AJ Bell Passive funds – Q3 2019 report

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments, covering the Passive 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.

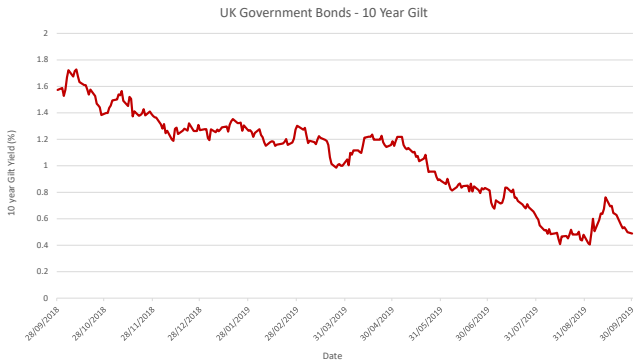
In the UK, Brexit was once again in the spotlight, with Boris Johnson installed as the new Prime Minister who then caused controversy by proroguing parliament before having the move overturned in court. Trade wars continued to escalate, while government bond yields fell sharply as investors digested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

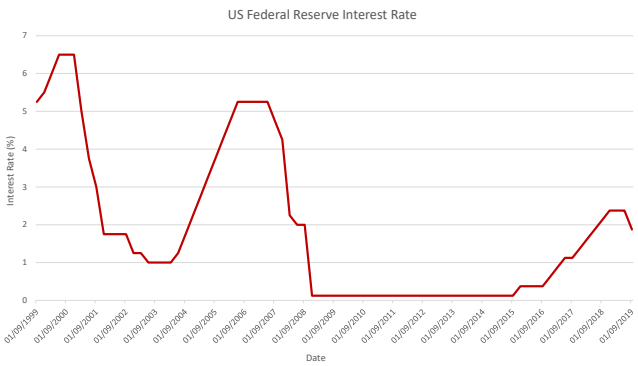
Needless to say, it was Brexit that dominated the headlines in the UK over the quarter, which started with the appointment of Boris Johnson as Prime Minister who immediately toughened the language on Brexit. This led to UK gilt yields and sterling falling sharply, as the risk of 'no deal' with the EU 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

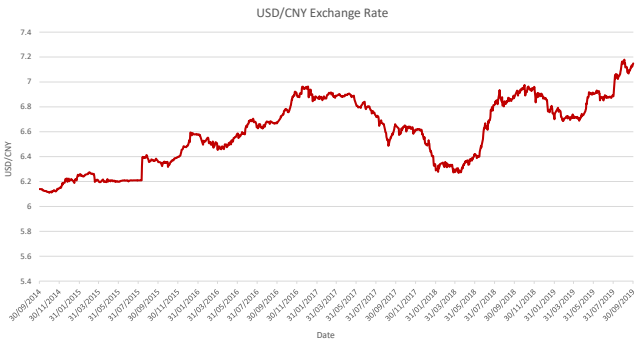
In the US, following talk of a shift by the Federal Reserve on its interest rate policy, the rate was reduced by 0.25% at the end of July, representing the first cut in rates in the US since December 2008. Jerome Powell, Chairman of the Federal Reserve, indicated that he did not expect this to be the 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.



Source: Bloomberg LP, AJ Bell Investments, September 2019

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%.

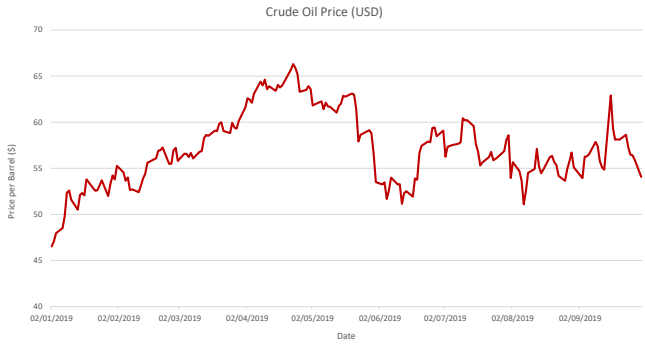
In Asia, focus has been on China and the impact of the ongoing trade war with the US, which introduced further tariffs on China in September, leading to China inevitably retaliating. To help the Chinese economy, the central bank allowed the Renminbi to break through the psychological 7-to-the-dollar 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.

