AJBell

Active Managed Portfolio Service – Q2 2018 report

Introduction

We are delighted to bring you the latest quarterly report from AJ Bell Investments. Designed to keep you up-to-date on what is happening with your AJ Bell managed investments, it covers the major macro-economic events of the past three months, looks at how these have impacted the portfolios, and highlights any changes made in the period.

Summary

As we reach the mid-way point in 2018, it has been the case of a tale of two halves, with the first quarter proving to be highly volatile with equity markets struggling to make headway, while in the second quarter, many major markets moved higher amid a less volatile backdrop. The overall picture has been one where Asian and emerging market equities have struggled while the UK and US have managed to deliver positive returns.

The constant in both quarters has been highly volatile currency markets which are having a large influence on the overall performance of assets, particularly for UK investors who are seeing big moves in the level of sterling this year.

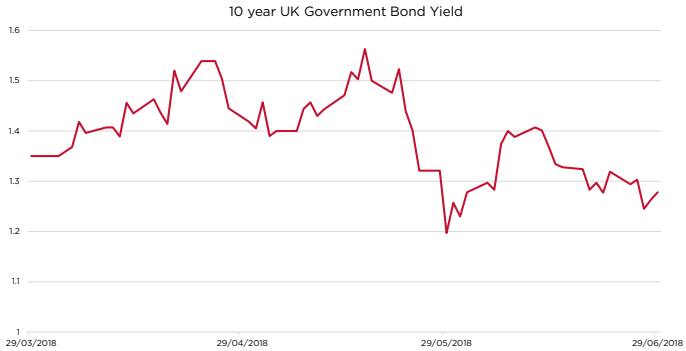
What is clear is that major central banks, with the exception of Japan, are in a period of tightening which will ultimately constrain the availability of liquidity in global markets. The Federal Reserve increased rates over the period and indicated its intention to raise further well into 2019, while the ECB informed markets that it intends to stop its monthly bond buying programme at the end of the year. While the global economy continues to grow, albeit at a slower pace, these actions indicate that central banks are confident that companies have the ability to thrive without the constant need for a backstop in the economy.

However, the onset of a trade war between the US and the rest of the world certainly has the potential to cause a few headaches as the year progresses. The risk coming from political factors is increasing across the world and we are cognisant that the intertwined nature of the global economy may mean that volatility picks up again and moves back to what would be considered more normal levels.

Economic and market review

The second quarter of 2018 saw positive returns come from a number of equity markets, however, fixed interest markets were more challenged while Asia and the emerging markets suffered on the back of a large strengthening of the US dollar.

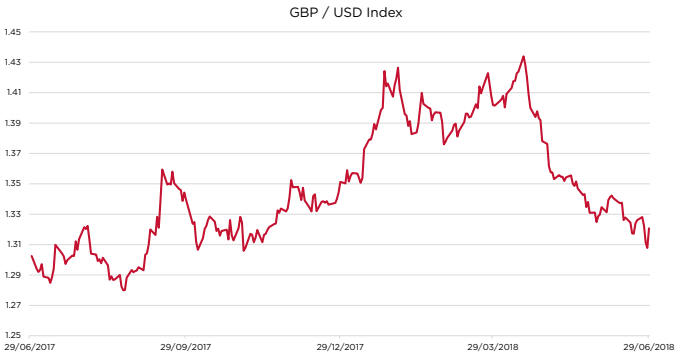
Having been one of the worst performers in the first quarter, the FTSE 100 Index was comfortably the strongest performing major market in the second quarter. While in Q1, the market was held back by strong sterling, in Q2, it was sterling weakness that was the major factor, helping those companies in the index that derive a significant proportion of their profits in US dollars deliver strong returns. Uncertainty over Brexit was certainly a major factor in this currency weakness, while indications from the Bank of England that the economy was perhaps not strong enough to cope with higher interest rates was seen positively by investors, in that low interest rates would be here for longer. This caution was reflected in the yield on the 10-year UK government gilt, which started the period at 1.39%, widened out to 1.54% during April and May on expectations that rates would rise, before falling back sharply in late May and June when the Bank of England decided against the rate rise. At the end of the quarter, the yield was down to 1.33% reflecting a greater level of prudence amongst bond investors than is currently being seen by equity investors. This volatility in bond markets ultimately saw UK bond indices broadly flat over the quarter.



