

IN THE SPOTLIGHT

Ian Williams, manager of the CF Strategic Gilt fund, talks to Jenny Lowe about why he is adopting a more defensive stance

Enhancing returns and reducing volatility



With yields down to levels unseen during most investors' lifetimes, Ian Williams, manager of the CF

Strategic Gilt fund, has repositioned his portfolio on fears that the gilt market is in "bubble territory".

He says: "The gilt market has gone up too far and yields have gone down too far so we have moved to a very defensive position to protect our investors' capital. This is probably the least-risky gilt fund in the market at the moment."

The fund aims to offer a superior risk-adjusted return instead of holding a conventional gilt portfolio with similar risk characteristics. Mr Williams, who works for Charteris Treasury Portfolio Managers, the outsourced manager for the fund, employs the process of writing options on the underlying portfolio. The aim is to enhance the total risk-adjusted return of the portfolio and reduced volatility.

"The ability to write covered call options against gilts is quite a unique feature of the fund, I don't think any others in the IMA UK Gilt sector do it."

According to Mr Williams, despite reassurance from the government and Bank of England, UK inflation is unlikely to come down to the 2 per cent target.

"Mervyn King has already penned eight letters to the chancellor explaining why inflation continues to run high. With Russian wheat rises, January VAT increases and 6 per cent-plus rail fare increases on the way, a ninth and tenth letter could be on the cards.

"We seem to be having a series of one-off factors that are constantly keeping inflation higher," he adds.

The gilt market is technically at its most overbought since the Asian currency crisis of 1998 – excluding the Lehman crisis – having risen for eight consecutive months and Mr Williams suggests it would need a global recession, bordering

on global depression to validate these yields, but globally "no such thing is on the horizon".

Three-year UK index-linked gilts are on a negative real yield of 1.6 per cent, while inflation, as measured by the consumer prices index (CPI), is currently roughly 3 per cent per year or 5 per cent using the retail prices index (RPI). Taking an average of the two gives a UK inflation rate of 4 per cent, placing the three-year gilt on a negative real yield of 3.2 per cent.

"The fund has always shown a positive return, even when the gilt market was going down"

His fund, however, has been popular with investors – recently breaking the £100m asset under management (AUM) mark, up from £8m at launch in December 2006. In just a little more than four years, the fund has returned 25.49 per cent, compared with a 22.16 per cent for the IMA UK Gilt sector.

Mr Williams says: "The fund has always shown a positive return, even when the gilt market was going down and some of the other funds in the sector have shown a negative return."

A distinctive feature of the fund is that it switches between conventional and index-linked gilts, depending on which Mr Williams feels is the best option at the time.

"We would maintain – and the evidence so over the past 18 months has proven it – that this is the only way to make money in the gilt market," he explains. "You do not make money by being long index-linked all the time, and you probably do not make much being long the conventionals all the time. But you can make money by switching between the two."

Over the past 12 months, however, the

fund has fallen from a ranking of second out of 27 funds over three years to a ranking of 30 out of 31 funds listed in the sector.

Mr Williams explains: "During August the fund rose in value by 0.75 per cent against a much larger increase in the FT Government Securities index. This relative underperformance was due to our decision to write a series of covered call options over the most volatile element of the portfolio. We have also taken the decision to shorten duration within the portfolio as the current level of bond prices in the UK, in our opinion, is unsustainable."

Looking at the fund's top 10 holdings, five of which account for 85 per cent of the fund, the longest dated is the Treasury 2.75 per cent Gilt 22/01/15.

At the start of 2009, Mr Williams opted to switch the portfolio from 100 per cent invested in conventional gilts to roughly 80 per cent in index-linked vehicles, a decision that resulted in the fund being the only one to outperform as the gilt market fell.

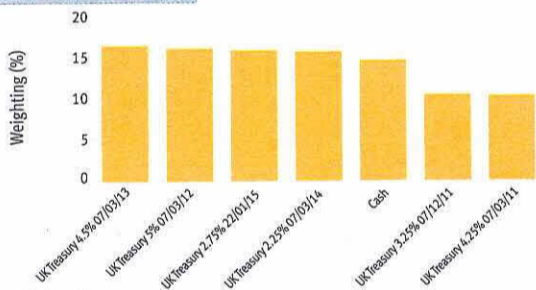
"There have been times in the past when index-linked gilts have quite badly underperformed, and you would not want to have the fund in that sector during that period," he adds. "When we decided to switch to index-linked vehicles in 2009, the 20 per cent held in conventional gilts was only short-dated ones."

