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Geopolitical impact on investment strategies of investors

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Abstract

In an increasingly interconnected and volatile world, geopolitical dynamics play a pivotal role in shaping investment strategies and capital flows. This research investigates how geopolitical risk influences the decision-making processes of individual and institutional investors, how it affects asset allocation, and what risk-management practices are adopted to mitigate its impact. Drawing on a mixed-methods approach — combining quantitative analysis of geopolitical risk indicators (such as the Geopolitical Risk Index) with qualitative interviews of portfolio managers — the study examines investment behaviour across diverse markets and asset classes. The quantitative component assesses the relationship between spikes in geopolitical tensions (e.g., military conflicts, trade wars, diplomatic crises) and changes in capital allocation to equities, bonds, commodities, and safe-haven assets.

Preliminary results suggest that heightened geopolitical risk tends to drive a flight to safety, with increased allocations to defensive assets (e.g., gold, government bonds) and reduced exposure to riskier markets, particularly in emerging economies. The qualitative interviews reveal that investors are increasingly integrating scenario-based planning, diversification, and hedging (using derivatives) into their strategic frameworks. The findings also highlight the role of geopolitical risk in accelerating the adoption of global macro strategies and stress the importance of political risk intelligence in portfolio construction. This research contributes to the literature by providing an integrated model of how geopolitical uncertainty reshapes investment patterns and offers practical insights for investors and policymakers aiming to enhance resilience in times of global instability.

Keywords: *Geopolitics, Investment Strategies, Global Financial Markets, Political Risk, Economic Sanctions, International Tridem, Relations, Market Volatility, Foreign Policy, Risk Management, Asset Allocation, Global Economic Stability, Investor Behaviour, Emerging Markets, Currency Fluctuations, Inflation and Interest Rates, Supply Chain Disruptions, Energy Prices, Portfolio Diversification, Geopolitical Conflicts, Financial Decision-Making*

Introduction

1. Context and Motivation

In the contemporary financial landscape, geopolitical risk has transcended its traditional domain of macro-political commentary to become a central consideration in investment decision making. Global capital markets are deeply interlinked, and geopolitical events — such as interstate conflicts, trade wars, diplomatic tensions, and regulatory shifts — can trigger seismic shifts in capital allocation, investor sentiment, and asset valuations.

Traditionally, investors have focused on economic fundamentals — GDP growth, interest rates, inflation, and corporate earnings — to inform their strategies. However, in an era characterized by geopolitical fragmentation and rising global strategic competition, non-economic risks pose significant challenges to this paradigm. Political instability, supply-chain disruptions, and policy unpredictability increasingly affect not just localized regions but global financial markets.

2. Key Concepts and Definitions

Here are the central concepts that will underpin this research:

i. **Geo political Risk (GPR)**

Geopolitical risk refers to the probability and potential impact of adverse political events — like wars, regime changes, trade conflicts, terrorism, and diplomatic crises — that can disrupt economies, financial systems, and global capital flows. One of the most widely used measures is the **Geopolitical Risk Index (GPR)** developed by Dario Caldara and Matteo Iacoviello.

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ii. **Investment Strategy**

This term encompasses how investors allocate capital, manage risk, and construct portfolios. It includes decisions about which asset classes to invest in (equities, bonds, commodities, safe havens), how much diversification to maintain, when and how to hedge, and whether to use tactical vs. strategic allocation.

3. Theoretical Foundations

To analyze how geopolitical risk affects investment strategies, the research draws on several theoretical perspectives:

i. **Modern Portfolio Theory (MPT)**

Originating from Harry Markowitz, MPT posits that risk-return trade-offs can be optimized via diversification: by combining assets whose returns are imperfectly correlated, investors can reduce portfolio variance for a given expected return. Wikipedia

However, geopolitical risk challenges some assumptions of MPT because geopolitical shocks may not be idiosyncratic — they can affect multiple asset classes and geographies together, reducing the protective power of simple diversification.