Source: Bloomberg LLP, AJ Bell Investments: July 2018

US equity markets continued their strong performance with a solid quarter from the S&P 500 Index helped by strong economic growth. Unemployment continued to fall and hit its lowest level since April 2000 at just 3.8% while GDP growth came in at 2% for the first quarter. This economic performance was enough for the Federal Reserve to have confidence that a rise in interest rates was warranted and as a result, the rate was increased by 0.25% in the June meeting. This was the seventh time the Fed has decided to raise interest rates since the end of ultra low rates was signalled in December 2016 and shows just how far the world's largest economy has moved on since Quantitative Easing, and the latest minutes from the Fed meeting indicated that further rises were likely over 2018 and into 2019. During the quarter, the 10-year US Treasury yield climbed back through 3% for the first time since 2012, before falling back beneath this level as the end of the quarter approached.

With the prospect of higher rates, the US dollar strengthened sharply over the period as the economic strength of the country proved attractive to investors. A move of over 6% against sterling helped significantly improve the return of US equities for UK investors once this was converted back to sterling, while the dollar also moved noticeably against the euro and the Japanese yen.



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At a political level, Donald Trump was at the heart of some major developments over the period. Mid June saw the unexpected sight of Trump shaking hands with Kim Jong-un, leader of North Korea, in a summit held in Singapore. Both leaders declared themselves happy with the talks and indicated that efforts to de-nuclearise the Korean peninsula would begin shortly. While time will tell whether the desired outcome of the talks actually materialises, the world welcomed the progress made by the two countries who up until recently had traded insults across the Pacific.

While Trump was making friends in North Korea, he was also doing his level best to upset leaders in Europe, Mexico, Canada and China with the imposition of a series of tariffs on imported goods. The US fired the opening salvo in the trade war with Europe and China, slapping a 25% tariff on steel imports and then Europe responded, introducing tariffs on nearly £2.5bn of US goods such as Harley Davidson motorbikes, whiskey and jeans, while China slapped tariffs on cars, planes and soybeans. This tit-for-tat trade war is a serious threat to the global economy and could reduce global growth as the cost of imports increases across the world. With Trump clearly pushing an 'American first' agenda, and with the knowledge that despite being the largest economy in the world, the US remains a relatively insular country that relies heavily on domestic demand, he is emboldened to take the fight to the rest of the world. Investors across the world continue to watch this developing story with concern and should it escalate further, it has the ability to create significant headwinds for the global economy.

A strong US dollar and trade wars meant that Asian and emerging markets struggled over the quarter, with both equity and bond markets falling back in these regions. In China, while economic growth was robust, the People's Bank of China saw it necessary to ease monetary conditions by cutting the reserve requirement ratio to help banks provide liquidity for smaller companies. Chinese data was particularly interesting over the period as it indicated a clear move towards building an economy reliant on domestic demand rather than simply being an exporter. This was reflected by data that showed that in the first quarter, 78% of the country's growth was driven by the domestic economy.

Over the quarter, there was clear divergence in country performance between the stronger nations and those with weaker economies. With the oil price increasing by over 13% during the period, those countries that are reliant on oil imports were hit particularly hard, and so were those countries that have issued significant government debt in US dollars, as their weakening currencies made US dollar-issued debt ever more expensive to service. Argentina was forced to call in the IMF for a $50bn loan while Turkey and Brazil also saw their currencies weaken significantly. The result was very challenging performance of emerging market bonds over the quarter, with the JP Morgan GBI EM Index falling back sharply.

