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FINANCIAL TIMES

The end of gilts' 30-year high is nigh

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Published: March 7 2010 09:50 | Last updated: March 7 2010 09:50

The toughest questions in investment are not those that challenge specific views, but those that challenge deep-seated assumptions.

Markets exist to accommodate a range of participants with divergent views or economic interests, so it is hardly a surprise that almost any position can be justified somehow. Those who judge the position right are rewarded, while those who do not are penalised.

But that is not how the most grievous or most costly mistakes are made. Those arise when it is investors' entire belief systems that turn out to be misplaced. Long Term Capital Management, the hedge fund that had to be bailed out in 1998, is a good case in point. Clever to a man, the principals lost their business because their faith in historical relationships that had worked so well for many years turned out in practice to break down during a period of extreme market stress.

The same, on an even bigger scale, goes for central bankers who bought in, naively, to Alan Greenspan's convenient view that bubbles in financial markets could not be identified in advance and even if they could, would prove more costly to pre-empt than to clear up after they had burst. As he confessed to Congress in October 2008, bankers' behaviour during the crisis had revealed "a flaw in the model???that defines how the world works".

The cost to the world of the chairman of the Federal Reserve's faulty assumption now runs into billions.

Are we approaching the point with government bonds where the assumptions that have carried this once-derided instrument triumphantly through three decades of consistently good returns need to be discarded? If we are not there already we are surely not far away.

A recent report by Andrew Smithers posed the question bluntly: Bonds – Government and Corporate, Nominal and Real – Why Should Anyone Hold Them?. His argument is that at current levels government bonds are "seriously overpriced" and therefore high risk. Returns are likely to be negative in the short term as the twin props of quantitative easing and bank window-dressing are withdrawn. Yields on inflation-linked bonds meanwhile have been driven so low by investors seeking insurance against a resurgence of inflation that, in his view, they are set to do badly whether or not inflation picks up.

Dimson, Marsh and Staunton are just as blunt in their latest Global Investment Returns Yearbook. They note that in defiance of financial theory, over the 40 years to

the end of 2008 government bonds outperformed equities. Their world bond index produced an annualised real return of 4.89 per cent between 1969 and 2008, compared with an annualised real return of 4.02 per cent for equities. The long run real historical return from government bonds since 1900, in contrast, has been just 1.0 per cent a year.

It is true that the anomaly of bonds outperforming equities over long periods has reversed after last year's equity market revival, but it remains the case, the professors note, that "in an apparent violation of the law of risk and return", bonds have "produced equity-like performance, with annualised returns just a little below those on stocks, yet at much lower volatility". Extrapolating these high returns in the future would, they conclude, "be fantasy".

They are right about that. With 10-year yields at 3.8 per cent in the US and 4.0 per cent in the UK, to project a 4.0 per cent annualised real rate of return from government bonds at these levels only makes sense if the world is heading for outright deflation, a fast receding possibility. Even if that were to happen, the boost to bond returns would at best be a transitory one.

In fact, from a valuation perspective it is hard to construct a plausible world economic scenario that would validate buying government bonds today other than as a short-term tactic. It is true that bonds were one of the few asset classes to display diversification value during the global financial crisis. Diversification remains the other prop, besides disinflation, on which investors' faith in government bonds rests.

But even this, an article of faith for entire generations of investors, is open to challenge. For Mr Smithers, the argument cuts little ice. As an instrument of diversification, cash shapes up at least as well as bonds, notwithstanding the current miserly returns on short-term deposits. The huge supply overhang that is implicit in the ballooning fiscal deficits in the US, Europe and the UK, meanwhile, seem sure to drive yields higher. When is a only matter of time and degree.

It is not that investors who buy bonds today cannot experience one last hurrah before the 30-year cycle turns for good. There will always be opportunities to play the yield curve (now much steeper than its historical average) for profit. The message is rather that the returns of the last 30 years cannot and will not be repeated over the next 30, with all the implications that must flow from that statement.

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