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The Sterling Corporate Bond Market and its Future Development

The Bond Portfolio Management Working Party

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Abstract

This paper looks at the size of the sterling corporate bond market, both conventional and index-linked, and their likely future development given significant potential institutional demand and limited government issuance. The impact of sterling joining or not joining the Euro is viewed as a key factor influencing the market.

Contents

Section 1 - Introduction and Summary

1.1 The sterling corporate bond market is substantial (£150bn or so of outstanding issues) and growing (with some £50bn of new issuance each year). Whilst the UK gilts market is much larger (£300bn outstanding) new issuance is forecast to be smaller (£10bn to £20bn per annum). Indeed, net of redemptions, new gilts issuance is likely to be minimal. The majority of long-dated issues are held by insurers and pension funds, particularly the former. In this paper it is noted that potential demand for sterling (long-dated) paper by these institutions is substantially larger than current issuance volume.

1.2 A natural strategy for HM Treasury to benefit from this situation would be to issue long-dated stock and redeem short dated gilts. With an inverted yield curve, this would secure long-term funding on cheaper terms than at present. However, for reasons that are not entirely clear, it appears that HM Treasury is unlikely to take substantial advantage of this opportunity, presumably unless the curve inverts further. The amount of redemption of short dated gilts in 2000/2001 was only £5bn.

1.3 One of the factors holding back further expansion of the (long-dated) market of both conventional and index-linked stock is uncertainty for issuers as to whether or not sterling will join the Euro.

1.4 A decision not to join could result in a significant fall off in yields, because of institutional demand. Current yields reflect a combination of a (fairly high) probability that sterling joins (in which case long-dated yields will converge upwards towards Euro levels) and a (low) probability that sterling will not join (in which case the impact of pent-up institutional demand will not be constrained by convergence possibilities, and market implied expectations are for a decline in yields). This effect is compounded because many corporates have associated defined-benefit pension schemes. A reduction in long-dated yields would further damage the solvency of these schemes because most schemes are mismatched and invest predominantly in equities rather than bonds. The decision to issue long-dated corporates can therefore be viewed as essentially a bet that sterling will join the Euro. Likewise, for the insurance company and pension fund investors, a decision <u>not</u> to buy long-dated paper is also a bet that sterling will join the Euro.

1.5 Taking this logic to the next stage, an increasing focus on prudent management of pension related assets would imply a trend for insurance companies and pension funds to buy long-dated corporate paper (and for corporates not to issue!) until a decision on the

Euro has been made. Whether current yields already reflect this trend is of course open to debate.

1.6 UK corporates currently issue significant volumes of stock, but the question naturally arises as to whether a large increase could be envisaged if insurance company and pension fund potential demand materialises, for example on a decision not to join the Euro. The working party's view was that corporates would borrow more, if long-dated yields decline.

1.7 It might be asked whether other market forces might solve the deadlock. Some argue that investment banks, arbitrageurs or foreign institutions will intervene and "borrow" long and invest in short-dated instruments. However, two difficulties arise: such strategies tie up significant capital, and rely on sterling joining the Euro. They would prove to be expensive if sterling did not join the Euro, demand materialised and yields declined. Consequently, the working party believes that it is corporate rather than other supply that would increase in the event that sterling does not join the Euro.

1.8 The position with regard to the index-linked corporate issuance is somewhat similar to that for the conventional market, but arguably a little less dependant on Euro entry. Even if sterling joined the Euro, it is unlikely that too many overseas borrowers would issue stock linked to UK RPI. However, with relatively little inflation uncertainty compared with the position some years ago, nominal yields on the index-linked and conventional markets are likely to continue to track each other closely. Consequently, the supply/demand arguments set out in 1.4 to 1.7 also apply to index-linked stock.

1.9 On the demand side, insurance companies and pension funds have large index-linked hedging requirements, relative to the current market size.

1.10 As for the conventional gilts market, it seems unlikely that HM Treasury will act on the potential for low cost funding through issuance of long-dated index-linked-total issuance in the last few years has been only £2-£3bn per annum.

1.11 Specialist issuers (for example utilities) are increasingly issuing index-linked stock. Increasingly, they also consider LPI (Limited Price Indexation) besides full RPI indexation. Other corporates appear reluctant to take advantage of index-linked issuance opportunities, possibly as a result of a preference for nominal rather than index-linked commitments or based on the view, for the reasons set out above, that sterling may not join the Euro.

