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Emerging Market Debt and the Rule of Law

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One of the well-known hazards of investing in emerging markets is the risk that an issuer will run afoul of the politicians that control access to both bank funding and prison cells. Because of this hazard, LM Capital generally avoids purchasing securities from issuers in countries that lack the "Rule of Law." We have no hard and fast rules as to the application of this guideline but in general, our thinking can be traced to the work of a 17th-century English philosopher, John Locke.

John Locke published *Two Treatises of Government* in 1689. In it, he states something that all emerging market investors understand: "For I have truly no property in that which another can by right take from me when he pleases against my consent." Locke calls for the supreme power of a commonwealth to govern by established standing laws that are well-known to the people, not by arbitrary decrees. He also calls for the laws to be applied by indifferent and upright judges who decide controversies by these laws.[1]

A non-governmental organization, the World Justice Project (WJP), publishes an annual survey-based Rule of Law Index. The WJP index *"measures adherence to the rule of law by looking at policy outcomes, such as whether people have access to courts or whether crime is effectively controlled. This stands in contrast to efforts that focus on the written legal code, or the institutional means by which a society may seek to achieve these policy outcomes".* [2]

One would reasonably expect developed market countries to be ranked higher than emerging market countries in the WJP Index, and this is the case. In the table below, we sort the issuers in the widely used Bloomberg Barclays Emerging Market Hard Currency Aggregate Index by "country of risk". We highlight in red the countries that we tend to avoid based on Rule of Law issues. Our application of Rule of Law issues tends to be in line with the WJP's Fundamental Rights Rankings. WJP describes its Fundamental Rights ranking as recognizing *"that a system of positive law that fails to respect core human rights established under international law is at best "rule by law," and does not deserve to be called a rule of law system. Since there are many other indices that address human rights, and as it would be impossible for the Index to assess adherence to the full range of rights, this factor focuses on a relatively modest menu of rights that are firmly established under the Universal Declaration of Human Rights and are most closely related to rule of law concerns".* [3]

Bloomberg Barclays EM USD Aggregate Statistics Index

	Weight (%)	WJP Rule of Law 2019 Ranking (out of 126)	WJP Absence of Corruption 2019 Ranking (out of 126)	WJP Fundamental Rights 2019 Ranking (out of 126)
China	20.06	82	48	121
Mexico	7.85	99	117	73
Brazil	6.70	58	67	68
Indonesia	4.96	62	97	82
United Arab Emirates	4.62	32	17	98
Russia	4.56	88	68	104
Saudi Arabia	4.42	N/A	N/A	N/A
Turkey	4.13	109	57	122
Qatar	3.19	N/A	N/A	N/A
South Korea	3.09	18	29	22
India	2.41	68	80	75
Colombia	2.39	80	94	74
Chile	2.08	25	25	24
South Africa	2.08	47	58	43
Argentina	1.87	46	52	28
Philippines	1.73	90	63	105
Peru	1.59	70	107	46
Oman	1.29	N/A	N/A	N/A
Israel	1.20	N/A	N/A	N/A
Malaysia	1.09	51	43	90
Panama	1.07	64	84	47
Kazakhstan	1.03	65	61	95
Ukraine	0.98	77	108	50
Bahrain	0.97	N/A	N/A	N/A
Ecuador	0.91	87	86	86
Egypt	0.84	121	90	125
Uruguay	0.79	23	19	19
Dominican Republic	0.76	95	93	62
Kuwait	0.72	N/A	N/A	N/A
Sri Lanka	0.71	63	66	70

Sources: Bloomberg, World Justice Project

We do not view our avoidance of China, for example, as a “negative ESG screen”, such as one would apply to tobacco or firearms companies. The avoidance comes down to the fact that the government rules essentially by arbitrary decree. In 2016 and 2017, there was a flurry of newspaper stories along the lines of “Scores of Chinese billionaires and CEOs have disappeared in ‘state-sanctioned abductions’”.[4] Even though the stories may have diminished, the message has not.

One avenue by which the Chinese government maintains control over both their private and public sector corporations is through a banking system that is largely owned by the government. The four largest banks in the world are Chinese banks and even though their “preference” stock is publicly listed they are referred to as state-owned banks, with the state controlling the ordinary shares. The banks act as an arm of the government. The government can, and does, withhold bank funding to companies to implement public policy.

The breakdown of the China weighting of 20.06% in the Bloomberg Barclays EM Index by sector shows that about 11% is classified as Agency, as an arm of the government. Many of the high yield industrials in the table below are property development firms that are particularly sensitive to government policy. Looking at the individual issues in the 20.06% weighting, it is clear that in each case they exist at the will of the government. Also, many of the higher-yielding bonds are actually issued by legal entities from the Cayman Islands and the British Virgin Islands. In the case of a default, the legal status may make it even more difficult to pursue payment.

China Breakdown

			Weight (%)	Yield
Barclays Bloomberg EM Index			100.00	4.88
China			20.06	4.17
	IG		10.51	2.87
		Agency	7.51	2.83
		Industrial	1.97	3.07
		Financial Institutions	0.47	2.97
		Sovereign	0.25	2.14
		Utility	0.20	2.75
		Local Authority	0.10	3.67
	HY		9.55	5.59
		Industrial	4.31	7.71
		Agency	3.46	3.42
		Financial Institutions	1.28	4.62
		Local Authority	0.39	4.69
		Utility	0.12	5.24

Sources: Bloomberg

At any particular time, the Chinese government may be sensitive to maintaining access to international capital markets and will ensure that debt issuers are able to make payments. On the other hand, the government is certainly aware of the moral hazard of an investor expectation that the government will take the necessary steps to avoid upsetting international credit markets. If the government must back everybody, creditors can lend to absolutely anybody and expect the government to step in if an issuer defaults. At certain arbitrary points, the government can be expected to demonstrate that issuers can and will declare bankruptcy. The problem for analysts is that the timing of these arbitrary demonstrations can be impossible to predict.

One of the core tenets of credit analysis is a proper evaluation of both the ability and willingness of the borrower to pay. One component of both the ability and the willingness to pay is that an investor must consider the legal regime that governs the process when a company defaults on its bonds. Most countries have processes that are unique to that country. The process governs both the timing and the ultimate recovery on the investment. Given the convoluted legal structure of many emerging market bonds, it may be unclear exactly which country's legal system would handle the default. Understanding whether a default will be governed by indifferent and upright judges, or by arbitrary decree, is crucial to understanding the risk of a bond. How does one quantify or measure arbitrary whims? At LM Capital, we believe that our mandate to preserve our investor's capital demands that we avoid countries that rule by arbitrary decree.

1 Locke, J. (1924). Two treatises on government. London: Dent.

2-3 Research and Data. (2019). Retrieved October 16, 2019, from https://worldjusticeproject.org/our-work/wjp-rule-law-index.

4 O'Neill, M. (2017, February 5). Scores of Chinese billionaires and CEOs have disappeared in 'state-sanctioned abductions'. Retrieved October 16, 2019, from https://www.news.com.au/lifestyle/real-life/news-life/scores-of-chinese-billionaires-and-ceos-have-disappeared-in-statesanctioned-abductions/news-story/7d2d1cfeadd6b47ab66087d7f44d877f.

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