



Global Matters 37

Why country risk matters

May 2022

At 4D Infrastructure (4D), we have developed a fully integrated investment process whereby country risk is assessed alongside our stock analysis. We do this because we believe country risk is real, can impact stock investment decision making, and the risk can shift – both positively and negatively – over time. In this article, Sarah Shaw (4D’s Global PM and CIO) and Greg Goodsell (4D’s Global Equity Strategist) describe what 4D’s country review process involves, why it is so important, how it fits in with our stock valuations and its impact on portfolio construction.

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Right from the early origins of the 4D business, country risk was a key area that we thought needed to play a significant role in our investment process. As truly global investors, we believe understanding not just a company’s drivers and risks, but also a country’s drivers and risks, is crucial to investment decisions. How can we invest in a company if we aren’t comfortable with its country of origin or operation?

In this article, we describe how the assessment of this key variable evolved to what it is today. First, however, we want to briefly demonstrate why country risk has always been so important to us.

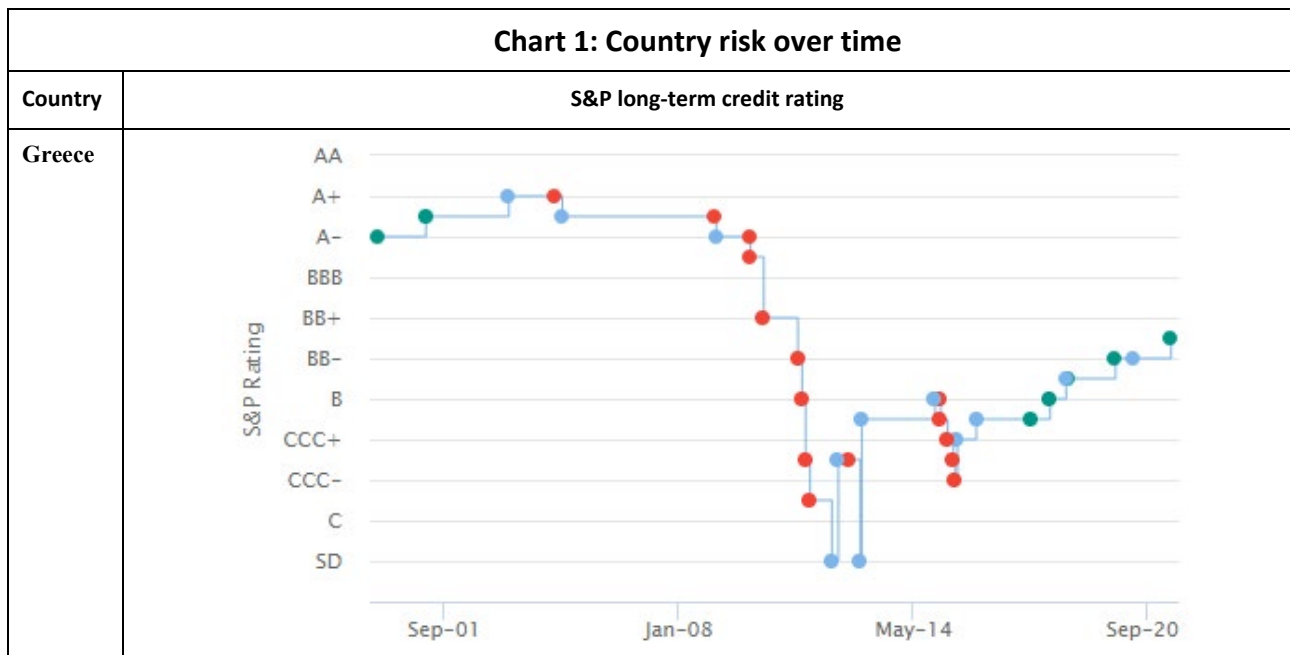
Country risk is real

Country risk is real, and shifts over time both in a positive and negative direction.

The current Russia/Ukraine war demonstrates country risk. Russia has been severely sanctioned by the international community as a result of its actions. At 4D, we have always graded Russia as red.

There has been no greater event exposing country risk than that exhibited during the global financial crisis (GFC) from 2007-2008. Prior to the recent COVID-19 recession, the GFC was considered the most serious financial crisis since the Great Depression (1929-1939). So, using changes in a country’s long-term Standard and Poor’s (S&P) credit rating as a proxy for changes in country risk, how did major global economies fare during the GFC and since?

Some nations really struggled, but none more so than Greece, which went from a solid S&P investment grade rating of ‘A-/A+’ pre the GFC to a virtually uninvestable ‘C’ (see chart 1 below). Now that is country risk deteriorating rapidly! Fortunately, Greece has exhibited a gradual recovery since then, although 4D still rates it as a red jurisdiction as a number of key metrics remain stretched and it has a propensity to quickly move into political instability (see the country review in the Appendix).