Section 2 - Current Market Size and Description

Market Size and Breakdown

2.1. As at May 2001, the total size of the market in sterling bonds is about £430bn in market value terms. The main part of the market consists of Gilts (£290bn), but the other bonds segment (corporate bonds and paper issued by non-UK sovereigns) has grown rapidly over the past 5 years and makes up about £140bn.

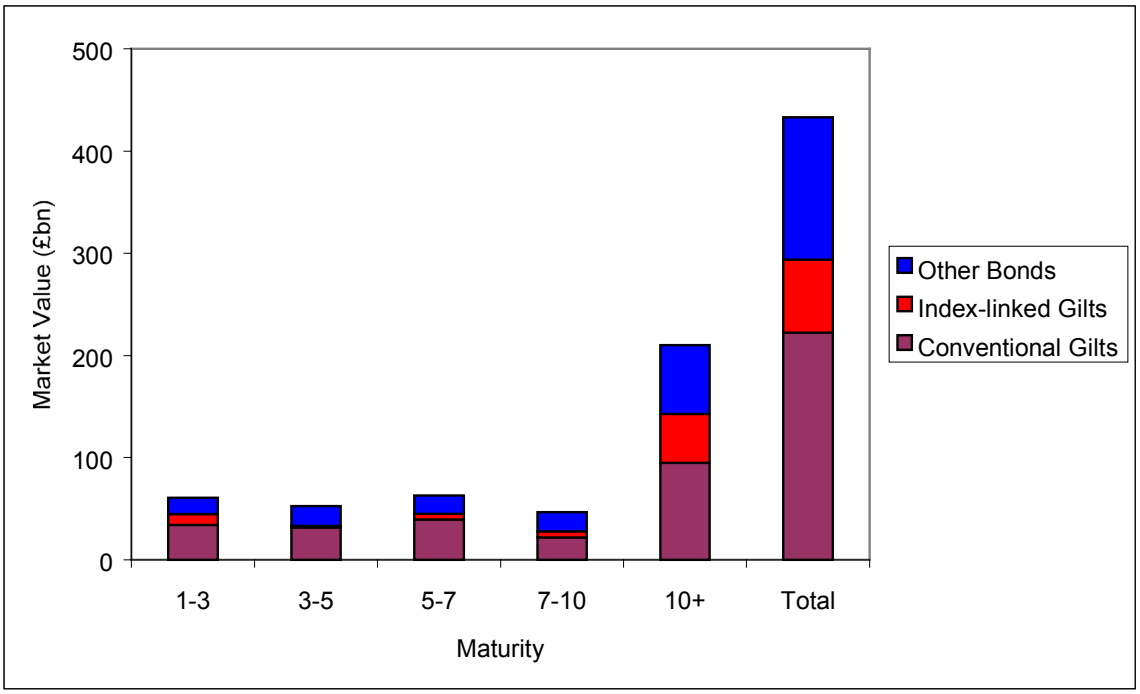
2.2. The following table shows the split of the sterling bond market between Gilts and other bonds and also by term to maturity. Figure 2.1 is a graphical representation of the same data.

Table 2.1 – Breakdown of market by maturity

	£bn		
Maturity	**Gilts**	**Other**	**Total**
1-3 years	**44.6**	**15.9**	**60.5**
3-5 years	**33.4**	**19.1**	**52.5**
5-7 years	**45.2**	**17.8**	**63.0**
7-10 years	**27.7**	**19.1**	**46.8**
10+ years	**142.9**	**67.2**	**210.1**
Total	**293.8**	**139.1**	**432.9**

