

FIXED INCOME

The Case for Active Gilts Management as Volatility Returns

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Investors are having to come to terms with the return of volatility. After several years of relatively stable conditions, the slide in equities at the end of last year and the subsequent recovery in the first quarter of 2019 were a stark reminder not to become complacent. David Zahn, Head of European Fixed Income, Franklin Templeton Fixed Income Group, looks at the implications for the gilts market and explains why he believes an active approach to gilts management makes sense now.

We believe investors should continue to expect a degree of volatility as markets unpack the uncertainty surrounding Brexit, global trade spats and pessimistic economic outlooks in certain regions of the world.

If we look back over the last 10 to 15 years, there have been times when bonds and equities were positively correlated.¹

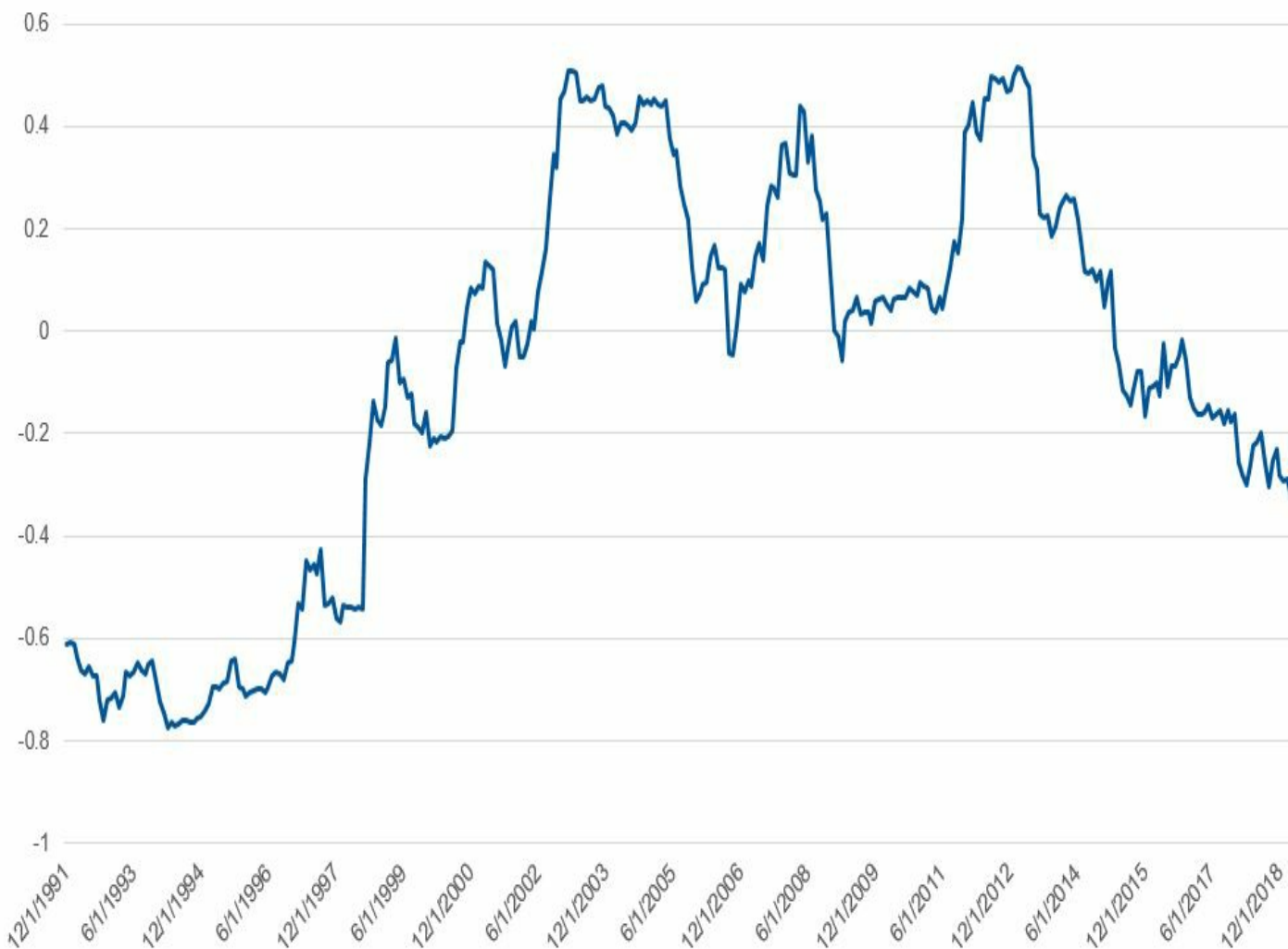
Now we're starting to see that negative correlation coming back.