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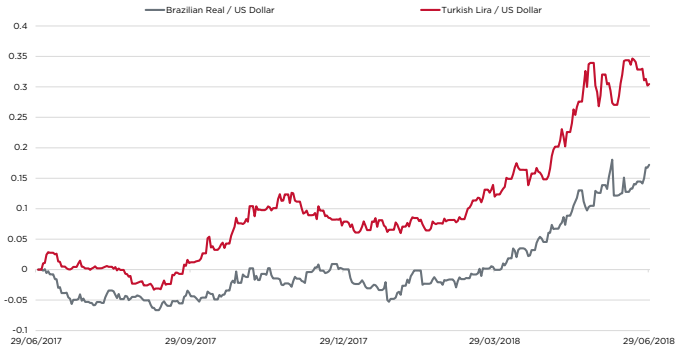

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In Europe, there were signs that the economy was beginning to slow as economic indicators pointed to more challenging conditions. The real issue in Europe once again was politics, with the Five Star Movement in Italy finally forming a government after their choice of finance minister, and ardent anti-Euro campaigner was vetoed by the country's President. With a compromise reached, focus shifted to their plans for looser fiscal policies despite high levels of debt and the continuing issue of economic migrants but it is clear that with such strong rhetoric, there is likely to be further tension within the EU nations. Over the quarter, Italian equities unsurprisingly performed poorly given the instability within the country, while France was much stronger as the reform agenda being pushed by President Macron moved forward following a high profile spat with railway operator SNCF.

Market outlook and our positioning

Overall, the second quarter was a period that saw significant divergence in the performance of major markets across the world. The main driver for all of this has been the currency markets and most importantly the strength of the US dollar, particularly for UK investors who have benefited from holding overseas assets as sterling has weakened. Looking ahead, with the US economy continuing to benefit from the Trump tax cuts, it seems plausible that the US dollar may stay strong for a while, particularly if other parts of the world begin to slow down as the impact of the strong dollar feeds through into the global economy, although, we may not see such a strong period of strengthening as we saw in this recent quarter.

The challenge ahead is to try and decipher the mixed messages that are now coming from both the equity and fixed interest markets. While equity investors seem broadly happy that corporate profits have the ability to keep growing from current levels, albeit perhaps at a slightly slower pace than we have been used to, fixed interest investors are pricing in a more unstable environment ahead. With an escalating trade war between the world's major nations, there is a clear risk that this could impact global economic growth, however, it is also clear that an all-out trade war is in nobody's best interests. Whether this rational thought is enough to stop certain world leaders is difficult to second guess!

On balance, we continue to see value in equity markets but it would be imprudent to assume that equity markets will simply move higher without some bumps in the road. As a result, our approach is to remain well diversified in each of the portfolios and not become overly reliant on any one area for returns.

Within the Active portfolios, we have two tactical positions in place, both designed to mitigate capital losses should economic conditions change. The first of these is to have our gilt exposure invested in short duration (less than five years) gilts as we expect interest rates to rise over time. This short duration exposure should limit the losses seen in gilts if this scenario occurs as we expect it to. The second position is actively deciding not to own UK commercial property on valuation grounds. In its place, we have instead invested in two absolute return strategies that offer low correlation to traditional assets

and importantly exhibit lower levels of volatility, similar to that of commercial property.

The first quarter reminded everyone that volatility can reappear quickly and while markets were a little more muted in the second quarter, it wouldn't be at all surprising if both equity and fixed interest markets saw an increase in volatility through the rest of the year.

Active Managed Portfolio review – Q2 2018

Introduction

On 19 February 2018, AJ Bell launched a range of actively managed portfolios (growth and income), adding further options to the AJ Bell Managed Portfolio Service to sit alongside the existing passively managed portfolios. This now brings the service up to 16 portfolios (eight active and eight passive) offering advisers a strong breadth of choice, with six growth portfolios and two income portfolios for both active and passive investors. The comments below relate to the model performance of the active portfolio range.