Source: MSCI Debt Indices, Bloomberg

Figure 2.1 – Sterling bond market by term to maturity

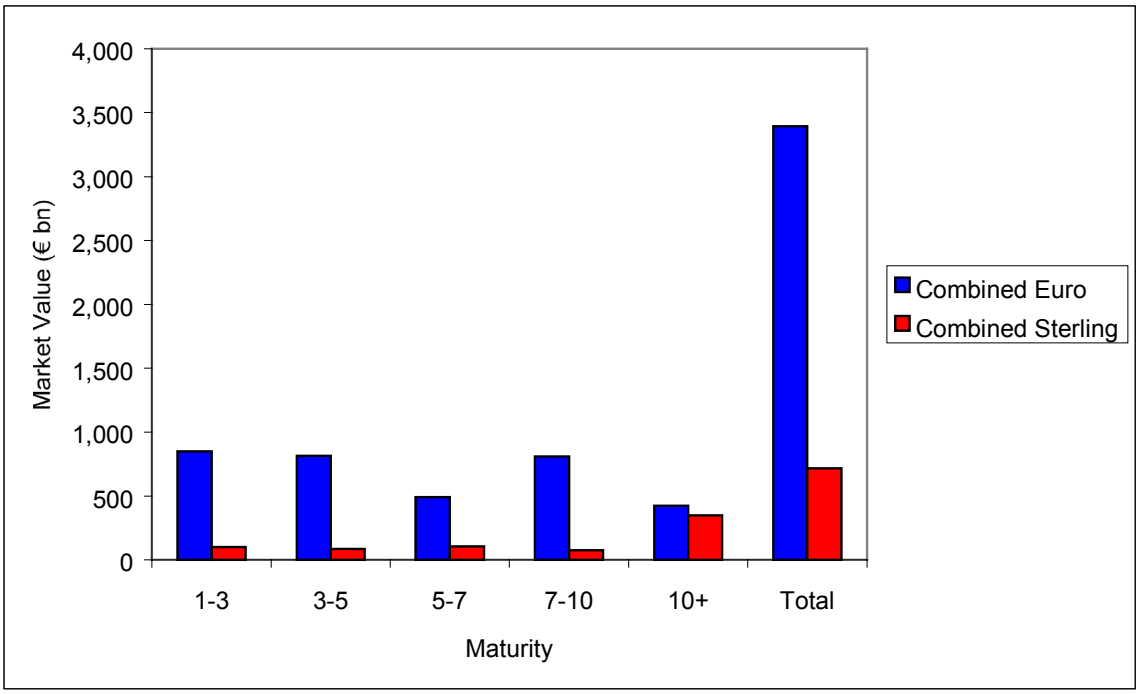


Source: MSCI Debt Indices, Bloomberg

Comparison with the Euro Denominated Bond Market

2.3. By comparison, the total market size for Euro denominated bonds (May 2001) is €3,400bn (≈ £2,000bn) in market value terms, with Government bonds making up €2,400bn and other bonds about €1,000bn. Figure 2.2 shows the full comparison by maturity.

Figure 2.2 – Comparison of UK and Euro markets



Source: MSCI Debt Indices, Bloomberg

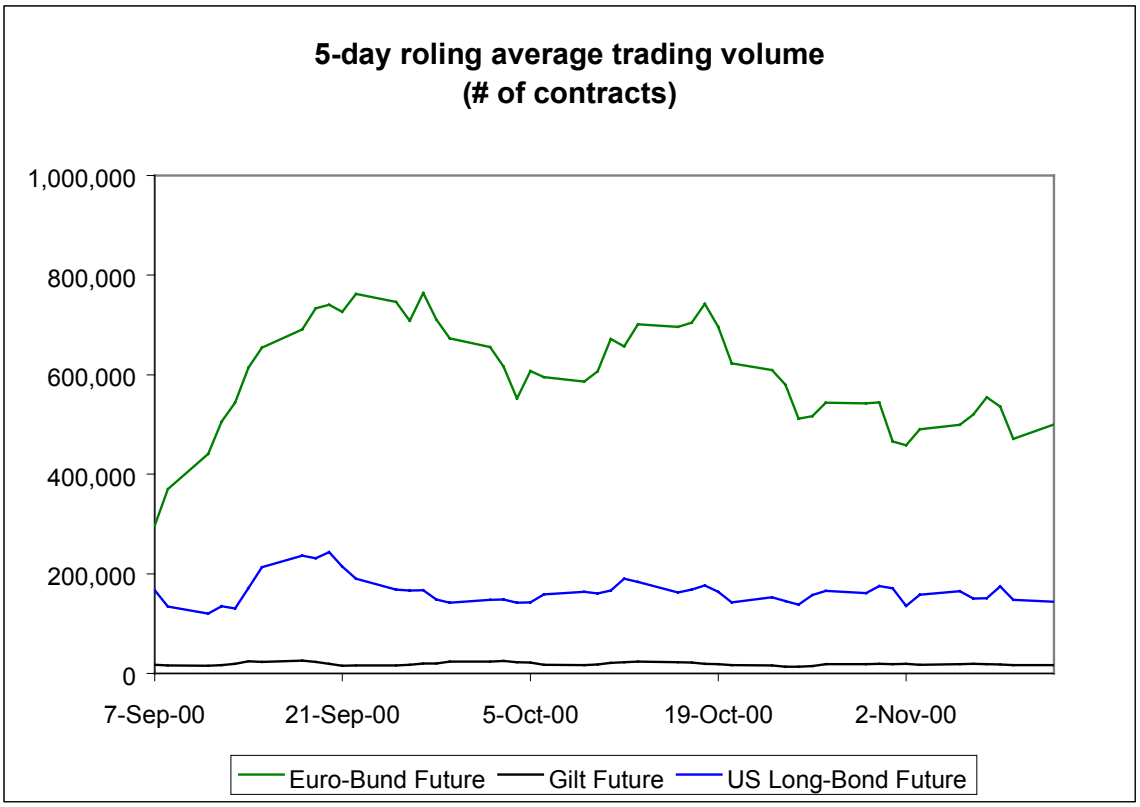
2.4. It is interesting to note that although the Euro denominated market is definitely larger, the 10year + segment is of similar size.

