AJBell

Passive Funds – Q1 2019 report

Introduction

We are delighted to bring you the first quarterly report from AJ Bell Investments covering the passive funds.

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

The start of 2019 has been a complete reversal of the end of 2018, with strong performance from both equities and bonds, and confidence returning after the volatility of last year. Perhaps somewhat strangely, this is amid a backdrop of slowing global growth and signs from central banks around the world that the economic environment is getting more challenging.

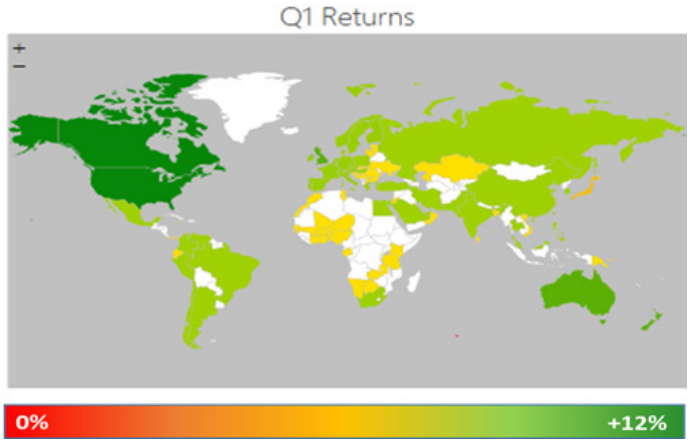
However, equity investors have taken this to mean that central banks will stop tightening monetary policy and become more accommodative, thus helping propel equities higher and indeed bonds too, as the prospect of rapidly rising interest rates receded.

In the UK, Brexit seems no closer to being delivered, while Germany has struggled to grow and France continues to battle its own citizens amid discontent over President Macron's reforms. The positive story seems to be around the trade war between the US and China that has showed signs of being amicably resolved and this has certainly boosted investor confidence through the first quarter of the year.

Economic and market review

The first quarter of 2019 saw a complete rebound from the turmoil, volatility and sharp falls in markets that were seen as 2018 came to an end, with all major equity markets rallying strongly as confidence returned to investors. This time it was the US that led the way as fears over the potential for the Federal Reserve to raise interest rates too far subsided. However, UK equities lagged most major markets as uncertainties surrounding Brexit worried investors. Away from equities, fixed interest markets also had a strong quarter, particularly high-risk assets which benefited from improved investor confidence.

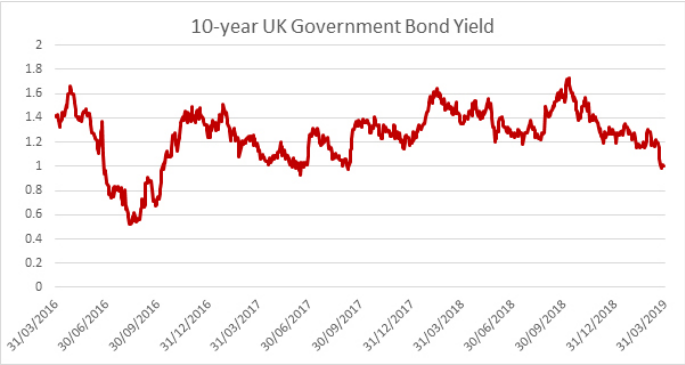
Across the regions, the US, Europe and Asia saw double digit returns in local currency terms, with the FTSE All-Share total return just below 10%. In what was a volatile quarter for sterling, it ended the quarter up against major currencies, which lowered international equity returns when converted back to sterling.



Source: Bloomberg LP, AJ Bell Investments, April 2019

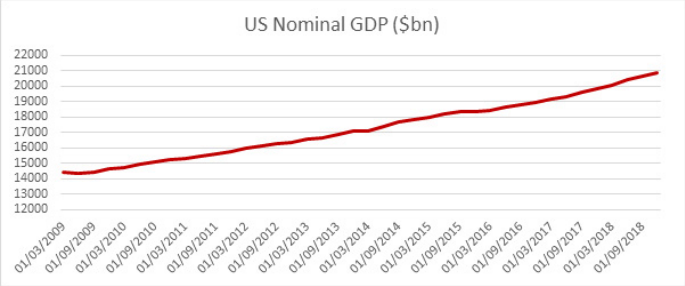
In the UK, it was Brexit that unsurprisingly dominated the headlines for the entire quarter as the 29 March leaving date moved ever closer. With Theresa May failing to get her deal approved by Parliament, then losing control of the order papers and then saying she would resign if her deal was passed, it was a tumultuous three months for the Prime Minister as she had little choice but to extend the date that Britain would leave the EU. By the time you are reading this, frankly anything could have happened so apologies if this narrative appears out of date! Unsurprisingly, this uncertainty started to show in the economic data during the period, with GDP falling back to an annualised rate of 1.3% while business confidence also fell back. One bright spot was that unemployment fell to its lowest level since 1975. As the end of the quarter arrived, the potential for a delay in the UK's departure from the EU saw larger UK companies surge in value, with the FTSE All Share Index returning 9.4% over the quarter.

