MPS and AJ Bell Funds update – April 2020

Plugging the (income) gap

Like all investors with a desire for income from their investments, the hit we've seen from COVID-19 has come quick and hard.

Old rules of thumb have been upended. Governments and central banks have stepped in in ways even those with the battle scars of 2008/09 would have thought unthinkable. And as the virus has spread, workforces have been forced into hibernation, causing dividend payments from equities to quarantine themselves along the way.

The dividend cuts from this crisis are stark. Many are precautionary in nature. Lots have been Government- or regulator-mandated, and now – faced with a groundswell of public opinion – even organisations which are willing and able to make distributions are opting to husband their cash for a later date.

For portfolios with income targets or objectives, this places investors in something of a quandary. Do you sit tight and accept lower income for the immediate future? Do you tip-toe past the dividend landmines to get income in other stocks or sectors? Or do you abandon equities altogether and seek out more certain sources of yield?

This is the decision facing us in the portfolios we manage at AJ Bell which have income objectives etched into their DNA.

Thankfully, as managers of multi-asset portfolios, the range of options available to us is larger than those available to managers of single-strategy funds. And so, with the choice of shrugging our shoulders and accepting lower yields or spinning the wheel on who will be next to chop their dividend, we have opted to take a third path with a **pivot away from UK equities into global high-yield bonds** – shifting 10% of our UK equity exposure in our [portfolio] in the process.

Are you mad? Everyone knows that default rates are bound to go up!

Yes. Default rates will increase. And yes, some bonds in the high-yield world will not make it to the other side. We have factored this into our decision-making process, where yields on global high yield in excess of 10% already account for significant increases in defaults. Even after taking higher defaults into account, we would expect the annualised return on high yield from here to be more like 8.5–9.0% p.a. – a figure in line with our long-term expectations for equity markets.

Why not go for safer forms of income like government bonds or even investment grade debt?

These were options we considered. Alongside our income objectives, the goal of the [portfolio] is to not only produce an income of 3–5% p.a., but also to protect against the impact of inflation. Given the degree of central bank intervention in more traditional bond markets, this inflation protection is simply not available in 'higher-quality' bond instruments.

OK, so why not emerging market debt? Surely countries are safer investments than companies right now?

Not in our opinion. The impact of this coronavirus is global and the response from all governments will result in higher levels of state borrowing. Whilst more developed nations – which would typically be asked to provide assistance to struggling, more emerging countries in times of crisis – are themselves under the cosh, the prospect of IMF-style bailouts is significantly lower than would otherwise be the case, and so the traditional escape hatch for emerging nations is currently closed.

Another reason is that – on top of this – countries only have access to one form of capital: debt. Unlike companies, which can raise **both** debt *and* equity.

How does equity help?

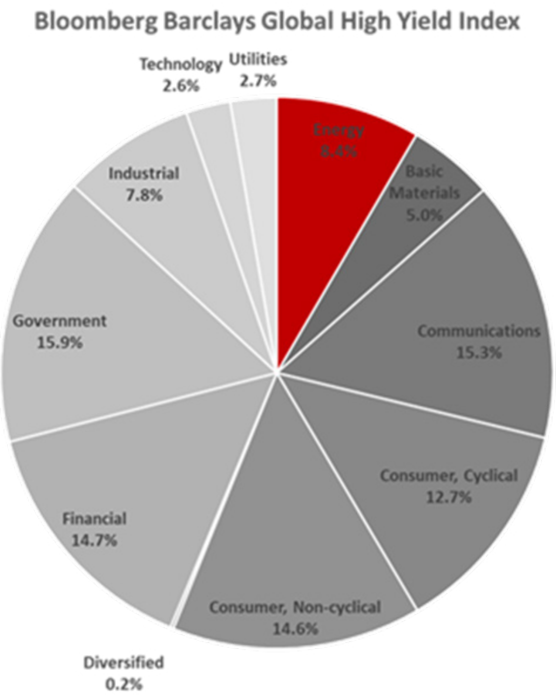
We accept that some issuers of high-yield debt will default. One way of avoiding defaults, however, is to raise equity. These equity raises bring in much needed cash-flow and improve the state of the company's balance sheet, making the risk of default fall in the process. We think we're at that stage of the credit cycle, when equity raises will come thick and fast.

