Rethinking Diversification in a Post Bond-Boom Market

By Michael Winchell

Did you ever wonder why so many financial advisors choose nautical images such as lighthouses or sailing vessels for their logos, websites, and advertisements? We have. We think it speaks to the notion of a captain’s firm hand on the rudder, piloting a strong vessel through stormy seas and safely delivering the client’s wealth to the various ports of call over life’s journey.

But wealth managers and financial planners do much more than keep a client’s net worth from hitting the rocks. At Larkin Point, we view the wealth management process as analogous to farming or manufacturing: Careful plans are made, then input prices are evaluated and strategies are adjusted as market conditions change. To us, the financial plan is not a navigational plan but a business plan.

Consider the leap of faith clients take when they choose to stop depending upon their own experience and expertise to make a living and hand over their hard-earned assets to us, their financial advisors. Building a retirement plan to last, without failure, for upwards of 30 years, to replace the income they will spend in the future, requires building reserves against the possible disappointment of the future. To reduce longevity risk, an advisor’s most important task is portfolio growth. Growth makes every other burden of planning lighter.

Our view is that advisors must have a plan for growth—and, in addition, for asset protection—that recognizes that what worked yesterday may not work as well in the future. Over the past 30 years the simple 60-percent stock/40-percent bond portfolio met the basic goals of growth and protection, but in recent years, not so much. We were spoiled by perfect financial conditions: disinflation and falling interest rates combined with radically increased productivity fostered by technological innovation. Since the turn of the century, though, this Golden Age for investing has been winding down. A tech bust followed by a financial meltdown took the global economy into deleveraging mode, and easy money flowed everywhere to ease the pain. And though we expect quantitative easing to bring inflation’s heat, we keep experiencing the cold winds of financial deleveraging.

If we do enter an inflationary period, bonds are in for a rough ride. If we continue with deleveraging, bonds offer better returns than cash—but perhaps not sufficient returns to justify the risk of being wrong. Consequently, a financial plan for the next 30 years will require a completely different allocation, away from bonds, in an attempt to build a safe portfolio.

Lifestyle, Losses, and Longevity Challenges to a Financial Plan
For many individuals in retirement, lifestyle, portfolio losses, and lack of growth combine to create longevity risk, which we define as the risk of a portfolio dying too soon. To reduce longevity risk, an advisor’s tasks include helping clients determine how much they will spend their money in the future, building reserves against the possible disruptions to well-laid plans, and limiting the failure of assets to produce adequate income or returns. But the advisor’s most important task is portfolio growth. Growth makes every other burden of planning lighter.

To envision all the possible mistakes an advisor or client can make in the planning process—or simply the ways the future can defy expectations—take a look at a plan you laid out 20 years ago. Wage growth hasn’t kept pace with increases in medical costs or college tuition. Property taxes rose with home values but typically did not return to pre-bubble levels. Equity prices surged and crashed.

None of us can accurately predict every blow to a plan over a lifetime. To reduce longevity risk, we believe in targeting growth—primarily, but not exclusively, with equities. If economies grow, our clients need to participate. But we also believe that those same markets (again, primarily equity markets) will be volatile, resulting in untimely portfolio losses, so strategies for asset protection and reduced drawdowns are necessary to reduce the likelihood of plan failure. In the best of plans, we will hold an alternative asset that generates cash in a market crisis, smoothing portfolio returns and providing an opportunity to buy more growth assets when prices are low. Protection that works creates confidence.

Thirty Years of the Balanced Portfolio—Government Bonds Were Perfect
For the past 30 years, the portfolio holding 60-percent stocks and 40-percent bonds seemed to exhibit a reasonable mix of both growth and protection. This balanced portfolio was generally a simple allocation to the market beta of two uncorrelated and very liquid asset classes. Low fees, broad diversification, and regular rebalancing produced reasonable returns with about half the drawdowns of investing wholly in equities. Most important, bonds were the source of cash in a crisis. Investors had confidence in bonds.

In fact, U.S. government debt in the post-Volcker era was very close to a perfect
asset, particularly within the context of modern portfolio theory. Dan Ferris of Stansberry & Associates Investment Research offers a description of a perfect asset that we have modified here with respect to asset allocation with equities. We believe a perfect asset in a portfolio also holding equity securities would:

- Have rates of return always in excess of inflation
- Have little or no default risk
- Be completely liquid
- Be negatively correlated with equities, particularly in times of crisis
- Require no active management other than rebalancing

To achieve portfolio balance, we need very liquid assets that go up in value when equities go down in value. Key to portfolio balance is the ability to harvest cash from assets that have risen in value and use it to purchase additional equities when prices collapse. For the past 30 years, U.S. government debt met this requirement better than most alternatives.

