

## Introduction

If you need a **known level of income** with a **guaranteed capital return** then you will certainly want to consider holding gilts as part of your investment portfolio.

Unlike many investments there is **no penalty for selling your gilts** before the redemption date. However, the guaranteed return then no longer applies.

The rate of interest (ie the 'coupon') on a particular stock is **fixed at the time of issue** and does not change when general interest rates rise or fall.

The income is therefore predictable but **will be affected by inflation**. If that is of concern to you then you will be pleased to know that you can also invest in **index linked gilts**.

## What are Gilts?

The term 'gilts' is short for 'gilt-edged stock' and is a **marketable security** issued by the UK Government to fund its excess spending over its revenues.

Gilt sales have been **rising steadily over the past few years** from £13.7 billion in 2001-02 to £58.5 billion in 2007-08 and plans of £80 billion in 2008-09.

In March 2008 there were £478.8 billion (by nominal value) of gilts in issue (£525.9 billion by market value). The majority of these (70.4% in March 2008) provide a **fixed rate of interest** (usually paid twice a year) for the life of the security and **full repayment of the nominal capital at maturity**.

"The income and repayment guarantees of Gilts are absolute, because they are given by the Government, which is safer than 'income' products depending upon share prices. As long as you buy and hold, you have certainty - you know exactly where you stand for both income and capital."

*www.contraryview.co.uk  
published by Kauders Portfolio Management*

An investment into gilts is therefore **particularly suitable for low risk private investors**, and for all types of private investor as part of a balanced portfolio. Pension fund managers use gilts a lot because they are ideal investments for matching known future liabilities.

Gilts are divided by market convention into the **following maturity categories**, although confusingly, many publications including the *Financial Times* use different periods (as indicated in brackets):

- **Shorts: 7 years or less** (5 years or less) until redemption. These are favoured by banks and other institutions as suitable for surplus deposits.
- **Mediums: 7 to 15 years** (5 to 10 years) until redemption. These are generally the least in demand. They are too long to be of interest to banks and building societies and they are often not long enough for pension funds.
- **Longs: Over 15 years** (10 to 15 years and over 15 years) until redemption. These are frequently used for meeting the long term income requirements of pension funds.
- **Undated: No fixed redemption date**. With undated gilts there is no commitment to redeem the loan.

The best known, indeed infamous, stock of this kind is the 3.5% War Loan. Interest continues to be paid until the Government decides to redeem them.

- **Index-linked:** The return is **linked to movements in the Retail Prices Index (RPI)** and such gilts therefore provide a guaranteed level of real return.

Some gilts have **two redemption dates** (eg 2013 – 2017). This means that the Government can choose to repay the gilt at any time from 2013 onwards with 3 months notice, but must repay the gilt by 2017 at the latest. **The choice of redemption date is the Government's** not the investors.

## The Stock Title

The title of each gilt stock will tell you most of what you want to know about a particular gilt issue except the current price of the stocks which is constantly fluctuating. As examples we can take some **gilts from those in issue at the time of writing**.

### Example

**9% Treasury Stock 2012.** This is a short-dated gilt offering a fixed return (the coupon rate) of £9.00 a year for every £100 nominal of stock held. The nominal amount is redeemed (ie repaid) in August 2012.

**In July 2008 it would have cost you £113.76** for each £100 nominal of stock and **the yield** (ie the actual return on your investment) if you then held the stock to maturity would be **5.17% pa**.

### Example

**8% Treasury Stock 2021.** This is a medium-dated gilt offering a fixed return (the coupon rate) of £8.00 a year for every £100 nominal of stock held. The nominal amount is redeemed (ie repaid) in June 2021.

**In July 2008 it would have cost you £126.37** for each £100 nominal of stock and **the yield** if you then held the stock to maturity would be **5.16% pa**.

### Example

**2.5% Consolidated Stock** (known as 'consols'). This is an undated gilt offering a fixed rate of return of £2.50 a year for every £100 nominal of stock held. The Government is under no obligation to redeem this stock but may do so at its discretion.

**In July 2008 it would have cost you £51.93** for each £100 nominal of stock and **the yield** would be **4.81% pa**.

### Example

**1.875% Index-Linked Treasury Gilt 2022.** The coupon is index-linked to the RPI which means that the purchasing power of the interest payments is maintained. Index-linking is also applied to the capital, so that when the stock is redeemed the holder will receive the original capital increased by the rise in the RPI since the issue of the loan.

**In July 2008 it would have cost you £107.66** for each £100 nominal of stock and **the yield** if you then held the stock to maturity would be **1.28% pa** (assuming future inflation is 1.875% pa). However, **the redemption value would also have increased in line with the RPI**.

## 'Clean' and 'Dirty' Prices

Gilts are rather like bank deposits in that **daily interest is accrued separately to the price**, although **interest is usually paid twice a year**.

Therefore, when you purchase a stock you pay the price (which may be higher or lower than the nominal price) plus the number of days accrued interest.

