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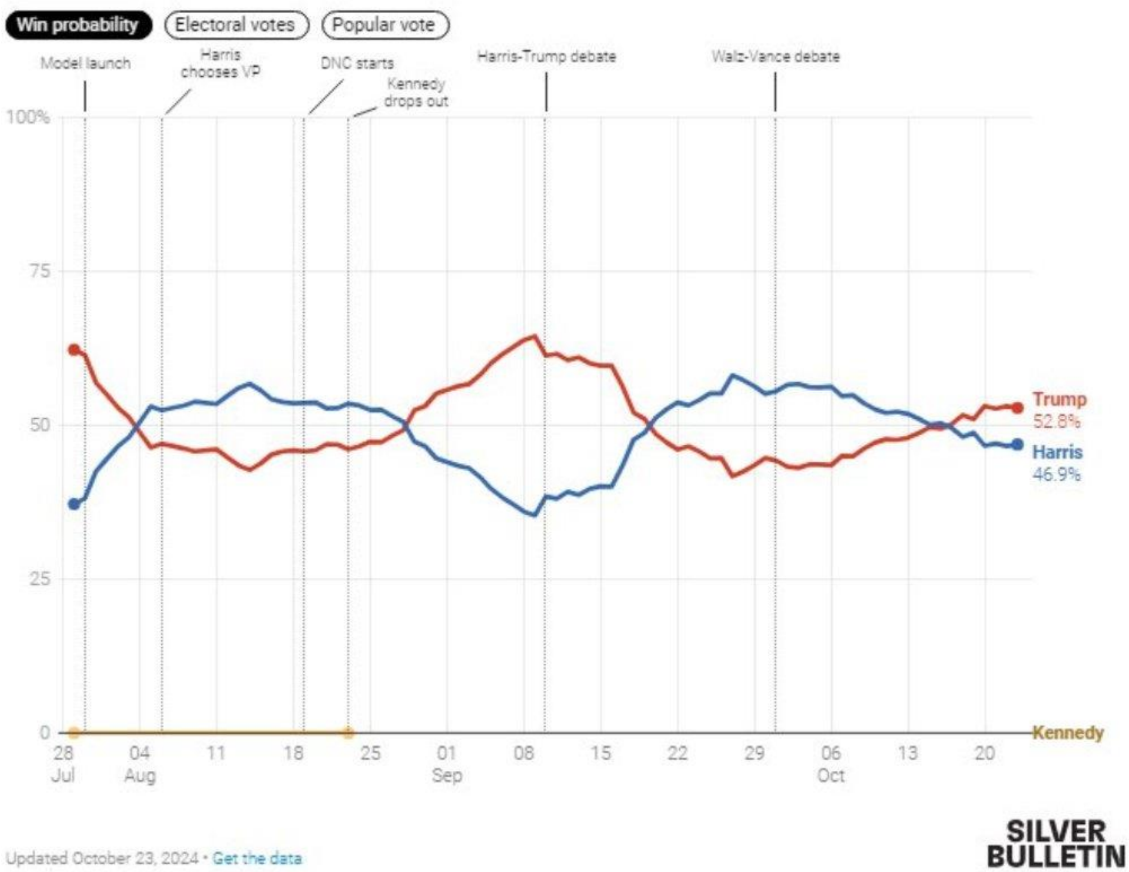
Navigating Political Risk: Election Uncertainty and Portfolio Management

