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Beware the hidden duration risk of gilts

Why UK government debt investors should be cautious

"Trading Post

UK government borrowing is on course to hit its target

The risk of putting money into UK gilts is considerably higher than it has been in the past, something which many investors have failed to appreciate — that is, according to Christopher Peel, chief investment officer at Tavistock Investments.

As yields on UK government bonds have fallen in recent years, their duration — the amount of time it takes for a bond's coupon payments to recompense an investor for the initial purchase price — has soared, Mr Peel says.

As a result, the duration of 10-year UK government debt is currently hovering at around eight times its yield.

This is down from its historic high of 12, which was reached last summer, but still well above its long-run average — a level of risk which Mr Peel calls "problematic" for "cautious investors that typically own bonds in their retirement portfolios".

Since 2000, duration as a multiple of yield has averaged three, according to Tavistock's data.

In an additional bearish note, Mr Peel adds that 10-year gilt yields are currently generating negative real returns (yield minus inflation) — a historically rare situation which he expects to last only a short time. He anticipates forthcoming rises in yields and a concomitant fall in asset prices.

To mitigate this, he advocates scaling back exposure to gilts, particularly at the long end of the yield curve. Instead, he proposes buying "sterling-hedged, short-duration, global investment-grade high-yield and emerging market local currency bonds".