ii. **Behavioural Finance**

Investors are not always purely rational. Behavioural biases — such as loss aversion, ambiguity aversion, and overreaction to news — shape how they respond to geopolitical risk. For instance, heightened geopolitical tension may trigger de-risking not just because of fundamental risk, but also due to fear and uncertainty

Mechanisms: How Geopolitical Risk Affects

4. Investment Strategies

To understand the impact of geopolitical risk on investors, we need to articulate the pathways through which risk translates into strategic behaviour. Some of the key mechanisms include:

i. **Risk Repricing and Capital Reallocation**

Geopolitical risk often leads to a reassessment of risk premia. As uncertainty rises, investors may demand higher returns for risky assets, particularly in geopolitically sensitive regions.

There may be a **flight-to-quality**, where capital flows shift from equities or emerging markets toward perceived safe-havens like gilt-edged government bonds, U.S. Treasuries, or gold.

ii. **Hedging and Risk Mitigation**

o Investors may use hedging instruments — derivatives (options, futures), long/short strategies, or overlays — to protect portfolios from tail geopolitical events. o Scenario analysis allows them to simulate various geopolitical outcomes (e.g., escalation of a conflict) and pre-define tactical hedges.

5. Empirical and Practical Relevance

The significance of this topic is both academic and practical.

• **Empirical Evidence of Risk Impact** o The IMF's Global Financial Stability Report highlights that geopolitical risk can lead to capital reallocation, supply chain disruptions, and lower asset prices during major risk events. IMF Research using the GPR index has shown that higher geopolitical risk often corresponds with lower investment levels, reduced employment, and negative macro outcomes. IDEAS/RePEc+1 Studies find that geopolitical risk negatively affects financial conditions in emerging economies. Korea Science

• **Investor Behaviour and Strategy**

According to investment insights, geopolitical risk can no longer be considered peripheral; it now underlies macro and economic risk. NAB Business Empirical work also shows that geopolitical risk influences returns in asset classes, including equities and commodities (e.g., oil). Bohrium On the predictive modeling front, some researchers use machine learning to forecast financial variables (like oil prices, exchange rates) using GPR as a leading indicator. MDPI

Chapter 2- Literature Review

2.1 Literature Review: Indian Research on Geopolitical

Impact & Investment Strategies

Impact of Geopolitical Events on FII (Foreign Institutional Investor)

Strategies o Vrishanki Pandya & Supriya Pal (2025)

Geopolitical Risk and Indian Equity Markets: Cap Size Effects

o Muhammadriyaj Faniband & Pravin Jadhav (2023)

iii. Theoretical Perspectives on Mitigating Geopolitical Risk for Indian Equities o Ashwini, Dharmananda M., & Harisha B. S. (2025)

2.2 Literature Review: Foreign Research on Geopolitical

Impact on Investment Strategies

i. **Measurement of Geopolitical Risk**

o *Caldara & Iacoviello (2022)* developed a widely used **Geopolitical Risk (GPR) Index**. This index uses newspaper-based text analysis to count articles about geopolitical tensions (wars, terrorism, diplomatic threats). matteoiacoviello.com+2Federal Reserve+2

o Their research shows that high GPR is associated with **lower investment**, worse employment, and increased downside risks in GDP. matteoiacoviello.com+1

They also decompose the GPR into *threats* vs *realized acts*, showing both contribute to economic effects. matteoiacoviello.com

Chapter 3- Research Methodology

3.1 Objectives of the Study

Based on the topic, the study might have the following objectives:

- **To examine** how geopolitical risk influences the investment decisions of different types of investors (institutional vs retail).
- **To analyze** the effect of geopolitical events on asset allocation (e.g., equities, bonds, commodities, safe-haven assets).

- **To identify** which risk-management strategies (such as hedging, scenario planning) are used by investors in response to geopolitical uncertainty.
- **To explore** the relationship between geopolitical risk and investment returns / volatility.
- **To propose** a framework for integrating geopolitical risk into long-term portfolio strategy.

3.2 Hypotheses

Here are some plausible hypotheses for the research:

H1: Higher geopolitical risk is associated with increased allocations to safe-haven assets (e.g., gold, government bonds).

