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Evaluating Country Risk for International Investing

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Many investors place a portion of their portfolios in foreign securities. This decision involves an analysis of various mutual funds, exchange traded funds (ETFs), or stock and bond offerings; however, investors often neglect an important first step in the process of international investing. The decision to invest overseas should begin with determining the riskiness of the investment climate in the country under consideration.

Country risk refers to the economic, political, and business risks that are unique to a specific country, and that might result in unexpected investment losses.

Key Takeaways

- Country risk refers to the uncertainty associated with investing in a particular country, and more specifically the degree to which that uncertainty could lead to losses for investors.

- This uncertainty can come from any number of factors including political, economic, and sovereign default risk.

- In general, countries are categorized into three levels of development: frontier, emerging, and developed markets, which are characterized by decreasing levels of country risk accordingly.

- Country risk can be measured using various metrics and studies, including sovereign credit ratings and independent sovereign risk reports.

Economic and Political Risk

Consider three main risk sources when investing in a foreign country:

- Economic Risk
- Political Risk
- Sovereign Risk

Economic Risk

This risk refers to a country's ability to pay back its debts. A country with stable finances and a stronger economy should provide more reliable investments than a country with weaker finances or an unsound economy.

Political Risk

This risk refers to the political decisions made within a country that might result in an unanticipated loss to investors. While economic risk is often referred to as a country's ability to pay back its debts, political risk is sometimes referred to as the willingness of a country to pay debts or maintain a hospitable climate for outside investment.

Even if a country's economy is strong, if the political climate is unfriendly (or becomes unfriendly) to outside investors, the country may not be a good candidate for investment.

Sovereign Risk

This is the risk that a foreign central bank will alter its foreign exchange regulations, significantly reducing or nullifying the value of its foreign exchange contracts. Analyzing sovereign risk factors is beneficial for both equity and bond investors, but perhaps more directly beneficial to bond investors.

When investing in the equity of specific companies within a foreign country, a sovereign risk analysis can aid in creating a macroeconomic picture of the operating environment, but the bulk of research and analysis would need to be done at the company level.

On the other hand, if you're investing directly into a country's bonds, evaluating the economic condition and strength of the country can be a good way to evaluate a potential investment in bonds. After all, the underlying asset for a bond is the country itself and its ability to grow and generate revenue.

Developed, Emerging, and Frontier Markets

There are three types of markets for international investments:

- Developed Market
- Emerging Marketss
- Frontier Markets

Developed Markets

These markets consist of the largest, most industrialized economies. Their economic systems are well developed. They are politically stable and the rule of law is well entrenched. Developed markets are usually considered the safest investment destinations, but their economic growth rates often trail those of countries in an earlier development stage.

Investment analysis of developed markets usually concentrates on the current economic and market cycles. Political considerations are often less important. Examples of developed markets include theUnited States, Canada, France, Japan, and Australia.

Emerging Markets

Emerging markets experience rapid industrialization and often demonstrate extremely high levels of economic growth. This strong economic growth can sometimes translate into investment returns that are superior to those available in developed markets; however, investing in emerging markets is also riskier than investing in developed markets.

There is often more political uncertainty in emerging markets, and their economies may be more prone to booms and busts. In addition to carefully evaluating an emerging market's economic and financial fundamentals, investors should pay close attention to the country's political climate and the potential for unexpected political developments.

Many of the fastest-growing economies in the world, including China, India, and Brazil, are considered emerging markets.

Frontier Markets

Thoughts from our interns

Frontier Markets

These markets represent "the next wave" of investment destinations. These markets are generally either smaller than traditional emerging markets or are found in countries that place restrictions on the ability of foreigners to invest. Although frontier markets can be exceptionally risky and often suffer from low liquidity, they also offer the potential for above-average returns over time.

Frontier markets are also not well correlated with other more traditional investment destinations, which means that they provide additional diversification benefits when held in a well-rounded investment portfolio. As with emerging markets, investors in frontier markets must pay careful attention to the political environment, as well as to economic and financial developments. Examples of frontier markets include Nigeria, Botswana, and Kuwait.

Measuring Country Risk

Just as corporations in the United States receive credit ratings to determine their ability to repay their debt, so do countries. In fact, virtually every investable country in the world receives ratings from Moody's, Standard & Poor's (S&P), or the other large rating agencies.

A country with a higher credit rating is considered a safer investment than a country with a lower credit rating.

Examining the credit ratings of a country is an excellent way to begin analyzing a potential investment.

Another important step in deciding on an investment is to examine a country's economic and financial fundamentals. Different analysts prefer different measures, but most experts turn to a country's gross domestic product (GDP), inflation, and consumer price index (CPI) readings when considering an investment abroad.

