A Spotlight On:
Gilts & Index Linked Gilts

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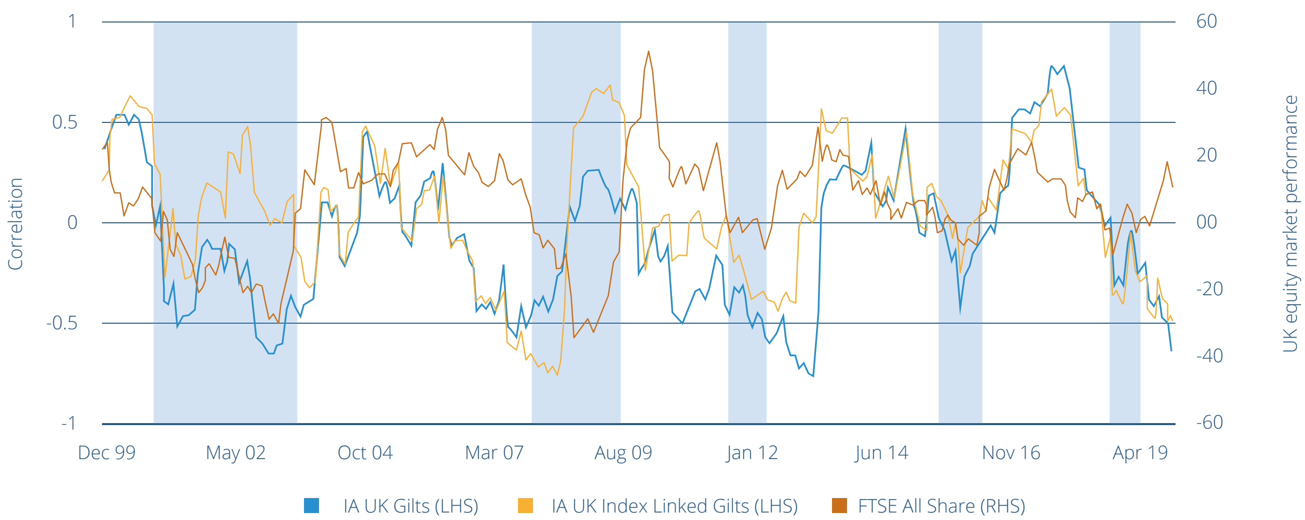
Introduction to Sector

These two sub asset classes, investing solely in the debt of the UK government, have traditionally delivered steady income to investors, with investors able to receive either a fixed rate of income in the gilt market or an inflation adjusted income in the index linked market. Combine these income streams with the negatively correlated capital returns both sub asset classes have provided when equity markets have fallen, see Figure 1, and it is easy to see why the sectors have traditionally been a key component of diversified portfolios for UK investors.



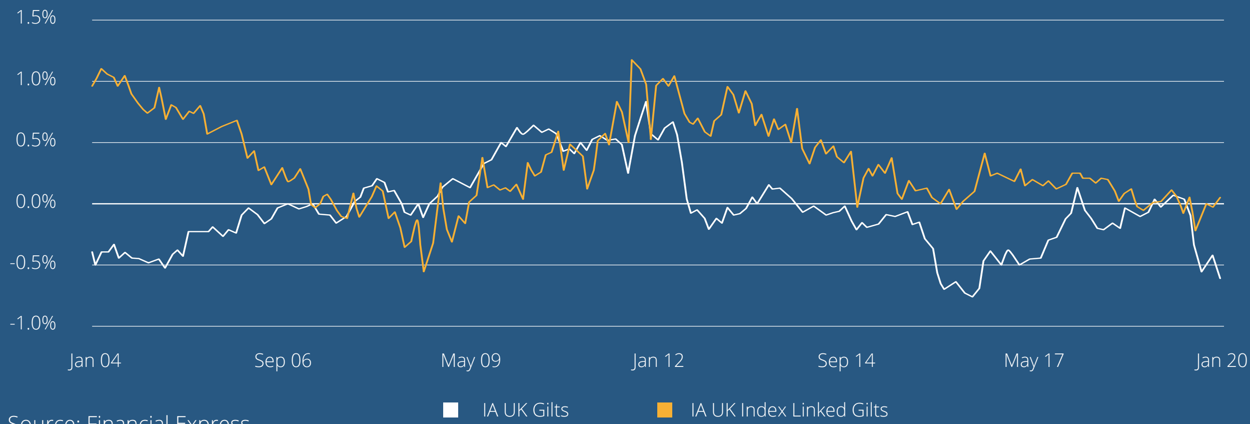
Source: Financial Express

Figure 1: 1 year rolling correlation of UK government bonds with UK equity market

Recent Sector Performance

For investors sticking with the asset class for its diversification benefits, the first fund selection call to make is whether to choose an active or passively managed strategy.