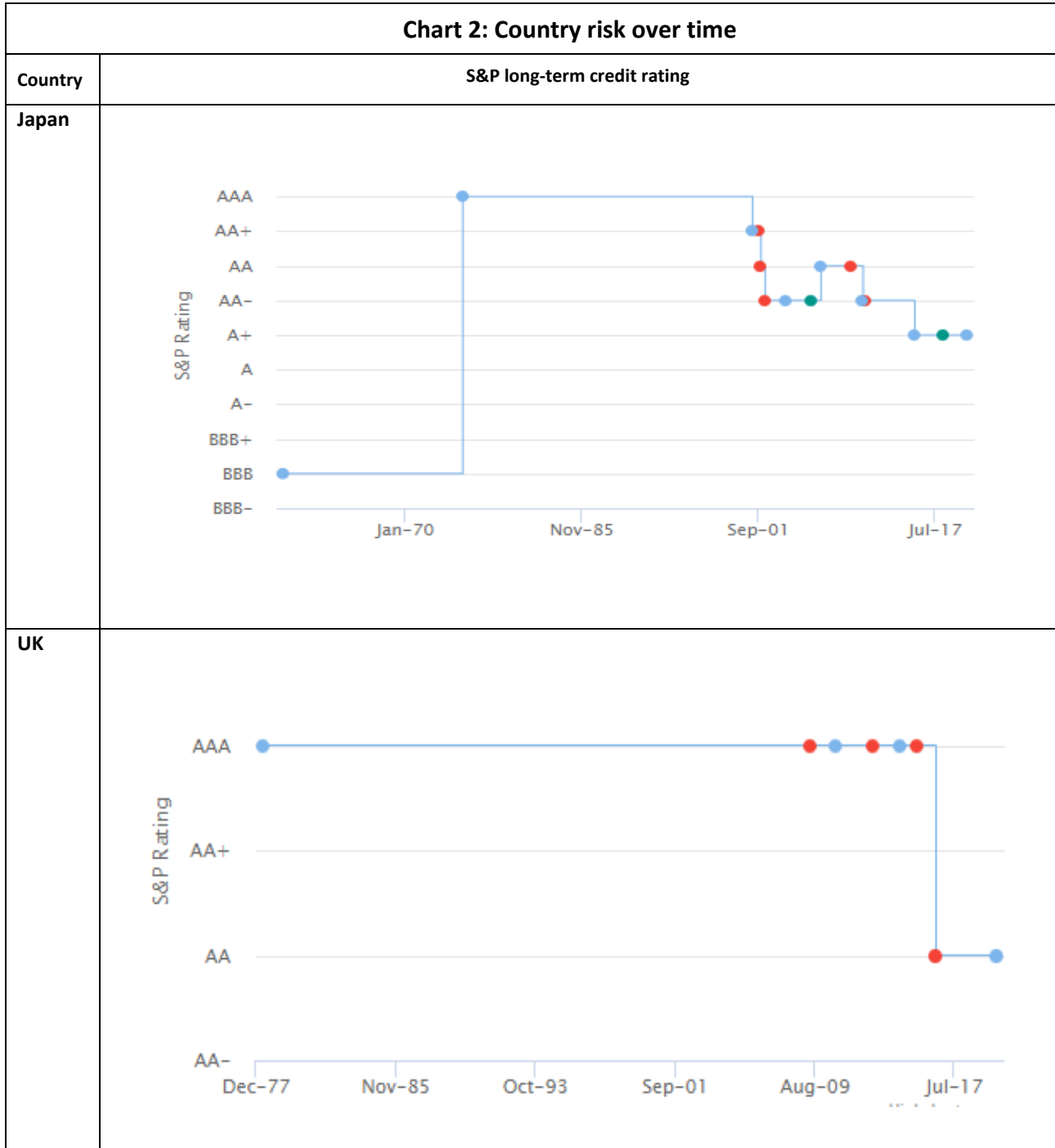


Source: World Government Bonds

But it is not just major, high profile, macro events that can impact country risk. Sometimes risk deterioration can be a far more subtle, almost a creeping, incremental event – a product of longer-term structural decline. For example, chart 2 reflects a gradual rating decline for Japan during the 21st century, although it remains in the investment grade ‘A’ category.