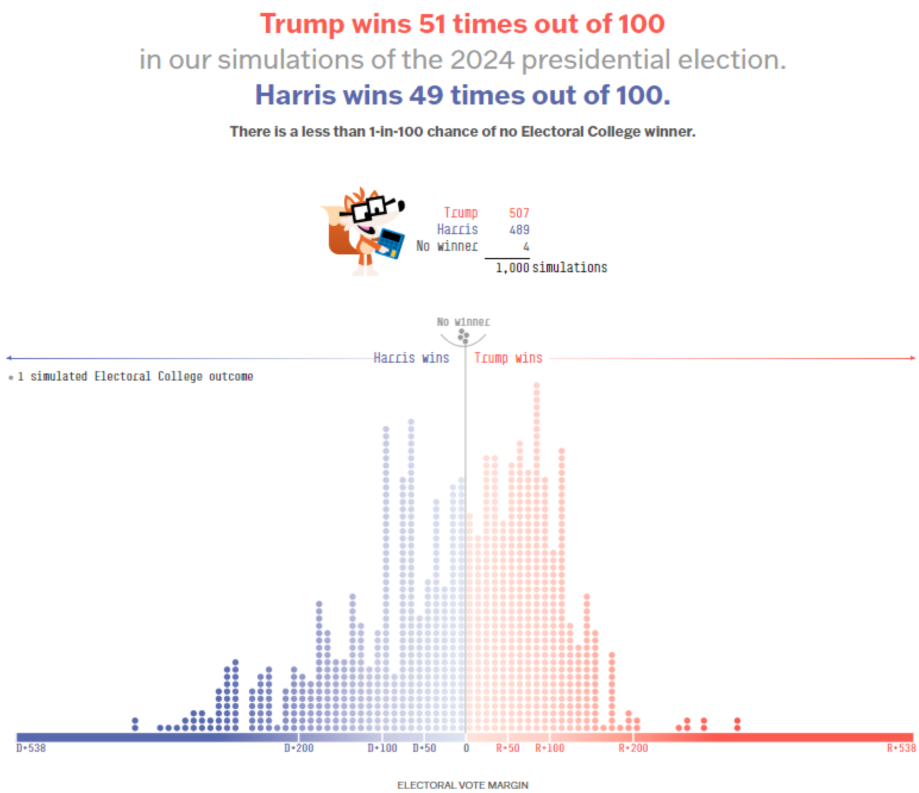
The biggest challenges in risk management often come from bi-modal events—situations where outcomes are vastly different, each carrying significant uncertainty. In these scenarios, hedging becomes a guessing game, and the 2024 U.S. election is shaping up to be just that.

Both the presidential race and the Senate balance are neck-and-neck:



[1]

[1] Chart provided by FiveThirtyEight, Nate Silver.



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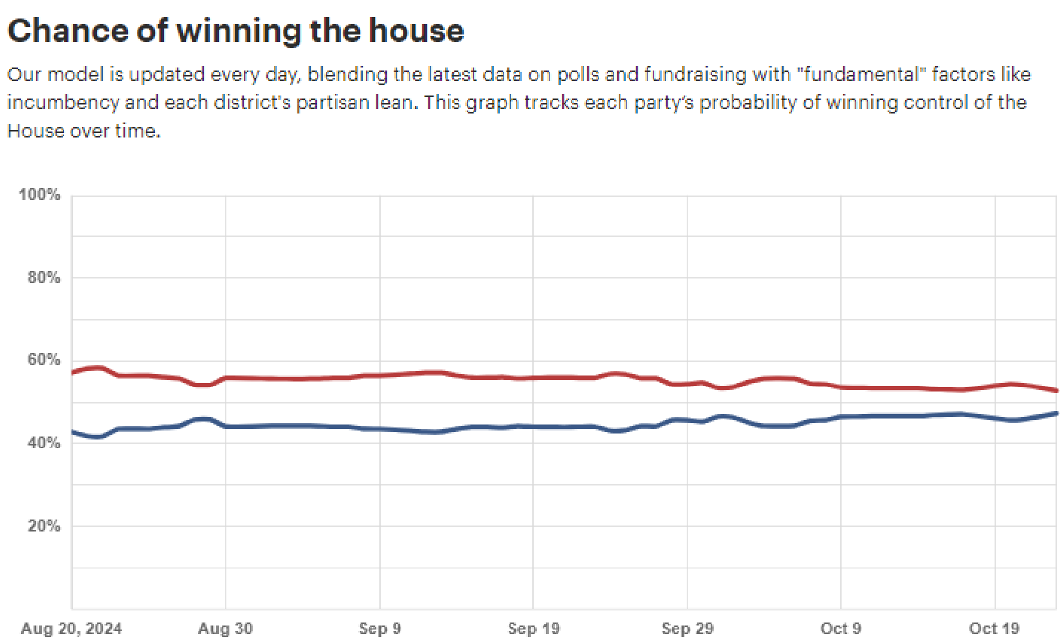
The Senate, often seen as leaning Republican, still shows enough uncertainty to be effectively a coin toss for risk managers:



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[2] Chart provided by FiveThirtyEight.
[3] Chart provided by FiveThirtyEight.