The underlying bond markets are small with just 46 and 26 issues in the gilt and index linked gilts markets respectively (as of September 2019). They are also highly liquid and mainly efficient; therefore investors are right to query just how much alpha an active manager can add. Figure 2 shows the 3-year rolling under and out-performance of active managers against passive competitors within the two sectors, net of fees.



Source: Financial Express

Figure 2: Relative Performance of Active funds vs Passive funds within Sectors (3 year rolling)

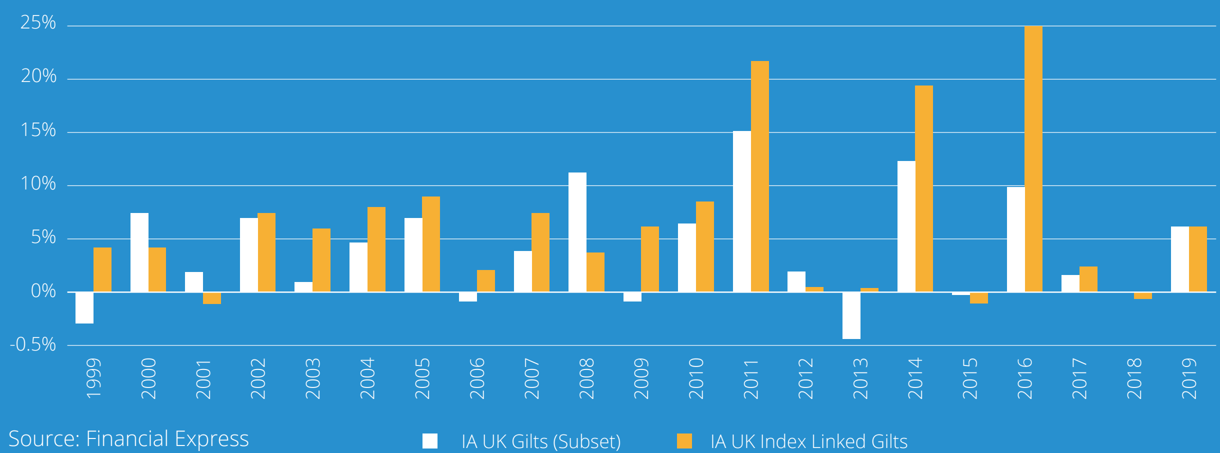
Looking at the chart it is evident that active gilt managers, as a collective, have consistently underperformed their passive competitors over most of the last decade. Active managers within the index linked gilt asset class, on the other hand, have managed to outperform their passive comparators in aggregate over most of the last 20 years. The reduced efficiency in this market is commonly cited as being driven within both the new issuance process as well as by technical dynamics at particular points of the yield curve.

Sector Nuance

However, with UK government bond yields remaining near record low levels and duration risk (the price movement of bonds accompanying an interest rate movement) on the bonds at record highs, many investors are steering well clear of the asset class on the view that risk is seismically skewed to the downside. To put some numbers to this thinking, as at December 2019, the Vanguard UK Government Bond tracker fund had a yield of just 1% for a duration of 13.6 years. This means that were yields to rise by two percentage points, the fund's capital value would fall by over 27%. These duration dynamics are even more elevated for index linked funds.

In fact, Figure 3 reveals that the low yields and high levels of duration that have been in the market since 2010 have resulted in a shift in the reliability of the annual returns of the two sub asset classes, from high single digit returns between 2000 and 2008 to either out-sized or de minimise/negative returns over the decade since the global financial crisis.

The asset class critics would posit that it is time for out-sized negative returns in the coming years.



Source: Financial Express

Figure 3: Sector Calender Year Returns

Funds in Focus

IA UK Gilts

Given the difficulty active managers have adding alpha within the gilt market it is perhaps unsurprising we currently only recommend one active fund to investors, this is the **Allianz Gilt Yield** fund. We have closely tracked the progress of this fund since Mike Riddell took over its management in 2015 and we have been consistently impressed by his market nous and his ability to deliver relative out performance for investors against different macroeconomic forces. Whilst we recognise the limitations to active management in this sector, we are of the view that Mr Riddell's fund could be of particular benefit to investors at certain times of the economic cycle, for example during prolonged periods of rising yields.