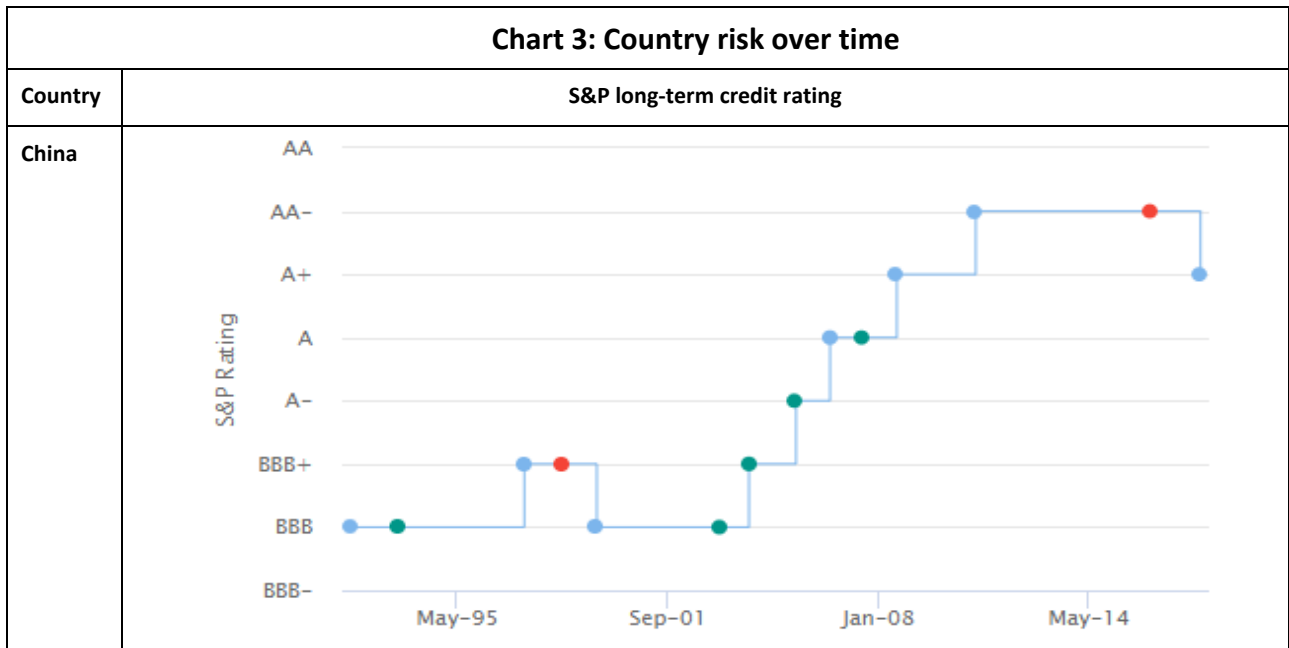
Deteriorating national demographics and excess levels of public debt have been important factors in this gradual rating erosion of Japan. Similarly, but more quickly, the UK rating deterioration shown below reflects its decision to exit the EU, which was driven by a narrow June 2016 referendum result (52% voted to leave, 48% to remain).

At 4D we currently grade both Japan and the UK as green jurisdictions, although the UK experienced some time at yellow during Brexit.