H2: Institutional investors reduce risk exposure more strongly than retail investors in response to geopolitical risk.

H3: Geopolitical risk leads to higher portfolio hedging activity (derivatives, options) by investors.

H4: Geopolitical risk negatively affects returns on geopolitically sensitive assets (like emerging market equities).

H5: Incorporating geopolitical intelligence and scenario analysis into portfolio decisions improves risk-adjusted returns.

3.3 Significance of the Study

- **For Investors:** Helps fund managers, institutional investors, and individual investors understand how to incorporate geopolitical risk into their strategies.
- **For Policymakers / Regulators:** Provides insight into how geopolitical risk affects capital flows, which can inform regulatory stress testing and financial stability measures.
- **For Academics:** Contributes to the literature at the intersection of political risk and finance, bridging gaps between geopolitical theory and portfolio management.
- **For Risk Managers:** Offers a framework for risk-management practices (scenario planning, hedging) tailored to geopolitical uncertainty.

Chapter 4- Data Analysis And Interpretation

3.5 Data Collection

- **Primary Data:**

1. Surveys / Questionnaires — to collect data from fund managers, institutional investors, or retail investors, about their perceptions of geopolitical risk and how they change their strategies.
2. Interviews — in-depth conversations with portfolio strategists, risk officers, or geopolitical analysts to understand qualitative insights.

- **Secondary Data:**

1. Geopolitical Risk Indices (e.g., the GPR Index by Caldara & Iacoviello) — for measuring geopolitical risk quantitatively.
2. Financial data — time-series data on returns, flows, asset allocations (e.g., equities, bonds, commodities) from databases like Bloomberg, Refinitiv, or public sources.
3. News sentiment / text data — using news archives and sentiment analysis to gauge geopolitical sentiment and its correlation with markets.

3.6 Tools Used for Data Collection & Analysis

- **Quantitative Tools / Techniques**

1. **Time-series econometrics**
2. **Returns-based style analysis**
3. **Machine Learning / Text Analytics** •

Qualitative Tools:

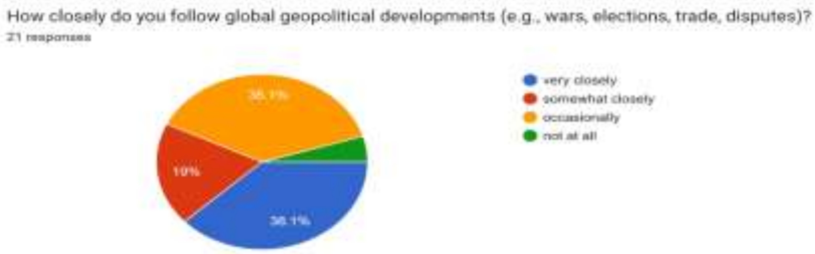
o Interview guides / semi-structured interviews. o Thematic analysis or grounded theory (if building theory from qualitative data). For instance, grounded theory helps generate hypotheses from qualitative input. Wikipedia

3.7 Limitations of the Study

1. Measurement Challenge
2. Data Bias
3. Causality Issue
4. Time Horizon
5. Generalizability
6. Complex Interactions

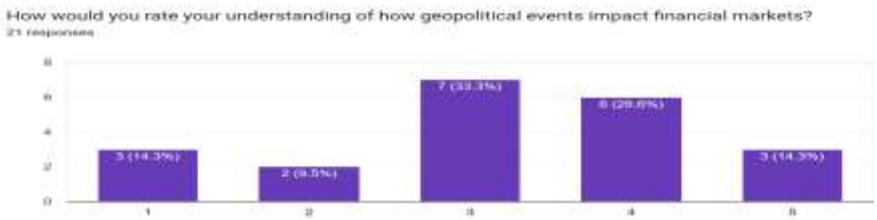
Interpretation

Out of 21 responses, 61.9% are retail/ individual investors and 28.6% are high net worth investors and other remaining are institutional investors.



