

Lessons for the management of sovereign risk

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Geneva's experience at the end of the eighteenth century offers several lessons for the management of sovereign risk, lessons with which contemporary wealth managers are well acquainted.

The first concerns concentration. A substantial exposure to a single state, however powerful, makes the investor's fortune dependent on a single fiscal policy, a single political order and a single currency. Diversification across several sovereign issuers, several currencies and several asset classes reduces that risk.

The second concerns yield. A state that offers returns markedly higher than those of its peers is often signalling a higher level of risk. French annuities paid more than English or Dutch funds precisely because investors perceived French credit as more fragile. The additional yield was compensation for a real risk.

The third concerns transparency. Investors must examine the complete financial position of the borrowing state, including off-budget commitments and extraordinary expenditure. Necker's *Compte rendu* demonstrated the limits of partial information.

The fourth concerns governance. A state whose financial management depends on one minister, without solid institutions to guarantee the continuity of its commitments, presents a higher risk. Necker's reforms were called into question after his departure, and his successors pursued different policies.

The fifth and last concerns political risk. A revolution, a war or a change of regime can radically alter a state's willingness or ability to honour its debt. That risk is difficult to measure, but it must be taken into account when a portfolio is constructed.

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Lesson	Contemporary application
Concentration	diversify sovereign exposures by issuer, currency and region
Yield	analyse the yield spread as an indicator of risk
Transparency	examine total debt, including implicit and off-balance-sheet commitments
Governance	assess the strength of fiscal and monetary institutions
Political risk	build in scenarios of political crisis, sanctions and restructuring

Worked example. A portfolio of CHF 10 million is invested 60 per cent in the bonds of a single state offering a yield of 7 per cent, and 40 per cent in the bonds of better-rated states paying 3 per cent. Its annual return is 5.4 per cent. If the principal state restructures its debt by halving the value of its securities, the portfolio loses CHF 3 million, or 30 per cent of its value, which wipes out more than five years of return. A portfolio diversified in equal shares across five issuers would have limited the loss to 10 per cent in the same scenario. The figures are fictitious and simplified.

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