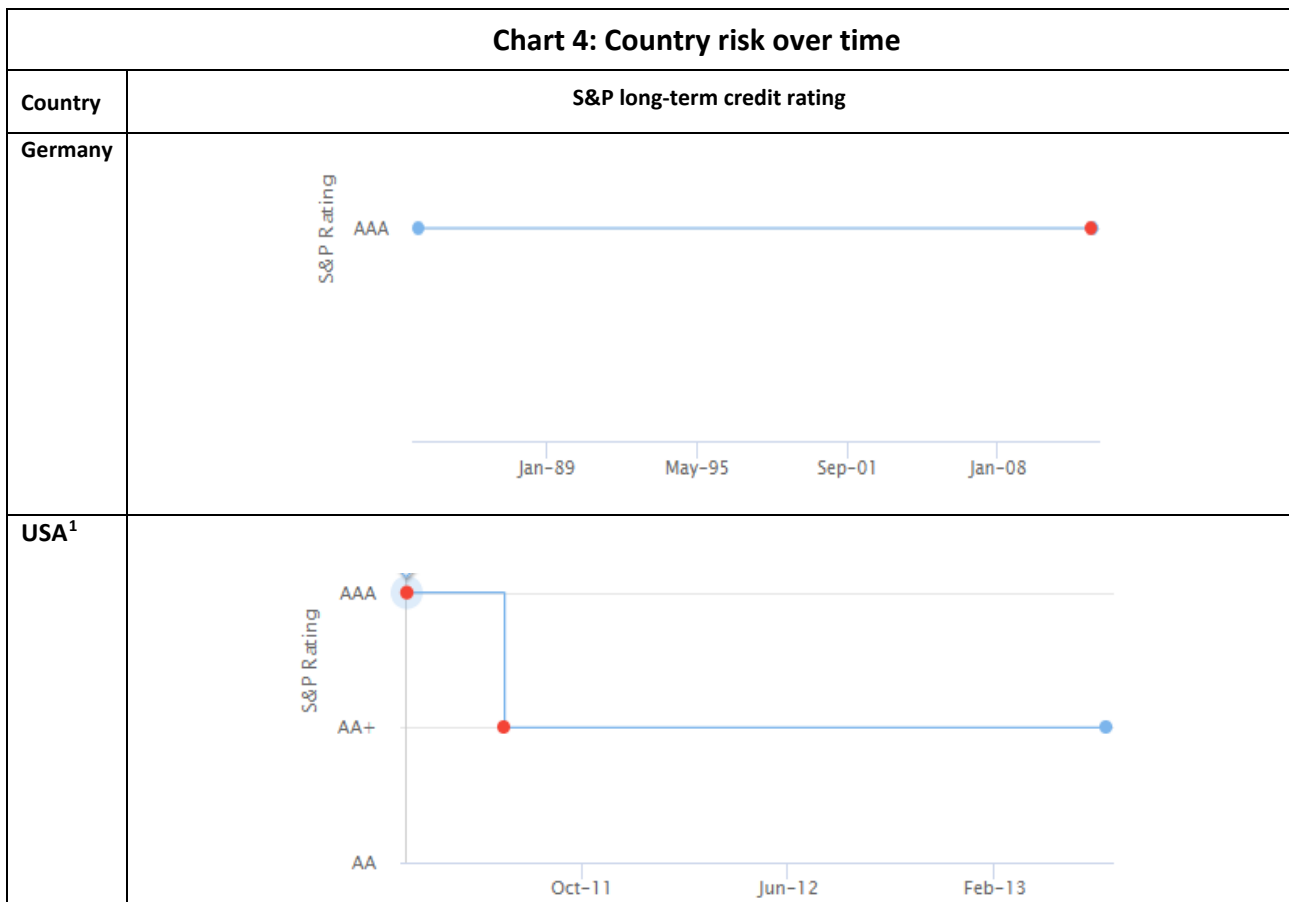
Source: World Government Bonds

Importantly, changes in country risk can also be positive. China’s rating history (see chart 3 below) very clearly reflects its economic and social growth and advance during the 21st century, with a steady rating climb since the early 1990s. We grade China as green.



Source: World Government Bonds

Finally, some things just ‘seem right’ and don’t seem to change, as reflected by Germany’s rock solid ‘AAA’ rating history below, and the ‘almost’ rock solid history of the US. We rank both countries as green.



Source: World Government Bonds

¹ The source for this data only reports the US S&P rating from April 2011, accounting for the short duration of this chart.





4D's approach to country risk assessment

Our approach to country risk assessment is designed to answer one key question: ***is the country under review an acceptable investment destination?***

To get the process underway, and provide a perspective on a country during its initial review, countries are given a *Preliminary Grade* based on their S&P long-term credit rating as follows.

Preliminary Grade	S&P Credit Rating
1	AAA - BBB
2	BB
3	Less than BB

This is a preliminary rating only. We then complete the 4D country review process, which involves a detailed assessment of the four key country risks below.

 <p>Financial risk</p> <p>Including country debt levels, credit ratings, credit default swap spreads</p>	 <p>Economic risk</p> <p>Including GDP growth, inflation, budget deficit/surplus, current account position</p>	 <p>Political risk</p> <p>Including political system and government stability, internal and/or external conflicts</p>	 <p>ESG risk</p> <p>Including ESG risks not considered in other risk assessments, also incorporates external research</p>
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After a country review is completed, each country is given a final grade using a traffic light system of:

- **Green:** the country is a relatively attractive investment destination;
- **Yellow:** the country is still an acceptable investment destination, but the risk is higher than in green countries. This could be a country that is improving from a red position, but is not yet low risk. Or it could be a country where we believe the risk has increased and is worth monitoring, such as Hong Kong or Italy post the 2018 elections;
- **Red:** the country is an unacceptable investment destination.

While every country is assessed on the four key risks identified above, the ultimate grade does not necessarily represent an equal attribution to each risk. That is, the ultimate grade (if not green) is likely dictated by the weakest link. For example, Russia has been graded red since 2015 despite a quite solid financial and economic position, due to ongoing political sanctions in Crimea, concerns around governance practices, and the recent Russian invasion of Ukraine.

This final colour designation dictates how much of the global fund's investment portfolio, in aggregate, can be allocated to stocks in that particular country grade. For example, as shown in table 7 below, stocks from yellow countries in aggregate can only make up 25% of the global portfolio. No stocks from red countries can be held in the portfolio. These gradings are assessed at both a listing and asset level.

Table 7: Final country grade and portfolio allocations

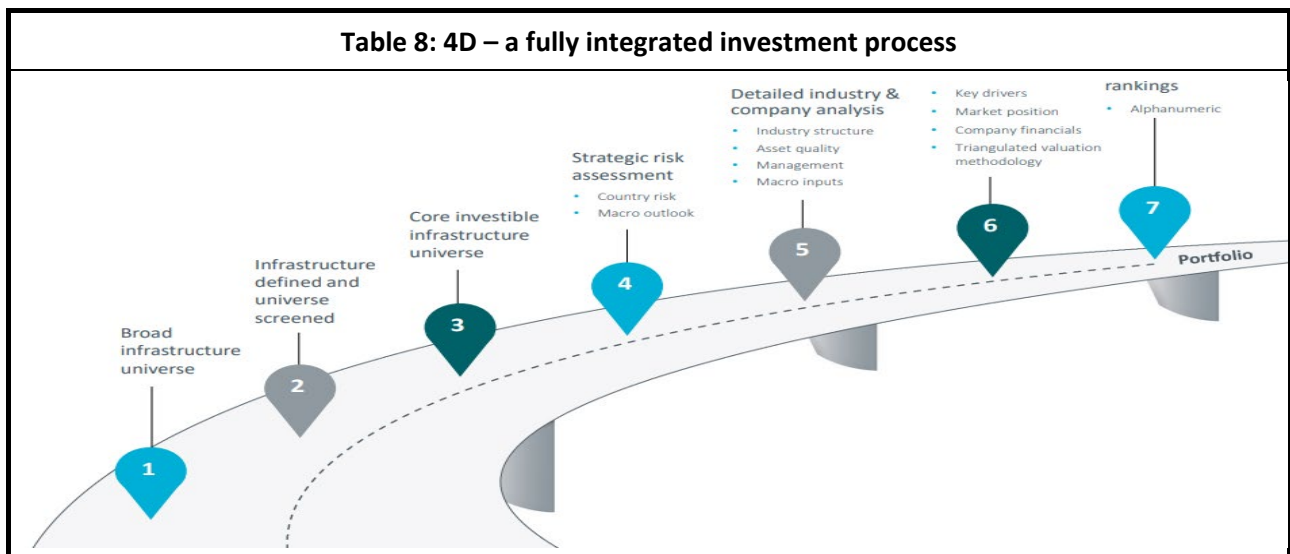
Weighting (% of total portfolio)	
Green flag - Grade 1	75-100%
Yellow flag - Grade 2	0-25%
Red flag - Grade 3	0%
Cash	0-10%

