Your Portfolio May Be Contributing to Authoritarian Aggression

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How Your Investment Portfolio Influences Foreign Policy

Ah, the good old days. I'm not talking about the prior administration, or even the last several administrations, I'm talking about the Cold War days. During those years, it was so much easier to distinguish between those who supported freedom and democracy, and those who didn't. Capitalist countries were lined up against communist ones, and rarely did investment flow between those two poles, unless it was to try to destabilize and convert one side to the other.

Failures of communism led to the collapse of the Soviet Union and the opening of China and things changed. Predominant Western thought was that if we gave these newly freer peoples a taste of capitalism and brought them into the fold of global trade, that they would eventually morph into something resembling ourselves, and that global peace and economic prosperity would follow. We were partially right.

Like many new relationships, there was a honeymoon period. Formerly closed communist countries opened their markets and their labor forces. Investment from the West poured in to try and take advantage of these new markets and to leverage the cheaper labor. Investors were falling over themselves trying to capture the benefits of globalization.

There were direct investments by Western companies investing in production or retail presence. There was also active investing by private equity, venture capital and active strategy investment firms. However, the most significant source of international investments has come from passive index funds that follow benchmarks such as the MSCI All Country World Index (ACWI) or the FTSE All World Index.

The Rise of Passive Index Investing

2021 marked the 45th anniversary of "Bogle's Folly". On August 31, 1976, John Bogle, the founder of Vanguard launched the first index mutual fund, the Vanguard 500. It came with little fanfare and its premise of simply buying and holding a market capitalization weighted index of stocks, in this case the S&P 500, at a much lower expense ratio, was soon met with derision as being "average" or even "Un-American". Over the last 45 years, Bogle has had the last laugh, even from the grave.

Since inception, index funds have proliferated both in mutual fund form and their later counterpart, exchange-traded funds (ETFs). According to Statista, investments in passively managed U.S. ETFs grew from $327.42 billion in 2002 to $4.8 trillion in 2020. Globally, across all types of public investment vehicles, **passive strategies now represent about $22 trillion in asset under management**. These figures do not account for all the public and private pension plans that manage their passive international benchmark exposures either directly or through separately managed accounts. While there has been a proliferation of indices, such as sectors, countries and fundamentally weighted indices, the vast majority of passive index investments with international allocations have been funneled to the ACWI ex-U.S. and its two sub-components the Europe, Africa and Far East (EAFE) index and/or the Emerging Markets (EM) Index.

Massive Investments in Market-Cap Based Global Indices Fuel Authoritarian Economies

It is with these global indices where the problem lies. For U.S. market-only index products, an investor is dealing with only one dimension – all companies are operating under basically the same set of rules and regulatory structures. Weighting by market capitalization makes sense in this environment. However, once a U.S. investor goes international, things become considerably less clear. **Market capitalization weighting in a global context treats all countries the same, regardless of the regimes governing those countries.** We believe this is a flawed premise.

For many years, communist and formerly communist countries with authoritarian governments mostly played along to attract Western investment, and the West happily complied. There was even the notion that these countries were practicing capitalism more purely than the developed market countries of the West, with a lot of "red tape" being stripped away to clear a path for economic development. **Authoritarian countries pushed for greater representation in these global indices, garnering massive investment flows.**

We Trusted Them…

Our trust was misplaced and in recent years, the tone has changed. Authoritarian leaders, threatened by the growing wealth, power and influence of their entrepreneurial citizens, are cracking down. Limitations were imposed on how supposedly "private" companies that traded on public exchanges could operate, if allowed to operate at all. Outspoken CEOs of these companies were either jailed or "disappeared" for a while. Intellectual property theft, human rights abuses, corruption, massive malinvestment to make government-mandated growth targets, and obfuscation about important global matters such as the COVID-19 pandemic all have become the norm. **This has been a huge U-turn that represents a massive rejection of basic Western democratic values by these authoritarian regimes, who are increasingly ready to confront, not conform to, those values.** Cyber-attacks and threats of war and actual acts of war are now at our doorstep. **Passive investment in companies that are under the control of authoritarian regimes has provided those regimes with economic fuel – a powerful stick they are using against us.** The question then becomes, "What can we do about this"?

Using Democracy as a Factor in International Investing

Historically, passive investors wanting international exposure have not had a means to avoid fueling authoritarian regimes. Many investors are unaware of the economic fuel they are providing and those who are aware of the problem are left wondering how they might hold these regimes to account. To address this challenge, we created the Democracy Investments International Index, which uses a politically based methodology to "tilt" a market capitalization weighted index away from authoritarian regimes and toward more democratic ones. By shifting passive investment allocation away from the current market capitalization-only vehicles, in favor of our democracy weighted index, investors now have the opportunity to actively deter the increasing growth and aggression of authoritarian regimes and align with their values of democracy.

In creating our democracy-focused index, we chose to use *The Economist's* Democracy Index. First published in 2006, *The Economist's* Democracy Index uses 60 questions to come up with scores in 5 categories:

- Electoral process and pluralism
- Civil liberties
- Functioning of government
- Political participation
- Political culture

The Economist's Democracy Index provides a clear, objective, and respected third-party standard by which to over and under weight countries versus their market capitalization weighting. Every country can research their scores and the underlying data to support those scores. Even small changes toward higher democracy scores can have an impact on overall investment weightings.

Democracy Investments' methodology underweights **authoritarian regimes like China, Russia and Saudi Arabia relative to their market capitalization weights by 70%, 60% and 72%, respectively.** Capital that would have gone to those countries is instead invested in the EuroZone, Taiwan, South Korea, and Australia – regimes far more friendly to the U.S. and more closely in line with investor values of democracy. Further, by not eliminating investments in authoritarian regimes entirely, our strategy incentivizes positive change toward democracy in a way that omission or screening out would not.

The Investment Case for a Democracy Tilt to a Passive International Index

Faced with increasing authoritarian aggression and intellectual property theft, as well as the response to the global COVID-19 pandemic, many Western companies are reconsidering their global supply chains. Labor cost differentials are no longer as large as they have been in the past. These companies are motivated now to make and grow their businesses in more stable, non-authoritarian markets.

As we experienced in 2008, a housing crisis becomes a banking crisis, becomes a financial crisis, becomes an economic crisis. In today's political and economic climate, the odds that an authoritarian regime will make a serious unintended policy mistake are much greater. **Suffice it to say that while open market-based democracies certainly have their problems, they should still outperform planned economies over the long run.** That was one of the big lessons of the Cold War.

Time to Act

A new concept or category in financial services can cause investors to move slowly - to sit back and watch for a while before acting. Unfortunately, there is little room for such luxury here. Every day, people who remain invested in products that track passive market capitalization weighted global and international indices are funding the instruments of eventual doom. **Investors can make an immediate difference by shifting to a democracy tilted strategy**. Doing so allows them to continue to enjoy international exposure but also significantly reduce capital flows to authoritarian regimes all while providing economic incentives for democratic reform globally. We invested ourselves into this problem, but we can turn it around. **Our way out is to take money away from those countries who threaten us and give it to those who help.**

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