Investors will also want to carefully evaluate the structure of the country's financial markets, the availability of attractive investment alternatives, and the recent performance of local stock and bond markets.


COUNTRY
RISK

Sources of Information on Country Risk

There are many excellent sources of information on the economic and political climate of foreign countries. Newspapers such as The New York Times, The Wall Street Journal, and the Financial Times dedicate significant coverage to overseas events. Many excellent weekly magazines also cover international economics and politics.

The Economist is generally considered the standard-bearer among weekly publications. International editions of many foreign newspapers and magazines can also be found online. Reviewing locally produced news sources can sometimes provide a different perspective on the attractiveness of a country under consideration for investment.

The Economist Intelligence Unit (EIU) and the Central Intelligence Agency's (CIA) "The World Factbook" are two excellent sources of objective, comprehensive country information with more in-depth coverage of countries and regions. Both of these resources provide a broad overview of the economic, political, demographic, and social climate of a country.

However, the most common method used by investors with time or resource restrictions that don't allow them to do the analysis themselves is to rely on experts who spend all their time doing that type of analysis.
Calculating debt service ratios, import/export ratios, money supply changes, and other fundamental aspects of a country, and attempting to incorporate them all into the big picture, requires a significant commitment if you do it by yourself. Sourcing these tools from organizations focused on analyzing country risk allows more energy to be focused on investing.

EUROMONEY
COUNTRY RISK

Euromoney Country Risk Survey

This survey covers 186 countries and gives a comprehensive picture of a country's investment risk. The rating is given on a 100-point scale, with a score of 100 representing virtually zero risk.
In general, the calculation of the ECR rankings is split between two overall factors: qualitative (90% weighting) and quantitative (10% weighting). The qualitative factors are derived from experts who assess the political risk, structure, and economic performance of the country.Euromoney Country Risk. "Methodology."

The quantitative factors are based on debt indicators, capital market access, and credit ratings. The rating for the qualitative and quantitative factors are available separately, so if you believe the weighting importance to be different than 90/10, you have the flexibility to manually adjust the weighting yourself.

640
675
560
560
480
420
400
515
430
480
410
320
240
1
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3
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9
10

Economist Intelligence Unit's Country Risk Service Report

The EIU is the research arm of The Economist and one of its best offerings is its Country Risk Service Report. These ratings cover 130 countries, with an emphasis on emerging and highly indebted markets. The rating analyzes factors similar to the ECR rating, such as economic and political risk, and provides a rating on a 100-point scale; however, unlike the ECR rating, higher scores mean higher sovereign risk.

A benefit of the EIU ratings is that they are updated on a monthly basis, so trends can be caught much earlier than other, less frequently updated methods. In addition, the EIU format offers investors more analysis and provides an outlook for the country, as well as two-year forecasts for several key variables. So, if you want to get a sense of the direction a particular country is headed in the near future, this may prove to be a useful tool.Economist Intelligence. "Country Risk


Institutional
investor

Institutional Investor's Country Credit Survey

This rating service is based on a survey of senior economists and analysts at large international banks. The uniqueness of this approach is appealing because it surveys people from companies that are at the ground level, lending and providing capital directly to these countries.

In a sense, this adds a degree of credibility to the ratings because major international banks typically do a significant amount of due diligence before exposing themselves to certain countries. Similar to the other approaches, this rating is based on a scale of 0 to 100, with 100 being virtually risk-free and zero being equivalent to certain default.Institutional Investor. "The


187.12

Important Steps When Investing Overseas

Once a country analysis has been completed, several investment decisions need to be made. The first is to decide where to invest by choosing among several possible investment approaches, including investing in:

- A broad international portfolio
- A more limited portfolio focused on either emerging markets or developed markets
- A specific region, such as Europe or Latin America
- A specific country or countries

Country Risk Premium

What Are Examples of Country Risk?

Country risks include all of the potential risks that can occur in a nation that could impact investments in that nation, whether that be capital investments or security investments. Such risks include political risks, climate risks, and social risks. Specifically, these consist of civil wars, mass protests, earthquakes, and so on.

How Do You Measure the Country Risk of a Nation?

The most common way to measure a country's risk is through its sovereign rating. A sovereign rating is a rating compiled through an analysis of various qualitative and quantitative factors of a country. Sovereign ratings are calculated and provided by the main global rating agencies, which are Moody's, S&P, and Fitch.

What Countries Have the Highest Risk?

The countries with the highest risk include Venezuela, Mozambique, Yemen, Libya, and Haiti. Pharmaceutical Tech

The Bottom Line

Overseas investing involves a careful analysis of the economic, political, and business risks that might result in unexpected investment losses. This country risk analysis is a fundamental step in building and monitoring an international portfolio. Investors that use the many excellent information sources available to evaluate country risk will be better prepared when constructing their international portfolios.

Thankyou