AJ Bell Income Funds – Q3 2019 report

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments covering the Income funds over Q3.

This report is 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

With weakening sterling due to heightened concerns of a potential hard Brexit, both equities and bonds broadly delivered positive returns over the quarter, helping to propel year-to-date returns to over 20% for global equities. With the Federal Reserve cutting interest rates and clear indications of further stimulus in other major economies, investors continued their 'risk on' approach, knowing that central banks were ready to act if necessary.

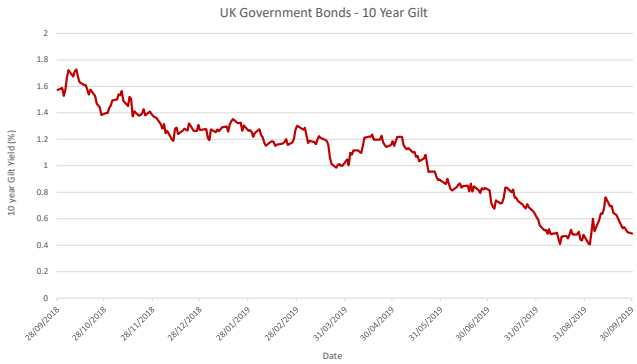
In the UK, Brexit was once again in the spotlight, with Boris Johnson installed as the new Prime Minister who then caused controversy by proroguing parliament before having the move overturned in court. Trade wars continued to escalate, while government bond yields fell sharply as investors digested the prospect of further central bank stimulus.

Economic and market review

The third quarter of 2019 was much tougher than earlier in the year, with a significant pick up in volatility and a wider dispersion of returns across both bonds and equities as investors looked to digest the direction of the global economy and the fragile state of global politics in a number of key regions. While equities overall finished in positive territory, it was lower-risk government bonds that performed strongest, as a combination of fears of a global slowdown and interest rate cuts in the US saw bond yields fall back. Sterling was weak over the period, and this had a significant effect on the returns of overseas markets, boosting returns to UK investors.

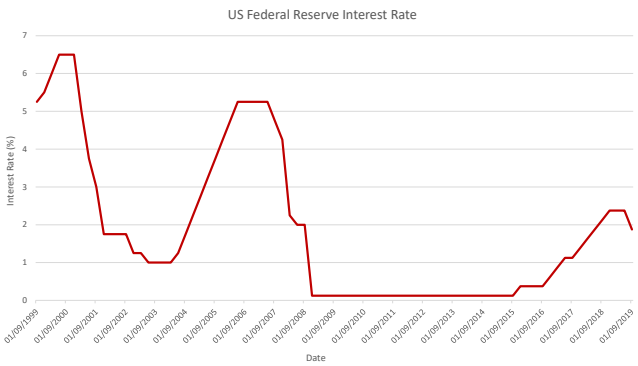
Needless to say, it was Brexit that dominated the headlines in the UK over the quarter, which started with the appointment of Boris Johnson as Prime Minister who immediately toughened the language on Brexit. This led to UK gilt yields and sterling falling sharply, as the risk of 'no deal' with the EU increased. However, Parliament flexed its muscles to pass a law forcing Johnson to request an extension to the 31 October deadline. With the prorogation of Parliament then overturned in the Supreme Court, it is not clear at this point what will happen over the next few weeks. Economic data over the quarter was mixed, with GDP contracting by 0.2% in the second quarter and retail sales also falling back, however, unemployment continued to fall. Over the period, sterling fell by over 3% against both the US dollar and Japanese yen. This fall was beneficial to larger UK companies that generate a large proportion of their earnings from overseas, and overall the FTSE All Share Index increased by 1.3% over the period.

With heightened risk of a 'no deal' Brexit, the 10-year gilt yield fell sharply, just as it did during the previous quarter. At the end of the period, the yield stood at just 0.49%, but this masked significant volatility during the quarter as rates bounced around as each political event unfolded. This helped the FTSE Actuaries UK Conventional Gilts All Stocks Index increase by 6.2% over the quarter. With risk running high, it was not surprising to see high quality corporate bonds also perform well over the quarter, as the iBoxx UK Sterling Corporate All Maturities Index increased by 3.7%. The higher risk Bloomberg Barclays Global High Yield Corporate Bond GBP Hedged Index increased by 0.9%.



