

## KISSing the gilt curve

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Regular readers will know that at Tacit we believe it is generally good to KISS, that it to “Keep It Simple Stupid”. There is a place for more complex investment instruments and strategies which make use of derivatives, harvest arbitrage differences, or amplify returns by using borrowing (known as leverage), but the first essential rule of complexity and exotica in investment is to thoroughly understand the unexpected circumstances in which the good idea can go horribly wrong. The investment industry likes to refer to these devastating conditions as Black Swans to give the impression that they are so rare that they couldn't be foreseen. There have been a good many examples over the last couple of decades, so we are not convinced that Black Swans are that rare, more the case that enthusiastic investment specialists don't always adequately account for one of them crossing their path.

We have had a good example of this in the last week in the UK pensions industry and it has made us think about UK gilts in an old-fashioned way, which some might say is dull and unadventurous. Some dull is not a bad component of a balanced long-term investment strategy if it helps the investor achieve their ultimate goal. At Tacit, we have an advantage over a newer generation of investment adviser brought up in the world of mathematically engineered complex products and strategies; we learned our trade a while back and can remember how effective ‘simple’ can be if the price is right and you have the time to wait for the value to be achieved.

Put very simplistically, what blew up in the defined benefit pensions world immediately after the Chancellor's ‘Fiscal Event’ on 23 September is a strategy known as liability driven investment, or LDI. LDI uses a mixture of derivatives and leverage to ‘hedge’ the future liabilities of cash flows to meet future pension commitment. The derivatives are linked to the gilt market and when interest rates rose rapidly and unexpectedly (the Black Swan) it forced the LDI managers to sell gilts to meet margin calls on their leverage. A margin call occurs when the percentage of an investor's assets in a margin account falls below the broker's required amount. The selling served to drive yields yet higher, risking a vortex of destruction which the Bank of England had to stop by stepping into the market as a hefty buyer of gilts, quite the reverse of what it had only recently announced it would be doing.

The lesson for Tacit clients is not so much to be wary of LDI, but to consider what the gilt market may have to offer with the 10-year yield near 5%. In that earlier era when most of your Tacit investment managers were serving their apprenticeship on private client desks in City firms, the daily gilt list was a printed paper document. LDI in those days took the form of scouring the list for a gilt of a chosen duration range that was cheaper than others and offered a higher yield to redemption. Then, private investors bought gilts and held them to redemption and the yield to redemption was the total return based on a combination of the annual coupon (the interest) and the discount or premium to the par value at which the gilt would be redeemed.

It is important to recognise that investing in gilts was not a ‘get rich quickly’ strategy. The returns were nuanced and valued in relation to two important factors: the near certainty that the UK government would not default (you got your £100 back at redemption for each £100 invested at par value), and the total return from annual coupons and possibly having bought below the par value. Gilts were the ultimate Stabiliser asset in any balanced portfolio.

Over two decades steadily falling interest rates turned gilts and other sovereign debt into money-making assets. They lost their essential purpose in the investment universe. There may be further to go before gilts become compellingly cheap, but if you stick to the principle of KISSing you may yet come to value them for their quaint quality of steady, stable cash flows and return of capital to achieve your long-term investment goals.

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