

Gilts: strength in uncertainty



Nick Smith, CEO of Allianz Global Investors (UK), explains why UK gilts are looking attractive in the current climate.



In brief

- While equity markets tumbled in 2008, gilts have held up well
- Return from gilts outperformed Absolute Return, Cautious Managed and Specialist sectors
- 'Flight to quality': gilts recognised as offering lower volatility than other asset classes
- Attraction to continue for as long as interest rates remains low
- Gilts likely to remain dominant investment theme throughout 2009

When equity managers look back at 2008 it will not be with much positive affection. The term 'unprecedented falls' has become much used in the media and comparisons have been made to the Great Depression in the years following 1929.

Indeed not since 1931 has the American stock market fallen so heavily, and a look at the returns of the other main equity markets in 2008 also makes for painful reading. Over the year to 11 December 2008, the FTSE 100 has fallen 29.1% in sterling terms, while in dollar terms the S&P 500 is down 40.6%. In euro terms the FTSE Europe ex UK is down 29.9%.

Bucking the trend

While equity markets have tumbled, there has been one asset class which has held up well – UK gilts. Over the twelve months to 9 December 2008, the IMA UK Gilt sector was the second best performing of all peer groups, returning 8.8% to investors. This was second only to global bonds, which were up 12% for the year.

The return from gilts is also substantially higher than some of the more fashionable peer groups such as Absolute Return, Cautious Managed and Specialist. Over the year, the average returns from the funds in these sectors were down 3.6%, 18.1% and 29.2% respectively. The more general UK All Companies sector fell even more, down 34.5%.

According to Barclays' 2008 Equity Gilt Study, gilts also outperformed equities in 2007, returning 1.2% compared with a 1% return from equities. Gilts also win out over ten years returning 3.3% versus 3.1%.

Attractive yield

On top of the strong return achieved so far in 2008 is the attractive yield UK gilts currently offer investors. A ten-year UK gilt currently yields some 4%. While this may not seem particularly exciting, it has to be put in context following the recent interest rate cuts by the Bank of England.

Not since 1951 have UK interest rates been at the current levels. Indeed, never in the history of the Bank of England have rates gone lower than 2%, but many feel this could happen in the coming months. As a result, from the start of 2009 the amount of interest investors can get on a deposit account will dip below 2%, and maybe to as low as 1%.

Alternatively, you could buy a secure income backed by the government which yields between 3% and 4%, depending on the maturity – an appealing prospect.

How appealing? Well according to the Investment Management Association, UK Gilts (for the first time in the asset class' history) was the top selling peer group by net retail sales for the month of October. This just

goes to show how concerned investors have become about the prospects for equities as the country enters what could be a prolonged recession. Since the onset of the credit crunch there has been a tendency for a 'flight to quality': investors flocking to gilts, a much less volatile asset class than equities.

Indeed, just in the last three months the Allianz PIMCO Gilt Yield Fund has seen inflows of more than £90 million as investors seek reassurance in uncertain markets and continue the trend of diversifying away from equities.

Why are gilts doing so well?

Gilts, or government bonds, are certificates of fixed interest issued by the British government. Generally, they go up in value as interest rates decline and reduce in value as rates increase.

When gilts are listed they are typically split into five sub sections: short-dated (redeem within five years), medium-dated (redeem between five and 15 years), long dated (redeem in over 15 years), undated and index-linked. Shorter-dated gilts tend to be more affected by moves in interest rates, while long gilts tend to follow inflation more. Right now, shorter-dated gilts are yielding 2-3% and the longer dated gilts are over 4%.

Recently, for the first time ever, the real yields on index-linked gilts became higher than the nominal yields on conventional gilts on the same maturity. So for example the real yield on an index-linked gilt maturing in 2013 was 4%, versus a 3% nominal yield on offer from a 2013 conventional gilt. This has fallen back slightly recently as investors have cottoned on to the trend, but the point is that beside gilts no other strategy would have consistently rewarded investors in 2008.

How long does it have left to run?

Well, maybe for some time yet if the UK does not come out of recession. It is conceivable that there could be four quarters of negative UK GDP growth in 2009. If

this is the case, there is less chance of any rate rises on the way and the story could run for another six to nine months.

The current low-inflation environment is also good for gilts. Going forward, this could go either one of two ways: if governments were to rapidly increase money supply and consider starting the printing press this could threaten currency stability and as such re-ignite inflation pressures. In this environment gilts would not perform well. However, there is also a good chance that ongoing de-leveraging and asset price weakness will lead to an engrained deflation scenario, in which monetary stimulus would have little effect on credit creation or inflation. This would be a more supportive environment for gilts.

So going into next year, while a lot of upward price movement has already happened, we believe there may be further to go. Further rate cuts should also push gilt prices higher and yields lower. As many companies' recapitalisation efforts will help reduce the level of volatility in markets, corporate credit and income schemes may be the first options among returning higher risk alternatives. Government debt, however, may well remain a dominant investment theme.

The Allianz PIMCO Gilt Yield Fund

In 2008, Standard and Poor's assigned the Allianz PIMCO Gilt Yield Fund an A/V3 rating. According to Lipper's scoring, the Fund is the Leader in the Preservation, Consistent Return and Total Return categories, and its manager, PIMCO's Mike Amey, has qualified for the number one spot in the IMA Gilt sector for most of autumn and winter 2008. A track record of consistent sector outperformance rounds off the compelling case for the Allianz PIMCO Gilt Yield Fund as an access vehicle for gilts.

All data as provided by Financial Express.

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