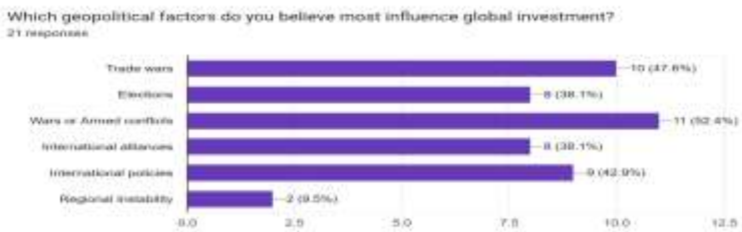
Interpretation

Out of 21 responses, majority of them equally follow geopolitical development on occasional basis and very closely, some of them do not follow it at all.



Interpretation

Out of 21 responses, majority of them understand the impact of geopolitical events on financial markets on a scale of 1-5 on 3 which means at mean, or medium.



Interpretation

Out of 21 responses a majority of them consider wars and armed conflicts as a major factor to influence global investments.

Hypothesis Testing And T- Test

Hypothesis testing is a statistical method used to make decision or draw conclusions about a population based on sample data. It helps researches test whether an assumption (hypothesis) about a population parameter is true or false using evidence from data.

A T- Test is a statistical test used to compare the means of two groups to see if they are significantly different from each other. It helps determine whether a change or difference you observe in your data is real or just due to random chances.

HYPOTHESIS TESTING – 1

H_1 There is a significant relationship between geopolitical event and changes in portfolio.

H_0 There is no significant relationship between geopolitical event and changes in portfolio.

Particulars	No. of respondents	Percentage
Yes	12	57.1%
No	9	42.9%
Grand total	21	100%

Particulars	Value
Sample size (n)	21
No. of 'yes' responses	12
Sample proportion	0.57
Hypothesized proportion	0.5 (assuming equal chance of 'yes' or 'no'0
Standard deviation	0.5
T- value	0.64

Since, the calculated T-Value (0.64) is less than the critical value 1.96, we fail to reject the null hypothesis. Therefore, there is no significant relationship between geopolitical events and portfolio changes.

HYPOTHESIS TESTING 2

H_1 Investors are interested in products designed to mitigate geopolitical risk.

H_0 Investors are not interested in products designed to mitigate geopolitical risk.

Particulars	No. of respondents	Percentage
Yes	10	47.6%
No	2	9.5%
Maybe	9	42.9%
Grand total	21	100%

Particulars	Value
Sample size (n)	21
No. of 'yes' responses	10
Sample proportion	0.47
Hypothesized proportion	0.5 (assuming equal chance of 'yes' or 'no'0
Standard deviation	0.5
T- value	0.22

Since, T-Value is less then 1.96, we fail to reject the null hypothesis. Therefore, there is no statistically significant evidence that investors are interested in products designed to mitigate geopolitical risk.

Chapter 5- Findings, Suggestions And Conclusion

Findings

i. **Negative Impact on Asset Prices During Geopolitical Shocks**

o Major geopolitical events (wars, trade tensions) tend to depress equity markets, as noted by the IMF. IMF+1

o For example, in the case of Inter-Korea tensions, firms with high fixed-asset intensity and large domestic investor bases saw sharper declines in returns.

ii. **Time-Varying Investor Risk Behavior**

o Mutual fund managers reduce their risk exposure when geopolitical risk increases, especially in the short term. PubMed Central

o The effect is not constant: in some geopolitical crises, managers may later take on risk again, balancing between risk mitigation and opportunity.

iii. **Heterogeneous Impact on Firms** o Geopolitical risk does not affect all firms equally. Financially fragile firms (high leverage, low liquidity) are more negatively impacted. MDPI o Some well-diversified or profitable firms show resilience or even benefit from geopolitical shocks, possibly because they can reallocate or tap new opportunities. MDPI

iv. **Increased Volatility in Commodities** o Commodity markets (precious metals, energy, industrial metals) show increased volatility during periods of high geopolitical risk. MDPI

