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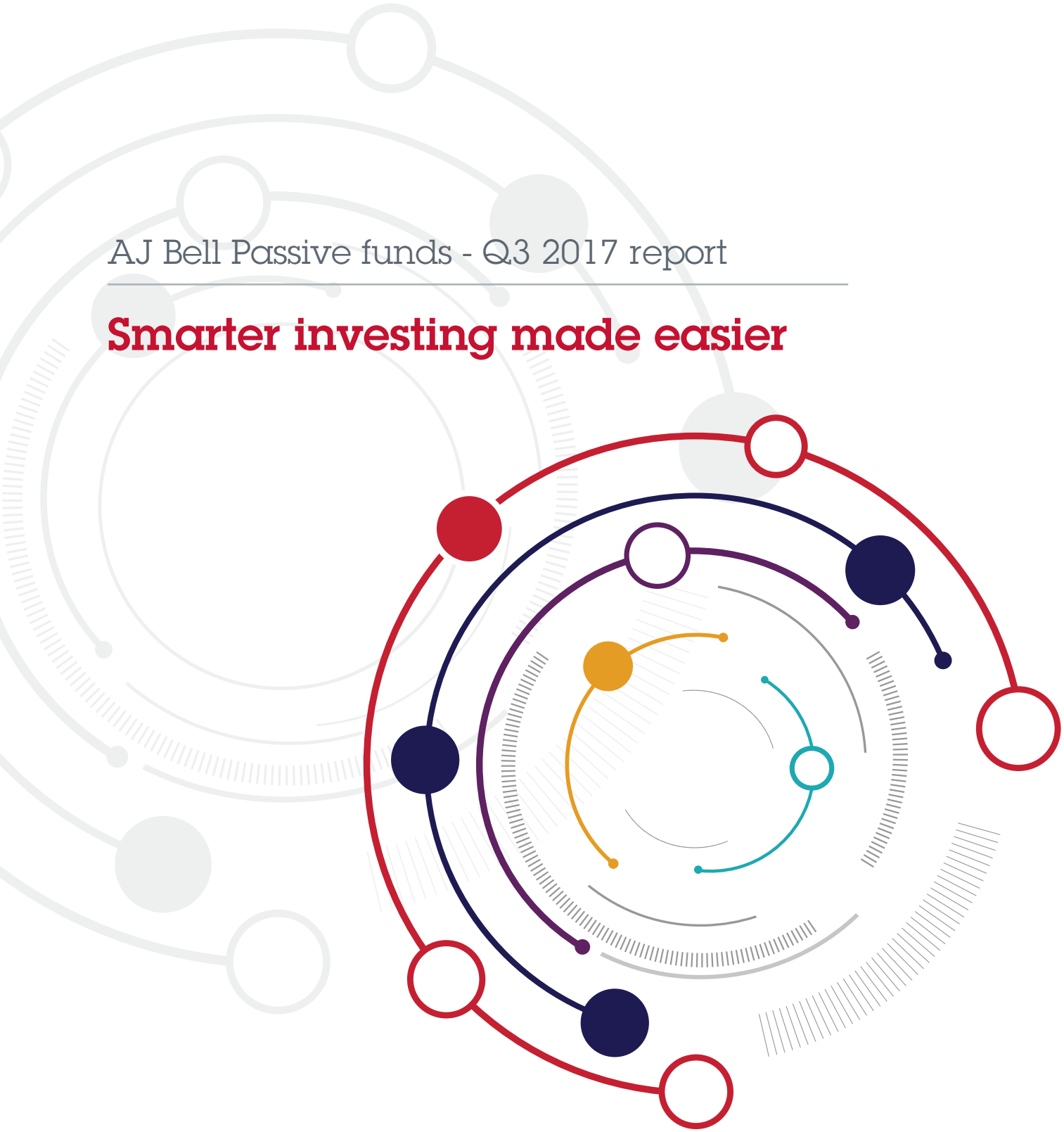
AJ Bell Passive funds - Q3 2017 report

Smarter investing made easier



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Introduction

We are delighted to bring you the first quarterly report for the AJ Bell Passive funds that were launched in April this year.

This report is designed to keep you up-to-date on what is happening with your investments that are managed by AJ Bell. It covers the major macro-economic events of the past three months, looks at how these have impacted the funds, and also highlights any changes that have been made in the period.

The third quarter of 2017 was a positive one for equity markets as the global economy continued to show signs of expansion. Politics was never far away from the headlines with Brexit negotiations, tensions with North Korea, terrorism in Europe, the re-election of Angela Merkel in Germany and the calling of a snap election in Japan all giving investors food for thought.

Around the world, equity markets were positive with strong performance coming from Asia, the emerging markets and Japan. However, currency moves were also significant over the quarter which held back these returns once they were converted back to sterling. The prospects of higher interest rates both in the US and perhaps surprisingly the UK were also challenging for fixed interest markets.

2017 - 3rd quarter macro-economic picture

Economic & market review

The third quarter of 2017 proved to be a positive one for equity markets, particularly in Asia and the emerging markets that benefited from clear evidence that the global economy is in solid shape.

Continued positive economic news out of the US proved an encouraging backdrop. The labour market in the US was strong throughout the period with initial jobless claims falling back towards 4% while 2nd quarter GDP was revised up to 3%. With strong business and consumer confidence, it was no surprise to see that corporate earnings have been coming in ahead of expectations and with little sign of a slowdown, there was strong underpinning of a buoyant US stock market. The strength of the US economy was evidenced by the much anticipated announcement from Janet Yellen, Chair of the Federal Reserve, that the removal of the stimulus that has been in place for years since the financial crisis would soon begin. While this will be a slow and gradual process, it was clearly a sign that the US economy was in robust health. As a result, the S&P 500 Index performed well, increasing by over 4% in US dollar terms.