It brings great pleasure to report the first full quarter's performance for the AJ Bell Active Managed Portfolios, following a successful launch during the first quarter of 2018. We pride ourselves on transparency and feel it is important to provide regularly updates to advisers on the service; however, we would kindly remind readers that our underpinning investment philosophy remains long-term in nature.

Active MPS Growth

Across the active growth range, the portfolios delivered a set of very strong absolute returns over the quarter, spurred on by a risk-on environment witnessed early on in the review period that ultimately tapered as the period came to a close. Since launch (19 February 2018) to the end of the second quarter of 2018, it is pleasing to report that all growth portfolios sit in positive territory.

At an overall level, an allocation to equities was a particularly strong contributor while fixed interest exposures yielded mixed results. Early on in the second quarter, equities benefited from both a continuation of strong economic data and a ramping up of M&A deals. The dedicated technology exposure, gained through a holding in the Polar Capital Global Technology fund (Portfolio 3-6) was a benefit as the sector continued to deliver, especial during the course of May 2018 with around 10% gains witnessed in that month alone. At the regional level, the strongest-performing areas included US and UK equities, which account for a large proportion of the equity component across all growth portfolios. US dollar strength accounted for some of the gain from US equities when reported in sterling terms. Equity markets however were not positive across the board, with emerging markets delivering negative absolute returns as US dollar strength impacted those economies directly and the portfolios' exposure here detracted from quarterly returns. Brazilian equities suffered on the back of further political uncertainty, falling by around 25% in sterling terms (Brazilian real weakness exacerbates the fall) over the quarter.

Within the fixed interest allocation, a number of the managers such as the Fidelity MoneyBuilder Income and TwentyFour Corporate Bond funds were broadly flat against their respective benchmarks. In the global bond sector, the M&G Global Macro Bond fund (Portfolio 1-4) performed very well, helped by its exposure to the US dollar while the M&G Emerging Markets Bond fund (Portfolio 1-5) managed to navigate some very challenging markets.

When looking at the equity allocation, the Investec UK Alpha fund (Portfolio 3-6) delivered a strong relative return against the FTSE All Share Index with stock selection proving to be beneficial particularly in the consumer and financials sectors.

In Asia, our core manager of Invesco Perpetual Asian (Portfolio 2-6) delivered a good positive return and also outperformed both its benchmark and the peer group, helped by exposure to the technology sector. On the negative side, both the Fidelity Emerging Markets fund (Portfolio 2-6) and the Man GLG Japan CoreAlpha fund underperformed their respective benchmarks. Man GLG Japan CoreAlpha suffered a headwind owing to its inherent biases towards value as an investment style, which has continued to struggle versus growth over the period. We remain confident in the long-term prospects of both of these strategies given our experience with each of the management teams.

From a Tactical Asset Allocation perspective, the lower-risk portfolios are underweight duration through exposure to the Lyxor FTSE Actuaries UK Gilts 0-5yr ETF (Portfolio 1-4) which invests in shorter-dated UK government bonds, and this proved to be ever so slightly beneficial over the quarter. The environment flickered between risk-on and risk-off and whilst the longer-duration gilts market delivered broadly flat returns, it was a very volatile period. Elsewhere, versus the long-term Strategic Asset Allocation, UK commercial property was not implemented due to concerns over the current valuation levels and potential economic headwinds. In its place, an allocation to two absolute return strategies, namely the M&G Absolute Return Bond fund (Portfolio 1-5) and the Janus Henderson UK Absolute Return fund. The ambition is to provide strong diversification away from traditional equities and bonds and give an element of capital preservation should equity markets see volatility increase further. Janus Henderson delivered a solid positive return over the period while M&G Absolute Return Bond was marginally negative. Both of these strategies underperformed UK commercial property over the short term.

Overall, the portfolios have behaved within our expectations from a risk/reward perspective during the recent quarter.