Market Liquidity

2.5. The long end of the Gilt market is often described as 'not very liquid' and 'suffering from a supply-demand imbalance'. These comments should be put into context, as the Gilt market is a liquid market with low transaction costs, when compared generally to other securities markets (e.g. equities/derivatives). However, it might be less liquid than other major Government bond markets. This is explored briefly here.

2.6. Liquidity cannot be checked directly because trades in excess of £50m are not reported. However, an alternative is to look at the futures market for broadly comparable futures contracts for long government bonds. The average daily volume is 20,000 contracts (£100,000 nominal each) for the UK long gilt future, 500,000 contracts (€100,000 nominal each) combined for the Euro notional 10 year bond future and the Bund future and 160,000 contracts ($100,000 nominal each) for the US long bond future. This is illustrated in Figure 2.3 below.

Figure 2.3 – Trading Volumes in Government Bond Futures



2.7. Figure 2.3 shows that trading volumes are lowest in the gilt future. This is to an extent explained by the difference in size of the underlying markets/economies, but the trading volumes in the combined Euro/Bund future are about fifteen times as large as long gilt future volumes.

2.8. The above shows that the long end of the gilt market is likely to be somewhat less liquid than the long end of the Euro bond market. This is, of course, not an issue for market participants, who generally achieve low overall trading costs through their buy/hold strategies. However, UK pension funds with substantial assets that want to increase their bond allocations might have some liquidity issues. This is likely be somewhat easier if the UK joins the Euro, mainly because the Euro bond market is much larger and not dominated by investors who strategically seek to increase their bond holdings. However, the relief will be limited as the sizes of long ends of both markets are similar.

Section 3 - Supply of Sterling bonds

Historic gilts issuance

3.1. Table 3.1 shows the history of the issuance of gilts during the last decade.

Table 3.1

UK Issuance £bn	Conventional			Linkers		
	0-5	5-15	15+	0-5	5-15	15+
2000-01	-	-	4.6	-	0.9	1.7
1999-00	2.5	2.6	6.1	-	0.8	2.3
1998-99	-	2.5	3.1	-	1.0	1.6
1997-98	1.5	11.8	7.6	-	1.7	3.0
1996-97	2.4	19.5	11.5	0.3	2.7	2.8
1995-96	4.1	14.1	8.6	-	2.0	2.6
1994-95	5.2	13.9	7.1	-	1.4	2.0
1993-94	7.9	26.5	12.7	0.3	1.3	4.8
1992-93	2.3	16.3	12.5	0.2	1.9	2.8
1991-92	1.2	8.5	5.9	0.2	0.4	0.4
1990-91	0.2	2.0	-	0.1	-	-

	Total			Overall
	0-5	5-15	15+	
2000-01	-	0.9	6.3	7.1
1999-00	2.5	3.4	8.4	14.3
1998-99	-	3.5	4.7	8.2
1997-98	1.5	13.5	10.7	25.7
1996-97	2.7	22.2	14.3	39.2
1995-96	4.1	16.2	11.2	31.5
1994-95	5.2	15.3	9.1	29.5
1993-94	8.3	27.8	17.5	53.6
1992-93	2.5	18.2	15.3	36.0
1991-92	1.4	8.9	6.4	16.6
1990-91	0.3	2.0	-	2.3

3.2. Gilt Issuance– peaked in 1993/94 and has declined significantly since then. The 5-15 bracket was the largest issue class up to 1998, 15+ thereafter. Conventional gilts issuance is expected to increase over the next two or three years, perhaps to £20bn, given that

receipts from the mobile phone auctions were a one-off benefit to the Government. However, issuance net of redemptions is likely to be minimal. Index linked issuance has been the more stable over time.