Gilt prices are quoted 'clean', that is **without the inclusion of accrued interest**. Prices **including accrued income** are described as 'dirty'.

The prices quoted in the Financial Times ([www.ft.com/gilts](http://www.ft.com/gilts)) are always clean, but a gilt list from a stockbroker will always include a note of the number of days and value of accrued interest alongside the clean price for the stock.

Gilts normally go 'ex-dividend' seven working days before each interest payment is due. Once a stock is ex-dividend the full period's interest belongs to the seller.

Anyone buying the stock in the period between the ex-dividend and the payment dates is deprived of interest from the date of purchase to the payment date.

In these circumstances the buyer pays **the price minus the number of days accrued interest**.

## How have Gilts fared?

The following figures were obtained from the **Barclays Capital Equity & Gilt Study 2008** with the exception of the property figures which are from **Investment Property Databank (IPD)**.

Investment Type	2007	Last 5 yrs	Last 10 yrs	Last 20 yrs	Last 50 yrs	Last 108 yrs
Cash	1.0	1.4	2.5	3.5	2.0	1.0
Gilts	1.2	1.0	3.3	5.1	2.4	1.1
Index-Linked	1.4	2.9	3.7	4.4		
Corp Bonds	-5.9	1.7	4.2	7.9		
Property	-7.4	8.8	8.2	7.9		
Equities	1.0	11.2	3.1	6.7	7.2	5.3

*Annualised Real Investment Returns (ie after allowing for inflation)*

In the above table the Corporate Bond figure in 'Last 20 years' column is actually for the last 17 years as this is the maximum period for which figures are available.

## Factors affecting Gilt Prices

**Supply and demand** are the main determinants of gilt prices. If investors are selling, prices will fall; if they are buying then prices will rise. The volatility of the price of the stock is driven by two factors:

- If the coupon is the same, **the longer the period to maturity the more volatile will be the gilt**. This is because the redemption amount has a declining relevance to the current price as the term to maturity increases.
- If the term is the same, **the lower the coupon the more volatile will be the gilt**. There is a technical reason for this which is based on the fact that with a low coupon gilt the interest element is a smaller part of the total value of the stock. The effect is that most of the interest rate change is worked out in the current capital value.

## Strips

This refers to the **separate trading of registered interest and principal of securities** (strips). Stripping allows certain approved investment houses to break down gilts into their component parts.

### Example

A gilt with twelve years to run **could be stripped into 25 securities**, 24 entitled to just one of the half yearly interest payments still left and the twenty fifth entitled to the redemption payment.

Stripping **extends the range of needs that can be met from gilts** (eg use for school fees) and also improves the demand for some gilts that might otherwise be ignored, thereby improving overall market liquidity.

## Interest Rates

Shorter dated gilts are **more sensitive to bank base rate changes** as they are in direct competition with bank and building society deposit accounts.

If bank base rates are moving up, **gilt yields must move up** to remain competitive. To achieve this, **gilt prices have to fall**. When rates move down, gilt prices rise.

When economic conditions are strong companies and individuals are prepared to pay more for goods, services and capital, which tends to push up prices. This can produce **higher inflation** and higher interest rates.

Investors in gilts require higher yields to compensate, so **gilt prices normally fall**.

It is not just the comparison with today's interest rates that matters. The prices of gilts will also reflect the market's collective view of **what will happen to interest rates over future years**.

## Taxation Issues

The tax situation is quite straightforward for UK private investors in gilts, although most overseas investors will also not be liable to UK tax on their gilts. **Interest on all registered gilts is now payable gross** (ie without deduction of tax) **but is liable for income tax**.

This is **particularly helpful for non tax payers** who do not have to reclaim tax deducted. Gilt interest is also payable gross to **non UK residents**.

Tax payers must complete an annual tax return so that the tax can be collected. This is fine for higher rate tax payers as they have to complete a tax return anyway but **is a chore for basic rate tax payers** who would otherwise not be required to complete a tax return.

**It is possible to opt to have tax deducted at source** on application to the **Gilt Registry, Computershare** and this is the best option for tax payers.

Higher rate tax payers should consider **investing in gilts via a Maxi Stocks & Shares ISA**. At present £7,200 a year can be invested in gilt funds in this way (or £14,400 for a couple) and **the interest is paid without deduction of tax or any tax liability in the hands of the ISA holder**.

Profits (or losses) made **when you sell your gilts** (including at redemption) **are not taxable** and do not have to be included in your tax return (either for income or capital gains). This is not true of selling 'strips' but that is a specialist area we can ignore for the purposes of this Guide.

## Index Linked Gilts

Index linked gilts now account for almost 30% of the Government's gilt portfolio and **can be particularly attractive** since the capital gain arising from the inflation uplift is not taxable in the hands of UK private investors. The interest is paid gross and liable for tax as mentioned above.

However, the amount of interest will be lower than under a conventional gilt because of the allowance for the inflation linking of the capital. For **tax paying lower-risk investors** who are not particularly looking for a high income then **index linked gilts are likely to be a better option**.

