

Market Musings from MDM

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Independent Financial Advisers

Not so Safe Gilts!



Undated gilts fell about 4.5% last month, which is not very re-assuring for safety-conscious investors; gilts are meant to be about the safest investment around, aren't they?

Well, yes and no.

Last month we touched on absolute returns, ie, getting a reasonable level of return regardless of market conditions, and not simply having a fund manager gloat that he lost less than his rivals, leaving the investor nursing losses, which certainly don't feel *relatively* OK.

Traditional thinking is that portfolios should be diversified, with some money invested in shares and some in other investments, including property and fixed interest holdings, such as gilts. The reasoning being that gilt prices exhibit low correlation with share prices. This may (or may not) work for large institutional funds, such as pension funds, but this may not be the case for individuals.

For one thing, institutional funds buy individual gilts to match future liabilities as far as income payments and capital returns are concerned. Individuals, on the other hand, will tend to buy gilt funds, which have certain constraints on them, so they will tend to get a return which is as much based on gilt price movements as it is on gilt total returns.

So, just what is a gilt?

Gilts are UK Government Debt, sold to investors so the government can meet shortfalls between tax revenues and government expenditure. They are called gilts simply because they were originally recorded in a gilt-edged ledger. Although they come in various types the commonest have a guaranteed redemption (or final) price of £100 plus guaranteed regular income payments on set, often half-yearly, dates throughout their lives. A few, however, have no redemption date (undated stock), only guaranteed regular income payments. These are the simplest to look at to learn how gilts work.

2½% Treasury pay income totalling £2.50 per year per £100 of "nominal" stock. Where the quirk comes in is that, unlike deposits, the current capital value can vary.

If issued when interest rates were 2½% the £2.50 income per £100 of issue price would have been in line with ambient interest rates. If, however, interest rates rose to 10% at some later date, the price would *have to move* to £25 to keep the £2.50 in line with 10% ambient interest rates. Herein lies a problem, as interest rate rises can cause price falls.

Most stocks, however, are dated. This means that, although the current price will be driven up or down in the *opposite* direction to interest rate movements, they also have a fixed date on which they will return £100. This means that non tax-paying investors such as pension funds will always make a profit out of gilts – if held to redemption.

Unfortunately, gilt funds have constraints imposed on them making this impossible to achieve if they wish to remain ISA qualifying.

The simplest form of absolute return fund is one which does achieve this, and these are usually offshore funds, which operate outside of these constraints, thus enabling all gilts in the fund to be held to redemption and deliver their guaranteed return.

Last month's investment returns

Index/currency	% Capital Return over past month	% Capital Return over past year
FTSE AIM 100	2.6	-15.4
FTSE Eurotop 100	1.5	11.1
Nasdaq 100	1.2	3.9
Nikkei 225	0.9	4.4
Hang Seng	0.7	27.6
Dow Jones	0.5	15.3
FTSE 250	-0.7	21.0
FTSE 100	-0.3	7.7
\$/£	0.2	-9.2
€/£	-1.3	-2.8
¥/£	-1.5	-12.2

Looking ahead, although most investment houses are comfortable with UK, European and Asian equities, there are still mixed signals about the US, Japan and Emerging Market equities, while most are still cautious of fixed interest and see property returns softening.

The above is not intended to imply any advice. MDM Associates Ltd, MDM House, High Street, Ripley, Woking, Surrey, GU23 6AN.