FIXED INTEREST AND INDEX-LINKED INVESTMENT

APRIL 2025

There is a place for fixed interest investments in some proportion in most long term investment portfolios. Fixed interest can offer the **potential for a secure income and capital gain**, and also provides useful **diversification** from other asset classes such as equities and property.

Here we look at the different types of fixed interest investment available, how each is taxed, and how you can gain exposure to this valuable asset class.

Please refer to our note on Risk and Asset Allocation for a discussion on how to determine the level of risk you should take, and consequently the proportion of fixed interest investment which might be suitable for you.

clarity

SUMMARY

Fixed interest investments are debts issued by governments, local authorities, companies and other organisations – known generically as **bonds** or **stocks**. Government bonds are known as **gilts**. They are usually issued for a fixed length of time, at the end of which the issuer will repay ('**redeem**') the initial cost of the bond. For index-linked stocks, the redemption value may be indexed in line with inflation.

Unlike cash deposits, the **capital value is not secure if the stock is not held until redemption**, and in addition there is a risk of default by the provider. There is also a risk that if interest rates in general rise further than expected over the period, the yield on the investment may become uncompetitive. Index-linked stocks can therefore be useful as they provide an income and capital return, which is linked to inflation.

The **total return** is comprised of the **interest paid** to the investor for the life of the bond, and the **capital gain/loss on redemption**. As **capital gains on directly held gilts and many corporate bonds can be tax free to individuals**, the most preferable bond issue will depend upon the investor's tax status.

As with all investments, the return is linked to the risk of investment, hence UK government debt will generally provide a lower yield than a corporate bond.

Fixed interest savings products are not dealt with here – these include fixed interest/fixed term building society bonds and National Savings products, which we would class as cash-style investments due to the relative security of capital. However, these can also offer competitive rates (particularly for higher rate taxpayers in the case of National Savings Certificates), and should also be considered. Also, please be aware the naming conventions can confuse: for example, the term "bond" could be used to describe a one year fixed deposit with a bank as well as a government security, corporate debt investments or even some insurance contracts. It is therefore important that the investor is clear on which type of bond they are contemplating.

FIXED INTEREST TERMINOLOGY

After the stock has been issued, it can usually be traded on the open market, and the **quoted price** will therefore vary from the **issue price** (the '**nominal**' or '**par**' value). Therefore the actual amount invested can be more or less than the nominal value of the stock, and so the investor could have a capital gain or loss if the stock is held to the redemption date. For example, £100 nominal of stock could be bought on the market for £120, hence the investor would expect a capital loss of £20 at redemption, and would need to factor this into his overall calculation of the return expected. Of course, the stock may be sold in the market prior to redemption at the market value at that time.

In return for loaning the issuer money, the investor will usually receive **interest** for the life of the loan. This can either be at a **fixed rate**, or the rate can be linked to an inflation index - most **index-linked** stocks are issued by the government. The actual rate of interest the investor receives will depend upon the market value of the stock at purchase.

For example, a '4.75% gilt 2030' pays 4.75% interest per £100 nominal value of stock, and is redeemed in 2030. If the investor purchases the stock when the market value is £150 per £100 nominal, the effective interest rate (**running yield**) they will receive is 3.16% (i.e. 4.75% of £100 divided by £150 x100). In addition to this, they will suffer a £50 capital loss if they hold the stock to redemption, and so the **redemption yield** would also need to be calculated to take this into account, and show the actual total return over the potential holding period of the stock. The **net redemption yield** is also often quoted, which in addition takes into account the tax to be paid by the investor.

TAXATION

Interest received may be liable to income tax as for other investment income (see the relevant Research Note on UK taxation). Income on UK government bonds ('gilts') is usually paid gross, but is still potentially liable to income tax.

Gilts and many UK corporate bonds are classed as 'qualifying corporate bonds' and as such there is no capital gains liability on any capital gains, for individuals and trusts. However, there is also no relief for capital losses. Gains on gilts and fixed interest collective investment vehicles (e.g. unit trusts) are, however, potentially subject to capital gains tax.

