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GEOPOLITICS AND THE MARKETS

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Markets and investor confidence have been rattled recently by geopolitical events. At the moment, three situations are dominating headlines; Russia/Ukraine, Israel/Hamas and instability in Iraq. Each of these issues ignites a variety of emotions for people impacted by the events. For investors however, it is important not to let these events distort your investment thinking or your longer-term investment plan. As depicted in the chart below, history is littered with events that at the time surely felt as though they had the potential to derail markets for an extended period of time.



Source: Fidelity Investments

As you can see, over time, markets have shown resiliency to even some of the most alarming of geopolitical events. That is not to say that this time or next time couldn't be different, but it is our opinion that risk analysis is best handled through a long term asset allocation plan that fits your time horizon, goals, objectives, risk tolerance and unique circumstances as opposed to reacting emotionally to what frequently amount to short-lived geopolitical events.

In the context of this article, however, it is important to understand why geopolitical events can have such a large impact on current stock prices. Generally speaking, it has to do with heightened risk sensitivity on the part of investors and the potential economic impact around the event itself. Higher risk sensitivity leads to a higher margin of safety requirement by investors. This higher margin of safety requirement frequently shows up in higher discount rates associated with financial modeling. Higher discount rates lead to lower present values of future cash flows. In fact, the discount rate is one of the biggest determinants of present value in financial modeling so even the slightest decrease in risk appetite can impact equity prices in a big way. The other lever is the economic impact of the event itself and how that might alter the future cash flows themselves; although in general this does not have the same impact as the discount rate because companies can still grow and innovate even in periods of geopolitical turmoil. As quickly as fear can spike on geopolitical news it can dissipate due to diplomatic solutions or today's shortened news cycle, both of which make investing tactically around global events very difficult especially after factoring in trading costs and potential tax consequences.

In closing, there will always be geopolitical noise in the markets. It is important to know and incorporate the levers (discount rate and actual economic impact on future cash flows) that effect security valuations but to analyze it within the context of your overall asset allocation which should reflect your unique goals, objectives, circumstances, risk tolerance and time horizon. We have quoted Warren Buffett before but it bears repeating that, "In the short run the market is a voting machine. In the long run it is a weighing machine." We believe that you put the odds significantly in your favor focusing on the weighing machine approach to analyzing geopolitical events.

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