The bond market reacted to the heightened risk with yields tightening sharply, resulting in the 10-year gilt yield falling back below 1% for the first time since mid-2017 – which helped the FTSE Actuaries UK Conventional Gilts All Stocks Index rally by 3.4%. With the risk-on environment, credit risk was rewarded, helping corporate bonds to perform well, with the iBoxx UK Sterling All Maturities Index increasing by 4.8% over the quarter, while high-yield bonds (that are more closely correlated with equities) performed even more strongly as the Bloomberg Barclays Global High Yield Bond Index increased by 6.3% over the period. Moves in sterling were significant over the quarter, with a strengthening against most major currencies during the period. This meant that returns from other markets were lower than they were in local currency terms.



Source: Bloomberg LP, AJ Bell Investments, April 2019

Having been very weak in Q4 2018, the US bounced back strongly in Q1 following a truce in the trade war with China and a clear signal from the Federal Reserve that interest rates were highly unlikely to rise this year. With economic data being delayed at the start of the year due to the government shutdown over the lack of budget approval, it took until the end of March before the final GDP data was known. This came in below expectations and was sharply lower than earlier in the year, and this would have been at the forefront of Jerome Powell's mind at the Federal Reserve when the announcement came that rates were unlikely to increase again this year. Tucked away in the statement was also the news that US growth was expected to be 1% less than previously expected at 2.1% for 2019, giving a clear indication that global growth is slowing down – something that has been mentioned in these quarterly updates previously. However, business confidence remained reasonably strong while consumer confidence got better throughout the quarter. At the same time, the labour market remained tight, with low unemployment and strong wage growth. This backdrop saw equities perform strongly, with the S&P 500 Index increasing by 10.9% over the period. The changing narrative from the Federal Reserve saw interest rate expectations change markedly and as a result the US 10-year Treasury yield fell from 2.7% at the start of the year to 2.4% at the end of the quarter.



Source: Bloomberg LP, AJ Bell Investments, April 2019

The weakness seen in Europe in the latter stages of 2018 continued into 2019 as a slowing China impacted upon the major export economies of the region. This was especially evident in Germany, which recorded no growth at all in the final quarter, while PMI data showed that manufacturing was contracting in the first months of the year. The slowdown was sufficient to see the Chief Economist of the European Central Bank say that it had been broader and more persistent and indicated that further support from the ECB may be required. Late in March, German manufacturing data collapsed, causing much alarm for European investors. The result was that the yield on the German 10-year Bund turned negative once again for the first time since the summer of 2016, showing just how worried investors are that a European slowdown may well be very difficult to exit. Over the period, the MSCI Europe ex UK Index grew by 8.0%.

Source: Bloomberg LP, AJ Bell Investments, April 2019

Focus in emerging markets was very much on China, particularly given the ongoing trade discussions with the US. Signs that the talks were progressing well helped investor sentiment and there was hope as the quarter ended that a positive resolution would be found. At the same time, the Chinese government continued to provide stimulus to help manage the slowing economy, with a cut to the reserve ratio requirement for Chinese banks. In Brazil, volatility picked up sharply towards the end of the quarter as controversial pension reform struggled to pass in parliament, with the failure causing the equity market and currency to fall sharply. In Turkey, attention again turned to the fragility of the currency, as it did last summer, with the Turkish Lira falling sharply against major currencies as confidence drained away from President Erdogan and the recession began to take hold. Over the course of the quarter, the MSCI Emerging Markets Index rallied 7.4%. Looking at fixed interest in the region, the JPMorgan GBI Emerging Market Global Composite Bond Index increased by 0.70% over the period.

The Japanese economy bounced back in the fourth quarter of 2018 to register solid GDP growth after the sharp slowdown earlier in the year. However, it wasn't all good news, as manufacturing data weakened over the quarter while consumer confidence steadily declined as the close trade links to a slowing China hampered progress. Over the quarter, the Topix Index increased by 4.6% as broader global investor confidence pulled equities higher.

