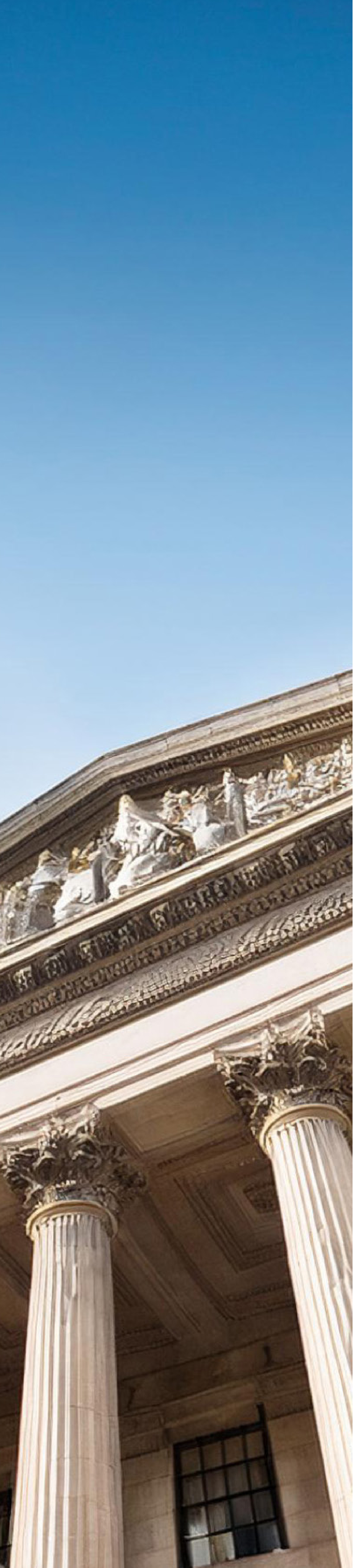
Unlocking the *potential* of the gilts market

A new era for gilts



A new era for gilts

Investing in UK government bonds, or 'gilts', has undergone significant changes over the past 15 years. This article explores the historical context, the turning point in 2022, and the current opportunities for investors.

The past 15 years

For much of the past 15 years, investing in UK government bonds wasn't very appealing. Interest rates were near zero and the Bank of England was buying bonds to increase the money supply (a policy known as quantitative easing). The was done to stimulate the economy by making borrowing cheaper and encouraging spending and investment. As a result, the yields available from investing in gilts were quite low.

From risk-free return to return-free risk?

Between 31 December 2010 and 31 December 2020, the yield on the 5-year benchmark gilt ranged from a high of 1.5% to a low of -0.1% during the Covid pandemic (source: FactSet). Looking back, it's incredible to think that, even for a brief period, yields actually turned negative and investors were effectively willing to pay the government to take their money for five years.

During this period, the rationale for investing in UK government debt changed from earning an attractive income yield through regular interest payments to a speculative asset class with returns heavily dependent on changes to future interest rates. With little or no natural income, generating a reasonable return from investing in gilts became almost wholly reliant on the forecast path of future interest rates (gilt yields) falling further, pushing up bond prices (prices move inversely to interest rates) and generating a positive capital gain to the investor.

The turning point in 2022

The year 2022 provided a brutal but necessary shock. The surge in energy prices following the Russian invasion of Ukraine in combination with post-Covid supply chain constraints, created a major global inflation shock that saw UK RPI (Retail price index) inflation peak at over 14%. Central banks across the world responded with co-ordinated tightening of monetary policy in order to bring inflation back under control.

The Bank of England increased the bank rate (the interest rate at which commercial banks can borrow from the central bank) from 0.25% to 5.25% in less than 18 months. That dramatic shift in monetary policy also drove an explosive re-pricing of future interest rate expectations which ultimately resulted in the gilt market declining by almost 30% as prices adjusted to reflect the new reality. That is a truly extraordinary outcome for a supposedly 'low risk' asset class.

The gilt opportunity today

We believe that the scale of the 2022 re-pricing of interest rate expectations, which remains largely intact despite some recent modest cuts to the bank rate, has fundamentally transformed the investment case for gilts.

- **Many short-dated gilts** (those maturing soon) issued during the post-GFC (Global Financial Crisis) era with low interest payments now trade at significant discounts to their face value.
- **The capital gain** as these bonds return to their face value at maturity is both certain and tax free for UK investors.
- **Higher and top rate UK taxpayers** who can buy and hold to maturity can benefit from this tax efficiency and secure equivalent yields of 6-7% across a range of maturities by lending to the UK government.

This represents a highly attractive risk-adjusted return, offering a compelling alternative to cash deposits where 100% of the return is subject to income tax.

The Brooks Macdonald Gilt Portfolio Service

Brooks Macdonald was one of the first wealth managers to identify this opportunity and launched our Gilt Portfolio Service in October 2023. Our dedicated portfolio managers design bespoke solutions tailored to meet each client's specific cashflow requirements and time horizon. Whether it is to meet specific future liabilities such as paying school fees or taxes, or simply as an alternative for surplus cash normally held in a bank or building society, our service offers a customised approach to gilt investing.

Important information

Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Investors may not get back the amount invested. Past performance is not a reliable indicator of future results. Changes in rates of exchange may have an adverse effect on the value, price or income of an investment.

Brooks Macdonald does not provide tax advice and independent professional advice should be sought. Tax treatment depends on individual circumstances and may be subject to change in the future, so you should seek independent tax advice, as to your own position. This information does not constitute advice or a recommendation and you should not make any investment decisions on the basis of it.

More information about the Brooks Macdonald Group can be found at **brooksmacdonald.com**

BM-2025-0325-003