To place the returns of U.S. government debt during 1982–2012 into some perspective, figure 1 shows the real returns, annually, of U.S. government intermediate-term bonds for the period from 1926–2013. Figures 2 and 3 show the corresponding yields for the same debt and inflation, respectively.

At the beginning of this Golden Age for bonds, yields across many countries and industries carried high nominal rates as investors priced in expected inflation. Yields subsequently declined dramatically with falling inflation. In our view, the Federal Reserve actively managed U.S. rates to target negative correlation between U.S. government debt returns and stock returns.

Most investors’ experience over the ensuing years provided regular evidence that the 60-percent stock/40-percent bond portfolio was balanced, with the Federal Reserve as the great mechanic of the system. Alan Greenspan was confirmed as Chairman of the Board of Governors of the Federal Reserve on August 11, 1987. Roughly two months later, as U.S. equities declined more than 22 percent in a very short time, the Federal Reserve issued a short statement in which it affirmed the readiness of the Federal Reserve “to serve as a source of liquidity to support the economic and financial system” (Carlson 2007).

For most of the past 20 years, we have seen the Federal Reserve respond similarly to six or seven spasms of broad market volatility...
could be extremely volatile but always recovered, and second, in a market crisis, regardless of origins, the Federal Reserve would lower short-term interest rates. But interest rates have gone about as low as they can go, and it’s time to find another perfect asset.

Why Search for an Alternative to Bonds?
The current popularity of liquid alternatives is driven by the low returns on cash, the low yields on bonds, the belief that the great bull market in bonds is over, and the belief that the world’s central banks cannot keep heating the economy without passing a tipping point. The search for alternatives really encompasses the following three motivations:

The Search for Income and Real Returns
If there has been one big shock to a wide number of financial plans, it has been the complete collapse in interest income on all forms of cash instruments and fixed-income investments. Cash now offers a negative real return, and low interest rates continue to adversely impact investment portfolios and plans that have relied on interest from certificates of deposit, money market funds, or U.S. Treasury bills. No one is being rewarded for holding cash in reserves.

Low bond yields are also a problem for financial plans over the long term in less visible assets such as Social Security and the expected cash value of various life insurance policies. Consider the Social Security Trust Fund: The weighted average interest rate of the securities held by the Fund declined from 7.853 percent in 1994 to 3.626 percent in 2013. Continued low interest earnings will bring us more rapidly to the date trust fund reserves are depleted (now estimated at 2033). With life insurers holding more than 80 percent of their assets in fixed income, sustained low interest rates will reduce investment yields and ultimately reduce insurance company crediting rates. Thus, it may be that the real advantage of U.S. government debt during the past 30 years was not that it was liquid and free of default risk. The real advantage may have been a high coupon rate and subsequent evaporation of system liquidity. After the 1987 stock market crash, we witnessed financial engineering gone awry with the 1994 failure of Orange County, California; the 1995 Mexican peso collapse; LTCM’s too-big-to-fail crisis on the heels of the Russian default; a tech bubble that burst in 2000; accounting frauds in 2002; and a real estate bubble that collapsed in 2007, morphing into the ultimate too-big-to-fail crisis in 2008. Table 1 shows the returns on various asset classes during a few of these periods of market crisis.

Each spasm generated continuing evidence supporting the 60/40 portfolio: First, equities

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The Search for Protection

U.S. total debt holdings are very large, with total debt outstanding more than twice the size of equity market capitalization. Holding debt with duration greater than five years now seems to be inviting equity-like volatility. The relative asymmetry of potential interest-rate changes makes the potential total return on fixed income less enticing than in the past. Finally, the ballooning U.S. budget deficit and recent debt-ceiling battles have created an environment in which some of our elected representatives have openly discussed the potential default of government obligations, effectively transforming the world’s safe haven into a potential tail-risk catalyst.

We believe that the search for alternatives is a search for other means of generating total return and liquidity in a future market crisis. It is a search to replace the once-dependable, safe haven of U.S. Treasury debt.

The Search for Consistent Low Correlation to Equities

Some writers have identified diversification as the only free lunch in finance. When the prices of two or more securities do not move in lock step, choosing a portfolio containing more than a single security allows investors to reduce portfolio variance (volatility) without too large a reduction in returns. Most asset allocation today relies on modern portfolio theory and the attendant search for noncorrelated assets that have positive returns. In a word, “alternative” drives this point home. Financial professionals are searching for asset classes (or asset structures) with low correlation to equities as the means of achieving portfolio diversification.