Against that background, we'd expect growing interest in gilts (UK government bonds), which have traditionally provided steady returns in times of heightened volatility.²

Why We See Value in Diversification



Correlation between Gilts and FTSE 100 As at 30 September 2018



Source: Bloomberg. Important data provider notices and terms available at www.franklintempletondatasources.com. Past performance is not an indicator or guarantee of future performance. For illustrative purposes only and not reflective of any Franklin Templeton fund. Diversification does not guarantee profits nor protect against risk of loss. The FTSE 100 Index is a capitalisation-weighted index of the 100 most highly capitalised companies traded on the London Stock Exchange. Indices are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges.

Low Point of Gilt Yields

In our view, we're at the low point of gilt yields in the cycle, in part due to the uncertainty surrounding the Brexit outcome.

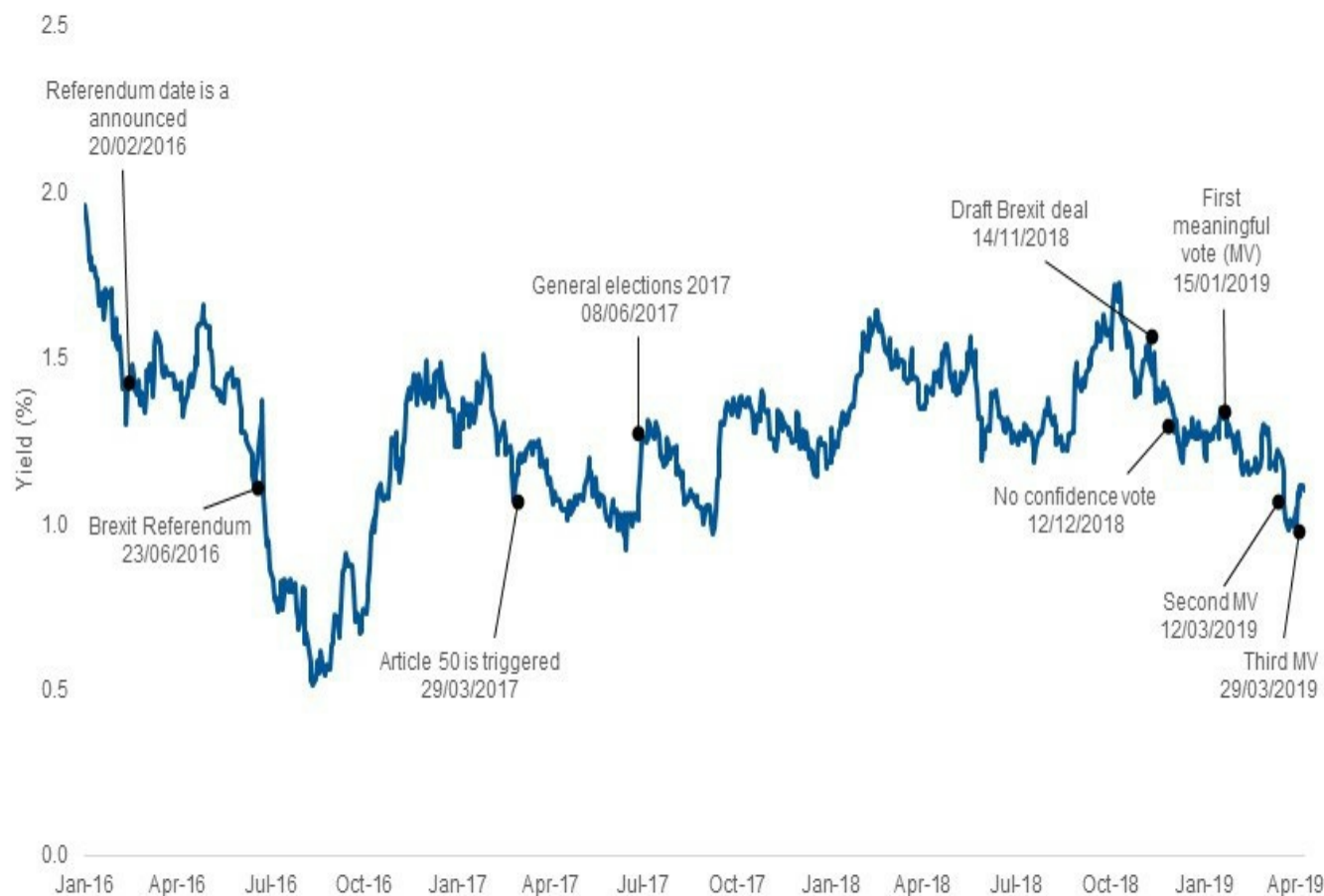
We don't feel there's much likelihood of yields falling further.

