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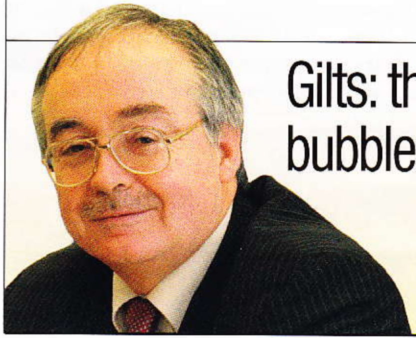

Gilts: the latest bubble?

Gilt yields have fallen to unprecedented levels as a mania develops among investors to avoid 'risk', but exactly how is risk being assessed, and is there not a danger that gilts, far from being risk free, actually carry significant risks that many investors do not fully appreciate? For example, the long-term average of long dated gilt yields over the last 50 years is around 8% compared to the current level of, say, 3.8% on UK treasury 4% 2060 which is priced at 103. If, or rather when, the interest rate cycle turns and the yield goes back to the long-term average, the price of this bond will fall to 51, giving a capital loss of over 50%.

However, it is worse than that. Let us assume that UK inflation, which remains stubbornly high at between 3% as measured by CPI or 5% as measured by RPI (average 4%), does not come down in line with Bank of England expectations. Governor King has already had to write eight letters explaining why CPI inflation is over 1% higher than the target of 2% and with Russian wheat, January VAT, and 6% plus rail increases to come, further letters are on the cards. This means that if yields return to their long-term average in five years' time and inflation chugs along at 4%, £100 invested today is worth £38 in real terms five years hence. This is hardly a risk free investment.

Gilts are also expensive compared to equities on a long-term historical perspective, as they are at their most expensive relative to equities for 50 years. Indeed, why would anyone buy a five-year gilt on a 1.7% yield when blue chip utilities such as National Grid yield 7%? Furthermore, the yield on the gilt is fixed while the income stream from the equity can be expected to rise as dividends are increased.

Ultimately, risk cannot be divorced from the price of the asset. Buying so-called 'safe assets' at the top of the market can carry more risk than buying so-called 'risky assets' at the bottom.

This is why the gilt fund I run (the City Financial Strategic Gilt fund) has reduced risk to the absolute minimum in order to protect our investors' capital to the maximum extent possible.

Ian Williams is CEO of Charteris Treasury Portfolio Managers and manager of the City Financial Strategic Gilt fund.