



## Smart money in favour of locking in now

Story by: Nick Rice | Magazine: [InvestmentAdviser](#) | Published Monday , November 10, 2008

Managers are urging investors to put their money in government bonds now to lock in capital gains before the market becomes saturated

Anyone seeking regime change after recent economic events should look no further than City Financial Investment Company. In a flyer reminiscent of a revolutionary pamphlet, the firm talked of “a tidal shift” in finance, of overthrowing sovereigns, of the general public “not going about things in the most efficient or beneficial manner”.

But the ruler in this case was not Charles I, and the heir apparent was not Cromwell. When City Financial said: “The King is dead. Long live the King!” it was not trying to start the next civil war. It was describing what it believes to be the new relationship between cash and gilts.

“Cash is no longer king,” says Ian Williams, manager of City Financial’s £31.1m Strategic Gilt fund. “If interest rates are coming to 2 per cent and you’re in a saver account, you’d be lucky to get 1 per cent. If you can still get a 5 per cent yield on a gilt and a 2 per cent yield on an index-linked gilt, that’s going to beat cash. The smart thing to do is lock in now to get the capital gain.”

If City Financial sees “a tidal shift” in the banking system, Mr Williams certainly sees a flood into gilts. As a long-term investment, bond managers certainly make a good case for them at present. When typical bond investments are benefiting from lower inflation, a flexible manager can move into ordinary gilts, a classic safe haven in times of distress. If inflation increases in the longer term, index-linked gilts, whose returns are proportionate to inflation, look more attractive.

An active gilt manager can switch between the two, and over the longer term is likely to do so. To take the current UK scenario as an example, the present outlook is for low inflation - some would even say deflation is a possibility. But if the government cuts interest rates and boosts spending to spur economic growth, this could be reflationary on a longer-term scale.

Some gilt investors are currently concerned about the UK government’s power over the market. It is the sole issuer and seems set to flood the gilt market over the next year to fund its partial nationalisation of the banking system. The Debt Management Office has already announced issuance to cover the crisis to the tune of £37bn, managers point out. If the government brings forward its spending plans to counteract the downturn, this number could swell.

As Jim Stride, managing director at Axa Investment Managers UK, observes: “The government is clearly going to issue heavily in the short end, so short-dated yields have moved out quite a lot.” There is also a chance they may issue debt at the very long end of the yield curve, bonds that mature a few decades from now. The most

expensive debt to issue is in the middle of the yield curve, where interest rates are highest.

Although some investors fear demand will never keep up with supply and gilts will be slow to appreciate, Mr Williams thinks otherwise. He says savers will buy gilts in the middle of the yield curve, where the interest will be most attractive, and the government will issue gilts at the long and the short ends so it pays as little interest as possible.

According to Mr Williams, the result is a supply/demand mismatch that sustains the case for a buying opportunity. Sovereign wealth funds are also helping the outlook, he says, because they are looking to diversify into safe-haven government bonds from issuers other than the US.

Safe haven is, of course, a relative term in the current climate. Jim Leaviss, head of retail fixed interest at M&G Investments, says: "It's very possible the UK government will get downgraded over the next couple of years." But if a safe haven is a place where you can almost guarantee eventual returns, Mr Leaviss says "the level of gilt yields is the cheapest value you'll find right now".

He even says index-linked gilts started to look better value recently, having always found them "pretty expensive" before. Stoked by investors' fears about inflation, the UK Index-Linked Gilt sector was the best-performing of the IMA peer groups over one year to 6 October, returning 9 per cent. The UK Gilt sector, by contrast, was the second best-performing sector with gains of 6.7 per cent. But after a spectacular run, the UK Index-Linked Gilt sector fell 0.5 per cent over three months as fears of much lower inflation hit the underlying assets.

There is still some benefit to be had out of the sector in the short term, however. Mr Stride says: "In our distribution funds, we are overweight index-linked gilts and moving to a neutral position in ordinary gilts."

But Axa Investment Managers has propped up the index-linked position with index-linked bonds that mature in May 2009 and whose interest rates have already been fixed to the last retail price index reading. In other words, nothing can affect the interest they pay until the government pays off the debt in the middle of next year.

Mr Williams has also used some more unusual strategies to deliver extra returns in his gilt fund. When markets are stable or falling, he sells covered call options off the back of his gilt holdings to generate extra profits. This means he sells people permission to buy his gilt holdings off him at a set price.

The tactic works in downward or stable markets because if the call option is exercised and Mr Williams has to sell a holding, he can then buy it back at a similar price or lower. If he hits upward markets, however, he will stop selling call options as, if the buyers exercise them, he will be forced to buy back his holdings at a higher rate. Mr Williams said he stopped selling call options in June this year to avoid precisely this scenario.

If it is possible to look past the financial revolution of the present, there may be an important doubt in investors' minds as to how long gilts will look attractive, even with tactics like Mr Williams's thrown in. If the economy does recover, but there is no

inflationary scenario, neither gilts nor index-linked gilts may look particularly profitable compared with opportunities in equities and bonds.

As far as Axa Investment Managers is concerned, Mr Stride says, "We expect corporate bonds to do much better in the recovery scenario. But at some point, there will be a reappraisal of asset allocation, which may well give government bonds a greater place." Even if the government stages an ideal recovery and leaves the private sector to get on with it, caution may still sustain the gilt market for many years to come.

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