Historic corporate issuance

3.3. Table 3.2 looks at the issuance of corporate bonds, up to October 2000.

Table 3.2

Maturity Band Split				£m		
	2000	**1999**	**1998**	**1997**	**1996**	**1995**
<5 years	10,665	10,149	12,808	9,450	6,925	1,825
5-15 years	13,080	13,289	12,325	9,928	9,414	3,745
>15 years	21,655	20,871	11,529	5,957	3,347	4,094
Total	**45,400**	**44,309**	**36,662**	**25,335**	**19,686**	**9,664**

Source: Barclays Capital

3.4. Nearly 5 times as many corporates were issued in the first ten months of 2000 compared with 1995. . Table 3.3 looks at the same data from the perspective of debt rating.

Table 3.3

Rating Band Split						
	2000	**1999**	**1998**	**1997**	**1996**	**1995**
AAA	**25,756**	**20,091**	**20,859**	**11,363**	**5,655**	**2,285**
AA	**4,798**	**8,114**	**7,122**	**5,244**	**6,610**	**2,800**
A	**9,456**	**10,551**	**4,073**	**4,603**	**4,785**	**2,250**
BBB	**2,885**	**2,854**	**1,542**	**1,252**	**1,045**	**265**
BB	**499**	**440**		**450**	**100**	
B	**730**	**1,031**	**1,453**	**400**	**200**	
NR	**1,276**	**1,228**	**1,613**	**2,023**	**1,291**	**2,064**
Total	**45,400**	**44,309**	**36,662**	**25,335**	**19,686**	**9,664**

3.5 The amount of non rated bonds issued has seen a significant reduction over the years. The most secure debt, AAA has seen by far the biggest increase. The relative amount issued was very similar for each of AAA, AA, A and NR in 1995. In 2000, AA saw a reduction, but AAA an increase.

3.6 It should be noted that the figures used for 2000 only run until Oct 2000 and therefore miss the issues in the last two months of the year. This issuance will have taken the total to over £50bn. While this is an increase on 1999 it is a smaller percentage. This could be explained by the poor performance of the corporate market in the first half of the year. With increased uncertainty, investors were reluctant to get involved in the market and stepped back from buying new issuance. This meant that while issuers may have wanted to issue in sterling, there was no market for them. Hence there was a lull in issuance in the middle of the year.

3.7 AA issues are typically the domain of the financial sector 2000 saw a reasonably high level of redemption in this sector, which in most cases did not need to be replaced. The latest structures coming out of the banks have been subordinated which has – in most cases – led to issues being rated in the A category.

3.8 Added to this it should be remembered that both the banking sector and Euro credit market provide very effective competition for the sterling bond market and a number of potential deals will have gone to these markets when demand from investors dried up during the year.

3.9 Non-rated issues have been in decline for years now and it would not come as too much of a surprise if they were to vanish completely over the next few years. The explanation is relatively simple, in that non-rated issues typically came when the sterling market was small and relatively unsophisticated. Companies used secured borrowing in lieu of obtaining a rating as they were issuing to a domestic investor base that already knew the company. As the market grew and the investor base not only became more sophisticated but included overseas issuers, companies could no longer rely on the investor base knowing and understanding their business. Thus it became increasingly important for companies to gain some kind of rating when issuing in the market.

3.10 On the basis that supply and demand will be equal, one needs to examine future potential demand in order to gauge future supply trends. Given limited long-dated gilt issuance, and enormous potential demand from insurers and pension funds, there is large potential for the supply of sterling denominated bonds. In the UK, corporates and financial institutions might reduce their reliance on bank debt, or increase their overall debt/equity mix.

3.11 The impact on overall net supply of overseas sterling borrowing is less clear cut, because institutions will often swap back into local currency. Financial intermediaries will then need to sell sterling bonds to balance their risk positions.

3.12 Any move to link with the Euro could result in large overseas "sterling" borrowing. Given the size of the long-dated UK market, entry to the Euro could see UK yields increase and Euro yields decline. On the other hand, as suggested in the introduction, a decision not to join the Euro could see a significant decline in sterling yields.

Section 4 - Demand for Sterling Bonds

4.1 As a starting point to look at demand for sterling bonds, we look first at who currently holds them.

Table 4.1 Distribution of holdings of gilts in market hands – Q3 2000

Insurance Companies and Pension Funds	**64%**
Overseas	**17%**
Local Authorities and Public Corporations	**1%**
Banks and Building Societies	**3%**
Other Financial Institutions	**6%**
Households	**9%**

Source: Debt management Office Quarterly Review 3rd Qtr 2000 July-Sep.
(website: www.dmo.gov.uk)

4.2 Ownership of the corporate debt market is difficult to assess. For a standard A corporate of around 15 years, we would suspect that around 75% of the market is held with the insurers, 20% with pension funds/IMG's and the rest with mutual funds and the odd overseas.