The persistence (half-life) of volatility differs by commodity class: for example, energy commodities may stay volatile longer after a shock. MDPI

v. **Capital Flow Retrenchment and "Flight Home"**

o Higher geopolitical risk is associated with a contraction in cross-border capital flows, especially in emerging markets. bimsa.net

o There is evidence of a "flight-to-safety" effect in direct investment: in some countries, direct investment inflows decline, while in others (advanced economies) they may even increase under risk. bimsa.net

vi. **Herding Behavior Under Geopolitical Risk**

o In some markets (e.g., MENA), geopolitical risk intensifies herding behavior. Investors tend to follow each other more during high-risk periods, especially when uncertainty is high. MDPI o There is asymmetry: herding is often stronger during "down" (bearish) markets than during "up" markets. MDPI

vii. **Spillovers into Real Assets / Energy Markets** Geopolitical risk transmits into energy markets: for instance, threat-based risks (potential conflict) increase spillover between oil and shipping markets.

Frontiers o This shows that geopolitical risk can affect not just financial assets, but also commodities and real-economy risk.

Suggestions (Recommendations)

Based on the above findings, here are some suggestions for investors, portfolio managers, and policymakers:

1. **Adopt Dynamic Asset Allocation**

o Use a **dynamic strategy** that shifts toward safe-haven assets (e.g., government bonds, gold) during periods of high geopolitical risk, and rotates back to riskier assets once tensions ease. Empirical analysis (e.g., from Schroders) supports that this can improve risk-adjusted returns. assetstandard.com

o Incorporate **adaptive investment approaches** to adjust allocations based on evolving volatility and risk conditions. Wikipedia

2. **Diversify Across Geography, Asset Classes, and Sectors** o Spread portfolios across countries, sectors, and asset classes to reduce concentration risk stemming from geopolitical events. Howard Capital Management Inc.

o Include commodity exposure, particularly to energy and precious metals, as part of a geopoliticallyaware portfolio because of their risk-hedging potential.

MDPI

3. **Hedge Currency Risk**

o Since geopolitical tensions often cause currency volatility, investors should use currency hedging strategies (for example, forwards or options) to protect cross-border investment returns. My Blog

o Re-evaluate currency exposure in light of major geopolitical risk events, especially for international portfolios. 4. **Monitor and React to Geopolitical Indicators** o Use *geopolitical risk indices* (like the GPR) and **news-based sentiment indicators** to inform risk decisions.

o Develop **scenarios** for possible geopolitical shock events (e.g., trade wars, border conflicts), and create a playbook for how to adjust the portfolio under each scenario.

4. **Stress Test & Build Resilience** o Financial institutions should conduct **geopolitical stress tests**, simulating the impact of major conflict or risk events on portfolios and capital. IMF

o Maintain higher liquidity buffers or safe-asset allocations to absorb potential capital flow shocks.

Conclusions

- **Geopolitical Risk Matters for Investors**: The empirical and theoretical evidence strongly supports that geopolitical risk is not just a macro concern — it has real implications for how investors allocate capital, manage risk, and construct portfolios.
- **Behavioral Adaptation**: Investors (especially professional ones) adapt their strategies dynamically in response to geopolitical tension, reducing exposure during shocks and sometimes re-entering when opportunities arise.
- **Heterogeneity of Impact**: The effect of geopolitical risk is not uniform — it varies by firm characteristics (leverage, asset structure), type of capital flow, and market. This means one-size-fits-all strategies are suboptimal.
- **Risk Mitigation is Possible**: Through diversification, hedging, scenario planning, and stress testing, investors can build portfolios that are more resilient to geopolitical uncertainty.
- **Policy Role is Crucial**: To support financial stability, regulators and governments should factor in geopolitical risk when designing stress tests, capital requirements, and macro-prudential frameworks.
- **Strategic Opportunity**: While geopolitical risk introduces danger, it also offers potential opportunities — for example, reallocation to undervalued assets, tactical hedging, or supply-chain realignments.

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Conflicts of interest

The authors declare that there are no conflicts of interest regarding the publication of this paper

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