Protection... What protection?

Intuitively clients think that holding sovereign debt is a secure and dependable way to protect your hard-earned assets. It's the government's debt after all. Indeed, historically UK government fixed interest securities (gilts) have often been considered as the provider of protection for portfolios in times of stress. In a normal operating environment (whatever that is today!) market stresses, wars and economic turbulence usually lead to rising gilt prices and to gilts acting as a source of protection for an investment portfolio.

In this economic cycle we are seeing the absolute opposite – and that's because the stresses and strains are a result of, amongst other factors, dramatically rising inflation and rising interest rates.

This has resulted in gilts being one of the worst performing assets in the financial markets with long-dated UK government debt falling as much as 30% in 2022. That's a bear market for gilts… although I have never heard that phrase before.

Of course, it's not only gilts - almost all sectors of the UK debt market have also fallen, reflecting the same economic factors mentioned above. But gilts are taking the brunt of debt sell-offs across investment books and at the present time huge swathes of institutional pension funds are taking a pounding as they are the "natural" holders of gilts. In the present environment it's a tough task being a gilt fund manager.

In short, UK government debt has been hit by a perfect storm. It has become almost unfashionable and is probably going to fall further before sanity prevails. Further inflation peaks and interest rate hikes will of necessity cause the weakness of the gilt market to continue. The ultimate UK asset that should provide protection is simply not working.

The behaviour of gilts in current circumstances leads us inescapably to the conclusion that defence oriented accounts across the industry in 2022 have been no more effective at protecting client assets than accounts with almost 100% equity exposure. That is a situation that is both unusual and not the easiest to explain. The gyrations of the fixed interest markets often get lost behind the more exciting shenanigans of the equity markets but, believe me, at this juncture the gilt market is the one to get your volatility fix on.

Across the industry you will find a much closer correlation than almost ever before between the falls witnessed in defensive style accounts and the more growth-oriented accounts. It's a very unusual phenomenon but we believe it is likely to last at least until the end of 2022 and possibly into 2023. The sad thing is we don't see real value in gilts at this level and in our view, they are likely to go at least 10% lower.

Yet again the industry has failed to spot what was going to happen in advance - the cathartic demise of one of its bastions of security in portfolio management. I certainly didn't see many commentaries on this subject – although I am sure there were probably some very limited exceptions.

TAM's position is, as you might surmise, significantly underweight UK government debt in its more defensive oriented portfolio and is now watching closely the drama unfold and the latest capitulation. In our opinion, UK government debt will not attain fair value until 2023 and only at that time will our interest be piqued.

It must be sobering for all the 'risk control' addicts to find their portfolios dented heavily by the most boring and stable of assets. You cannot foresee risk no matter how much statistical work you do. Investments that are risky become stable and stable investments become risky… but that's a story for another day.

I hope the comments herein give you some helpful background as to why the industry has seen its lower risk accounts suffer generically almost as badly as balanced/growth-oriented ones. If you would like to speak to someone about anything in this note, or our discretionary investment services in general, please do not hesitate to get in touch via any of the details below.

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