4.3 For below 10 year paper the position is different. High quality issues will see up to 10% being bought by overseas investors and 10% by banks and asset swappers, this portion will come out of the insurers which have less demand in this area. Incidentally asset swappers will have interest in bonds out to 15 yr. so for 10 – 15 years they may comprise 5% of an issue.

4.4 As a rule of thumb, the higher the quality of the issue, the more likelihood of there being overseas interest, which will decline as the maturity of the bond increases.

4.5 This has evolved from being almost 100% insurers. The overseas element has always been present in the shorter dated high quality stocks but some of this will have been a currency play. The IMG's are relatively new to the corporate market and are still building their teams – this would explain why there has been such an increase in AAA issuance recently as they "dip their toe" into the corporate market.

4.6 Assuming no major cashflow or window dressing exercises, then the seasonal patterns are, as you would expect. The first quarter tends to see the highest level of issuance as issues and structures are put in place before financial year-end. If done carefully this issuance can be done to match demand but there have been a number of occasions when

supply has easily outstripped demand and spreads have widened significantly. The summer months are reasonably quiet from an issuance point of view – or at least, historically they have been! – However as cashflow is still coming in there can be a rally in spreads as investors take out any over hang of stock. The end of the year tends to be complicated by the window dressing exercises.

4.7 As discussed in the section on pension fund specific issues, there is enormous potential demand for sterling bonds from UK defined benefit pension funds. There is a pronounced trend towards more prudent investment strategies, a trend that is being accelerated by regulatory, accounting and legal (trustees with personal liabilities) pressures. The total size of UK defined benefit pension funds is some £700bn. A shift of 20% to a total of 40% investment in bonds, if all sterling denominated, would result in a 30% increase in the overall bond market and represent two years' of total new supply.

4.8 The insurance sector is also likely to be a significant net investor in UK sterling long dated bonds, over and above existing investments. This is for two reasons. Firstly, many insurance products contain guarantees and many companies will be likely to consider adopting hedging strategies in the future, particularly as pressures on capital build-up as a result of next generation low margin stakeholder and similar products. Secondly, many pension policies are approaching selected retirement dates and the volume of immediate annuity business on the books (both index-linked and conventional) is steadily increasing.

Section 5 - Pension Fund Specific Issues

Pension Fund Investment

5.1 UK pension funds are not subject to any specific investment guidelines, except for some self-investment restrictions and the 'prudent man' principle. Typically the majority of assets are invested in equities, with only 17% invested in bonds, of which 12% is in the UK and 5% overseas. Total pension fund assets are £700bn, so pension funds invest about £80bn in government gilts and about £10bn in corporate bonds, both mainly in the long end. These low bond allocations imply that UK pension funds take huge asset-liability risk as the portfolio that matches the liabilities most closely contains almost no equities and is mostly long-dated gilts and corporate bonds, index-linked and conventional.

5.2 Pension funds are estimated to hold about 30% (£60bn) of the 10+ segment of the UK Gilts market and it is believed insurers hold pretty much all the rest – a lot of which is in respect of pension business.

5.3 UK pension funds typically invest around the universe average asset allocation. This approach can be seen as a rational herd-like behaviour. The driving force is that Trustees are not investment experts, there is no clear consensus amongst experts/advisers about what the appropriate investment strategy and how this is determined. This pushes Trustees to seeking the comfort of the median: They hardly get any reward if things go well and can potentially be personally liable if things go wrong! Whether median based strategies will continue to be the minimum risk strategy for Trustees in the future is less clear because increasing use of market values rather than actuarial values, for assets and liabilities, will highlight the risks that members and shareholders are running.

5.4 The use of scheme specific benchmark allocations has increased over the past two decades, but still half of pension funds use the universe median as their target. Besides that, the scheme specific benchmark allocations often do not differ significantly from the industry average. This herd behaviour is best illustrated by comparing the dispersion of asset allocations among UK pension funds with the difference in allocations between pension funds in different countries. If we compare e.g. the average UK pension fund to investment strategies in other countries with similar pension structures (e.g. Netherlands), we note more significant differences between countries than within countries. The Myners review addressed most of these issues and is likely to be a catalyst for change.

5.5 Most pension fund trustees set their investment strategy based on the results of traditional style asset-liability studies. In theory, this is intended to set strategy in relation to the

liabilities. However, these studies often incorporate the reality that substantial deviations from the average are not acceptable and typically set their assumptions in line with this. Also, there is often no clear link between the results of the study and the suggested benchmark allocation. Again, comparing the UK and the Netherlands confirms this. As the pension fund environment is very similar and funds invest in similar assets, one would expect asset-liability models to show similar results. However, consultant recommendations differ widely between both countries, particularly now with some consultants moving towards market value-based rather than actuarial asset/liability modelling.