Source: Bloomberg LP, AJ Bell Investments, September 2019

In the US, following talk of a shift by the Federal Reserve on its interest rate policy, the rate was reduced by 0.25% at the end of July, representing the first cut in rates in the US since December 2008. Jerome Powell, Chairman of the Federal Reserve, indicated that he did not expect this to be the start of a lengthy cutting cycle as economic growth remained, but clearly the Fed was concerned enough by the impact of the continuing trade war with China to provide stimulus into the economy. Over the quarter data was mixed with business confidence, retail sales and manufacturing data all hitting lower levels than a year ago. While in August, manufacturing data hit a decade-low level before rebounding a little in September. This led to US GDP coming in at 2.3% for the 12 months to the end of June, some way lower than the dizzy heights seen in 2018 when growth hit 3.2% fuelled by President Trump's tax reforms. As the quarter progressed, the Fed then cut interest rates again in the middle of September, leading to President Trump accusing the Federal Reserve Chairman of lacking guts for not reducing rates further. In his accompanying remarks, Jerome Powell said that there were uncertainties in the global economy and conditions worsened over the summer with job creation slowing and inflation coming in lower than hoped. During the quarter, the yield curve inverted, or in other words, rates on the 10-year Treasury were lower than the 2-year Treasury. This is significant because it is seen as a reliable indicator of a recession, as the same event has occurred before most recessions in the US since 1950. This backdrop saw equities move slightly higher in USD terms but in GBP terms the S&P 500 Index increased by 4.9% over the period. The interest rate cuts saw the US 10-year Treasury yield fall from 2.0% at the start of the quarter to 1.67% at the end of the quarter, resulting in a strong rally for US bonds.



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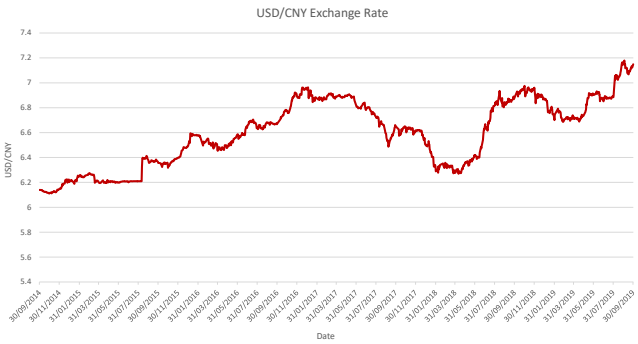
In Europe, events were dominated by the manoeuvrings of politicians to finalise the next round of appointments to the top jobs. The Chairman of the ECB, Mario Draghi, will be replaced by Christine Lagarde, currently Head of the IMF, in what was seen as a relatively uncontentious appointment given her support for the policies implemented by Draghi over recent years. Draghi looked to leave a legacy, with strong hints to the market that he expected Quantitative Easing to be restarted in order to help support the ailing European economy. This sent government bond yields tumbling, with the German 10-year Bund falling further into negative territory. This stimulus requirement was in part driven by very poor data coming from Germany, which saw manufacturing data register its steepest decline since the financial crisis a decade ago and GDP fall 0.1%, making it highly likely that Europe's largest economy will have slipped into a recession when the next data point is released. Away from Germany, European data was a little better, particularly in the services area which helped overall economic growth remain positive, but it is clear that growth has all but stagnated leading the ECB to point to further stimulus. Over the period, the MSCI Europe ex UK Index increased by 1.7%.