"Indexing works downwards as well as upwards. Note the difference compared to index linked savings certificates - the latter have a minimum return built in, whereas index linked Gilts have no minimum return.

As always with capital markets, the best prices are when nobody wants to know, while the worst prices are when something is popular. Currently index linked are popular while soothsayers worry about inflation. You can draw the appropriate conclusion!"

*www.contraryview.co.uk  
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In choosing between ordinary and indexed gilts you need to compare the difference in yield compared to expected inflation rates.

### Example

At the time of writing, the redemption yield of standard ten year gilts is around 5.03% and the real redemption rate on ten year index linked gilt yields is around 1.50% at an assumed 3% to 5% RPI. **If you feel that the 3.53% difference in yields is sufficient to cover expected inflation** over the redemption period plus a 'risk premium' (ie an allowance for holding fixed rate stock), **then ordinary gilts would be the preferred choice**, otherwise indexed gilts are preferable.

## Indexation Lag

In September 2005 a **major development took place in the index-linked gilt market**. The first index-linked gilt with a 3-month indexation lag was issued. All new index-linked gilts issued subsequently **now use the 3-month as opposed to the 8-month lag** designed used previously.

The 3-month design is now recognised as international best practice and provides better protection against inflation than the old design. 3-month lag index-linked gilts **continue to be linked to the UK Retail Prices Index (RPI)** but the indexation is applied in a significantly different way. In addition, 3-month lag gilts **trade on a real clean price basis**.

As a result, the effect of inflation is stripped out of the price of the new gilts for trading purposes, although it is included when such trades are settled.

## Using a Fund Supermarket or Wrap

Rather than purchasing one or more direct holdings in gilts, **you can also invest via a unit trust fund** whereby a fund manager holds a portfolio of gilts on behalf of a large number of investors.

The advantages of this approach are that **you obtain the services of a professional fund manager** who will buy and sell gilts as he thinks fit and **you will also benefit from the spread of risk** by using a portfolio of gilts rather than investing in just one or two.

Such a fund **can also be held in an ISA** which means there is **no tax liability for the investor on the income paid**.

The disadvantages of this approach are that **there will be charges applied by the unit trust manager**, and **there is the risk of capital loss** as you will not have the option of holding any particular gilt to its redemption date.

The simplest way to invest into such a gilt fund or range of gilt funds is to use a platform such as a Fund Supermarket or Wrap.

We use the **Nucleus Wrap** and the **Cofunds Fund Supermarket** for the majority of our unit trust, OEIC and Stocks and Shares ISA purchases and would be happy to let you have further details.

## Further information

You can purchase gilts through a stockbroker or bank or, if you know what you want, you can register to deal via Computershare, the world's largest share registry **www-uk.computershare.com**

The Bank of England transferred its stock registration services to Computershare in December 2004 and Computershare is now **the main registrar of gilt holdings under a contract from HM Treasury**.

The United Kingdom Debt Management Office (DMO) publishes an excellent booklet *A Private Investor's Guide to Gilts*, which gives an introduction to conventional and index-linked gilts and details on how to buy and sell them; and a more technical booklet looking more at the gilt market as a whole and which is updated annually, *UK Government Securities: a Guide to 'Gilts'*. Both can be downloaded from the United Kingdom Debt Management Office website (**www.dmo.gov.uk**). Hard copies are available (free of charge) on request from the DMO, telephone **0845 357 6500**.

Daily reference prices and yields for all gilts are published on the DMO website at **www.dmo.gov.uk/index.aspx?page=Gilts/Daily\_Prices**

## Risk Factors

- If gilts are purchased and held to redemption there is no risk of receiving less than the guaranteed redemption value. To that extent gilts are risk free, but even in that situation there is the risk of the loss of purchasing power. Inflation is thus the chief risk factor in investing in long-dated gilts.
- The only guaranteed way of avoiding the effects of inflation in the long term is by purchasing index-linked stocks and holding them to redemption. Furthermore, investors who purchase gilts at a price higher than the nominal value and hold them until redemption lose a proportion of their capital.
- For investors who do not hold their gilts to redemption the most significant risks are changes in the prevailing interest and inflation rates. Being traded investments whose prices (quoted on the London Stock Exchange) depend on supply and demand, gilt prices go up and down just as shares do, though usually less dramatically.
- An investment into an ISA, unit trust, OEIC or other collective investment scheme is intended as a long-term investment. It is important that you are aware that the value of units in a unit-linked investment such as an ISA, unit trust, OEIC or other collective investment scheme, as well as any income which they generate, can fall as well as rise.
- If you surrender the contract, especially during the early years, you may get back less than you have invested. Where past performance is mentioned please note that the past is not necessarily a guide to future performance.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an investment in gilts or a gilt fund is suitable, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

### For personal advice

If you would like to discuss whether an investment into a gilt or gilt fund might be appropriate for you please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
Email: **enquiries@arch-fp.co.uk**  
Online: **www.arch-fp.co.uk**

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