Aegon Asset Management US (Aegon AM US) believes environmental, social and governance (ESG) issues matter. As an active fixed income manager, we factor ESG considerations into our analytical framework in three distinct ways—integration, exclusion, and engagement. To affirm this belief, we are a signatory to the United Nations-supported Principles for Responsible Investment (PRI).

The ESG acronym has grown in market importance during the last few years. For the emerging markets investment team, the concepts behind the acronym have been a continuously evolving part of our investment methodology for more than two decades. Of course, we didn’t call it ESG back then, but have always considered it a critical part of our investment process. As the data, academic research and our learning advance, we continue to evolve our ESG approach to maximize its portfolio impact. We have the benefit of a dedicated Responsible Investing team, as well as research and portfolio management teams who are well-versed at investing with ESG as decision drivers.

In our paper, “The integral role of ESG factors in emerging markets investing,” published earlier this year, we argued that differing governance factor scores can lead to particularly large spread differences in low-quality credits. Recently, we witnessed two interesting event studies that further support our claim in the form of issue versus issue pricing penalties among the same issuer where we believe the market to be discriminating along subtle governance differences between the issues. As we indicated in our paper, we don’t always refer strictly to these pricing anomalies as ESG, but the techniques and sympathies are aligned and help further illustrate the variety of ways we integrate ESG into our emerging markets debt (EMD) investment process.

Governance case study: Venezuela

On May 23, 2017, Goldman Sachs Asset Management and Nomura Capital negotiated a purchase from the Central Bank of Venezuela of bonds issued by Petróleos de Venezuela SA (PDVSA), a 100% state owned company. Protesters, academics and some market participants immediately panned the deal as Eduardo Lugo, a long-time Venezuelan government critic, argued that JPMorgan should remove Venezuelan bonds from its widely used index. We believe Hausmann was trying to use an ESG exclusion tactic to create a pricing penalty on debt stock of the despotic government. Interestingly, the market started to price the hunger bonds differently than the rest of the Venezuelan and PDVSA debt stock and it is thought to be due to the doctrine of “Odious Debt”.

As a general rule, governments inherit the debts of prior governments, regardless of their character. International law refers to this as the “strict rule of government succession.” This is however not a strict rule, where new governments have not paid the debts of their predecessors, particularly when the exiting government used the debt proceeds in hostile ways, buying guns for example, to quash civilian revolution. From a creditor’s perspective, if we know ex-ante, that incoming “good guys” will selectively not pay debt used for hostile purposes then we should price discriminate to the extent the claim of Odious Debt would be successful in a New York-based restructuring proceeding.

On May 26, 2017, Venezuelan opposition leader, Julio Borges, announced the proceeds of the hunger bonds would be used to buy military equipment, that the Venezuelan government was illegitimate, and that when the opposition came to power they would investigate this transaction.

Analyzing the pricing impact of odious debt on the PDVSA 6% 2022 bonds is particularly challenging given differing coupons of nearby bonds, an Original Issue Discount problem, a default on the Venezuelan sovereign bonds (PDVSA’s parent), market participants valuing on recovery price not credit spread, and differing bond structure (sinking versus bullet). As market participants, our experience was that “hunger bonds” were being treated differently – counterparties refused to transact in the bonds and we saw these bonds cheapen relative to nearby maturities. Academics at Duke University have estimated the Odious Debt penalty to be worth nearly 1,500 basis points off a curve average of 5,000bps.

This brings us to the case of Ecuador and its new government – a situation where we believe the effect of Odious Debt on pricing is more definitive than the one in Venezuela.

Governance case study: Ecuador

Ecuador is not known to be a strong credit. In fact, after the 2015 repayment of principal on its external global notes, Ecuador’s Vice President, Jorge Glas said, “it is the first time in the history of Ecuador that this payment is made on time.” Unlike other countries with default history, the market is particularly leery of the credit considering the 2008 default on two bonds it considered “illegitimate.” In this case, Ecuador claimed Odious Debt.

Ecuador elected President Moreno, who took office in May 2017, on an agenda of ridding the country of the corruption and bad actions that included the leaders behind the 2008 “illegitimate debt” episode. His administration promptly opened a debt audit committee in January 2018 to investigate debts incurred during the second term of the previous President Correa — this was the same approach that led to the 2008 “illegitimate debt” episode. On March 6, Moreno appointed Maria Elsa Viteri Finance Minister. Viteri was Finance Minister under Correa and responsible for the 2008 illegitimate bond default.
Then, on May 8, 2018, President Moreno asked his cabinet to resign. It was unclear if he intended to promote legacy Correa appointees (notably Finance Minister Maria Elsa Viteri). A few weeks later, Moreno replaced Viteri with Richard Martinez, a “business friendly” minister expected to be intellectually distant from ideas of odious debt. We focus on the period leading up to the cabinet reshuffling and the appointment of Martinez for the event study.

With this background we examined two sovereign bonds, 7 7/8% January 2028 bonds issued during current President Moreno relative to 9 5/8% December 2026 bonds issued at the end of President Correa’s term. Using the Odious Debt model explored above we expected to see similar market discrimination during times of heightened concern specific to this risk. Consistent with our expectations developed during the Venezuela episode, we saw the Moreno 2028s significantly outperform the Correa 2026s, and the rest of Ecuador’s curve, during May 2018 cabinet reshuffle periods.7 We estimate the Odious Debt factor was in the range of 30 basis points of relative performance between the two bonds in May. We believe this is an interesting event study test finding in favor of ESG governance because, unlike the Venezuela situation, we have two virtually identical bonds, except for the issuing administration.

Conclusion

We believe ESG factors are an integral part of the fundamental research process and may help directly, or indirectly, explain pricing anomalies. The Venezuela and Ecuador situations demonstrate the impact governance, and more specifically the Odious Debt doctrine, can have on the valuations for particular sovereign bond issues. We highlight these unique situations to illustrate the importance of combining traditional fair value investing with ESG-based methods in an effort to identify relative value opportunities and ultimately enhance the portfolio’s risk-adjusted return potential.

1Mitu Gulati and Ugo Panizza, April 2018
2Buchheit, 2007
3Georgetown Law Professor Anna Gelpiern. “No national or international tribunal has ever cited Odious Debt as grounds for invalidating a sovereign obligation. Each of the treaties and other examples of state practice cited even by the doctrine’s most thorough and principled advocates appears fundamentally flawed—it lacks one or more of the doctrine’s essential elements and/or is accompanied by a chorus of specific disavowals of the doctrine by indispensable parties. But even if the examples were on point, the fact that Odious Debt’s most fervent proponents to this day must cite an 1898 treaty and a 1923 arbitration as their best authorities suggests that the law-making project is in trouble.”
4Mitu Gulati and Ugo Panizza, April 2018
5ElCiudadano, December 2015
6After the 2008 selective default announcement, Ecuador proceeded to buy back about 91% of the bonds, a good portion of that in the open market at levels around 20 cents, and others in a Dutch auction at approximately 35 cents. We believe this was a shrewd way to cut the repayment amount on these bonds by two-thirds or more in a short time period. The country was excluded from international markets for over five years, and only returned to issue another bond in 2014.
7We performed tests on the relative performance to the curve holding level and slope constant since there should be a normal elevation of spread for the general uncertainty of the credit during these periods.

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