However, the search for low correlation is also a search for an asset class that performs well in a broad market crisis when many other asset classes do not. Too often, low correlation is not consistent and fails when needed most. For example, Contessi et al. (2013) found “the correlations between a majority of liquidity-related spreads increased so substantially during the GFC [Global Financial Crisis] that they have not reverted to normal correlation levels in the aftermath of the crisis.”

Corporate, Mortgage, High-Yield, and Emerging Market Debt

Three decades ago, high-yield debt, mortgage-backed debt, emerging-market equity and debt, and perhaps even non-U.S. developed-market equity and debt might all have been considered alternative investments. In fact, the tremendous growth of investment banks starting in the early 1980s was based on successfully introducing these products to the buy-side and developing robust market-making across multiple product lines.

All types of debt were offered to the buy-side as substitutes for holding U.S. government instruments in the bond portion of the portfolio. With the greater risk of default in high-yield debt and the risk of prepayment in mortgage debt, most of this product offered higher coupon income and higher potential total returns than did government debt, and all debt was benefiting from falling inflation. But adding credit-spread risk or prepayment risk to fixed-income portfolios turned out to be highly correlated with equity-market risk in periods of market crisis.

We believe this was primarily the result of investment banks choosing U.S. Treasury notes as the primary short position to hedge away interest-rate risk while holding “spread product” in inventory. Positive net-interest margin on such positions was an addicting byproduct of carrying large positions.

Whenever a geopolitical event or collapse in system liquidity struck, the flight to the safety of U.S. government-issued debt meant dealers were forced to cover short positions and liquidate long positions as funding evaporated. Any rush to liquidity and safety typically would cause a spasm of deleveraging among dealers, and the correlations between equities and credit-sensitive debt would converge. The greater the leverage within these institutions, the more severe the contraction, and, as we saw five years ago, a severe funding crisis led to the demise of many investment banks.

It would be a mistake, however, to assume that U.S. high-yield, emerging-market debt (issued in U.S. dollars), U.S. mortgage-backed debt, and high-grade corporate debt are not correlated with U.S. government debt given large movements in interest rates. Although the total returns and volatility of many debt classes rivaled equities over the past three decades, and often appeared to move in tandem with equities, all classes of debt will be adversely impacted by any future increase in interest rates. Thus, if we are looking for an alternative to U.S. government debt, we must acknowledge the potential asymmetric return profile for all these other classes of debt as well.

Alternatives May Be Less Correlated with Interest Rates, Equities

An alternative investment can be most simply defined by exclusion: An alternative investment is not a traditional long-only equity investment, nor a long-only bond investment. This opens the door to a wide range of possibilities that we divide into either alternative asset classes or alternative structures.

Alternative asset classes include direct investments in commodities such as precious and industrial metals, energy, and agriculture, as well as investments in real estate, currencies, art, and other collectibles. Bitcoin is an alternative investment that also is designed as a medium of exchange. Venture capital (which invests in pre-product, pre-revenue companies), private equity (which helps existing companies expand products and revenues), and mezzanine financing often are labeled as alternative investments because of the low liquidity and private placement method of attracting capital, even though such investments are, strictly speaking, long-only equity. Crowd-funding and peer-to-peer lending are also examples of new types of lending structures that we would consider as alternative investments.

Alternative structures provide a wider range of return profiles than is possible by choosing another asset class. Any asset class, or even a collection of classes, can be combined, long or short in a single fund. Targeted returns are engineered based upon liquidity, leverage, market-timing decisions,
and perceived relative value. Short positions can be established alongside long positions. Consequently, strategies can take form as long/short equity, equity market neutral, equal-weighted, unconstrained bond, credit arbitrage, global macro, managed futures, dedicated short-bias, volatility, absolute return, and so on. A fund-of-funds or multi-manager structure allows multiple strategies in a single diversified investment.

Among the wide array of alternative structures, leverage is the one investment tactic that has the greatest potential impact on return profiles, regardless of investment structure or strategy. Because of limits on investors’ time and skill, even when complete transparency exists, leverage can be difficult to measure. Many relative value strategies, global macro strategies, managed futures strategies, and currency strategies rely on leverage to deliver returns.