Portfolio changes

As each of these growth portfolios follows a long-term investment approach, there have not been any changes to the underlying holdings or exposures, aside from market drift. We do however remain focused on ensuring that each of these portfolios is exposed to the most appropriate investments and therefore, should the need arise to undertake changes to the underlying holdings, we will not hesitate to alter the current portfolios' positioning.

Active MPS Income

The absolute performance of the portfolios was strongly positive over the second quarter. This is mainly due to the portfolios' exposure to equities, which rebounded strongly from a period of weakness witnessed at the end of the first quarter. Since launch (19 February 2018) to the end of the second quarter of 2018, it is pleasing to report that both income portfolios sit in positive territory.

From a high level, an allocation to equities was a particularly strong contributor while fixed interest exposures yielded mixed results. Early on in the second quarter, equities benefited from both a continuation of strong economic data and a ramping up of M&A deals. Within equities, UK equities were a standout performer and account for a large portion of the equity component of the portfolios. Equity markets however were not positive across the board, with emerging markets delivering negative absolute returns as US dollar strength impacted those economies directly and the portfolios' exposure here detracted from quarter returns.

On a relative basis, the portfolios' contributors came from the Artemis Global Income and JPM Emerging Markets Income funds. The JPM Emerging Markets Income fund managed to protect against a weak market backdrop but was unable to cling on to a positive return. In a similar vein, the Jupiter Asian Income fund also performed well both in relative and absolute basis as

its focus on highly cash generative companies was rewarded amid investor uncertainty. On the flip side, the UK equity funds were positive but rose to a lesser extent than the FTSE All Share index, which was predominately driven by large caps where most active managers are structurally underweight.

Away from standard equity exposure, the dedicated infrastructure fund Premier Global Infrastructure Income delivered broadly a flat return, underperforming the benchmark in the main due to its exposure to emerging markets. Property exposure through both the iShares UK Property ETF and L&G Global Real Estate Dividend Index fund produced very strong performance over the period.

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Fund	3 months	6 months	1 year	Inception*
Active MPS 1	2.65%			1.39%
Active MPS 2	3.48%			1.34%
Active MPS 3	4.85%			2.13%
Active MPS 4	5.74%			2.54%
Active MPS 5	6.18%			2.64%
Active MPS 6	5.48%			2.47%
Active MPS Income 1	5.55%			1.83%
Active MPS Income 2	6.64%			3.89%

*Active MPS launched on 19 February 2018.
Source: Bloomberg LLP

This report provides general information about the AJ Bell Managed Portfolio Service. It should not be read or construed as investment advice. It is your responsibility to assess your client's circumstances and make a personal recommendation that is suitable for their needs.

The value of investments can go down as well as up and your client may not get back their original investment.

Past performance is not a guide to future performance and some investments need to be held for the long term.

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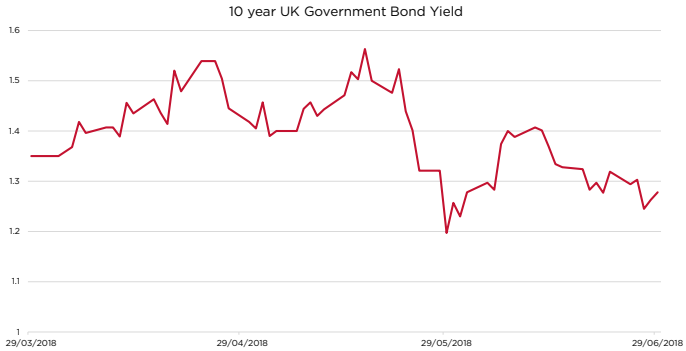

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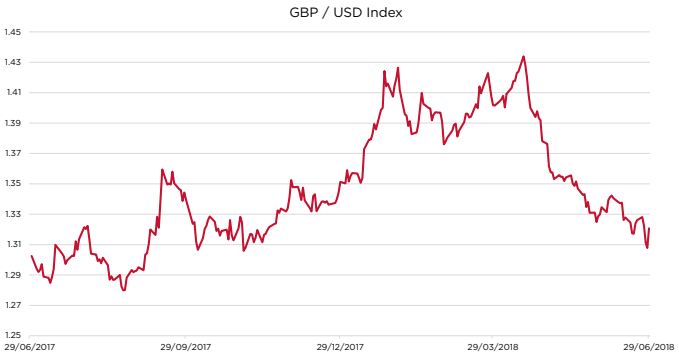