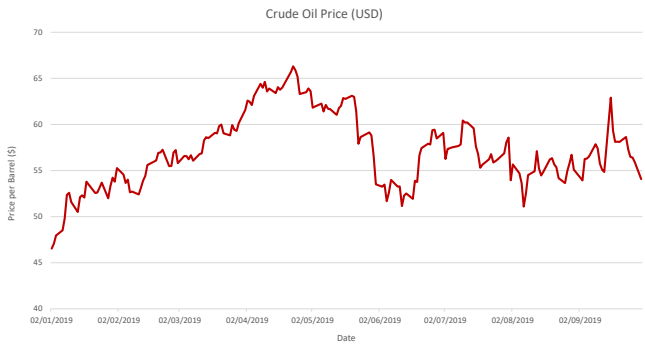
In Asia, focus has been on China and the impact of the ongoing trade war with the US, which introduced further tariffs on China in September, leading to China inevitably retaliating. To help the Chinese economy, the central bank allowed the Renminbi to break through the psychological 7-to-the-dollar level, which prompted a strong response from the US as well as providing further stimulus to the banks to encourage further lending. Manufacturing data rebounded strongly in September, however business confidence remained subdued, not helped by the continuing unrest in Hong Kong. Away from China, retail sales in South Korea increased sharply in August after falling in three of the previous four months, while in India Corporation Tax was surprisingly cut from 30% to 22% in an effort to boost investment and growth which currently sits at a six-year low. This is on the back of four cuts in interest rates in four months by the country's central bank. Over the period, the MSCI Ac Asia ex Japan Index fell back -1.4%.



Source: Bloomberg LP, AJ Bell Investments, September 2019

In Japan, economic growth came in at 1% for the second successive quarter after a weaker previous period. Exports were weak, with a fall of over 8% on a year-on-year basis in August, while manufacturing data hit a seven-month low as the slowdown in China hit the export-led market of Japan hard. Unsurprisingly, this meant that business confidence came in worse than expected, hitting a three-year low and, as a result, the Bank of Japan indicated it would be ready to step in with further support for the economy given it saw increasing risk from overseas. Having been the worst-performing major market in Q2, the Topix Index bounced back in the third quarter, delivering a positive return of 6.5%, helped by sterling weakening against the yen.

In the emerging markets, those countries exposed to a strengthening US dollar struggled, with the likes of Turkey, South Africa and Brazil all suffering. The big event over the quarter was the collapse in Argentina following a surprise election result which saw the currency fall well over 20% against the US dollar, and the stock market lose nearly half its value in just a week – reminding everyone just how volatile some of these countries can be. The Middle East also saw increased tensions during the period after a bombing of Saudi Arabia's main oil facility. The oil prices spiked 5% on the news that production would be reduced for a period of weeks before it could be brought back on tap. Over the period, the MSCI Emerging Markets Index was down by 1.1%, while emerging markets fixed interest was positive, with the JPMorgan GBI Emerging Market Global Composite Bond Index increasing by 2.3% over the period.



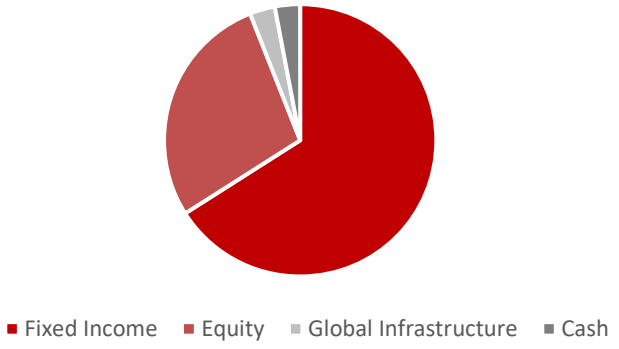
Source: Bloomberg LP, AJ Bell Investments, September 2019

Asset allocation and positioning

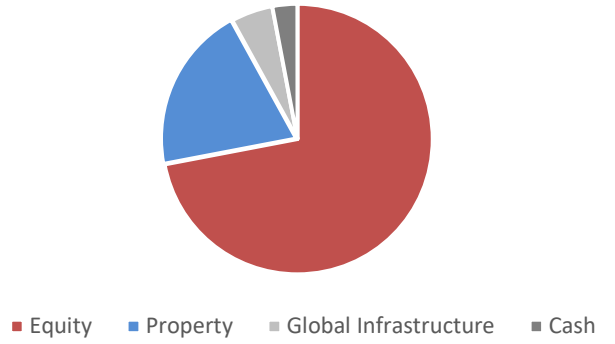
As highlighted previously, with Brexit continuing to dominate the headlines in the UK, the third quarter was, in the main, another challenging one for sterling, which continued to bear the brunt of the negative newsflow. Although we don't actively seek to trade specific currencies, as investment managers, we need to remain cognisant of the currency exposures we hold as a result of our asset allocation decisions, as fluctuations between them add another layer to the returns received by investors. That being the case, in a similar vein to Q2, a volatile sterling was a significant factor in the performance seen across the portfolios this quarter, with the fall in the currency boosting returns from overseas holdings.

