Straw poll
Do you agree with Ernst & Young's prediction there will only be 10,000 IFAs by 2013?
Yes No Vote

Results!

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Sense of gilt

Kira Nickerson Investment Matters - 16-Oct-2008

Where to go? is the question on the lips of anyone who has been closely watching the events of the past few weeks.

There are those who want to escape the most troubled areas - banks - and then there are also those who are looking to take advantage of some of these dramatic falls by putting their money into the market.

Many have taken the traditional approach to troubled equity markets and headed towards the safety of sovereign debt. However, many investors have piled into direct issuances rather than seeking out funds, so while they may be finding safety they are also forgoing returns in what may be the only asset class making money at the moment.

Out of a mutual funds universe of 2,366 funds, just 113 portfolios produced a positive return over the month to October 9 and of these the highest gain was 4.8 per cent, according to Trustnet. The worst performers over the past month fell by some 40 per cent while the average of the entire market has been a fall of 15 per cent.

Over six months, the biggest gain in any single fund was 19.4 per cent and the largest fall was 53.8 per cent with the average for all funds being -18.6 per cent. Out of 2,264 funds with six-month figures, only 139 did not see their returns fall. Unsurprisingly, only seven of 139 funds were not invested in bonds or cash (two were biotech funds).

Over six months to October 9 just UK gilts and the UK money market sectors in the IMA categories achieved positive average returns. Gilt funds on average gained 3.9 per cent while money market portfolios averaged a return of 1 per cent. Over one month, only gilts have shown a gain, with money market funds falling by 0.3 per cent.

City Financial Strategic Gilt fund manager Ian Williams says everyone has been seeking gilts, predominantly at the short end of the market. As investors have exited banks and money market funds and as fund managers themselves have looked for a safe haven for cash reserves, gilts have been the beneficiary.

But as many in the market have been seeking safety rather than investing, the short end of the market has seen the most activity and it is there that yields are so low that investors are getting less return than if they had left the money on deposit.

As of October 9, the yield on 50-year gilts was 4.28 per cent and on 20-year paper it was 4.75 per cent compared with the short end of the market where the one-year gilt was 3.37 per cent and the six-month issue was yielding 2.56 per cent. Considering interest rates in the UK are 4.5 per cent, Williams says he does not see the value in the short end. Neither, though, does he see value in cash as he expects rates to fall further in the coming months, possibly to 3 per cent.

Peter Geikie-Cobb, co-manager of Thames River's global bond fund, which invests in government debt, agrees that UK interest rates will fall much further and suggests it could hit as low as 2.5 per cent. Again, this does not make deposits or the short end of the gilt market that attractive from an investment point of view beyond the safety aspects.

But while recent gilt purchases have been a rush to quality, there is no reason investors could not also be making capital gains from this move. Williams points out that at the longer end of the gilt market there has been great price appreciation in recent months. He notes that his fund, which was overweight in the long end of the market, has risen in value by some 6 per cent since June.

Geikie-Cobb says gilts as well as Treasuries and French and German bonds have all benefited from the flight from other investment markets. The average duration in his fund is around 9.5 years, with 80 per cent of the portfolio in long-dated core European bonds, such as bunds and gilts. But he adds that while the long end of the gilt market may look more attractive from a price and yield perspective, there is a concern about issuance, particularly as the Government looks to bail out the troubled financial sector.

Williams, who is now moving more towards the middle of the yield curve and 10-20-year gilts, says there may be increased gilt issuance, but then there is also a lack of supply due to panicked investors running to the gilt market. That picture has not changed significantly either with the coordinated interest rate cut last week or the announcement of the Government's intended financial bailout plan, Williams notes. "The moves have reduced some of the potential demand as well as increased the potential supply, but this brings about greater balance and gilts may now be traded more on their own merits rather than the rush we have seen," he says.

It is these complications and influences impacting the government debt market that make gilt portfolios more attractive at the moment. "It is a better time to be in a gilt fund rather than individual gilts as it is very time-consuming to try to work out the yield curve and the impact of what is happening," adds Williams.

Although traditionally intermediaries look to investment-grade corporate debt when looking at bond investing, he believes that could change. Particularly when they notice the yields that are now available in the government debt market.