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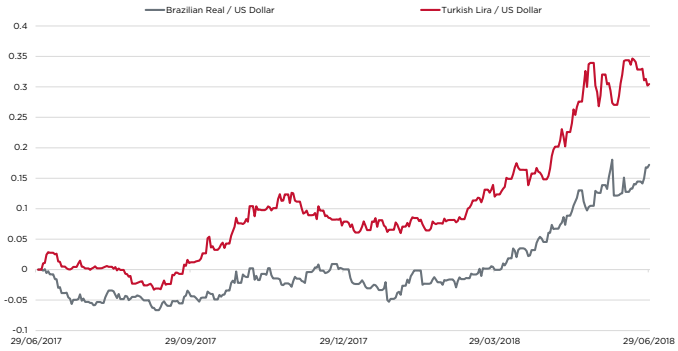

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Market outlook and our positioning

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The challenge ahead is to try and decipher the mixed messages that are now coming from both the equity and fixed interest markets. While equity investors seem broadly happy that corporate profits have the ability to keep growing from current levels, albeit perhaps at a slightly slower pace than we have been used to, fixed interest investors are pricing in a more unstable environment ahead. With an escalating trade war between the world's major nations, there is a clear risk that this could impact global economic growth, however, it is also clear that an all-out trade war is in nobody's best interests. Whether this rational thought is enough to stop certain world leaders is difficult to second guess!

On balance, we continue to see value in equity markets but it would be imprudent to assume that equity markets will simply move higher without some bumps in the road. As a result, our approach is to remain well diversified in each of the portfolios and not become overly reliant on any one area for returns.

Within the Passive portfolios, we have one tactical position in place, designed to mitigate capital losses should economic conditions change. Our gilt exposure is invested in short duration (less than five years) gilts as we expect interest rates to rise over time. This short duration exposure should limit the losses seen in gilts if this scenario occurs as we expect it to.

The first quarter reminded everyone that volatility can reappear quickly and while markets were a little more muted in the second quarter, it wouldn't be at all surprising if both equity and fixed interest markets saw an increase in volatility through the rest of the year.

Passive Managed Portfolio review – Q2 2018

Introduction

On 19 February 2018, further options were added to the AJ Bell Managed Portfolio Service to sit alongside the existing passively managed portfolios. This now brings the service up to 16 portfolios (eight active and eight passive) offering advisers a strong breadth of choice, with six growth portfolios and two income portfolios for both active and passive investors. The comments below relate to the model performance of the passive portfolio range.

It is now over four months since we launched our passive income options and added a sixth higher risk growth portfolio. This complements our five existing growth portfolios, which are fast approaching their second anniversary. We are pleased to see a strong performance track record building, consistent with our projections; an important factor in any outcome-orientated portfolio solution.

Passive MPS Growth

Against a backdrop of strong equity performance in developed markets, weaker performance in emerging regions and benign returns for fixed income investments, we are pleased to see good absolute returns over the quarter, especially as volatility returns to the market. Back in February when we launched the new portfolios we also moved the asset allocation process in house, enabling us to add in additional asset classes, improving the diversification of the portfolios. We added higher risk asset classes such as Global Technology alongside lower risk assets such as short duration gilts and Emerging Market Debt. We also made the conscious decision to remove some of the currency risk in the portfolios in favour of taking more equity risk.

It's almost impossible to get all decisions right all the time, however on balance the changes have helped performance. The removal of currency risk hindered returns as the US dollar performed strongly, however a reallocation of risk to Global Technology – one of the best-performing markets over the quarter – more than offset this. Despite the weak performance of Emerging Market Debt when measured in dollar terms, this asset class did benefit from the positive performance of the dollar, increasing returns for a sterling investor.