The final country colour grading also dictates the **market risk premium (MRP)** we employ to value stocks from that country – the lower the country grade, the higher the MRP used, which means the country risk is directly reflected in stock valuations.

Finally, the detailed country research helps build a strategic outlook, identifying relative country strengths and weaknesses, aiding stock coverage as well as portfolio level sector and demographic exposure.

A fully integrated investment process at 4D

Because our country reviews have a direct link to company financial models (via the MRP) and lead to hard portfolio country limits, we believe our investment process is fully integrated, with country risk assessment playing just as important a role as our stock reviews and valuations. We believe this is unique to 4D.



A selection of 4D’s country risk assessment outcomes

We have been employing our country review process since 4D’s inception in 2015. Each relevant country is assessed at least annually, but an interim review can also be triggered by a particular event such as Brexit. In 2021, we completed over 30 country reviews, with 70% ranked green, 15% yellow and 15 % red. Some of the interesting rankings and changes over the past six years are summarised below.

Table 9: A selection of country grading changes and comments	
Country	Comments
Hong Kong: taken to yellow in 2020 (from green)	Downgraded on concerns re China's intentions
Italy: to yellow in 2018 (from green)	Political instability post a fragmented election outcome. It has since been returned to green
UK: to yellow in 2019 (from green)	Brexit concerns and increasing political uncertainty, since reinstated to green
Argentina: from red to yellow in 2016 and back to red in 2017	Required an IMF bailout, concerns about interest rates
Thailand: to yellow in 2020 (from green)	Concerns over increasing social unrest. Since returned to green
Philippines: to red in 2020 (from green)	Concerns about the Government interfering with utility concession deeds
Russia: always red	Graded red in 2015 due to western sanctions around Crimea and governance issues. The current Ukraine invasion validates the red grading
Greece: always red	Political instability, weak financially
India: green to red in 2021	Concerns about the COVID-19 outbreak, reverted to green in 2022 on economic recovery

Conclusion

At 4D, we have always considered country risk a key factor in stock analysis and portfolio construction. The GFC provided a very real demonstration of country risk in practice. In response to that, we intentionally developed an integrated investment process that included both country and stock analysis as described above. We believe our investment process is both effective and unique, and has supported our overall performance since inception.

Included in the Appendix is a sample of some of our 2021 short-form country reviews – Austria (green), Hong Kong (yellow) and Russia (red) – which reflect a summary extract of the much more detailed full country reviews.

For more insights from 4D Infrastructure, visit [4dinfra.com](https://www.4dinfra.com)

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Appendix: Sample short-form country reviews – Austria, Hong Kong and Russia

Austria Country Review: 30 April 2022

	Rating/Outlook/Date	Preliminary Grade	Final Grade/Trend
Standard & Poor's (Max portfolio weight)	AA+ / Positive / Feb 22	Grade 1 (100%)	Grade 1/ Negative (100%)
CIU Stocks/Past Grades	2	2015/16/17/18/19/20/21/22	
MSCI ESG Rating	AA (Leader)	Economic Freedom	25 th freest in 2021
12 mth catalysts:	Ukraine war & inflation		
Next Election	September 2023		
Other ratings	Moody's Aa1 / stable	Fitch: AA+ / stable	EIU Country risk: A

Austria Summary



INTRODUCTION

Once the center of power for the large Austro-Hungarian Empire, Austria was reduced to a small republic after its defeat in World War I. A State Treaty signed in 1955 recognized Austria's independence.

GOVERNMENT

Chief of State

President Alexander VAN DER BELLEN

Head of Government

Chancellor Alexander SCHALLENBERG

Government Type

federal parliamentary republic

Capital

Vienna

Legislature

bicameral Federal Assembly or Bundesversammlung consists of:
Federal Council or Bundesrat (61 seats);
National Council or Nationalrat (183 seats)

GEOGRAPHY

Area

Total: 83,871 sq km
Land: 82,445 sq km
Water: 1,426 sq km

Climate

temperate; continental, cloudy; cold winters with frequent rain and some snow in lowlands and snow in mountains; moderate summers with occasional showers

Natural Resources

oil, coal, lignite, timber, iron ore, copper, zinc, antimony, magnesite, tungsten, graphite, salt, hydropower

as of October 2021

ECONOMY

Economic Overview

one of the strongest EU and euro economies; diversified trade portfolios and relations; enormous trade economy; Russian energy dependence, but investing in alternative energy; aging labor force but large refugee population; large government debt

GDP (Purchasing Power Parity) \$463.1 billion (2020 est.)