FACTORS AFFECTING STOCK PRICES

As with any traded product, supply and demand determine the current market price for any stock. These are affected by a number of factors:

- **Interest rates**: clearly, if general interest rates rise, investors will be prepared to pay less for a fixed interest investment (to gain a higher interest rate). All other factors being equal, market prices will therefore fall, and vice versa.
- **Sensitivity to interest rate changes** (volatility): longer dated stocks (i.e. with a longer period to redemption), and low coupon stocks are generally more sensitive to interest rate changes than shorter dated/higher coupon stocks.
- **Inflation**: this is intrinsically linked to interest rates.
- **International currency movements**: for example, for gilt yields as these essentially represent the return on sterling, and so will be affected by the overall supply and demand for sterling.
- **Credit rating**: investors will naturally demand a higher yield from a company (or a government) with a lower credit rating, because of the higher perceived risk of default by the issuer. Conversely, capital gains can be made from investing in companies where the credit rating is upgraded, and many bond fund managers seek to target such companies.
- **Market expectations** of future movements in any of the above. Thus it is often the case that, for example, a Bank Base Rate rise has been fully priced into the market prior to announcement, so much so that the actual announcement of an interest rate rise does not affect the market price at all.

LONG TERM BOND RATINGS

As detailed above, the credit rating of an issuer will be a large determinant of the yield of the stock. The table below outlines the credit rating system used by the 4 major agencies. The grading will often appear in bond tables featured regularly in the financial press. Please note that non-investment grade bonds are commonly referred to as junk bonds.

	Rating Agency:			
Moody's	**S&P**	**Fitch**	**DBRS Morningstar**	**Grades**
Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-	AAA AA+ AA AA-	AAA AA+ AA AA-	Prime Maximum Safety High Grade High Quality
A1 A2 A3	A+ A A-	A+ A A-	A+ A A-	Upper Medium
Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-	BBB+ BBB BBB-	Lower Medium
Ba1	BB+	BB+	BB+	Non Investment Grade
Ba2 Ba3	BB BB-	BB BB-	BB BB-	Speculative
B1 B2 B3	B+ B B-	B+ B B-	B+ B B-	Highly Speculative
Caa1	CCC+	CCC	CCC	Substantial Risk
Caa2 Caa3	CCC CCC-			In Poor Standing
Ca	CC	CC	CC	Extremely Speculative
C	C	C	C	May Be In Default
	D	DDD	D	Default

METHODS AND COSTS OF INVESTMENT

Investment can either be made directly, or through a collective investment fund (e.g. unit trust or OEIC).

DIRECT INVESTMENT

Historically, much private client fixed interest investment has been into gilts, although in recent years, many investors have viewed gilts as relatively expensive and hence less attractive. Investing in gilts independently means that the redemption yield for each gilt is fixed at purchase, which may or may not prove to be a good decision in hindsight. In addition, reinvestment on redemption must be considered, and the investor must also manage income payments.

For direct investment into gilts, you can use the Bank of England dealing service or a stockbroker, who may be cheaper for larger investments. The holding costs for direct investment are likely to be lower than those for an actively managed fund. Also, you also need to take into account the dealing commission charged by the broker used, compared to the initial (often nil after discounts arranged by clarity) rate for investment into collective funds.

However, a diversified fixed interest portfolio would have exposure to all levels of credit grades in differing proportions, and so it is unusual that a portfolio of gilts would be sufficient as a stand-alone portfolio. It can be difficult for a private investor to gain access to a sufficiently diversified range of individual UK and international bonds, and for this reason, much private corporate bond investment is through collective funds.

INVESTING IN A FUND

Most investors will not have the level of investment funds or time and expertise required to invest in directly issued gilts or bonds. The attractions of investing in a fund include diversification and convenience, in that the investor can spread the investment across a number of issues, without suffering the additional paperwork involved. In addition, the fund manager will actively manage exposure to different areas. This method of investment gives a variable yield to the investor. Please see our 'Buy List' for some examples of the types of fund available.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.