings naturally exclude the worst autocracies--there is no Russia, no China, and no Saudi Arabia, no Egypt, no Turkey. Typically, all these countries make up 40% of most emerging markets funds. Instead, our overweights are in Taiwan, Chile, Poland, and South Korea. They're at the forefront of standing up for Ukraine. We also have mid-sized and smaller countries.

**Q: You have a big position in Taiwan. Isn't that a China risk?**
A: The big risk is 30%-plus in China. We should be allocating assets to countries like Taiwan that promote freedom and peace. These countries tend to have better gender equality, higher life expectancies, lower infant mortality, higher GDP, higher income per capita. There is a correlation between higher freedom countries, stronger institutions, and rule of law. Freedom is a prerequisite for development. We're seeing some of the alpha it provides. We're in extraordinary times. The divergence between freedom levels in the emerging markets indices are increasing.

**Q: What about using ESG, or environmental, social and governance funds, to deal with this kind of risk?**
A: Most ESG funds operate on the level of individual securities. That doesn't work in emerging markets. That's why you have 30%-plus in emerging markets funds in China, because they have to follow the ESG index, and the rule books say you can't deviate much from the parent index. A lot of ESG investors aren't aware of freedom as a metric. They should be. Freedom is the basis for all other ESG and has these great outcomes like gender equality and lower poverty rates and

lower corruption. If you lead with the G (governance) on the country level, you automatically get [better performance] on E (environmental) and S (social) factors of ESG too.

**Q: Does Putin’s misadventure in Ukraine mean China is less likely to invade Taiwan?**
A: I hope so. My intuition is that China is not stupid. Looking at this they are deterred. You would have to be stupid not to be. But there’s a lot of capriciousness in autocracy that you can’t predict.

Thanks Perth.