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The Hunger Bonds

Ricardo Hausmann | Harvard University | 29 May 2017

Investing often creates moral dilemmas over goals. Should we aim to do well or to do good? Is it appropriate to invest in tobacco companies? Or in companies that sell guns to drug gangs?

The recent popularity of so-called impact investment funds, which promise to deliver decent returns while advancing social or environmental goals, is based on this unease. Foundations often find that these investment vehicles help them to do good – both with the money that they spend on philanthropy and with the endowment assets that yield the returns on which their philanthropy depends.

Nowadays, it is emerging markets as an asset class that should make people morally queasy. Should decent people put their money in emerging-market bond funds?

The returns of the JP Morgan Emerging Market Bond Index (EMBI+) are heavily influenced by what happens in Venezuela. The reason is simple – while Venezuela represents only about 5% of the index, it accounts for about 20% of its yield, because the yield on Venezuelan debt is about five times larger than that of other countries in the index, a reflection of the huge risk premium that Venezuela faces. Moreover, the price volatility of Venezuelan debt – the highest in the EMBI+ – accounts for a disproportionate share of the index's daily price movements.

You might invest in the EMBI+ because it promises higher returns, or because you want to make your savings available to a larger segment of humanity. But if you do, you will root for Venezuelan debt, which means wishing for really bad things to happen to Venezuela's people.

As has been widely reported in the media, Venezuela is experiencing one of the most calamitous economic collapses ever, accompanied by massive doses of political repression and human-rights violations. So investing in the EMBI+ means that you rejoice when Wall Street analysts inform you that the country is literally starving its people in order to avoid restructuring your bonds.

Your happiness is easily explained. Venezuelan imports, after having collapsed by 75% from 2012 to 2016, are down more than 20% in the first quarter of 2017. That's good news for you as an EMBI+ investor, because it means that more money is left to service your bonds. Meanwhile, Venezuelans are involuntarily losing weight and searching for food in garbage piles. Sure, it's a humanitarian catastrophe. But, to you, it's a fabulous investment opportunity.

Now assume that you want to hold Venezuelan debt because you are hoping that President Nicolás Maduro will lose power and that a more sensible, democratically minded government, more in line with your moral compass, will emerge. Even in that case, you will still want the gains from Venezuela's future recovery to be used preferentially to service the old debt issued to finance the corruption and national destruction brought about by Maduro and his predecessor, Hugo Chávez. You will not be rooting for the recovery of livelihoods that Venezuelans deserve after having lived through this nightmare.

You will also be rooting for US judges to seize assets and impound money to pay you. In fact, analysts who are bullish on Venezuelan debt have been lobbying the government and opposition leaders with an implied threat – even considering a restructuring of your bonds, they point out, will allow those managing your assets to cause havoc in Venezuela.

If you are a decent human being, investing in Venezuelan bonds should make you feel "mildly nauseous" to borrow a phrase recently used by former FBI Director James Comey while testifying to the US Congress.

Emerging-market fund managers feel a similar discomfort. They currently spend a disproportionate share of their time "getting the Venezuelan call right", because their bonuses are based on their over-performance relative to the index, of which Venezuela is the main driver.

The less morally burdened among them bask in the recognition they receive for having been right to predict that Maduro's government would decide to starve its people rather than restructure the bonds you hold. Analysts and bondholders have also lobbied the government and the opposition not to seek financial support from the International Monetary Fund, for fear that the international community will demand that you accept a significant "haircut" on your investment, as has been required of Greece's creditors.

That would probably not be "good for the credit". Analysts and bondholders have also lobbied the opposition-controlled National Assembly to recognise Venezuela's external debt in exchange for the freedom of political prisoners, implying that the payment of your bonds can be secured through ransom.

So, should you stop investing in emerging-market funds just because 5% of your savings would go toward financing Venezuela? Clearly, this would punish other countries that are innocent bystanders in the Venezuelan mess.

There must be a better way.

There is. The solution is to demand that JPMorgan immediately exclude Venezuela from the emerging market bond indexes it calculates, thereby freeing fund managers from the need to compare their performance with hunger bonds.

Over time, JPMorgan should introduce a Decent Emerging Markets index, which would save you from moral anguish by ensuring that only countries adhering to minimal standards of respect for their citizens are included. The DEM would allow you to root for higher returns on your savings without wishing for human misery. You could do well, without feeling bad.

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