

European Fixed Income Research: Sterling

Anomalies VI: 07Dec2015

Gilt STRIPS Inevitable

- **January auction to be of a new 8% 07 Dec 2015 stock, same coupon dates as 8% 2000 and 8½% 2005.**
- **Matching coupon dates ⇒ STRIP market coming. Bullish for 8½% Dec 2005 and 8% Dec 2015.**
- **Tax implications bullish for non-FOTRA and high coupon stocks.**

On 17 January 95 the Bank of England announced that the January auction will be of £2 billion of a new FOTRA stock, maturing on 07 Dec 2015 with an 8% coupon. This announcement is of great importance for the gilt market.

In the past the BoE has attempted to ensure that different gilts have different coupon dates. Hence stocks with matching dates have been rare and typically issued years or even decades apart. Last September the BoE auctioned the 8½% 07 Dec 2005, which is now the 10 year benchmark. In October 1994 the BoE announced that that month's auction would be of an 8% 07 Dec 2000. The matching coupon date prompted speculation that the BoE might be preparing for a STRIP market (*Anomalies IV: 6%99, 8%00 & STRIPS, 19 Oct 94*). The announcement on 17 Jan of a third stock maturing on 07 Dec (the 8% 2015) strongly supports our view of the Bank's new issuance policy. (However, we do not anticipate any further new issues until Q3 95 as the BoE will probably wish to reopen these three stocks to build up the issue size.)

The new 8% Dec 2015 is particularly important for those cash constrained investors tracking long indices. Currently it is not possible to buy British government debt with duration longer than 10.5 years (ignoring the relatively illiquid perpetuals). When the 8% 15 becomes STRIPPABLE each of the cashflows beyond 10.5 years will have a longer duration than can be accessed through any other gilt. The only way that these cashflows can be constructed will be by STRIPPING the 8% 15. Hence the 8% 15 will be in demand, and will remain in demand.

The creation of a STRIP market has other implications. Both STRIPS and the forthcoming gilt repo (see *Anomalies* articles dated 18 Aug and 30 Nov 94) would be greatly facilitated by a change in the procedure by which the Inland Revenue collects income tax from holders of gilts. In our view the market consensus is that the simplest and best solution is for

Table. Below are shown issue sizes and estimated prices & yields for the various pieces of the STRIPS (assuming that all of the three 07 Dec issues are stripped). Note that the early coupons have much larger issue sizes than the later coupons. This is because several bonds contribute to issue size of the early coupons — they will therefore be more liquid. Of course, this fungibility of coupons is only possible when coupon dates match.

Type	Date	Approx Cost	Yield	Nominal IssueSize	Approx Total Present Value
P.O.	07 Dec 2000	60-06++	8.812%	£2,800m	£1,685.8m
P.O.	07 Dec 2005	39-23+	8.662%	£4,400m	£1,748.4m
P.O.	07 Dec 2015	17-27	8.426%	£2,000m	£356.9m
Cpn	07 Jun 1995	97-22+	6.035%	£452m	£441.5m
Cpn	07 Dec 1995	94-04	6.972%	£379m	£356.7m
Cpn	07 Jun 1996	90-07++	7.557%	£379m	£342.0m
Cpn	09 Dec 1996	86-08+	7.976%	£379m	£326.9m
Cpn	09 Jun 1997	82-13+	8.257%	£379m	£312.4m
Cpn	08 Dec 1997	78-23 +	8.461%	£379m	£298.4m
Cpn	08 Jun 1998	75-06+	8.594%	£379m	£285.0m
Cpn	07 Dec 1998	71-27++	8.690%	£379m	£272.4m
Cpn	07 Jun 1999	68-22++	8.746%	£379m	£260.4m
Cpn	07 Dec 1999	65-23	8.784%	£379m	£249.1m
Cpn	07 Jun 2000	62-28 +	8.804%	£379m	£238.3m
Cpn	07 Dec 2000	60-06++	8.812%	£379m	£228.2m
Cpn	07 Jun 2001	57-22	8.807%	£267m	£154.0m
Cpn	07 Dec 2001	55-09	8.800%	£267m	£147.6m
Cpn	07 Jun 2002	53-00 +	8.785%	£267m	£141.5m
Cpn	09 Dec 2002	50-25++	8.770%	£267m	£135.7m
Cpn	09 Jun 2003	48-23++	8.751%	£267m	£130.2m
Cpn	08 Dec 2003	46-25	8.734%	£267m	£124.9m
Cpn	07 Jun 2004	44-29	8.717%	£267m	£119.9m
Cpn	07 Dec 2004	43-03 +	8.699%	£267m	£115.1m
Cpn	07 Jun 2005	41-12+	8.679%	£267m	£110.5m
Cpn	07 Dec 2005	39-23+	8.662%	£267m	£106.1m
Cpn	07 Jun 2006	38-05 +	8.643%	£80m	£30.5m
Cpn	07 Dec 2006	36-20++	8.627%	£80m	£29.3m
Cpn	07 Jun 2007	35-06++	8.610%	£80m	£28.2m
Cpn	07 Dec 2007	33-26 +	8.595%	£80m	£27.1m
Cpn	09 Jun 2008	32-15	8.580%	£80m	£26.0m
Cpn	08 Dec 2008	31-06 +	8.567%	£80m	£25.0m
Cpn	08 Jun 2009	29-31 +	8.553%	£80m	£24.0m
Cpn	07 Dec 2009	28-25++	8.540%	£80m	£23.0m
Cpn	07 Jun 2010	27-21++	8.527%	£80m	£22.1m
Cpn	07 Dec 2010	26-18++	8.516%	£80m	£21.3m
Cpn	07 Jun 2011	25-17++	8.504%	£80m	£20.4m
Cpn	07 Dec 2011	24-17+	8.494%	£80m	£19.6m
Cpn	07 Jun 2012	23-18++	8.485%	£80m	£18.9m
Cpn	07 Dec 2012	22-21 +	8.475%	£80m	£18.1m
Cpn	07 Jun 2013	21-25	8.466%	£80m	£17.4m
Cpn	09 Dec 2013	20-29 +	8.457%	£80m	£16.7m
Cpn	09 Jun 2014	20-03 +	8.448%	£80m	£16.1m
Cpn	08 Dec 2014	19-10 +	8.441%	£80m	£15.5m
Cpn	08 Jun 2015	18-18	8.433%	£80m	£14.9m
Cpn	07 Dec 2015	17-27	8.426%	£80m	£14.3m