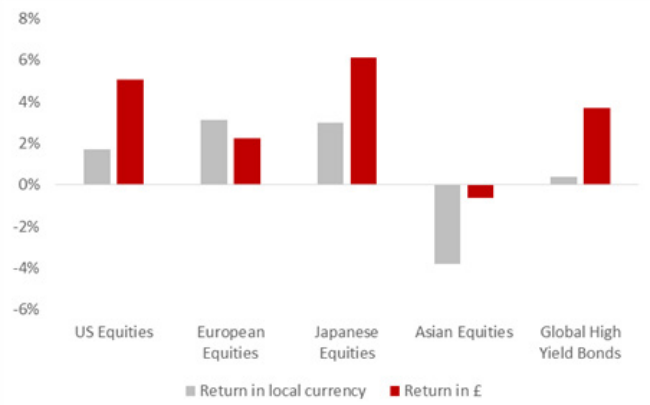
In the emerging markets, those countries exposed to a strengthening US dollar struggled, with the likes of Turkey, South Africa and Brazil all suffering. The big event over the quarter was the collapse in Argentina following a surprise election result which saw the currency fall well over 20% against 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.



Selected asset class returns for Q3 2019, Source: AJ Bell Investments, Bloomberg LP, September 2019

However, in Q3, currency was not the only factor at play, with the quarter seeing notable dispersion in returns across regions and asset classes, as significant macro-economic and poilitical stories were digested by investors. With Brexit wrangles in the UK, an ongoing US/China trade war, a European economic slowdown and dovish central banks, the multi-asset nature of the portfolios came to the fore, as the lower-risk products benefited from their significant holdings of high quality government and corporate debt, whilst the higher-risk products benefited from equity returns, which were further enhanced on translation back into sterling. This led to most of the portfolios, regardless of risk profile, returning similar levels of performance in the quarter of between 1.5% and 3%, with only our highest-risk allocation lagging (albeit still positive at around 1%) due to holding no fixed income exposures and significant Asia Pacific and emerging market allocations, which fell in the period.

When we reset our strategic asset allocation back at the turn of the year, there was a conscious effort to further diversify the broader asset classes we hold, with additional equity sectors such as global consumer staples and global healthcare being added to global technology, along with some more focused fixed income allocations, like short-duration US treasuries, currency-hedged US corporate bonds and hard currency emerging market debt. It was pleasing, therefore, to see some of these allocations helping in the quarter, as uniformity began to breakdown and asset classes begin to dance to different tunes and narratives.

In equities, consumer staples performance was good in Q3, with the MSCI World Consumer Staples Index up around 4% in local currency and over 7% when converted back into sterling, as the headwinds to the global economy saw traditionally defensive holdings outperform. All of our portfolios hold 5% in consumer staples exposure, with the exception of the highest risk rating, which doesn't hold any, so gains here were a positive for the majority of the range. In a continuation of this theme, traditional safe haven region Japan also performed well, with the MSCI Japan Index returning 3.1% and 6.5%, in local and sterling- adjusted terms, respectively. Japanese equity is held across the range, so all portfolios benefitted from gains here.

In fixed income, 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, with UK gilts and UK corporate bonds notable outperformers. However, our portfolio gilt holdings are all in short-duration maturities of one to five years so, whilst still positive in the period, they didn't participate fully in the outsized gains seen on conventional maturities. We did benefit from our holdings in UK corporate bonds, however, and our decision to include hedged US corporates and hard currency emerging market bonds was vindicated over the period too, helping soften the blow from missing out on gilt upside. The Bloomberg Barclays US Corporate Bond Index returned over 3% in local currency and the Bloomberg Barclays Hard Currency Emerging Market Debt Index returned over 4% in sterling terms.

Asset allocation contributors

	Portfolio					
Top Contributors	MPS 1	MPS 2	MPS 3	MPS 4	MPS 5	MPS 6
1	UK Corporate Bonds	UK Corporate Bonds	UK Corporate Bonds	Japan Equities	North American Equities	North American Equities
2	Global Consumer Staples Equities	Global Consumer Staples Equities	Global Consumer Staples Equities	North American Equities	Japan Equities	Technology Equities
3	US Treasuries (Short Duration)	Emerging Market Equities (Hard Ccy)	North American Equities	Global Consumer Staples Equities	Technology Equities	Japan Equities

Source: AJ Bell Investments, Bloomberg LP, September 2019

All market performance figures are in GBP.