Regulations

5.6 The Minimum Funding Requirement (MFR) is destined to be abolished after the Chancellor's remarks in his March 2001 Budget. The MFR test links the value of liabilities to a combination of gilts and equities. In general the 'MFR liability-matching' portfolio contains less overseas equities and more gilts than the asset allocation of the typical pension fund. Consequently, it has been said that the MFR has driven pension funds into gilts and therefore increased the pressure on the long end of the yield curve. In practice there is limited evidence for this viewpoint when analysing universe asset allocations.

5.7 There is significant opposition within the government to imposing transparent funding or solvency tests, not least because the typical pension fund is now significantly underfunded. Disclosure of underfunding would be undesirable for some. Whilst transparent disclosure is likely to be beneficial to members and highlights the equity risks being undertaken by pension funds, it would upset actuarial advisors, equity fund managers and company managers. Some argue that increased disclosure would be counter-productive in that it might encourage companies to close their defined benefit schemes.

5.8 Nevertheless, with legal liabilities becoming clearer cut, there is a pronounced trend in the industry towards prudency.

Accounting

5.9 With MFR on its way out, the new accounting standard for retirement benefits, FRS 17, is set to become the most important source of transparent accounting. The ASB recently approved FRS17 and it will be fully operational from 2003, with disclosure in the notes to the accounts from 2001. FRS17 is in line with FAS87 and IAS19 in that it prescribes liability valuation based on corporate bond yields. The difference is that besides the

pensions expense, surpluses and deficits occurring in the pension are realised in the P&L immediately (although 'below the line'). FAS87 and IAS19 specify gradual deficit/surplus amortisation outside a corridor.

5.10 The consequence is that investment performance relative to corporate bonds has an immediate P&L and balance sheet impact. This again might result in pressure for pension funds to increase their bond allocations.

Section 6 - Inflation Linked Sector

History

6.1 Following the launch of the index-linked gilt market in 1981, the first non-government index-linked issue in the UK was made by the Halifax Building Society four years later. Subsequent issues were initially few and far between. By the end of 1998 there had been 11 issues with a total issue size of £642m, the largest of which was one of £131m used towards financing the second Severn River Crossing.

6.2 One particular reason for the lack of issuance was tax related. Issuers were allowed to offset income payments on bonds against tax, but were unable to offset the inflation uplift at maturity on index-linked issues. As this inflation uplift effectively compensates for the lower coupon payments on index-linked issues compared with conventional issues, there was thus a tax disadvantage for a borrower making an index-linked issue. Thus the only issuers were non-taxpayers and those who were unlikely to pay tax during the life of the bond.

6.3 However the total size of the market increased dramatically in late 1999, when following a re-organisation of BG Transco, equity holders were offered index-linked debt (as well as non-index linked and floating debt) in exchange for their equity holdings. With many equity holders wishing to sell their acquired debt, this for the first time provided a marketable alternative to UK index-linked gilts. Since then, there have been a number of other issues from corporate and supra-national issuers so that the market has grown to 41 different issues. Most issues have been of relatively long maturity. In the past few months, much of the issuance has made by arbitrage driven issuers at low margins over gilts.

6.4 A full list of non-government index-linked issues is available on the index-linked section of the UK Debt Management Office web site at http://www.dmo.gov.uk/gilts/index.htm.

Table 6.1 Issuance of non-UK Government Sterling index-linked debt

1985 - 1998	£642m
1999	£797m (of which £503m was BG Transco)
2000	£2074m
2001	£1046m (to May)
Total	£4,560m

Table 6.2 Breakdown of non-UK Government Sterling index-linked debt by final maturity at date of issue

0 –10 years	£7m	0.2%
10-15 years	£32m	0.7%
15-20 years	£1275m	28.0%
20-25 years	£1504m	32.9%
25-30 years	£1039m	22.8%
30-35 years	£525m	11.5%
35-40 years	£178m	3.9%
	£4,560m	

6.5 As far as the authors are aware, all issues have been made with the same structure as government issues i.e. linked to the RPI with a lag of eight months and twice yearly coupons. Indeed many have identical redemption dates to index-linked gilts. However, some do have redemption proceeds amortised according to a pre-determined schedule rather than all the maturity proceeds being paid on a single date. In addition, there have recently been a couple of LPI issues. As might have been expected with the Government's target rate of inflation at 2.5%, the issue yield on an issue with indexation limited to a 0% to 5% range has been similar to RPI-linked issues.

