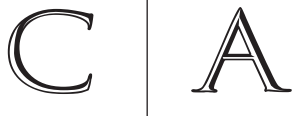

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT

ULTRA-LONG GILTS—TOO, TOO DEAR

November 2005

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Ultra-Long Gilts
Too, Too Dear

U.K. investors have been voraciously gobbling up 50-year gilts in recent weeks. Yields on 50-year conventional gilts have fallen below 4.0%, while those on 50-year linkers have slipped below 1.0%. In fact, Morgan Stanley estimates that real long-term interest rates are at their lowest levels since gilts were first issued at the end of the 17th century.

Most demand has come from pensions, insurers, and investors who need to match their liabilities (falling real yields this year have actually increased this burden). Regulatory pressure has intensified the demand for duration, which is widely expected to remain quite strong. There is a generally perceived shortage of duration in Europe's fixed income market, and the mounting urgency among many investors to match liabilities may ensure the bonds remains well bid.

These buyers have driven up prices on ultra-long bonds to levels that make them unattractive for investors who do *not* need to match liabilities. Linkers are even less attractive than nominal gilts. Fifty-year linkers are expensive relative to nominal bonds of comparable maturity. As of November 28, the 50-year inflation-indexed offered a yield of 0.90%, while the recently issued 50-year nominal bond yielded 3.99%. The breakeven inflation point, therefore, is 3.09%, meaning that 50-year linkers will outperform nominal gilts if the average annual inflation rate exceeds 3.09% over the next 50 years.[1]

In the context of the United Kingdom's long-term experience with inflation, betting that annual inflation will exceed 3.09% seems compelling indeed. Over rolling 30-year periods since 1957, U.K. RPI has been at least double 3.09% in every period (out of 19), while the average annual inflation rate was 6.1%.[2] The peak inflation years occurred during 1973-81 when it averaged 15.0%, topping out at 24.9% in 1975. Inflation has averaged only 2.48% during the most recent seven-year period; an achievement widely attributed to the Bank of England's gaining of independence in 1998. In the post-1998 context, 3.09% annual inflation seems rather high.

If they were not so expensive, ultra-long gilts would offer a few attractive benefits to investors who do *not* explicitly engage in asset-liability matching and who manage their own bond portfolio. Long-dated nominal gilts offer a way to extend duration with a smaller allocation to bonds, while maintaining a constant degree of portfolio protection in the event of a prolonged economic contraction or outright deflation. Table A illustrates the relationship between duration, convexity, yields, and maturity. Both duration and convexity increase with maturity, and decrease as yields and coupons increase; when yields are low, as they are today, duration across maturities differs substantially, and as yields rise, duration and convexity converges, but material differences persist until yields hit double digits. Despite offering the potential to reduce a portfolio's overall bond allocation, however, ultra-long gilts come with considerable risk. While their extremely high duration and convexity present the opportunity for substantial market value gains if rates fall, it also offers the potential for considerable losses if rates rise.

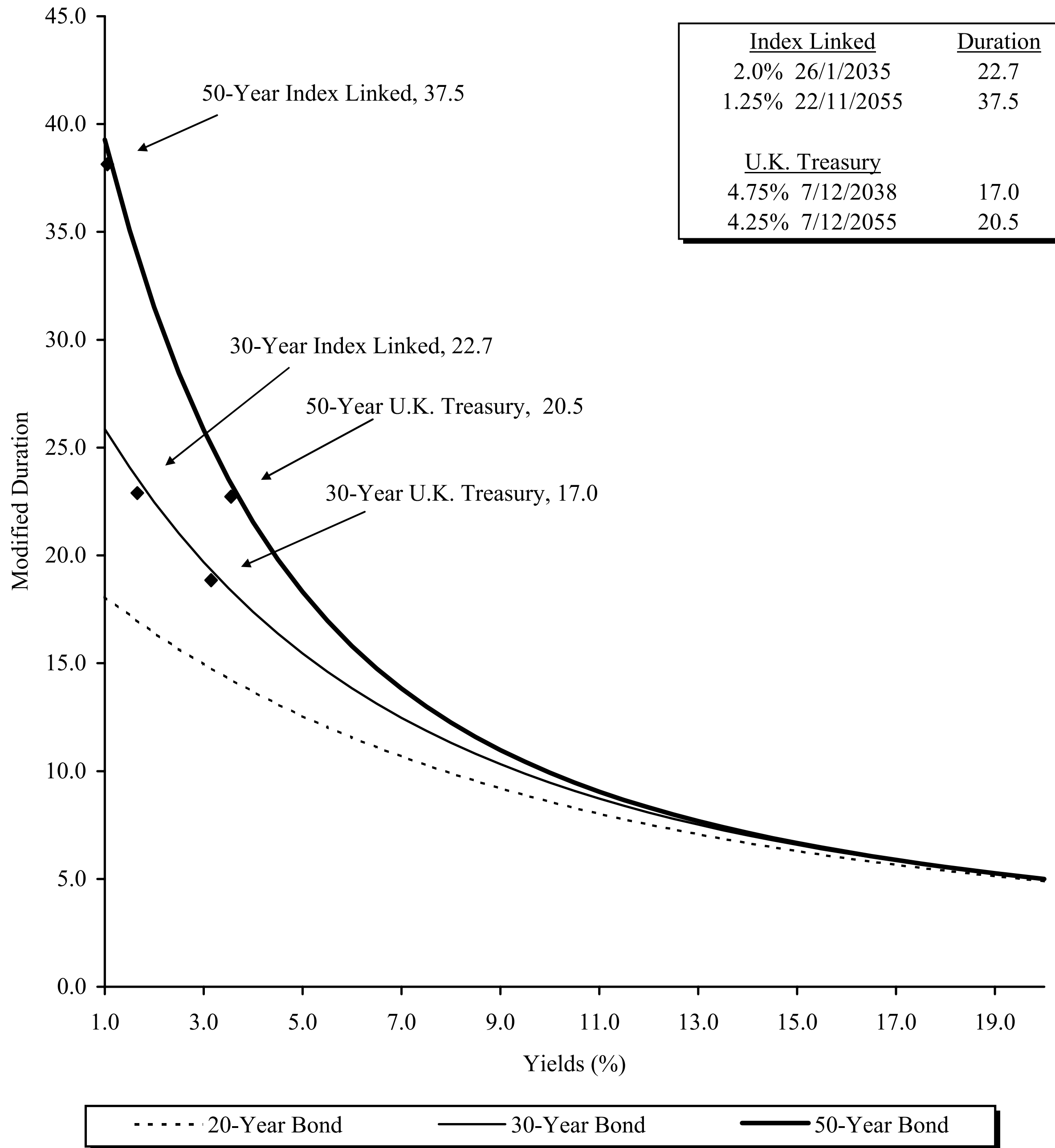
[1] This of course assumes that coupons will be reinvested at current yields.
[2] Because inflation data begin in 1957, we cannot calculate the average inflation rate over rolling 50-year periods.

Table A

CHANGES IN DURATION DIMINISH WITH MATURITY AND INTEREST RATES

Duration of a 20-, 30- and 50-Year Par Bond at Various Yields

As of 30 September 2005



Sources: Barclays and The Bloomberg.