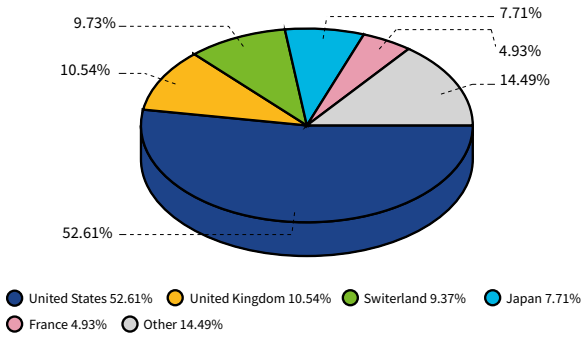
AJ Bell Passive funds review – Q3 2019

Fund performance

Passive investing, by its nature, means that the bulk of the performance for an investor should be generated by the asset allocation that is being followed. When choosing an asset allocation, we select an index that we feel is the most appropriate to act as a benchmark for us to track, based on it being simple to understand, not subject to excessive turnover and easily investable. Once we have this index, we then set about selecting the most appropriate investment product with which to track the index. Ordinarily, it's very difficult to select a passive product that beats its parent index; however, what we describe as 'passive-alpha' can sometimes be demonstrated with an intelligent route to implementation. At our annual review of our strategic asset allocation at the turn of the year, one of the main changes we made was introducing more equity sectors as distinct asset classes. We believe traditional geographic allocations overstate the level of diversification they bring to a portfolio, whereas sectors bring very different characteristics, such that they improve return and reduce risk. That being the case, global consumer staples was one of the sectors we added to the mix. As mentioned, in equities in Q3, defensive and quality names were amongst the best-performing areas, with consumer staples being a big beneficiary of this theme, as investors fretted about headwinds to the global economy.

Although our asset allocation specified the MSCI Global Consumer Staples Index as the one we should be allocated to, products tracking this are expensive at around 0.30% per annum. That being the case, we made a decision in February to instead use a US consumer staples product, the **X-Trackers MSCI USA Consumer Staples UCITS ETF** which is available for 0.12% per annum, due to the fact that the US represents over 50% of the global consumer staples index anyway (see graphic below), and so is the dominant determinant of the returns to the index. It was therefore pleasing to see that since implementation to the end of Q3, our selection has outperformed our benchmark index by 2.99% in total return terms, for a sterling investor. This 'passive-alpha' i.e. getting better outcomes for cheaper cost, is something which sometimes goes unheralded by users of passive portfolios and is, we feel, one of the big advantages of having a dedicated team managing your passive allocations. The **X-Trackers MSCI USA Consumer Staples UCITS ETF** is held in all of the Passive funds, with the exception of the Global Growth Fund.

COUNTRY WEIGHTS



MSCI Global Consumer Staples Index weightings,

Source: MSCI, August 2019

Across the board, fixed income benefited from a reduction in yields across most developed government bond complexes and a tightening in spreads, for quality corporate bonds. UK corporate bonds remain a significant allocation within our range, being included in all funds up to and including Moderately Adventurous. To affect our implementation in this asset class we use the **iShares Core Sterling Corporate Bond UCITS ETF** and, in a quarter that saw it return over 3%, at the lower end of the risk spectrum, where allocations are largest, it played a significant role in boosting returns to the portfolios.

At the higher-risk end of the range, global technology continued to play a part in the returns, with the **iShares S&P 500 Information Technology Sector UCITS ETF** we hold gaining almost 7% in the quarter. In addition, US equities posted good gains in Q3, with the **Vanguard S&P 500 ETF** we hold seeing returns of over 5%.

All other areas of the portfolios performed in line with expectations, with the funds all returning between 2% and 3% for the quarter, with the exception of the highest-risk portfolio, the Global Growth Fund, which lagged a little due to falls in Asia Pacific and emerging market equities, which in aggregate are its largest exposures.

Fund changes

In the portfolios, there were no significant changes to be seen in the quarter. However, we maintain a watching brief on developments in the passive ETF and indexing space, and costs continue to fall across the providers' various ranges, to the benefit of all end investors, as the price wars continue. Unfortunately, none of our holdings saw cuts in their OCF in Q3, however, we believe this speaks to the fact that we are already using some of the most efficient and best-value products available in the marketplace, and we continue to work with and engage providers in order to improve the variety and quality of the products available to us within the funds.

Performance summary (all models)

Portfolio	3 months	6 months	1 year	Inception*
VT AJ Bell Passive Cautious	2.44%	5.72%	6.65%	9.40%
VT AJ Bell Passive Moderately Cautious	2.45%	6.51%	7.02%	12.23%
VT AJ Bell Passive Balanced	2.59%	7.26%	7.09%	15.40%
VT AJ Bell Passive Moderately Adventurous	2.59%	7.59%	6.63%	16.79%
VT AJ Bell Passive Ad-venturous	2.14%	7.50%	6.00%	17.06%
VT AJ Bell Passive Global Growth	1.08%	6.63%	5.35%	4.76%

**All the funds launched on 18 April 2017, with the exception of the Global Growth Fund, which has a launch date of 11 June 2018. All performance is net of fees.*

Source: Bloomberg LP, AJ Bell Investments, September 2019

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.

AJB/QR/PF/20191010