

Guide To...

Fixed Interest



Gilt & Fixed Interest

The term fixed interest is often used by banks and building societies relating to an account that pays a set rate of interest for a set time period. This type of investment is capital secure and the returns are known at outset.

However, fixed interest within the investment world is a completely different concept. It is used to describe funds that invest in Government Gilts and Corporate Bond securities.

It is perhaps easiest to consider the issues surrounding **Gilts**.

Gilts are effectively Government borrowing. When the Chancellor does not have sufficient income to meet his expenditure, then the Government will often borrow money in the form of gilts. These can be for a variety of different terms, paying a range of interest rates.

A typical example would be a ten year gilt which may pay, say, 5% income. This is the most secure investment you could buy, as you know the rate of return and you know when you will receive your capital back. The UK Government has never defaulted on a gilt. If however you wanted to access your money before maturity then you would have to sell your gilt on the open market.

Let's say you were trying to sell your gilt after one year. In order to obtain a value any potential purchaser will look at the term remaining on your gilt and the interest rate promised, and compare this to new gilts being launched at the time. If the Government was then launching a new gilt over a nine year time period, and promising to pay 6% per annum, then clearly nobody is going to want to pay the same amount of money for your gilt which is offering a lower interest rate.

They would probably therefore offer at least 9% less than you originally paid for it to reflect the 1% difference in income over the nine years of the remaining term.

So whilst you had set out to achieve guaranteed returns, if you sell a gilt before maturity you could potentially make a capital loss on it, in this instance a loss of 9% over the year.

However, if you decide to keep the gilt until its maturity you will still receive all of your interest and the capital back. Having said this, your valuation each year will vary depending on market conditions.

Corporate Bonds are similar to gilts but are a form of borrowing by companies rather than Governments.

Let's say Astra Zeneca wished to borrow a billion pounds for research and development. They would initially approach their brokers who would review the strength of Astra Zeneca versus the Government to assess what is a reasonable "risk premium" or "spread".

A secure company might be able to borrow money at 1 or 2 percentage points above the gilt rate and a very insecure company may have to pay 10 percentage points or more above the Government rate.

Guide To...

Fixed Interest

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Companies' security is generally graded from AAA to no rating, the less secure debt being known in the UK as "High Yield", or as it is more accurately described by Americans as "Junk Bonds".

So with Corporate Bonds the short term returns will vary in line with interest rates as they do with gilts, but also in line with the perceived strength of the company.

In Summary

It is clear that whilst fixed interest can be described as a low risk investment it is important to realise it is not a 'no risk' investment. In order to reduce this risk you can invest in a collective investment such as a unit trust, OEIC or investment trust. The typical fund will invest between 40 and 60 different holdings over a range of timescales to maturity and a range of different companies. A good fund manager will purchase corporate bonds and gilts at the right time and subsequently sell when interest rates are perhaps lower or where the company is stronger and make a short term capital profit.

In our portfolios we will wherever possible avoid high yield funds, as we feel that the risk return ratio is not favourable. We aim to invest in a range of funds that compliment each other in order to reduce the risk.

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