Tim Shufelt, Financial Post · Saturday, Jun. 26, 2010

Perhaps the most noteworthy aspect of the G20 is that it has become noteworthy.

True, the summit always garners attention for its temporary police state, its showdown between riot police and anarchists and its photo opportunities of political celebrities.

But it's almost as if the meeting of the stewards of the world's economy now has bearing on the world's economy -- and investor portfolios.

"When did we in financial markets so closely follow the schedule of the G20 or G8 meetings?" asked Kurt Reiman, head of thematic research at UBS Wealth Management Research Americas. "Now everybody is hanging on the very word of what the agenda is going to be and what they're going to say."

Governments essentially spent a path to relevance through colossal stimulus measures designed to float economies through recession.

That dramatic rise of state involvement in economic affairs, however, now poses a significant geopolitical risk, just the kind that can blindside a portfolio, Mr. Reiman said.

And there are many others, according to a UBS report that attempts to classify the types of geopolitical risks investors must be wary of and the impact those events are likely to have on various markets.

While the probability of a major geopolitical event occurring is low, the decade just ended should be evidence enough that investors ignore this brand of risk at their peril.

It included the 9/11 terrorist attacks, the tech bust, U.S. housing collapse and the global recession.

And it marked a new era in which the potential for destabilizing shocks is constant, Mr. Reiman said.

The relative tranquility of the 1990s had lulled investors into thinking they could ignore geopolitics.

"It never really used to matter because most of our money was in developed markets -- Europe, U.S., Canada -- and it was pretty stable," said Pierre Fournier, a geopolitical strategist at National Bank. "You didn't have to bother with emerging markets until recently."

Even those sticking to domestic investments are not off the hook, as Canadian and U.S. companies are putting ever more resources into countries with less stability, Mr. Fournier said.

Globalization has injected geopolitical risk into even the safest investment portfolios.

"Honestly, brokers, investment advisors and firms have been very, very slow to adapt to that new reality," he said. "Firms don't have the in-house capability to deal with these things."

According to the framework set out by the UBS report, the first step is to identify the major global risk factors, the list of which can be daunting.

The still fragile world economy and tentative prospects for a recovery has produced geopolitical tensions that go well beyond mere macroeconomic metrics.

State stimulus has produced soaring levels of public debt, making the stability of governments all that more important. Among the member states of the European Economic and Monetary Union, the ratio of debt to GDP has risen to 85% from 65% in 2007.

Unemployment has also spiked in Europe and North America, as has income inequality. Prior to the global credit crunch, ready access to credit masked income disparities, which are now more apparent.

That global instability has led to renewed protectionism, pulling back on years of steady growth in the integration of major economies and producing tensions between trading partners.

Meanwhile, suspected clandestine nuclear weapons programs in Iran and North Korea are raising the spectre of major armed conflicts. In general, military spending is rising, particularly in China, which is expanding its naval capabilities to secure global shipping routes and ensure access to resources.

Increasing scarcity of certain natural resources, however, may produce significant future increases in commodity prices and further strains on relations between competing nations.

But the shifting balance of power is undeniable, with China's steady march to global economic predominance producing an uneasy relationship with the United States, dubbed by senior White House economic adviser Larry Summers, the "balance of financial terror."

"This means that the greatest imbalances in international trade and finance -- China's stockpiling of U.S. dollar-denominated foreign exchange reserves and the persistently large U.S. current account deficit--exist between the world's largest and soon-to-be second-largest economies," UBS said.

After identifying major geopolitical questions, investors next need to consider specifically how those events might affect their assets.

The UBS framework identifies four sources of geopolitical stress: natural resource needs, national strategic ambitions, non-state ideological ambitions and income inequality. Each type of shock would resonate differently through the world's markets.

For example, a resource shock, like a Russian energy embargo, could lead to stagflation in which government bond prices would fall, gold would appreciate and stock and commodities markets would have mixed effects, though oil and natural gas prices would rise.

Alternatively, a border dispute, like an escalation between China and Taiwan, could produce a flight to safety, in which government bonds and stocks would fall, while gold and reserve currencies would rise. A terrorist attack, may lead to hyperinflation, as would a sustained global war.

And a currency crisis could be followed by depression and deflation, in which stocks and commodities would fall. Amid so many potential catastrophes, it's understandable for investors to become extremely risk averse, said Dan Mitchell, a senior fellow at the Cato Institute.

"But how do you minimize risk in an environment where government bonds are not perceived as safe anymore?" he said, noting Canadian and Australian markets as relative brights spots.

Mr. Mitchell blames ill-conceived bailout plans and stimulus spending in which governments have incurred too much sovereign debt, tainting a traditional safe haven for investors.

"Even though people are fleeing to the U.S. because of the assumption that we're a safe haven, that's just a case of being the tallest midget in the circus," he said.

"This is why gold keeps hitting record highs," he explained, noting that gold doesn't deliver any stream of income. "But if you're really pessimistic, that's where you go."

The opportunity costs of excessive risk aversion, however, are too great to make it a viable investment strategy, Mr. Reiman said.

The most obvious precautionary portfolio strategy is diversification.

"The reason they say to do this is that assets aren't correlated," Mr. Reiman said, noting that destabilizing shocks involve sudden changes in the relationship between disputing parties, which typically don't spill over to other countries or economies.

Of course, there is a limit to the benefits of diversification as geopolitical shocks can go global -- witness the worries over Europe's debt crisis --or can destabilize resource markets, a concern for all.

Next, investors need to assess risks continuously, a step that is omitted too often, said Mr. Fournier.

For example, investors should consider in advance the likelihood of an attack on Iran. "You should make your scenario today, you shouldn't react after," he said.

He pegs the chances of bombs falling on Iran in the next 12 months at about 20%. "So I'm not going to build my strategy around it, but if it happens, the first thing I do is go long oil and short most markets."

If an identified geopolitical risk is then considered to be unacceptable, an investor can choose to exit the market or simply hedge against it, the UBS report said. Alternatively, where risks may be overemphasized, buying opportunities exist. Finally, investors need to consider their reaction strategies to potential geopolitical shocks, Mr. Fournier said.

For example, he put out a note earlier this month indicating that the recent clashes in Kyrgyzstan would probably not be fatal for Centerra Gold Inc., a Toronto-based company that operates the Kumtor mine in the former Soviet state. But investors overreacted to the riots and bailed on Centerra stock, which plunged in value, Mr. Fournier said.

"This is a gut reaction by people who had no idea where things were going and decided to sell low. But if you analyzed the situation, you probably would have bought the stock and made good money."

When it comes to the G20, investors should perhaps be thinking whether the communique will advocate the stimulus taps remain open or a move toward austerity.

"The G20 meeting itself is an identifiable geopolitical event," Mr. Reiman said.