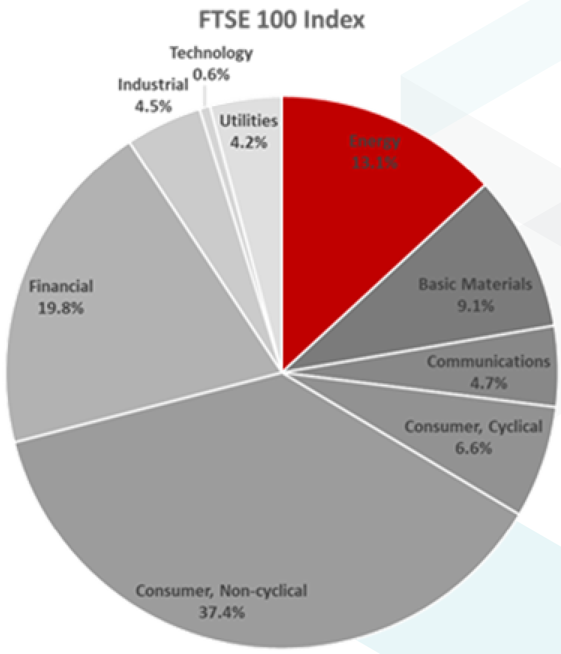
But what about when the recovery eventually does come? Won't you miss out on the rally?

Again, we don't think so. The overall performance of high-yield bonds and equities tends to be very similar over time. The sources of return are different, but the overall return is closely correlated. In the event of market conditions that see equity markets turning skyward, we would expect the same conditions to advance high-yield bonds at the same time – and with the prospect of equity raises seemingly on the horizon, we think there's a good chance that the returns may come to high yield ***before*** they come to equity markets.

Everyone knows that high-yield bonds are massively exposed to the oil sector though. What about the oil price? Surely that hurts high-yield bonds more than it hurts equities?

This falls into the category of 'things you are sure are true, but actually aren't'. Yes, there is some oil market exposure in the high-yield bond markets, but nothing like as much as is commonly perceived. The sector breakdown of the [benchmark] Global High Yield index and the FTSE 100 index demonstrates where the biggest oil and gas exposure sits.





OK, I get it. So how have you implemented this within your portfolios?

Passive Income 2 MPS

Within the Passive Income 2 portfolio, we will be funding the high-yield position through a 5% reduction in the iShares FTSE 100 ETF, and a full exit of the SPDR UK Dividend Aristocrats ETF.

Given the uncertainty of dividends in the UK, we believe it is prudent to remain as diversified as possible. The SPDR product is fairly concentrated, targeting 40 holdings; as such, we believe it is sensible to exit this product fully, with the remainder funded with the FTSE 100 tracker. We will be switching into the iShares Global High Yield (GBP Hedged) ETF, in line with the growth portfolios. This will lead to a 0.04% increase in the OCF due to the higher cost of high-yield products.

Active Income 2 MPS

In the Active Income portfolio, we are using our existing high-yield manager, Baillie Gifford, to implement this change. The fund is relatively conservatively managed, with a clear focus on quality. This is indicated by 70% of the portfolio being in BB or above assets and a process that is not focused on picking over the recovery value of distressed assets.

To fund this, all three UK equity managers are being reduced to broadly maintain the current spread of assets and, overall, this will reduce the underlying OCF by 0.04% per annum.

AJ Bell Income & Growth Fund

The Income & Growth Fund will mirror the approach already taken within the Income fund and being used in our Active Income 2 MPS portfolio: initiating a position in Baillie Gifford to enact the high-yield positon.

To fund the switch, we will be making equal reductions in our iShares FTSE 100 tracker and the Man GLG UK Income Fund, resulting in a 0.01% reduction in the underlying OCF per annum

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