Considering the alternatives

Gilt alternatives

While gilts may be the safest choice for UK-based investment in fixed income, other options from high-grade corporate to emerging market debt are available to savvy investors. The question though, says Iain Morse, is if now is the right time for exposure

To the casual observer, it might seem like the time is ripe to invest in bonds. Equities and property have both had a good run and now seem to be faltering, so a contrarian's view of the market might lead to increased bond exposure. "But the prognosis for them remains poor," warns Richard Batty, global strategist at Standard Life Investments. Inflation expectations have increased, and central bank interest rates are still rising in the UK, EU and USA. Any increase in inflation threatens to depreciate bond returns pushing their values down.

"The bottom line for charities is whether bonds are at all suitable for them from a strategic asset allocation point of view," adds Alasdair Gill, lead of the charities group at Mercer Investment Consulting. "We would be reviewing whether they should look at alternative investment options." The logic of this argument is not hard to follow. As rates rise, bonds already in issue start to look costly and fall in value. Worse still, in the UK, defined benefit pension funds have been, and remain, forced buyers of bonds as a result of their ever tightening and more prescriptive regulatory framework. This has made gilts more expensive than the US Treasuries, for example, and as a result the real coupon rate on UK gilts and investment grade corporate bonds has been compressed to a point where they look very expensive.

With Bank of England interest rates at 4.5%, the real yield on gilts, assuming 0% retail price inflation, currently sits around 2.4% for gilts maturing within 5 years, falling to 1.87% for those with a maturity of 5 to 15 years. Given that UK equities currently yield approximately 3.7% with the prospect of a 10% increase over the next twelve months, it is hard to argue the case for increasing gilt exposure unless investors also require capital security. The consensus view is that property funds promise a total return of 7% for the year to come, and even cash can be invested to beat gilt yields. There are alternatives to gilts, notably investment grade corporate bonds. HBOS, a AA rated borrower, is paying a nominal yield of 6.38% or a real yield of 5.05% on a bond maturing in 04/08, while AAA issuer Network Rail is paying a real yield of 4.95% on a bond maturing in 03/09. "Buying investment grade corporate debt does increase yield," concedes Gill, "but only by a limited amount."

Trustees tend to be conservative and have proved reluctant to follow pension funds into more exotic areas such as high yield and emerging debt. High yield, issued by corporates with a sub-investment grade rating, pay higher yields than investment grade bonds, but this reflects their greater risk of default. "There is still plenty of cash around and we don't expect default rates to increase substantially," judges Batty, "but we are only half way through a longer-term economic cycle." As rates rise, high yield defaults will increase making them look expensive. At present, the real yield on Fiat Finance, for example, is 5.66%; a slim reward for sub-investment grade paper.

Emerging debt, issued by the governments of countries like Brazil or Turkey, may be better value. Defaults by emerging economies, particularly those rich in oil, gas and minerals, are now very unlikely. Indeed many of these countries are running a balance of trade surpluses, in contrast to the UK and US. The returns on emerging debt have tended to be better than those on emerging equities, reflecting this imported credit worthiness. But there are almost no emerging bonds issued in Sterling; the most highly traded are denominated either in US$ or euros. This makes direct investment risky except for the very largest charities, but there are pooled funds with low minimum cash investment limits which offer cost effective exposure to the smaller investor.

"There are still arguments for investing in bonds," argues Gill. These relate to portfolio diversification and the need to control risk. A case can be made for bonds within a wider portfolio of assets. For charities that decide to go down this route, there are two choices for investment. Stockbrokers like Laing & Cruikshank, now part of UBS, offer discretionary management of equity and bond portfolios. As an alternative, pooled fund managers like Newton offer a suite of appropriate bond funds to charity investors. The minimum for each type of investment can be low, as little as £50,000, but this only purchases an off-the-peg service. Charities with larger amounts will find it easy to get a bespoke service.

Index construction	Return %	Asset mix % total charities	un constrained	cnstrnd by income
UK Equities	8.1	56.1	55.2	59.7
Overseas Equities	5.7	7.4	7.2	7.6
North America	3.4	6.9	7.8	4.8
Europe	11.3	6.7	7.5	4.5
Japan	5.7	3.3	3.7	2.4
Pacific (Ex Japan)	4.7	2.9	3.1	2.0
UK Bonds	-0.6	12.0	11.2	14.9
Cash/Other Investments	1.1	4.0	4.0	3.6
Total property	3.8	3.1	3.2	2.8

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