GDP per capita (Purchasing Power Parity) \$51,900 (2020 est.)

Industries - construction, machinery, vehicles and parts, food, metals, chemicals, lumber and paper, electronics, tourism

Agricultural products - milk, maize, sugar beets, wheat, barley, potatoes, pork, triticale, grapes, apples

Exports \$226.8 billion (2020 est.)

cars, packaged medical supplies, vehicle parts, medical vaccines/cultures, flavored water (2019)

partners: Germany 28%, US 7%, Italy 6%, Switzerland 5% (2019)

Imports \$211.9 billion (2020 est.)

cars/vehicle parts, broadcasting equipment, refined petroleum, packaged medical supplies (2019)

partners: Germany 39%, Italy 7%, Czechia 5% (2019)

PEOPLE & SOCIETY

Population

8.9 million (July 2021 est.)

Population Growth

0.32% (2021 est.)

Ethnicity

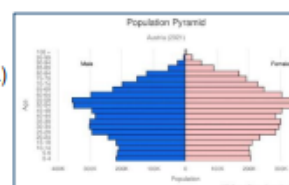
Austrian 80.8%, German 2.6%, Bosnian and Herzegovinian 1.9%, Turkish 1.8%, Serbian 1.6%, Romanian 1.3%, other 10% (2018 est.)

Language

German (official nationwide) 88.6%, Turkish 2.3%, Serbian 2.2%, Croatian (official in Burgenland) 1.6%, other (includes Slovene, official in southern Carinthia, and Hungarian, official in Burgenland) 5.3% (2001 est.)

Religion

Catholic 57%, Eastern Orthodox 8.7%, Muslim 7.9%, Evangelical Christian 3.3%, other/none/unspecified 23.1% (2018 est.)



Austria maintained at grade 1 (green flag) / trend negative

Like all nations Austria struggled with the COVID-19 pandemic. However, we are retaining it at grade 1 **(green)** jurisdiction noting:

Financial

- The country has a wealthy, diversified and open economy with no large macroeconomic imbalances, as well as a robust fiscal framework that produces manageable fiscal deficits
- **Public debt** is moderate at ~84% of GDP, **CDS spreads** are low at ~12bp
- A **green country grade 1** is consistent with its **preliminary grade 1**, which is based on an investment grade 'AA+' S&P credit rating
- **Being a member of the EU bloc is a core strength for Austria.** Significantly, in July 2020 EU leaders struck a deal on a huge post-COVID-19 recovery package. It will see the 27-nation bloc offering €750bn (US\$859bn) in grants and loans to counter the economic impact of the pandemic

Economic

- **The economy is forecast to return to growth this year** as remaining restrictions are gradually lifted
- The market forecasts **GDP to grow 3.2% in 2022 and 2.6% in 2023**
- Austria has **experienced tough COVID-19 impacts with 1,770 deaths/1m people as at April 2022.** Its COVID infection 'curves' may be accelerating again

Political

- A generally stable coalition is in government and **political risks remain low**
- Like much of the developed world, **Austria's demographics are only fair** with an ageing population. It **has quite a moderate degree of income inequality with a Gini of 0.27.** These will be increasingly important factors over coming decades

ESG

- Austria's ESG rating by MSCI is BBB or **'Leader' which is a clear positive**
- Austria is a **signatory to the Paris Accord and has a Net Zero Carbon goal of 2040**
- a coalition government sworn in January 2020 promised to pursue climate neutrality by 2040 and 100% clean electricity by 2030, underpinned by binding carbon targets. The right-wing People's Party agreed to the goals in partnership with the Green Party
- A reliable and accessible land registry system safeguards secured interests in property. The country's investment climate has been enhanced by its **stability and strong rule of law.** The independent judiciary provides an effective means for protecting real and intellectual property rights and enforcing contracts. Corruption is relatively rare

The **trend** is maintained at **negative**, with the main near-term risk is developments in the **Russia/Ukraine war.**

Hong Kong Country Review: 30 April 2022

	Rating / Outlook / Date	Preliminary Grade	Final Grade/Trend
Standard & Poor's (Max portfolio weight)	AA+/Stable/Sept 2017	Grade 1 (100%)	Grade 2 / Negative (25%)
CIU Stocks/Past Grades	4	2015/16/17/18/19/20/21/22	
MSCI ESG Rating	BBB (Average)	Economic Freedom	Not rated
12 mth catalysts:	Chinese actions		
Next Election	Chief Executive election 2025		
Other ratings	Moody's Aa3 / stable	Fitch: AA- / stable	EIU Country risk: A

Hong Kong Summary



INTRODUCTION

Occupied by the UK in 1841, Hong Kong was formally ceded by China the following year. Various adjacent lands were added later in the 19th century. Pursuant to an agreement signed by China and the UK on 19 December 1984, Hong Kong became the Hong Kong Special Administrative Region of the People's Republic of China on 1 July 1997.