Summary of contributors and detractors by asset class:

Asset Allocation Contributors and Dectractors

	Fund					
Top Contributors*	**Cautious**	**Moderately Cautious**	**Balanced**	**Moderately Adventurous**	**Adventurous**	**Global Growth**
1	UK Corporate Bonds	North American Equities	UK Large Cap Equities	UK Large Cap Equities	UK Large Cap Equities	UK Large Cap Equities
2	North American Equities	UK Corporate Bonds	North American Equities	North American Equities	North American Equities	Emerging Market Equities
3	UK Large Cap Equities	UK Large Cap Equities	Technology Equities	Technology Equities	Technology Equities	North American Equities

	Fund					
Top Detractors*	**Cautious**	**Moderately Cautious**	**Balanced**	**Moderately Adventurous**	**Adventurous**	**Global Growth**
1	International Bonds	International Bonds	International Bonds	International Bonds	Health Care Equities	Health Care Equities
2	Health Care Equities	Health Care Equities	Health Care Equities	Health Care Equities		
3						

*excludes alternative investments, due to different implementation routes across portfolios

Source: Bloomberg LP, AJ Bell Investments, April 2019

All market performance figures are in GBP

Fund performance

All portfolios delivered positive returns over the quarter, helped by strong returns from both equities and bonds. As expected in a risk-on market, the higher-risk portfolios were up the strongest, with net total returns ranging from 4.2% to 8.2%.

The Passive funds use predominantly tracker products to implement the asset allocation, and therefore the lion's share of performance is explained by our asset allocation positioning. However, in certain regions and sectors, the benchmarks tracked can have large performance differences. For example, the FTSE benchmark series classifies South Korea as a developed country, whereas MSCI still classifies it as an emerging nation. This means the inclusion of South Korea in developed Asia and emerging market products varies depending on the passive product used, and its selected index. Other vagaries like this exist, especially within the fixed income space, where index inclusion rules consider issues such as liquidity, minimum size and the definition of government and non-government debt, which then can lead to fundamental performance differences. For example, when considering Emerging Market Debt indices, FTSE has a different definition of government debt compared to Barclays. As a result, the FTSE index has 3% exposure to China, whereas the Barclays index has a much larger weighting at 17%. When selecting ETFs we try and choose benchmarks that we feel best represent the asset classes, which means deciding if we think emerging market debt is best represented by FTSE or Barclays.

An ETF can trade at a small premium or discount to the underlying NAV of the fund, due to investor demand, and the underlying cost of creating or redeeming units in the fund. This can also lead to short-term differences between the ETF performance and the index performance, however over the longer term (one year or more) this becomes less relevant.

Another point to consider as a passive investor when looking at performance over short periods is the differing valuation points of ETFs and indices. For example, a London-traded ETF stops pricing when the stock exchange closes at 4.35pm, however the underlying index may continue to price if, for example, it is tracking US equities. This again can lead to performance differences between different passive products, especially when markets and currencies are swinging around due to issues such as Brexit.

In the UK we split our exposure into large-cap stocks, by tracking the FTSE 100 or MSCI UK indices, with a smaller exposure to mid-cap stocks (tracking the FTSE 250). Over the quarter both products delivered similar returns, delivering a blended total return similar to the FTSE all-share index.

When adjusting for differing index points and premiums and discounts, our international equity ETFs all performed in line with their designated benchmark. In the Asian ex-Japan region we track a developed market index rather than one that includes both developed and emerging economies. We use the iShares MSCI Asia Pacific ex-Japan ETF. This performed in line with all-country index, despite the strong performance of China.

For our sector-based equity investments, we use US indices as proxies for global exposure. This is because US-tracking products are widely available, represent better value in terms of OCF and trading costs, and represent highly correlated performance with the global indices over the longer term. For consumer staples and technology the US ETFs delivered similar performance to the global benchmarks over the quarter, whereas the healthcare product lagged slightly, as Amazon announced plans to form a healthcare division, providing a threat to incumbents. In the Global Growth fund we hold a thematic automation and robotics product within our technology allocation. This slightly outperformed the global technology benchmark, up 17.2%.

Within our gilt positions, we have made the tactical decision to go short duration. Over the quarter gilt yields fell, leading to underperformance versus an all maturity index. We are comfortable with this position, given the near historic lows of gilt yields, and therefore the asymmetry of expected future returns. Our other fixed income ETFs performed in line with expectations.