Notes for the table. Some of the coupon dates fall on weekends, these have been moved forward to the Monday. The estimated prices assume that settlement would have taken place on 18 Jan 95, and are calculated from a smooth forward rate curve constructed from non-callable conventional gilt prices as of the close of 17 Jan 95. Hence these estimates will not necessarily sum to the exact current market price of the three 07 Dec issues each bond.

the Inland Revenue to allow all gilt dividends to be available on a gross basis, with quarterly self-assessment of tax liability by domestic holders. We believe that the Inland Revenue will accept that the costs of allowing gross coupon payments will be more than offset by the gain of cheaper financing in a more efficient market. Other tax rules applying to deep discount bonds may also need to be modified.

If the gilt market is to switch to gross payment of coupons then any premium currently associated with FOTRA stocks will disappear. Further, a STRIP market will allow holders of high coupon bonds to attach 'additional principal', thus lowering the effective coupon. (See box opposite.) Any premium currently associated with low coupon bonds should substantially reduce.

Conclusions.

- The new 8% 15 will be much in demand. Currently this is yielding only 1 bp less than the 8³/₄% Aug 2017, and is trading roughly level with the 6¹/₄% Nov 2010. We believe that, because of its future STRIPPABILITY this bond will acquire a substantial premium to neighbouring stocks, possibly of 8 or 10 bp. (Note that the potentially STRIPPABLE 8%00 is 15 bp rich to fair value). Holders of ultra long stocks should switch into the WI.
- The inevitability of STRIPPING will support the current 10-year benchmark, the 'STRIPPABLE' 8¹/₂% Dec 2005, particularly against the previous 10-year benchmark, the 6³/₄% Nov 2004. As there will be much more demand for STRIPPING the 8¹/₂%05 than the shorter 8%00 the 10-year should trade more expensively to the curve: it is currently much cheaper. Holders of the 6³/₄%04 should switch into the 8¹/₂%05.

Using STRIPS to Lower Coupon

Consider buying £60 nominal of a gilt with a 10% coupon, and also buying £40 nominal of a STRIP with a similar maturity date to the 10% gilt. We now have an instrument with £100 'principal' that has a coupon of only 6%, and this can be thought of as a 6% bond. As taxed investors adopt this type of approach the prices of both high coupon gilts and STRIPPABLE gilts will be supported.

- The BoE will want to increase the issue size of the 8% 15 (from £2bn) with at least one further auction, probably in Q2. This supply (coupled with the repo market starting in July) will help to disinvert the curve. Those able to duration-weight switches from the ultra-longs into the peak of the curve should do so. Alternatively, if possible, switch shorter cash-for-cash and then bolster duration with swaps, options or futures.
- The increased likelihood of gross payments will support higher coupon stocks. Switch stocks maturing after 1999 into the 9³/₄% Aug 2002 or 10% Sep 01, duration-weighted.
- Those willing to take a slight option risk should consider the high-coupon callable issues, especially the 11³/₄% Jul 2003-2007, the 12¹/₂% Nov 2003-2005 and the 13¹/₂% Mar 2004-2008.

For more details of individual gilt anomalies see
Gilt Anomalies II: Repo Anticipation Wiseman 18 Aug 94
Gilt Anomalies III: FOTRA Switches Wiseman 31 Aug 94
Anomalies IV: 6%99, 8%00 & STRIPS Wiseman 19 Oct 94
Anomalies V: Gilt Repo Announced Wiseman 30 Nov 94