GOVERNMENT

Chief of State

President Xi Jinping

Head of Government

Chief Executive Carrie LAM

Government Type

presidential limited democracy; a special administrative region of the People's Republic of China

Legislature

unicameral Legislative Council or LegCo (70 seats)

GEOGRAPHY

Area

Total: 1,108 sq km
Land: 1,073 sq km
Water: 35 sq km

Climate

subtropical monsoon; cool and humid in winter, hot and rainy from spring through summer, warm and sunny in fall

Natural Resources

outstanding deep-water harbor, feldspar

ECONOMY

Economic Overview

high-income tourism- and services-based economy; global financial hub; COVID-19 and political protests fueled recent recession; ongoing recovery but lower-skilled unemployment remains high; investing in job-reskilling programs

GDP (Purchasing Power Parity) \$420.1 billion (2020 est.)

GDP per capita (Purchasing Power Parity) \$56,200 (2000 est.)

Industries - trading, logistics, financial services, professional services, tourism, clothing and textiles, shipping, electronics, toys

Agricultural products - pork, poultry, spinach, vegetables, pork offals, game meat, fruit, lettuce, green onions, pig fat

Exports \$615.9 billion (2020 est.)

gold, broadcasting equipment, integrated circuits, diamonds, telephones (2019)

partners: China 23%, India 14%, Netherlands 6%, UK 5% (2019)

Imports \$609.1 billion (2020 est.)

integrated circuits, broadcasting equipment, office machinery, telephones, diamonds (2019)

partners: China 46%, Taiwan 7%, Singapore 7%, South Korea 5%, US 5%, Japan 5% (2019)

PEOPLE & SOCIETY

Population

7.26 million (July 2021 est.)

Population Growth

0.2% (2021 est.)

Ethnicity

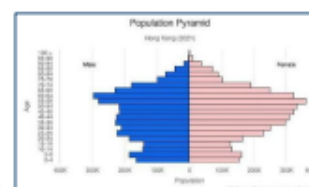
Chinese 92%, Filipino 2.5%, Indonesian 2.1%, other 3.4% (2016 est.)

Language

Cantonese (official) 88.9%, English (official) 4.3%, Mandarin (official) 1.9%, other Chinese dialects 3.1%, other 1.9% (2016 est.)

Religion

Buddhist or Taoist 27.9%, Protestant 6.7%, Roman Catholic 5.3%, Muslim 4.2%, Hindu 1.4%, Sikh 0.2%, other or none 54.3% (2016 est.)



as of October 2021

Conclusion: Hong Kong maintained at grade 2 (yellow flag) / trend negative

We are retaining Hong Kong as a **grade 2 (yellow)** jurisdiction largely because:

- **of the uncertain position re China's long-term intentions, and**
- **as the central Chinese government reasserts its authority** via the national security law, political freedoms in Hong Kong will be eroded in 2022-26, along with the territory's autonomy.

Note: based just on its **economics and history, Hong Kong would be a strong grade 1 (green)** country, as it has largely been since the inception of 4D's country review process in 2015. It has an extremely strong external position and has always been a prudent economic manager.

Financial

- **Public debt** is low at ~38% of GDP, **CDS spreads** are also low at ~35bp
- A **yellow country grade 2** is below with its **preliminary grade 1**, which is based on an Investment Grade 'AA+' S&P credit rating

Economic

- After softening in Q421, **economic prospects for Q122 are weak** as COVID-19 cases have surged to record highs, and led to a corresponding tightening of community restrictions
- Hong Kong has huge **currency reserves**

Political

- Like much of the developed world, **Hong Kong's demographics are only fair** with an ageing population. It also **has a very high degree of income inequality with a Gini of 0.539 – one of the highest in the world**. These will be increasingly important factors in the future
- **Hong Kong's Chief Executive, Carrie Lam's, announcement in April 2022** that she won't seek a second term ends a tumultuous 5-year tenure. She came under fire repeatedly as China tightened its grip on the city and drew scorn from international businesses for one of the world's strictest COVID-19 quarantine policies. A vote to replace her will be held on 8 May 2022 by 1,500 Beijing loyalists

ESG

- Hong Kong's ESG rating by MSCI is BBB or '**Average**'. Hong Kong is a **signatory to the Paris Accord, but has not set a Net Zero Carbon goal**
- In relation to its economic output, Hong Kong's **energy consumption and greenhouse gas emission levels are very low**. This is mainly due to the large added value in the country's service sector
- **Property rights** are recognised and contracts are enforced. The judiciary's authority to rule independently on commercial cases is unlikely to be affected by the Chinese clampdown

The **trend** is also left as **negative** as China continues to act in an aggressive manner.