On a longer-term view we are concerned about the current low yields on UK government securities. As such all our gilt positioning is in a short-dated (less that five years to maturity) gilt ETF. Over the quarter the decision to be in shorter bonds had a small positive effect, as the expectations of rate rises diminished on weaker economic data, and the CPI Index, the Bank of England's preferred inflation measure, stabilised at 2.4%. After years of easy monetary policy we believe the risk to inflation is on the upside, and therefore feel it is prudent to own short maturity bonds, which would suffer smaller capital losses in the event of an inflation spike, whilst still offering some protection against geopolitical and recessionary risks.

The entire range has exposure to UK property through investment in a UK REIT ETF. This performed strongly, outperforming physical property indices over the quarter as the discount to net asset value of the majority of the holdings in the ETF narrowed. Performance for the quarter ranged from 2.65% for our lowest-risk MPS 1 portfolio to 6.18% for our second-highest risk MPS 5 portfolio. Our highest risk portfolio delivered a slightly lower return of 5.48%, as Emerging Market and Asian equities underperformed developed markets such as the US and UK.

Portfolio changes

As each of the growth portfolios follows a long-term investment approach, there have not been any changes to the underlying holdings or exposures, aside from market drift. We do however remain focused on ensuring that each of these portfolios is exposed to the most appropriate investments and therefore, should the need arise to undertake changes to the underlying holdings, we will not hesitate to alter the current portfolios' positioning. We expect to make some changes on the 18 July rebalance date, with the dual focus of reducing third party OCFs and introducing new ETFs that meet the objectives of our asset allocation in a better fashion.

Passive MPS Income

The objective of the Income 1 portfolio is capital preservation over a longer time horizon, and a competitive yield (currently we see this as somewhere close to 4% based on yields for different parts of the market and central bank interest rate policy across the globe). The objective for Income 2 is the same yield target, however it aims to grow capital at least in line with CPI inflation over the longer term.

This equates to around a 4% per annum total return target for Income 1, and around 6% for Income 2.

Over the quarter Income 1 delivered a total return of 5.55% and Income 2 delivered 6.64%, both ahead of their long-term objectives, as income generating sectors such as Oil and Gas performed particularly well. Our High Yield Bond exposure is denominated in dollars, and performance was boosted in Income 1 due to this currency position.

Portfolio changes

As each of these income portfolios follows a long-term investment approach, there have not been any changes to the underlying holdings or exposures, aside from market drift. We do however remain focused on ensuring that each of these portfolios is exposed to the most appropriate investments and therefore, should the need arise to undertake changes to the underlying holdings, we will not hesitate to alter the current portfolios' positioning. We expect to make some changes on the 18 July rebalance date, with the dual focus of reducing third party OCFs and introducing new ETFs that meet the objectives of our asset allocation in a better fashion.

Fund	3 months	6 months	1 year	Inception*
Passive MPS 1	2.65%	0.14%	2.96%	4.0%
Passive MPS 2	3.48%	0.10%	3.72%	7.3%
Passive MPS 3	4.85%	1.00%	4.98%	10.8%
Passive MPS 4	5.74%	1.78%	6.19%	13.7%
Passive MPS 5	6.18%	1.48%	6.53%	15.3%
Passive MPS 6	5.48%			3.17%
Passive MPS Income 1	5.55%			5.11%
Passive MPS Income 2	6.64%			5.21%

*MPS1-5 launched on 18 August 2016, MPS 6 and Income portfolios launched on 19 February 2018.

Source: Bloomberg LLP

This report provides general information about the AJ Bell Managed Portfolio Service. It should not be read or construed as investment advice. It is your responsibility to assess your client's circumstances and make a personal recommendation that is suitable for their needs.

The value of investments can go down as well as up and your client may not get back their original investment.

Past performance is not a guide to future performance and some investments need to be held for the long term.

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