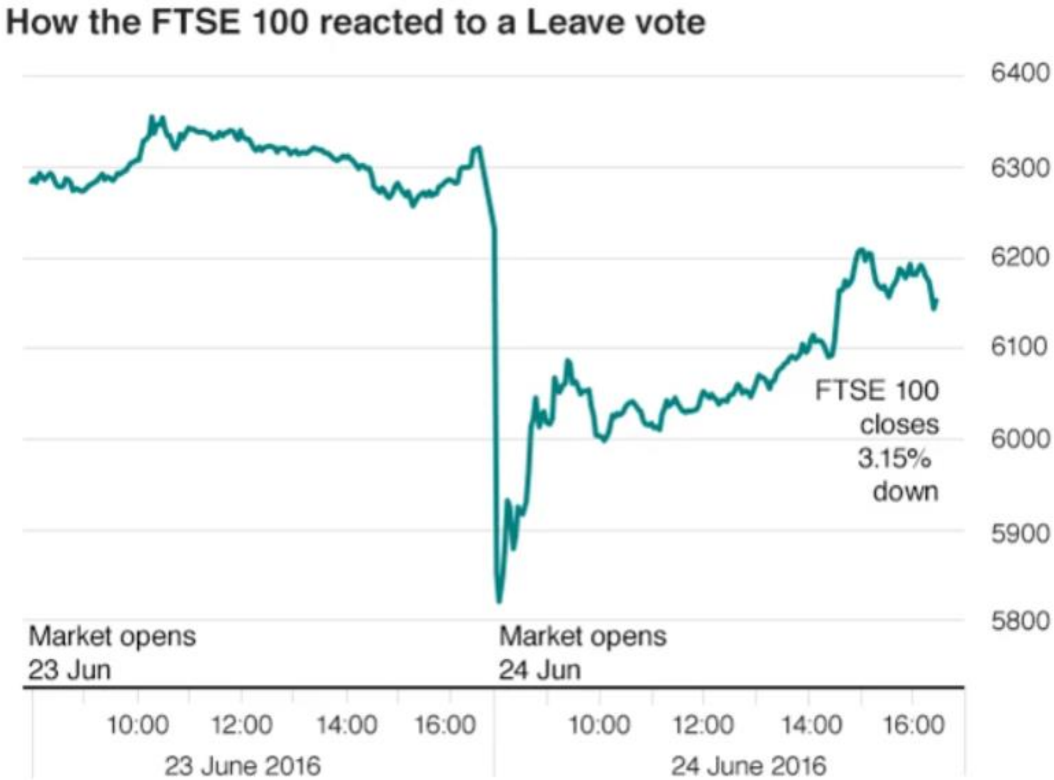
This political fog mirrors what we've seen before: a landscape filled with unknowns, with very few ways to map out a clear investment playbook.

The problem isn't just the outcome, but the ripple effects on markets. We can speculate on policy differences between a Democratic sweep versus a Republican one, but history tells us that even if we correctly predict the political result, translating that into market movements is a different beast. Look back at 2016—the markets oscillated wildly overnight, reacting to each piece of news before rallying sharply when Trump's victory was confirmed. Days earlier, markets priced in a negative beta, only to surge when the opposite materialized.

[4]

And it wasn't just equities. A diversified global asset book, even one running moderate volatility, could see 5% swings within hours. Brexit, another example, had markets teetering on polling results before the vote and was followed by a wave of volatility. Yet, despite all the chaos, the FTSE 100 ended the week higher after calming words from the Bank of England.

[4] Chart provided by FactSet.



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These past events underscore that periods of high uncertainty and binary outcomes create substantial market volatility, but not necessarily directional clarity. From a risk management standpoint, this should be a moment of control, not a chance to seek alpha.

The Folly of Political Speculation

Betting on market outcomes from elections is essentially a two-part wager. First, a manager must believe they have a better read on the election outcome than experts who also view it as a toss-up. Second, they need to predict how that outcome will manifest across the markets—an almost impossible feat.

Think about it: Most managers specialize in analyzing companies, economic trends, and industry linkages. Even then, generating consistent alpha is a challenge. So why would anyone believe they have an edge in predicting a political event that occurs once every four years, and is mostly outside their domain?

Sure, someone might get lucky and make the right call, but that's the key—luck, not skill. And if they do believe they have some special insight, the sample size is so small that it's impossible to verify any genuine edge. Plus, even if you correctly forecast the political outcome, pricing in market reactions adds a layer of complexity that can easily derail a strategy.

History has shown us that the market response to political events is often unpredictable. Even if you knew the election results ahead of time, the market trajectory could still surprise you. The best asset managers thrive on repeatable, time-tested strategies—making election bets is the antithesis of that.

[5] Chart provided by Wall Street Journal.

When Speculation Signals a Problem

For allocators, election season is a stress test. If a manager is making speculative bets based on political outcomes, it’s a red flag. They are unlikely to have a real edge on predicting elections, let alone the secondary effects on markets. More importantly, this behavior suggests a lapse in discipline, potentially creeping into other parts of their investment process.

A prudent asset manager trims risk and avoids making directional bets on high-stakes, high-uncertainty events like elections. They stick to their game plan, focusing on what they do best—picking investments that can outperform over the long term. For allocators, this is an opportunity to identify who is staying true to their mandate and who might need to be shown the door.

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