Russia Country Review: 31 July 2021

	Rating / Outlook / Date	Preliminary Grade	Final Grade/Trend
Standard & Poor's (Max Portfolio Weight)	BBB- / Stable / Feb 2018	Grade 1 (100%)	Grade 3 / Stable (0%)
Past Grades		2015/16/17/18/19/20/21	
No. CIU stocks:	4		
ISS ESG Rating	C- (B- = Prime)	Economic Freedom	94th freest in 2020
12 mth catalysts:	COVID developments		
Next Election	March 2024		
Other ratings	Moody's Baa3 / stable	Fitch: BBB / stable	EIU Country risk: BB
Info: Country Rankings	Preliminary Grade 1	Preliminary Grade 2	Preliminary Grade 3
S&P's Rating	AAA – BBB (Investment grade)	BB	<BB
Source include	BBC, Bloomberg, BIS, Brokers, BOE, CIA Factbook, Economist/EIU, Euromoney, Fitch, Focus Economics, Forbes, ISG, IMF, ISS, Moody's, S&P, Trading Economics, RBC, Wolfe Research, OECD, World Bank, The Heritage Foundation (Index of Economic Freedom)		

Russia Summary



GOVERNMENT

Chief of State

President Vladimir Vladimirovich PUTIN

Head of Government

Premier Mikhail Vladimirovich MISHUSTIN

Government Type

semi-presidential federation

Capital

Moscow

Legislature

bicameral Federal Assembly or Federalnoye Sobraniye consists of Federation Council or Sovet Federatsii (170 seats) and State Duma or Gosudarstvennaya Duma (450 seats)

Judiciary

Supreme Court of the Russian Federation (consists of 170 members); Constitutional Court (consists of 11 members)

Ambassador to US

Ambassador Anatoliy Ivanovich ANTONOV

US Ambassador

Ambassador Jon HUNTSMAN

GEOGRAPHY

Area

Total: 17,098,242 sq km
Land: 16,377,742 sq km
Water: 720,500 sq km

Climate

ranges from steppes in the south through humid continental in much of European Russia; subarctic in Siberia to tundra climate in the polar north; winters vary from cool along Black Sea coast to frigid in Siberia; summers vary from warm in the steppes to cool along Arctic coast

Natural Resources

wide natural resource base including major deposits of oil, natural gas, coal, and many strategic minerals, bauxite, reserves of rare earth elements, timber

as of September 2020

ECONOMY

Economic Overview

reforms have stalled in recent years; predominantly statist economy with a high concentration of wealth in officials' hands, particularly in the energy, transportation, and banking sectors; as one of the world's leading producers of oil and natural gas, Russia is vulnerable to boom and bust cycles that follow swings in global commodity prices

GDP (Purchasing Power Parity)

\$4.016 trillion (2017 est.)

GDP per capita (Purchasing Power Parity)

\$27,900 (2017 est.)

Exports

\$353 billion (2017 est.)
partners: China 10.9%, Netherlands 10%, Germany 7.1%, Belarus 5.1%, Turkey 4.9% (2017)

Imports

\$238 billion (2017 est.)
partners: China 21.2%, Germany 10.7%, US 5.6%, Belarus 5%, Italy 4.5%, France 4.2% (2017)

PEOPLE & SOCIETY

Population

141.7 million (July 2020 est.)

Population Growth

-0.16% (2020 est.)

Ethnicity

Russian 77.7%, Tatar 3.7%, Ukrainian 1.4%, Bashkir 1.1%, other 12.2%, unspecified 3.9% (2010 est.)

Language

Russian (official) 85.7%, Tatar 3.2%, Chechen 1%, other 10.1% (2010 est.)

Religion

Russian Orthodox 15-20%, Muslim 10-15%, other Christian 2% (2006 est.)

Urbanization

urban population: 74.8% of total population (2020)
rate of urbanization: 0.18% annual rate of change (2015-20 est.)

Literacy

99.7% (2018)



Russia maintained at grade 3 (red)/ trend stable

Like all countries, Russia had a tough battle with COVID-19. An economic recovery is underway. But we are retaining it as a **grade 3 (red)** jurisdiction.

Financial

- **The US maintains sanctions on Russia** related to Russia's 2014 invasion of Ukraine, malicious cyber activities and influence operations (including election interference), human rights abuses, use of a chemical weapon, weapons proliferation, illicit trade with North Korea, support to the governments of Syria and Venezuela, and use of energy exports as a coercive or political tool
- **Russia's external position is stable**, with a public debt ratio of a relatively high ~110%, CDS spreads of just ~18bp and reserves well in excess of 100% of GDP. It has generally been well managed economically
- A **red country grade 3** is well below its **preliminary grade 1**, which is based on an investment grade 'BBB-' S&P credit rating

Economic

- **The Russian economy is poised to recover in 2021**, with the central bank predicting it will rebound to pre-crisis levels
- Russia has had a relatively **tough COVID-19 with 1,079 deaths**/1 million people by July 2021

Political

- **The connection between political power and property is strong in Russia**, with some senior officials reportedly using their government positions to amass vast property holdings. **Tensions with the West have been increasing**
- **Russia's current demographic picture is fair**. The country has a large working-age population that supports a relatively small dependency ratio. The growth in this ratio going forward is a concern as the population ages rapidly, with a younger cohort in-line to occupy jobs and power. It also **has a high degree of income inequality with a Gini of 0.38**

ESG

- Russia's ESG rating by ISS is 'C-' or '**Not Prime**', which is poor
- The abundance of available energy, in the form of oil, gas and coal, leads to one of the **most inefficient and highest energy consumptions in the world**, and an economic structure dominated by extractive industries. Transport, households and industry are squandering energy since domestic prices are kept low
- Russia is a **signatory to the Paris Accord but does not have a Net Zero carbon goal**
- The **judiciary lacks independence**

The **trend** is returned to **stable** with improvement hoped for.