

28 May 2009

Fixed Interest Update

We have been saying in our recent briefing notes and meetings that we were likely to be selling gilts from our Fixed Interest portfolio at some point in the near future.

That point has now arrived and for our discretionary clients, our gilt holdings were sold on 26 May.

We were holding gilts for two reasons:

Firstly, to keep an element of safety in what is still an uncertain environment for fixed interest.

Secondly, because we felt there could be some pretty decent returns as quantitative easing effectively meant there was a new buyer in town with plenty of (newly created) cash, and who wanted to keep gilt yields low (and therefore prices high).

Quantitative easing (QE) has not had quite the effect on gilt yields that we had expected and they have actually risen (therefore prices have fallen) since the start of QE. A number of investors have started to pull out of the gilt market, many of them moving into equities as risk appetite returned.

In addition, since QE started the government has announced that borrowing levels are to become even higher than their initial forecasts. The market is starting to become concerned about what effect these borrowing levels will have on the UK economy. There is even some speculation that the UK government could lose its coveted "AAA" rating. Although we don't think this is likely, it is certainly not impossible.

All this leads us to believe that the risks of remaining in gilts outweighs the potential benefits. We are not saying there will be a gilt "crash" and we do not know whether gilt returns may be positive or negative in the short term. However, we do think that if the returns are negative the potential losses are much greater than the potential gains if returns are positive.

Where next?

We have debated whether this is the right time to go back into index linked bonds. In the end, we concluded that it isn't quite time. YET. Instead, we are increasing our holdings in corporate bonds, and have switched the proceeds from the sale of gilts into the Schroders All Maturities Corporate Bond fund.

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An institutional approach

The Schroders fund is an institutional fund and not generally available to retail investors. With our discretionary service we can now get access to funds into which we could not otherwise invest.

Although we are increasing the risk by moving from gilts to corporates, we are comfortable with the overall risk in our Fixed Interest portfolio. We still hold the Dimensional Global Short Dated Bond fund, which is very cautious and has historically been less volatile than gilts. The M&G and Fidelity funds we also hold are relatively cautious funds.

The Schroders fund has more of a global outlook than some funds, although currency risk is hedged.

It invests in some global government bonds as well as corporate bonds and a number of the corporates are actually quasi-government institutions such as the World Bank, the European Investment Bank, and various state backed utility companies.

We think the fairly cautious approach of this fund and its global outlook could lead to some good potential returns without unduly increasing risk.

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Non-Discretionary Clients

Where appropriate, you will be invited to move your portfolio to our discretionary service at your next review meeting.

For those clients who do not currently have assets on the Nucleus or Seven Investment Management platforms, we will be recommending you switch out of any gilt funds you hold and into the corporate bond funds we use with the specific product providers.

You should note that the non-platform Fixed Interest portfolios are likely to be higher risk than if we can invest via a platform. This is because the cautious Dimensional fund and the institutional Schroders fund are only available on platforms. We still believe that the right thing to do is to switch out of gilts, but you should be aware that this increases the risk.

The great benefit of using platforms is that we have all these funds available that we could not otherwise invest in. Our discretionary service means we can act extremely quickly, and the size of investment we can give to fund managers means they are very keen to negotiate excellent terms, and will allow us to invest into their restricted-access institutional funds.

If you would like further information about gilts and corporate bonds, please let us know and we'll send you our "Guide to Gilt & Fixed Interest".

If you have any queries, please contact your usual adviser.

Mike Deverell
Investment Manager

Contact information:

Equilibrium Asset Management LLP
Brooke Court, Lower Meadow Road,
Handforth Dean, Wilmslow, Cheshire SK9 3ND

t 0161 486 2250 f 0161 488 4598
e askus@equilibriumam.co.uk
www.equilibriumam.co.uk

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