How LPs and GPs Can Navigate Regulatory Risk

The ability to discern risk when evaluating opportunities is high on the list of requirements for being an effective investment analyst. If untamed, risks have the potential to only be limited by one's imagination. It is important that an analyst is educated on what risks to rigorously focus on when reviewing individual investments. Past curve balls like the GFC, COVID-19, various wars (including trade ones), and conflicts have distorted most risk-preparedness plans, but an analyst's main goal still remains to be aware of what could logically go wrong while also (these days) leaving some room for mind-blowing inconceivable possibilities. Systematic, unsystematic, capital loss, operational, volatility, counterparty, credit, etc., are some buzzword risks that wear high visibility jackets during due diligence. Some other risks tend to be a little more low-profile, although they pack the same punch as their more high-profile comrades. Regulatory (sometimes coupled with "political") risk is one such abstruse hazard that investors must evaluate. For clarity's sake, regulatory risk is generally defined as the risk that a change to the laws or regulations will hurt a business or investment by affecting that business, sector, or market.

Regulatory risk consistently lurks just beneath the surface of most investment considerations. As investment opportunities are analyzed, due diligence memos and investment committees inevitably mention regulatory risk, but most times, it comes up in a downplayed manner just to cosmetically display a sense that all bases have been covered. Like with most investment or due diligence factors, the past (history) serves as the primary guide. Indeed, some investment sectors invigorate regulatory fears more than others. Gaming, crypto, defense, cannabis, energy (traditional and renewable), financial services, and insurance investment opportunities tend to bring regulatory risk to the front of the queue, but seemingly more "traditional" investments in healthcare, industrials, technology (including AI and other privacy-related segments), finance, agriculture, and transportation have regulatory risk sensitivities that cannot be ignored.

So, how do GPs claim to traverse regulatory risk, and how should LPs reckon with what they are told about this issue? Philosophically, questions like this are stimulating to ask but hard as nails to answer in reality. In our current era, where regulatory (political) risk is more relevant for consideration than in recent memory, below are a few thoughts related to how this risk permeates investor psyches.

- **Sector-focused expertise**: In my experience, sector-focused funds tend to be relatively more predisposed to talking about regulatory risk in their target sectors. For example, healthcare managers are very likely to ease investor concerns by accentuating their understanding of and familiarity with the regulatory bodies that govern their space. The same is true with financial services- and energy-focused managers. It is not uncommon for healthcare and energy manager pitches to stress their embeddedness in the regulatory infrastructure of focus sectors – this is typically done by stressing relevant networks, past experience, and the successful navigation of sector-specific cycles. Additionally, these managers often underscore high-touch guidance of their portfolio companies' compliance infrastructure, which includes internal controls, policies, and procedures. This is not to imply that diversified managers lack proficiency in regulatory issues. In fact, the broadness of some sectors, like healthcare (~18% of US GDP), make healthcare-focused funds' proclamations of complete regulatory mastery worthy of challenge. However, managers operating in multiple sectors will likely have more to prove to LPs regarding their conversance with the regulatory implications of each targeted sector.

- **The power of information**: Closely related to the above point, "information is power" when it comes to assessing regulatory risk. Folks/organizations proven to be well-versed in pattern recognition, as well as those believed to be present in or invited into important policy rooms or those that traffic the corridors of power, tend to gain decently sized audiences when they chime cautionary/reassurance bells around potential future regulations. Although "feelings" will never be a viable or consistently reliable investment approach, I think it must be noted that, as it relates to regulations, the current times "feel" more uncertain than ever before, so basing actions on any information that asserts certainty is imprudent. These days, how things were done in the past, provides little comfort or certainty about what will probably happen in the future.

- **Analysis paralysis**: The degree of susceptibility of certain sectors to regulatory risks/volatility can cause investor inaction or, in some cases, wholesale avoidance of certain investment opportunities. While not trying to meddle in the portfolio matters and risk tolerance profiles of investors, I do believe that the tried and true "portfolio diversification" can be a powerful tool in combatting regulatory fears. Each sector has its idiosyncratic risks, and although some sectors are more prone to certain risks, a diversified portfolio (with well-thought-out tactical or strategic sector over- and under-weights) can help numb some of the inevitable pain all portfolios eventually endure.

- **Yes, tariffs fall under regulatory risk**: In case you were wondering, yes, tariffs do fall under regulatory risk, as these government-imposed measures can impact businesses and industries. As many of us are aware (from quickly getting up to speed with Macro Economics 101), tariffs can raise the prices of imported goods, act as a catalyst for supply chain disruptions, and wreak havoc on cost and sales projections. Tariffs affect goods directly and services indirectly, and because their eventual consequences are hard to predict, it is advisable to stay cognizant of the inputs that could be affected and have contingency plans in place. I believe many sponsors with investments sensitive to tariffs have not fully solidified their contingency plans. However, since necessity is said to be the mother of invention, with time and strategic planning, appropriate standby counteractions will be established.

- **Regulations related to investment vehicles**: Lest we forget, regulations also determine the structure of investment vehicles. Fund compliance requirements, investor protections, LP qualifications, investment transparency, incentive structures, the number of investors per vehicle, the tax treatment of returns/incentives, etc., are all regulated. Both LPs and GPs must be aware of regulations that can alter the alignment within investment vehicles, as certain policies may favor one party over the other.

Anthony Kwesi Hagan
Founder and Head of Research, Freedomization™
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