Gilt investors who have held since early 2009 have lost money in real terms, a fact little appreciated in all the discussion over the recent outperformance of bonds versus equities.

While Mr Williams' reasoning for taking a more defensive stance this time around will please his investors, he does admit that the move may have been slightly premature.

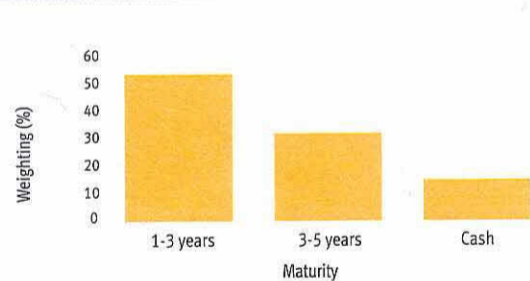
"We missed out on the final spike in the market by exiting about three weeks too early, but it has come back to where it was and appears to be continuing its descent. Analysts are predicting a bloodbath in gilts, and if this happens investors in this fund will have a lot more protection than if they were in some of the others."

Portfolio breakdown



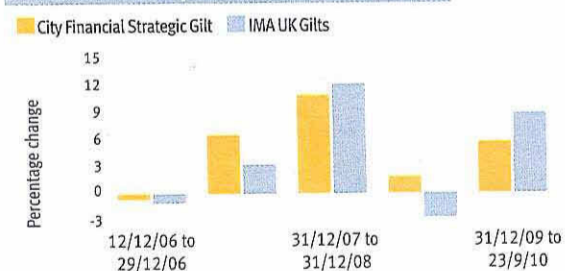
Source: City Financial

Maturity breakdown



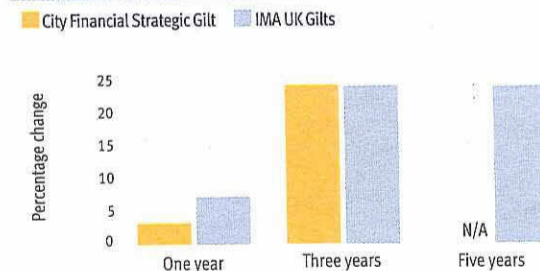
Source: City Financial

Discrete annual performance since launch



Source: Morningstar

Cumulative performance over one, three and five years



Source: Morningstar

Fund size history over three years



Source: Financial Express/City Financial

Volatility v return profile



Source: Morningstar

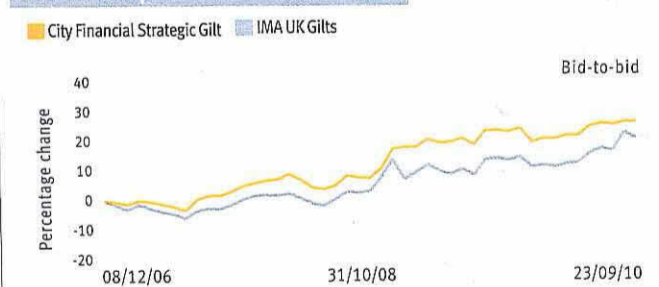
fund footprint

Launch date: 08/12/06
 Manager start date: since launch
 Fund size: £98.5m
 Number of holdings: 7
 Benchmark: FTSE Gilts 5-10 year

Information ratio: -0.2
 Sharpe ratio: 0.16
 Tracking error: 1.13
 Volatility: 1.84
 Turnover: 1.83

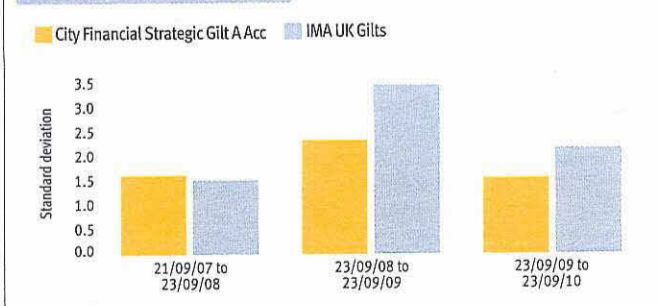
Source: City Financial/Morningstar

Cumulative performance since launch



Source: Morningstar

Volatility over three years



Source: Morningstar