

Gilts – the mysteries explained

Government borrowing is colossal by historical standards, and the main way in which the Government raises the money it needs is by issuing Gilt-edged securities. Gavin Oldham unravels their mysteries.

Gilts were mainly bought by institutions until the Bank of England started buying them through its 'quantitative easing' plan. But personal investors can also buy them post-issue on the stock market as a relatively secure investment offering regular interest payments. They are eligible investments in a wide range of investment plans including ISAs, SIPPs and Child Trust Funds.

Gilts are issued with a fixed rate of interest (a coupon) and in most cases a redemption date. The market price of a Gilt may fall as interest rates rise (because investors can get better returns from cash) and rise as interest rates fall. Sounds simple. In fact, they're more complex than that. If you prefer a simple overview of Gilts visit the Gilts page on our website at www.share.com/gilts or jump to the section on Exchange Traded Funds. They give you a simpler way to get exposure to government-backed stock. Otherwise, read on!

Types of Gilts

There are four basic types of Gilt:

- **Conventional Gilt:** Interest is paid half yearly on dates which are set at issue, and a final payment coincides with the final redemption date.
- **Dual-dated Gilt:** Similar to a conventional Gilt but with a range of earliest and latest possible redemption dates, at the Government's discretion.
- **Index-linked Gilt:** Both the interest payment and the redemption amount are adjusted in line with the Retail Prices Index.
- **Undated Gilts (Irredeemables):** These have low interest rates and redemption is at the discretion of the Government. The best known of these are the War Loan Gilts.

Gilts normally have the name 'Treasury' in their title although other names may be used ('Exchequer', 'War Loan', etc). The most common Gilts are listed in the Financial Times (FT). The list is headed 'GILTS – UK CASH MARKET' within the BONDS section, and a typical display is shown below. The full list of Gilts is printed in the FT on Saturdays.

	Issue Date	Price	Yield	Day	Week	Month	Year
Tt 4.75pc 10	10/04	107.04	0.00	+0.01	-	-0.00	-1.32
Cr/Spd 11	11/11/06	111.98	0.00	-0.00	-0.18	-	-2.74
Tr 1pc 12	11/01/15	118.75	1.47	0.00	-0.04	-0.27	2.30
Tr 1pc 13	12/02/12	122.52	2.07	-0.05	0.08	0.25	1.87
Tr 5pc 14	11/06/14	111.64	2.47	-0.01	0.05	0.18	1.48
Tt 4.75pc 15	11/07/15	111.73	2.60	-0.00	0.07	-0.19	-1.45
Tt 4pc 4 16	10/07/16	107.46	2.90	-0.00	-0.04	-0.22	-1.24
Tt 4.25pc 10	11/01/10	111.85	0.90	+0.01	-0.04	-0.19	-0.91
Tr 1pc 11	10/07/11	107.28	3.51	+0.01	-0.09	-0.14	-0.88
Tr 1pc 15	11/07/15	117.89	3.83	0.00	-0.09	-0.16	0.64
Tr 1pc 20	12/04/20	129.44	3.82	0.00	-0.07	-0.17	0.62
Tr 4.25pc 22	10/01/22	105.12	3.91	0.00	0.06	0.17	0.48
Tt 4.25pc 35	10/04/35	104.12	4.00	0.01	0.06	0.18	0.28
Tt 4.75pc 38	11/01/38	113.19	3.08	0.01	0.07	0.18	-0.24
Tt 4.25pc 40	10/07/40	105.75	3.98	0.01	-0.06	-0.17	-0.14
War Ltn 1.25pc	01/01/45	81.95	4.77	-0.01	-0.00	-0.15	-0.14

Gilt pricing

Gilts are priced in pounds per nominal £100 both at the time of issue and when traded on the stock market. Although you can buy units of £1 nominal the nominal price is not how much it will cost you to buy. The market price you pay will reflect the supply and demand for Gilts which will be influenced by interest rates, inflationary expectations and other factors. More on price volatility later.

Gilt pricing has two components: a quoted 'clean' price and an 'accrued interest' component which reflects the length of time since the last interest payment went 'ex-dividend'. This can reduce (if it's before pay date) or increase the amount actually paid. Together these two components set the 'dirty' price of the Gilt, which is the price you actually pay.

Interest (Coupon)

The coupon is the annual rate of interest paid on £100 nominal of stock, and is set by the Government at the time of issue. It may be fixed for the life of the stock, as in a conventional Gilt, or it may be adjusted by the inflation rate (index-linked). The amount of interest you receive and for how long is indicated in the title of the Gilt. For example, a 7.5% Treasury Gilt 2019 pays 7.5% interest per annum on £100 nominal until 2019, when it is redeemed.

The coupon offered on an index-linked Gilt will be lower than on a conventional Gilt because of the allowance for the inflation-linking of the coupon and the capital. However, there is no capital gains tax payable on this inflation uplift. All interest payments are made before tax: so a taxpayer would need to declare interest payments on their tax return for income tax purposes.

Redemption

The redemption date is the date on which the Government repays its borrowing. With a conventional Gilt the amount repaid is £100 per £100 nominal of stock. However, with an index-linked stock this redemption amount is also adjusted by the inflation rate, and this can drive the eventual amount to be repaid up to much higher figures.

