Investors and asset managers alike could be excused, in their current travails, for wishing that Greece had never existed. Quite how the world might look today without the contribution of Greece and Greeks to the development of civilisation, democracy, philosophy and science, among other things, is a topic beyond the author’s competence (and also irrelevant to the subject of this note).

Without doubt, however, recent financial market history might look very different: volatility and risk aversion would not be so high; equity markets could be stronger; yields on U.S. Treasuries, U.K. Gilts, German Bunds and other so-called safe havens might well be higher; Italy perhaps would not be paying 6%+ for short-term funding; and the longevity of the Euro as a currency would not be in doubt. Yet this is not the world that we live in.

Fixed income vanishing act

Now take a look at fixed income indices today and try to find Greece, or OTE, the Greek telecommunications operator, or Fage Industries, a Greek dairy business and high yield bond issuer. Of course these are all constituents of many indices, but not necessarily the indices that investors and managers are accustomed to using:

- None are (now) investment grade securities so they do not appear in any index with an investment grade rating criterion.
- Greece is not in the J.P. Morgan GBI-EM or EMBI indices, perhaps the most common index family in emerging market investing. These have a World Bank low income classification requirement to determine an “emerging market.”
- Nor is Greece in the less tightly defined EMBI+ index, which is limited to dollar-denominated sovereign issuance, as Greece has no USD denominated bonds that have met the inclusion criteria.
- OTE and Fage Industries, both rated non-investment grade, are, apparently, not high yield issuers. As the related sovereign is below investment grade, according to the most commonly used high yield indices (as currently defined), the Bank of America Merrill Lynch indices, these are emerging market corporates.
Disappeared Sovereigns and Orphaned Corporates

• Equally, they do not qualify for the J.P. Morgan emerging market corporate index series, CEMBI, failing on the definition of an emerging market.

So it does seem that the fixed income world has wiped Greece and most things Greek, from the investment map.

So What?

With less than $1 billion in value and only four issues, the fact of Greek issuers leaving the high yield universe is not really a big deal for that market, and the subject, given all the concurrent market nervousness, has not attracted much comment. Likewise, the loss of Greece erstwhile investment grade ratings appear inconsequential to global benchmarks (Exhibit 1).

EXHIBIT 1: INDEX PERCENTAGES, GREECE

<table>
<thead>
<tr>
<th></th>
<th>Barclay’s Global Aggregate</th>
<th>BofA ML Global High Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nov 2011       Dec 2009</td>
<td>Nov 2011       Dec 2009</td>
</tr>
<tr>
<td>Australia</td>
<td>Sovereign Corporate</td>
<td>Corporate</td>
</tr>
<tr>
<td>Sovereign</td>
<td>0.00           0.00</td>
<td>0.80            0.00</td>
</tr>
<tr>
<td>Corporate</td>
<td>0.00           0.00</td>
<td>0.00            0.00</td>
</tr>
<tr>
<td>Greece</td>
<td>0.00           0.00</td>
<td>0.10            0.00</td>
</tr>
</tbody>
</table>


The bigger question is Italy. Italian-domiciled issuers represent 2% of global high yield and about 12% of the European high yield market with nearly $25 billion of issuance. Italy also has around $1.2 trillion of sovereign debt in the Barclays Global Aggregate Index and Italian corporates are also well represented (Exhibit 2). Were this to drop out of investment grade, the implications would be significant. The global economic consequences will be at the forefront of all investors’ minds, but this much debt becoming off-benchmark can only add to the stress which such a situation would create.

EXHIBIT 2: INDEX PERCENTAGES, ITALY

<table>
<thead>
<tr>
<th></th>
<th>Barclay’s Global Aggregate</th>
<th>BofA ML Global High Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nov 2011       Dec 2009</td>
<td>Nov 2011       Dec 2009</td>
</tr>
<tr>
<td>Sovereign Corporate</td>
<td>3.00           0.50</td>
<td>3.90            0.60</td>
</tr>
<tr>
<td>Sovereign Corporate</td>
<td>2.00           2.30</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>3.00           0.50</td>
<td>3.90            0.60</td>
</tr>
</tbody>
</table>


If portfolio managers have no performance risk from not owning a bond, they need a greater reward for making that investment. That could drive down the prices of debt forced off benchmark even further.

Rule Changes In the Works

It is perhaps because of this threat that Bank of America Merrill Lynch has rewritten its rules effective December 31. The investment grade country rating criteria will no longer apply to its Global and European Currency High Yield indices. Having been dropped earlier in the year, Greek issuers will be reinstated and will be joined by corporate issuers from Venezuela, Indonesia and elsewhere. These indices will take on more of an emerging markets slant and will present more of a challenge to investment teams that do not have expertise in emerging market corporates.

At the same time, the rules for U.S. High Yield replace the country rating criteria with a G-10 or Western European limitation—so here again a Greek corporate bond (there is only one in this case) is to be reinstated. But while the Greek corporate rejoin the index, others will drop out including issuers from Russia, Brazil, Mexico and other investment grade countries. Thus U.S. High Yield will move in the opposite direction to Global High Yield as it loses its slight emerging market exposure.

Asset class labels create distortions and opportunities

The difficulties with developed market sovereigns are challenging the dynamics of risk and reward:

• Developed market sovereigns seem misaligned against the (arguably) better fiscal and solvency position of their supposed higher risk emerging counterparts.

• The financial prudence we are seeing in many corporate and high yield bond issuers compares favourably to the banking sector’s volatility and lower transparency.

Risk is not necessarily in the places that investors are accustomed to looking for it. Asset class definitions no longer divide the world into neat categories of risk and return, and index
criteria do little to help. So the artificiality of asset class nametags and indices has a real economic impact, adding yet more stress and confusion to what is an already hyper-stressed situation.

But these distortions also represent opportunities. Ultimately prices can reach levels where off-benchmark risk is worth taking. For those funds and mandates with a more flexible, less benchmark-constrained approach—something which we see increasingly warranted as asset class and benchmark labels lose their meaning—taking a holistic, cross sector view of investment opportunities can provide valuable additional returns.

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