On the Income range, both mandates have a 4% income target, with the lower-risk mandate looking to protect capital on the downside and the higher-risk one looking to protect capital from the effects of inflation. In order to achieve this the two strategic allocations have very different makeups, with the lower-risk allocation being a blend of equity, fixed income, global infrastructure and cash, whilst the higher-risk one eschews fixed income in favour of larger equity weights, a UK and global property allocation, global infrastructure and cash. As a result of the differences in allocation, the drivers of returns and yield differ across the two mandates, with the lower-risk earning the bulk of its yield from fixed income holdings, whilst the higher-risk earns yield from dividends from equities.

AJ Bell Income Fund



AJ Bell Income & Growth Fund



Source: AJ Bell

In the quarter, as concerns for global economic growth increased amidst a number of headwinds, central banks returned to a more dovish tone and stance, with further easing seen in Europe and the US, and an increased probability of cuts being priced into the UK curve, due to 'no-deal' Brexit risks. This led to strong gains for high quality fixed income as yields fell, helping the lower-risk income portfolio, which holds significant fixed income exposures. When we set the strategic asset allocation for the portfolios in February 2019, a conscious decision was taken to further diversify our fixed income exposures in the lower-risk portfolios. To this end we included allocations to unhedged US treasuries and US corporates, as well as hard currency emerging market debt. All three sub-asset classes provided strong returns in Q3, with the Bloomberg Barclays US Corporate Bond Index returning over 3% in local currency and over 6% in sterling terms, whilst the Bloomberg Barclays Hard Currency Emerging Market Debt Index returned over 4% in sterling terms.

On the higher-risk portfolios, the lack of fixed income exposures saw us diversify the sources of yield within equities instead when we set the strategic allocation at the start of the year. This saw us add Asia Pacific, emerging market and North America equities to the portfolios. In Q3, Asia Pacific and emerging market equities saw falls, as trade war concerns and a stronger US dollar impacted returns, however, a weaker sterling did help offset the worst of this. Pleasingly, North American equities had a much stronger quarter, up over 4% in sterling terms.

Whilst we don't allocate to specific equity sectors (with the exception of Global Infrastructure, which we see as a distinct asset class), due to our yield mandate we are by default larger holders of companies in more mature sectors. Industries that are mature are able to pay out more of their earnings as income, due to the lower growth opportunities available in their field. Utilities and consumer staples are two of these sectors and, due to their characteristics, they can act bond-like, or 'defensive' during risk-off periods. Unsurprisingly, therefore, given the political and economic headwinds seen across markets and the outperformance of quality, the best-performing equity sectors in the portfolios were utilities, real estate and consumer staples.

All market performance figures are in GBP.

AJ Bell Income funds review – Q3 2019

Fund performance

The funds are mainly invested in rules-based, or passive ETFs, alongside holdings in active open-ended funds where we believe this is a more appropriate route to invest in this asset class to achieve our 4% yield objective.

The active funds used performed well this quarter. Within infrastructure we use the **Legg Mason RARE Global Infrastructure Fund**. This delivered a total return of 5%, 1% ahead of the return of the infrastructure benchmark we use to represent the asset class. Another strong performer was the **Baillie Gifford High Yield Bond Fund**, in this case 3% ahead of the high yield bond benchmark. Our Active selection in UK corporate bond selection didn't fare quite so well, lagging the benchmark by 2% over the quarter. Our remaining active holdings were within 1% either way of the benchmark return.

Our passive holdings continued to perform as expected, with some slightly ahead and some slightly behind, which is no surprise given the nature of income investing, leading to some factor tilts away from the standard equity benchmarks.

Fund changes

The funds launched on 8 April, and since then no changes have been made. The funds have been fully invested throughout the period.

Fund holdings are continually reviewed and changes, where appropriate, will be made on an ongoing basis and communicated in a timely fashion.

This report provides general information about the AJ Bell funds. It should not be read or construed as investment advice. It is your responsibility to assess your circumstances and make sure it is suitable for your needs.

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

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

The target yields are not guaranteed and can fluctuate.

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