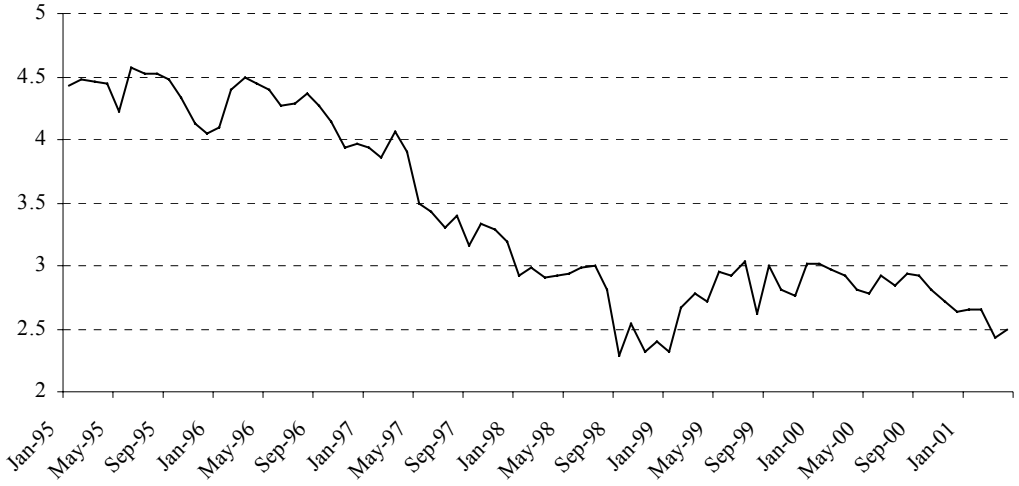
Issuer's Viewpoint

6.6 The reasons why index-linked debt may be more appropriate for an issuer are:

a) For some issuers, the retail price index may be highly correlated with their revenues e.g. utilities where prices are regulated (examples could be Anglian Water, BG and Scottish Power), food retailers (e.g. Tesco), hospital trusts whose rents are linked to inflation or road financing with inflation-linked receipts. Hence there may be a better match of income and outflow if index-linked debt is issued.

b) Index-linked debt may have a lower cash flow cost, as borrowers save the inflation risk premium, although this premium has been declining over the years as inflation uncertainty has decreased. In addition, the borrower may be required to pay less of a margin over government debt than with conventional bonds. For example, in recent months supra-national borrowers have been able to obtain LIBOR funding cheaper via swapped index-linked issues rather than conventional issues.

Chart 6.3 Breakeven inflation rate of UK Treasury Index Linked 2016



Source: Bloomberg

c) An issuer may wish to take advantage of a belief that inflation may turn out lower than the 2.0% or so currently priced by the market (based on a 0.5%pa inflation risk premium).

d) An issuer may wish to take advantage of the lower initial cashflows involved with index-linked borrowing.

Table 6.4 Breakdown of non-UK Government Sterling index-linked debt by issuer type

Utilities	£1,513m	33.1%
Supranational Banks	£1,321m	29.0%
Healthcare	£537m	11.8%
Transport	£291m	6.4%
Housing	£284m	6.2%
Telecommunications	£250m	5.5%
Retailing	£200m	4.4%
Building Socities	£125m	2.7%
Investment Trusts	£39m	0.9%
	£4,560m	

6.7 However, some issuers are reluctant to commit themselves to a redemption payment denominated in real rather than nominal terms.

Demand

6.8 From the investor's point of view the fact that margins on index-linked issues are often slightly lower than that for conventional issues indicates that there is demand for index-linked issues. Many bonds suffer from a lack of liquidity: almost by definition bonds are being bought to match inflation-linked liabilities. For investors not too worried by liquidity, an issue such as BG Transco, where the real yield is currently around 4.2% compared with 2.4% on a gilt of the same maturity, might be attractive, depending on one's view on credit.

The Future

6.9 Following the recent Dwr Cymru (Welsh Water) issue, further water company issuance may follow as a result of restructuring in the sector. At the moment there is no index of non-gilt sterling index-linked issues. An investment bank has considered producing such an index. Although this would be useful for investors, investment managers may be reluctant to be benchmarked against a benchmark where so many of the constituents are unmarketable. With the proportion of the index-linked market in non-governments still only around 7% compared with a number approaching 50% for the conventional market, there is plenty of scope for the index-linked non-government sector to increase.