Yield

There are two yields quoted to help investors judge what return they'll receive and how one Gilt compares with another.

The **flat yield** describes your annual return in relation to the money you've invested (the price paid). It pays no attention to the redemption date or amount. So if you purchase a 7.5%

Treasury Gilt 2019 which is priced at £125 per £100 nominal of stock, your flat yield will be 6% ($7.5 \div £125$). As interest is paid twice a year, you'll receive £3 each half year until redemption for every £100 you invest.

For conventional Gilts, the **redemption yield** considers both the coupon and the redemption date and amount to give you a true reflection of return. So your 7.5% Treasury Gilt 2019 priced at £125 will 'lose' the extra £25 in the price between now and the redemption date. That's at a rate of £2.50 per year, or 2.5% of the nominal £100 of stock. In simple terms the redemption yield will therefore be $(6\% - 2.5\%) = 3.5\%$, although the actual calculation for redemption yield is rather more complicated.

For a dual-dated Gilt, the redemption yield is calculated on the assumption that the Government will choose the latest date if the market price is below £100 and the earliest date if it's above this level, in order to provide the cheapest cost for the taxpayer.

It's fiendishly difficult to calculate the redemption yield of index-linked Gilts, because both the coupon and the redemption amount are dependent on subjective opinions about future inflation rates. This is further complicated by two different methods of showing the inflation impact in the price, and the length of time since the Gilt was issued. We recommend much more detailed research if you're interested in this area, or use the 'Index-linked' Gilt Exchange Traded Fund featured further on.

Price volatility

As a general rule, longer-dated Gilts are more volatile than shorter-dated Gilts and low-coupon Gilts are more volatile than high-coupon Gilts. The key to understanding the volatility of market prices, and their sensitivity to interest rate expectations is the 'maturity yield curve': that is, how the redemption yield of different Gilts varies with the length of time to their redemption. The chart opposite shows the current maturity yield curve, which can be described as mildly positive: that is, the redemption yields rise as the maturities get longer.

As a comparison, we also show the shape of the maturity yield curve as it

was in 1975 and in 1995, and therefore how much it can change.

If the long-dated end (that is, the Gilts with a long time to go before redemption) of the maturity yield curve becomes more positive (ie its redemption yield goes higher), market prices have to fall. Long-dated Gilts are generally more sensitive to changes in interest rates than short-dated Gilts: they can fall, or rise, by a significant amount to reflect changes in their yield. Typically, a 25 year Gilt price will fall by over 10% to reflect a change in redemption yield from 4% to 5%. Think of it like a lashing whip: the end moves by much more than the bit in your hand.

Exchange Traded Funds

If it all sounds too complicated, there are also three Exchange Traded Funds (ETFs) which provide a simple way to get exposure to government-backed stock:

- Short-dated conventional Gilts: iShares UK Gilts 0-5 (Code: IGLS)
- Long-dated conventional Gilts: iShares FTSE UK All Stock Gilt (Code: IGLT)
- Index-linked Gilt stocks: iShares £ Index-Linked Gilts (Code: INXG).

As with all investments, please do your research carefully. Check the price history and indicative redemption yields on

At a glance

Gilts offer regular interest payments.

Yields can be complex to calculate.

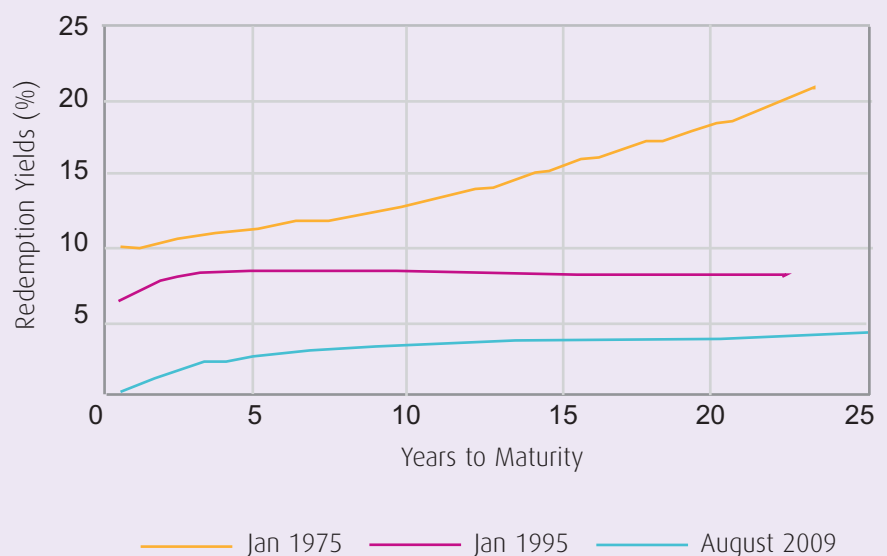
ETFs can also offer exposure to government-backed stock.

www.ishares.co.uk (enter the code in the 'search' box), seek investment advice from the Advice team if you need guidance in relation to your individual circumstances, and make good use of our price limit services when placing orders. And remember, even Gilt prices can fall as well as rise!

Find out more

For more information or to buy gilts visit share.com/gilts

The current Maturity Yield Curve



Source: Capital Economics