



Newsflash – Fixed Interest

22 December 2010

We have recently become more concerned about the prospects for fixed interest.

Fixed interest has shown some losses over the past few weeks as investors have been selling both corporate and government bonds. This is partly due to concerns about the levels of government debt; a knock on effect from the Irish and Greek crises. However, we believe the main reasons for the sell-off are actually due to optimism about the economy.

There has been better economic data coming out of the US and some of the UK data points to increased economic growth too. Companies are expected to do well, meaning equities become more attractive. Part of the reason that people are selling bonds is to invest in riskier assets such as equity.

The data is also pointing to increased inflation. This is bad for bonds, since fixed interest yields don't look so attractive against a higher inflation outlook.

We believe inflation will remain above the Bank of England target throughout next year, and could become a problem in the longer term. As a result, we have decided to reduce fixed interest.

Changes Made

For our model portfolios, we have moved into an overweight position in alternative equity and reduced exposure to corporate bonds. Alternative equity should make some good returns if equities rise, but it also should provide some protection against falls in markets.

Whilst alternative equity is higher risk than fixed interest in some ways, in the past our portfolio has shown volatility of a similar level to fixed interest.

For clients of our full discretionary service who have a bespoke asset allocation, we have made similar changes but of course it has been adapted to your own special instructions.

Future Changes

We have concentrated initially on reducing fixed interest exposure. We are now planning to change the composition of our portfolios.

We will be moving out of a corporate bond fund and into an inflation linked fund. As we believe inflation is going to rise we think this could be a good investment.

We will also include an "absolute return" fixed interest fund. This can potentially make returns from fixed interest whether prices rise or fall.

We will make these changes for all discretionary clients over the next few days and will provide further details in the New Year.

Outlook

We actually believe corporate bonds can still make positive returns over the next 18 months. Our best guess is maybe 4% to 5% per annum (but of course we can't predict the future!).

However, we can also envisage a scenario where fixed interest could drop 10% to 15%. We therefore think the risk is quite high for the potential returns.

We believe returns are most likely to be higher than cash and so are not exiting the asset class completely. However, as we always focus on reducing risk, we believe that reducing fixed interest exposure is the best course of action.