Finally, a liquid alternative has come to mean an alternative investment that an investor can liquidate quickly (usually within a single trading day). Thus, an investment in a hedge fund with a two-year lock-up would be precluded from such classification. But if the hedge fund manager has decided to offer some of its portfolio as a mutual fund (a ‘40 Act fund), that same strategy now might be considered a liquid alternative. Nearly all alternative asset classes or alternative structures can be offered as either a hedge fund or a mutual fund, with liquidity and leverage being constraints on each, respectively. Mutual funds usually will be less levered by regulation and more liquid by design. Hedge funds can utilize more leverage, and hedge fund managers view long lock-ups as more desirable because the end-investor is less likely to determine when positions are liquidated.

Which Alternatives Offer Real Returns, Protection, and Low Correlation with U.S. Equities?

Table 2 lists traditional asset classes on the left and alternative asset classes on the right. Many alternative asset classes are very illiquid, difficult to store, or require physical management of day-to-day operations. Consequently, to make these asset classes more attractive to investors, liquid derivative contracts are designed to offer better liquidity and the opportunity to rebalance.

Most derivatives, but not all, trade on an exchange. In this instance, counterparty risk is low, and liquidity reasonably high. Very few of these alternative asset classes offer a safe haven in a crisis, with volatility (VIX) and gold being the notable exceptions.

We present a partial list of alternative structures in table 3. Most, but not all, can be accessed as either a hedge fund or as a mutual fund. Global macro funds are among the more difficult strategies to offer in mutual fund form because of the wide range of investment mandates and the typical reliance on leverage. Many global macro funds manage large positions in currencies and execute large relative value trades or yield curve trades in various countries and so would have leverage too great for a mutual fund.

Most alternative structures are actively managed and typically have much higher fees than passively indexed investments. Alternative structures also offer the opportunity to create funds that target negative correlation to equities by the use of put options or short positions.

Table 4 shows the returns of a few traditional asset classes compared to the returns of three hedge fund indexes during periods of market stress. (Hedge fund returns are available for the period beginning 1990 only.) One index, the HFRI Hedge Fund Composite Index, measures the weighted returns of all hedge fund strategies monitored by Hedge Fund Research, Inc. In addition, the returns of the HFRI Macro Index and HFRI Equity Market Neutral Index are shown because of their low correlation to equities during the market sell-offs in both 2000–2002 and 2008–2009.

Figures 4, 5, and 6 show the potential growth in a dollar invested in 1990 in the same eight investments. It should be noted that investments in indexes such as those shown in table 4 are not generally possible, and all return data are expressed without regard to transaction costs. The hedge fund index returns are, however, shown net of fees charged to investors. The strong total returns generated by hedge funds overall, as evidenced by the increase in the HFRI Fund Weighted Composite Index and the HFRI Macro Index, are indeed impressive. So too are the relatively low drawdowns in most periods in which the S&P 500 declined sharply.

The return profile of the HFRI Equity Market Neutral Index also demonstrates
Table 4: Returns of a Few Traditional Asset Classes Compared to the Returns of Three Hedge Fund Indexes During Periods Of Market Stress

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Source: Hedge Fund Research, Inc. www.hedgefundresearch.com, © 2014 Hedge Fund Research, Inc. All rights reserved.
the low correlation to equities and low volatility otherwise found in U.S. government and U.S. high-grade corporate debt. Finally, for comparative purposes, we show the returns of the S&P 500, U.S. high-yield debt, and USD emerging market debt to reveal the high correlation these two debt classes shared with equities during periods of equity market stress.

There are clearly alternative strategies for an investor searching for total return and consistent low correlation to equities. However, whether the successful hedge fund strategies employed over the past two decades can be delivered in truly liquid mutual fund form remains to be seen. We believe such liquidity is essential to the primary characteristic necessary for alternatives to U.S. government debt, namely “cash in a crisis” for rebalancing and portfolio protection.

The mutual fund format will open alternative structures to a wider audience, allow investors to follow various strategies as easily as they now follow a single stock, and provide financial advisors with a wider array of tools to construct portfolios for both growth and protection, reducing portfolio drawdowns and volatility without relying on low-yielding bonds. Liquid alternatives will not come close to the near perfection offered by U.S. government notes over the past 30 years and will never match the liquidity or the guaranteed return of principal of a government obligation. Liquid alternative investments may, however, offer greater total return than government debt, and may serve to balance the ups and downs of equities reasonably well.

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References

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The Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM bench-marking from traditional sovereign bond indices to aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Barclays US EM Index and history is available back to 1993.

The Barclays EM High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds, and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Barclays EM Intermediate Corporate Index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC -registered. The index includes both corporate and non-corporate sectors. The corporate sectors are industrial, utility, and finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are sovereign, supranational, foreign agency, and foreign local government.