

Solutions to hostile climate

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In difficult economic times, gilts - secure and liquid - are a safe port of call for risk-averse investors.

A UK government bond fund that uses option-writing can provide a highly effective way of protecting capital without necessarily foregoing an inflation-beating rate of return from the gilt market during a UK recession.

From an economic standpoint, reading the headlines recently has become a gruelling affair. It seems that every day the news is worse. Inflation, oil prices, the housing market, job losses; people are now finally accepting that the UK is in recession.

In times like these, it is not at all surprising to find a certain degree of casting about among investors as they try to protect their capital and find some degree of return on their money. For some, the quest to “call the bottom” will continue, focusing doggedly on the good times that must, they assure us, be right around the corner. For others though, with lower tolerance for the vagaries of the equities and commodities markets, the call is out for a flight to quality.

During volatile times prudent investors reassess their exposure to low-risk assets to ensure that their portfolios preserve enough capital to take advantage of buying opportunities in the future. UK government bonds - “gilts” - have always been a staple of this class.

Gilts have a number of highly desirable characteristics. Crucially, they are liquid - just try selling a corporate bond in today’s markets to see what illiquid means - and as sovereign UK government paper their counter-party risk is practically non-existent.

Given the twin benefits of liquidity and security, the question becomes how to derive the best returns from a fund which focuses on the class.

The first strand of an effective investment process for achieving strong returns from gilts is to actively manage a portfolio of gilts rather than just one gilt investment. This is fundamentally dependent on where the best value can be found in the gilt market in terms of short, medium or long duration. Investors who hold fewer than six or seven gilt positions risk volatility or short-term losses by being misplaced along the yield curve.

Once the base portfolio is constructed, it is then vital to constantly monitor the gilt market to establish where value lies. Then, having established a view of where the best opportunities to add value lie within the market, the fund’s modified duration can be adjusted to take advantage of the market’s movement or lack thereof.

Of course, even with careful and deliberate monitoring of the gilt market, one is still