FLEXIBILITY IN PRACTICE

Navigating Geopolitical Events

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Recent conflict between Russia and Ukraine is an important reminder that geopolitical risk is a part of investing in global markets. Navigating geopolitical events requires expertise and flexibility. Dimensional's systematic active approach is designed to adjust to new information in real time, including information about geopolitical events and their potential repercussions for markets.

GLOBAL DEVELOPMENTS AND THEIR IMPACT

Geopolitical events like military or economic conflicts can affect stock markets in many ways. These events are generally widely followed by investors. We believe current market prices quickly incorporate expectations about the effects of these events on economies and companies. Our investment approach centers on using information in current market prices rather than trying to outguess them. If markets stay open and continue to function normally, we generally continue investing our portfolios according to our usual process. We believe that the most effective way to mitigate the risk of unexpected events is through broad diversification and a flexible investment process. This philosophy applies to other crises, like natural disasters, social unrest, and pandemics.

However, geopolitical events may sometimes lead to restrictions on investors' ability to trade in specific stocks or on certain exchanges. One way is through government sanctions. In recent days, the US and other Western governments have stated they would impose new sanctions on Russia in response to an invasion of Ukraine. The exact nature of these sanctions and extent to which they would impact listed securities are uncertain. If imposed, they would add to sanctions on Russia that have been in place for a number of years.

In another recent example, the US issued executive orders in 2020 and 2021 that prohibited US persons from investing in certain Chinese companies. Like the ongoing situation in Russia and Ukraine, this period was marked by uncertainty. For weeks and months after the original order took effect in November 2020, fund managers sought clarity on the scope of the restrictions and the exact list of sanctioned stocks.

In some cases, geopolitical events have led to market closures, impacting all stocks in a certain market for a period of time. For example, on June 27, 2015, Greece closed its stock market after defaulting on its government debt. The Athens Stock Exchange stayed closed until August 3 of that year. During the Egyptian revolution of 2011, the Egyptian Stock Exchange closed after January 27 and remained closed for over a month. Unplanned market closures are not limited to emerging markets. In 2019, the Tokyo Stock Exchange closed for 10 days after Japanese Emperor Akihito abdicated the Chrysanthemum Throne. In 2001, the New York Stock Exchange closed until September 17 after the September 11 attacks on the World Trade Center.

These types of market events are not new, and the form that they take can vary. We've seen other examples over the decades during which we have managed portfolios, including currency repatriation restrictions in Malaysia in 1997, the introduction of capital controls in Argentina in 1999, and a successful coup d'état in Thailand that led to a market closure in 2006.

THE VALUE OF FLEXIBILITY

Flexibility is valuable in managing portfolios through these events. No two events are the same, but common themes are uncertainty and rapid change. The diversified nature of our portfolios is important in allowing us this flexibility. If we halt investing in a market or in certain stocks, we can continue trading across multiple other eligible countries and securities. Dimensional equity portfolios typically invest across thousands of stocks. If we divest from certain stocks or markets, we consider the costs and portfolio impact in our trading strategy.

Unlike traditional index funds, we are not constrained to follow the actions of a benchmark during these times. Deletions from benchmarks in the wake of geopolitical events typically follow a similar pattern as other index rebalances. The index provider announces the deletion date in advance, and funds seeking to mirror the holdings of that index must sell the deleted securities at the market close on that date. Seeking to track the index limits a manager's options regarding what actions to take and over what time frame. It may also result in demanding liquidity in specific stocks at the same time as other managers who are also seeking to track the same index fund.

For example, on January 7, 2021, MSCI announced it would drop China Mobile, China Telecom, and China Unicom from certain benchmarks effective at market closing prices the following day as part of a larger set of moves by major index providers to remove sanctioned Chinese stocks from their indices. Together these stocks represented more than 0.5% of the MSCI Emerging Markets Index. Funds tracking that index would need to sell their entire positions in those stocks at the market close on January 8 if they wanted to minimize their tracking error vs. the index. In fact, on that date all three stocks traded at their lowest closing price for the week and closed higher every day in the week that followed. We divested from these stocks within portfolios for US investors for the same regulatory concerns that caused MSCI to drop them. However, because we have flexibility, we didn't need to isolate our trading to a short period of a single trading day. Instead, we traded over several days during the week of MSCI's announcement and the following week.

PLANNING FOR THE UNEXPECTED

Investors in global equity portfolios inevitably face periods of geopolitical tensions. Sometimes these events lead to restrictions, sanctions, and other types of market disruptions. We cannot predict when these events will occur or exactly what form they will take. However, we can plan for them by managing diversified portfolios and building flexibility into our process.

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Tracking error: A measure used to quantify how closely a portfolio follows an index or benchmark, often defined as the standard deviation of the difference between the portfolio and index returns.