Picking investments

Harvey study says risk ratings predict good investment choices

A research project headed by Professor Campbell R. Harvey of the Fuqua School of Business has found that the political, financial, economic and composite risk ratings produced by the International Country Risk Guide (ICRG) have a high correlation to actual future equity returns.

According to the new study, "Political Risk, Economic Risk and Financial Risk," the system for assessing country risk in terms of capital and trade investing is "remarkably effective" for equity investment, producing surprising risk-adjusted returns.

Harvey and his colleagues, Claude Erb and Tadas Viskanta of First Chicago Investment Management Co., carried out a historical analysis of ICRG risk ratings for every month dating back to 1984 and compared these ratings to actual equity market returns. Their research showed that a simple buy/sell strategy based on an upgrade or downgrade in the ICRG ratings produced "extremely high" risk adjusted returns. These returns were achieved in both industrialized countries and in volatile emerging markets.

The implications of this research for fund managers and investment strategists are profound, according to Harvey, an internationally recognized expert in portfolio management and global risk management. Devalued currencies, failed economic plans, coups and other national financial "shocks" are notoriously difficult to predict and can have disastrous consequences for investment portfolios.

Harvey said the research demonstrates that the ICRG risk ratings not only allow fund managers and strategists to factor comprehensive risk into their investment decisions, but also to generate high rates of return.

Harvey's work on the implications of changing risk and the dynamics of risk premiums for tactical asset allocation has been published in leading academic and practitioner journals. He recently received the American Association of Individual Investors' Best Paper in Investments Award for "Predictable Risk and Returns in Emerging Markets."