We also recommend four IA UK Gilt passive funds to investors, these are provided by **iShares, Vanguard, HSBC** and **L&G**. We believe each fund has delivered returns within an acceptable tracking error of the index and that they are operated by businesses committed to the UK retail market.

IA UK Index Linked Gilts

Given the greater opportunity for active managers to outperform passive competitors within the index linked market than in the fixed rate gilt market, we currently have two active funds rated in our Academy of Funds.

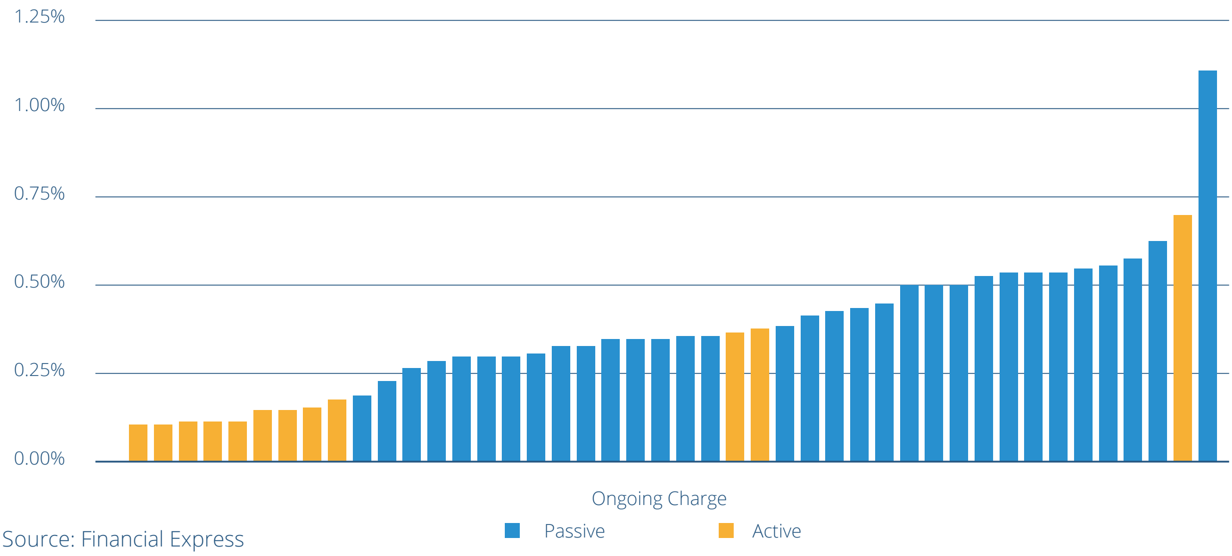
The **Allianz Index Linked Gilt** fund, again managed by Mike Riddell, launched more recently (February 2018) and has slightly wider investment restrictions than the Allianz Gilt Yield fund. The fund has, however, made an impressive start to life and Mr Riddell has many years of experience in managing bond funds for some of the UK's biggest asset management houses, including a number of years managing a similar fund at M&G.

The **Royal London Index Linked** fund is managed by experienced fixed income managers, Paul Rayner and Craig Inches, who have shown an ability to combine macroeconomic assessment with an understanding of the UK index linked government bond market to navigate various market conditions and construct a portfolio that has delivered solid returns over the long-term. The team use sophisticated models to identify pricing anomalies and exploit any inefficiencies in the markets, for example around bonds entering and leaving the index. This attention to detail, seeking out and benefiting from even relatively small opportunities to add value, can be well rewarded in this market.

We also recommend three passive funds in the IA UK Index Linked Gilt sector, these are provided by **iShares, Vanguard** and **L&G**. Again, it is our view that each fund has delivered returns within an acceptable tracking error of the index and are operated by businesses committed to the UK retail market.

Fees

Due to the relatively small levels of alpha available in the asset classes, fees become particularly pertinent when selecting a fund, unsurprisingly passive funds do tend to be significantly cheaper, with most being approximately 50% cheaper than their active counterparts, see Figure 4.



Source: Financial Express

Figure 4: OCF's in IA UK Gilts & IA UK Index Linked Gilts sector

Sector Outlook

Asset allocators will no doubt remain split on the merits of these two sub asset classes. Some portfolio builders will continue to want and need return streams that can provide negative correlation to UK equity market downturns. Other investors however will continue to want to avoid the unprecedented levels of interest rate risk latent in UK government bonds at all costs.

In the near term, the risk of UK interest rates rising appears small, however the chance of further falls appears structurally limited given the Bank of England's keenness to avoid negative interest rates in the UK. We therefore struggle to paint a bullish picture for positive returns in these asset classes in the years ahead.

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