The portfolios have an exposure to property. In general, investment in physical property is in the realms of active investors. However, we are able to achieve physical-property-like exposure by investing in a UK REIT ETF and blending together short-dated index-linked gilts. The use of index- linked bonds helps dampen the volatility, although in the short term the blend does exhibit higher performance variation. Over the quarter the blend of the ETF and index-linked bonds was up around 7% compared to 2.5% for a physical property fund, such as L&G. This is perhaps the one area of the funds where selection has led to a significant performance uplift.

Fund changes

AJ Bell performed its annual asset allocation review during the quarter, updating its long-term strategic positioning to reflect market moves over the preceding year, and an evolving investment universe, making it possible to invest in different asset classes to further increase the diversification within portfolios. This is in line with the MPS asset allocation review provided in a February update.

The main changes made over the quarter are summarised below:

Main asset allocation changes:

- Cash was reduced in the lower-risk funds where it is held.
- Fixed interest exposure was increased in the lower-risk funds and reduced higher up the risk spectrum.
- Equity exposure was increased across all funds.
- Property exposure was reduced across all funds.

Further changes were made due to new products coming to the market, allowing AJ Bell to either implement the fund at a cheaper total cost to the investor, or to track a benchmark more aligned with our asset allocation decision.

As a 'passive' investor, it is often thought that the best thing to do is nothing, pick some low-cost index tracker funds, and look again at retirement. Long-term low-cost investment is central to the AJ Bell Passive fund philosophy, however it is important to note that the investment universe is constantly evolving, and therefore to ensure the investments remain best in breed, it is important to continually review the route to implementation in the portfolios. That being the case, alongside being active on our asset allocation in the Passive funds, we are also 'active' in our selection of trackers and ETFs, to take advantage of changes such as price cuts.

A number of investment managers have recently entered the ETF market, which has led to significant pressure on the OCF of ETFs. Unlike an open-ended fund, where the investment manager can remain competitive through multiple share classes and rebates, the single share class structure of an ETF means an ETF manager has to lower the OCF for all investors to remain competitive against new entrants.

It is, however, important to remember that headline OCF is not the only factor to consider when choosing which ETF to invest in. Other considerations should include dealing costs, tax implications, ETF size, replication style, index tracked and ETF manager infrastructure, amongst other factors.

AJ Bell does not necessarily switch immediately into cheaper products, however once appropriate due diligence has been

undertaken to assess the other important factors, a product switch is implemented.

AJ Bell is engaged in dialogue with all the major ETF providers to understand their future plans, and this ensures we are not constantly switching between products. However, the emerging ETF entrants disrupting on cost have led to price cuts from the large incumbents. The following table shows the OCF of UK Equity ETFs from various providers at the end of 2013 and the end of Q1 2019.

	iShares	Vanguard	SPDR	Xtrackers	HSBC	Lyxor	L&G	Average
End of 2013	0.15%	0.10%	0.30%	0.09%	0.35%			0.20%
End of Q1 2019	0.07%	0.09%	0.20%	0.09%	0.07%	0.04%	0.05%	0.09%
Price Cut	-53%	-10%	-33%	0%	-80%			-56%

Source: AJ Bell Investments, April 2019

On average, the OCF of existing products has fallen by 35%. If new entrants are included, the average cost of investing passively in UK equities has fallen, on average, by 56%.

We took the opportunity over the quarter to switch into different products, leading to an OCF saving or a more representative benchmark:

Vanguard FTSE Europe Ex-UK ETF (OCF 0.12%) into Xtrackers S&P Europe ex-UK ETF (OCF 0.09%)

Vanguard FTSE 100 ETF (OCF 0.09%) into Lyxor Morningstar UK ETF (OCF 0.04%)

Xtrackers NIKKEI 225 ETF (OCF 0.09%) into Lyxor MSCI Japan ETF (OCF 0.12%)

Lower OCF products exist in other asset classes, however, we currently still believe the higher-priced products are the most appropriate, when taking into consideration; index tracked, liquidity and dealing costs, alongside other factors.

Performance summary (all funds)

Portfolio	3 months	6 months	1 year	Inception*
VT AJ Bell Passive Cautious	4.22%	1.35%	4.37%	3.97%
VT AJ Bell Passive Moderately Cautious	5.16%	0.48%	5.27%	5.37%
VT AJ Bell Passive Balanced	6.54%	-0.15%	6.69%	7.59%
VT AJ Bell Passive Moderately Adventurous	7.04%	-0.90%	6.97%	8.55%
VT AJ Bell Passive Adventurous	7.98%	-1.39%	7.46%	8.89%
VT AJ Bell Passive Global Growth	-	-	-	-

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, April 2019.

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.