Equally, we don't expect any imminent increase in interest rates across major developed economies, which could send yields on an upward trajectory.

Timeline to Brexit: 10-Year Gilts



January 2016 – April 2019



Source: Bloomberg, FTI Fixed Income Research. For illustrative purposes only and not reflective of any Franklin Templeton fund.

We don't expect the European Central Bank (ECB) to begin raising interest rates until at least 2021. Similarly, we think the Bank of England's Monetary Policy Committee (MPC) is unlikely to raise rates for at least a couple of years until it sees a Brexit resolution. The US Federal Reserve (Fed) has said it's not going to raise interest rates this year and the Bank of Japan is still implementing quantitative easing (QE).

But the bond market—particularly the longer-dated securities—doesn't always move just based on central bank activity.

For example, we think gilts yields currently are artificially low, because of the Brexit uncertainty.

Once Brexit is settled, we think fundamentals could reassert themselves. Therefore, we should see yields start to rise once a resolution emerges.

At the same time, if there were to be a growth surprise to the upside, you could see yield curves—the graphical representation of the spread between short- and long-term interest-rate instruments—steepen even before central banks act.

How Do Gilts Fit Into a Portfolio?

We think it's important for investors not to think of gilts simply as a separate asset class, but to think how it fits into an entire portfolio. And what does it do for risk-adjusted returns.

We feel that a gilts allocation can contribute to a balanced portfolio composition. Many people have held gilts in their index-based investment products. But in many cases, they haven't considered that the duration³ of the gilts market has lengthened dramatically.

Longer duration means more sensitivity to interest-rate changes. So there's a real chance that by that measure, an index gilt fund is riskier today than it was 10 or 15 years ago.

Effect of Interest-Rate Changes on Duration



Duration (years), vs US Treasury
As at 30 September 2018



Source: Bloomberg. For illustrative purposes only and not reflective of any Franklin Templeton fund. Duration is the measure of the sensitivity of the price of a bond to a change in interest rates.

A passive investment can only follow market turbulence. An active manager strives to use the volatility to an investor's advantage by actively managing duration.

Gilts have been a very liquid asset so an active manager can move duration in their portfolios (longer or shorter) depending on their analysis of conditions.

Although we don't expect an interest-rate increase in the United Kingdom in the near future, we do believe it's important to have the opportunity to move asset allocations and/or the duration of a portfolio without having to make a decision to exit the asset class completely if conditions change.

That generally requires moving away from a passive index approach to an active approach.

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments.

1. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

2. Correlation measures the degree to which two investments move in tandem. Correlation will range between 1 (perfect positive correlation where two items have historically moved in the same direction) and -1 (perfect negative correlation, where two items have historically moved in opposite directions).

3. Past performance is not an indicator or guarantee of future performance.