In the UK, focus was on the Brexit negotiations but there were limited signs of progress over the quarter. This prompted an intervention from Theresa May late in September to try and break the deadlock by indicating a willingness to have a transition period following the supposed exit in March 2019. However, with clear differences between the EU and the UK on how to even negotiate, the political uncertainty leaves a huge question mark over the UK economy for the coming few years. Encouragement continues to be seen in employment data which fell to its lowest level since 1975, however, this masked weaker consumer confidence, a slowing London housing market and a slower services sector.
The biggest surprise over the quarter was the announcement from Mark Carney, Governor of the Bank of England, that there was a strong likelihood of an interest rate rise before the end of the year. This was based on concerns that consumer credit was becoming a worry and that banks were not lending responsibly. With this more challenging outlook, UK equities performed poorly compared to other major equities markets across the world, albeit, the FTSE All Share Index managed to increase by just over 2%.

The European economy continued its recovery during the third quarter, with economic data coming in stronger than anticipated. Job creation was positive, increasing at its fastest rate since the ECB started recording data in 1997, while economic sentiment also picked up, reaching levels last seen before the financial crisis. As a result, the ECB indicted that it expected GDP growth of 2.1% for 2017, representing a significant increase since the start of the year. This economic strength gave the ECB encouragement that they were close to being able to reduce the level of Quantitative Easing, with an announcement expected in October. The major political event of the quarter was the German election. Unsurprisingly, this saw the re-election of Angela Merkel for a record fourth term, however, her government will be a coalition across three parties, which could lead to some challenging decisions as Merkel tries to keep all parties content. With such positive economic performance, and strong corporate earnings growth, European equities were strong performers over the quarter with the FTSE Developed Europe ex UK Index increasing by over 4%.

With the global economy performing well, it is no surprise to see Asia growing strongly given its position as the manufacturing engine of the world. China delivered strong economic growth with Q2 GDP coming in at 6.9% with both industrial production and domestic demand being strong. However, credit rating agency S&P downgraded China during the period due to high levels of debt and a potentially overheating property market. Away from China, the region was also positive with South Korea performing strongly on the back of its focus on technology companies which have been performing very well this year. However, India struggled a little as the package of much needed reforms from Prime Minister Modhi weakened domestic demand. The major risk over the quarter was the rapid escalation in tensions with North Korea. A nuclear warhead test along with the firing of ballistic missiles over Japan reminded investors of the instability of the Korean peninsula. With the war of words with the US

growing, investors have kept a nervous eye on Kim Jung-un and his provocative behaviour. Despite this risk, Asian equities were strong performers over the quarter, helped by a weaker US dollar. The MSCI AC Asia ex Japan Index increased by well over 5% during the quarter.

Moving to Japan, economic performance was stronger than expected, with Q2 GDP growth coming in at 4%. With strong performance from the manufacturing heart of the economy and robust consumer spending, the economy carried strong momentum through the quarter, failing to be knocked off course despite North Korean issues. Prime Minister Abe looked to consolidate his position by calling a snap generation election that will take place in late October, while the Bank of Japan looked to continue its support of the economy through Quantitative Easing, bucking the trend of other major central banks that have looked to withdraw that support. Japanese equities were strong over the quarter, with the Topix Index increasing just under 5%.

In emerging markets, Russia benefited from a stronger oil price and falling inflation which hit its lowest ever level. Brazil was helped by another cut in interest rates, helping job creation and consumer confidence, however, Mexico was hit by two devastating earthquakes which are likely to hurt economic growth in the short term. The emerging markets were the stand-out region over the quarter, with the MSCI Emerging Markets Index increasing by over 7.5% helped significantly by Chinese equity performance.

Looking at fixed interest, the major central bank announcement already mentioned above had a significant influence on bond markets. The announcement from the Bank of England in September that it was highly probable that interest rates would rise before the end of the year sent UK government bonds sharply lower. With fears of a deterioration of lending standards, the BoE hinted that it wanted to nip this in the bud before it became a major risk to the economy. Gilts reacted very badly to this, with the FTSE Actuaries UK Conventional Gilts All Stocks Index falling by over 3% during September having been positive for most of the quarter. Index-linked bonds were hit even harder, with the Bloomberg Barclays UK Government Inflation-Linked Bond Index falling nearly 6.5%.

UK corporate bonds were a little more resilient, as investors were more comfortable taking the credit risk of corporate debt compared to government debt. Even then, the Merrill Lynch Sterling Corporate Bond Index was only just in positive territory, gaining 0.27% over the quarter. With strong performance across the world and corporate earnings ahead of expectation, it was a good quarter for high yield bonds. Default rates remain at very low levels, giving investors comfort that the additional risk that comes with high yield debt is currently attractive. The performance of the Bloomberg Barclays Global High Yield Index was positive with a return of 2.8%, however, due to currency moves when converted to sterling, this return was actually negative, falling back 0.4%.

The commercial property market, which is accessed by investing in property equities, had a challenging quarter. UK property stocks fell back late in the period as economic data pointed to a more difficult period ahead, compounded by the lack of progress with Brexit negotiations. As a result, the FTSE EPRA/NAREIT UK Index was flat for the quarter. Global property was also weak over the period, with investors focused on exciting growth stories rather than the lower octane property sector. In addition, returns in this area were held back by the strength of sterling which culminated in a negative return over the quarter of the FTSE EPRA/NAREIT Global Index of 0.3%.

Portfolio review

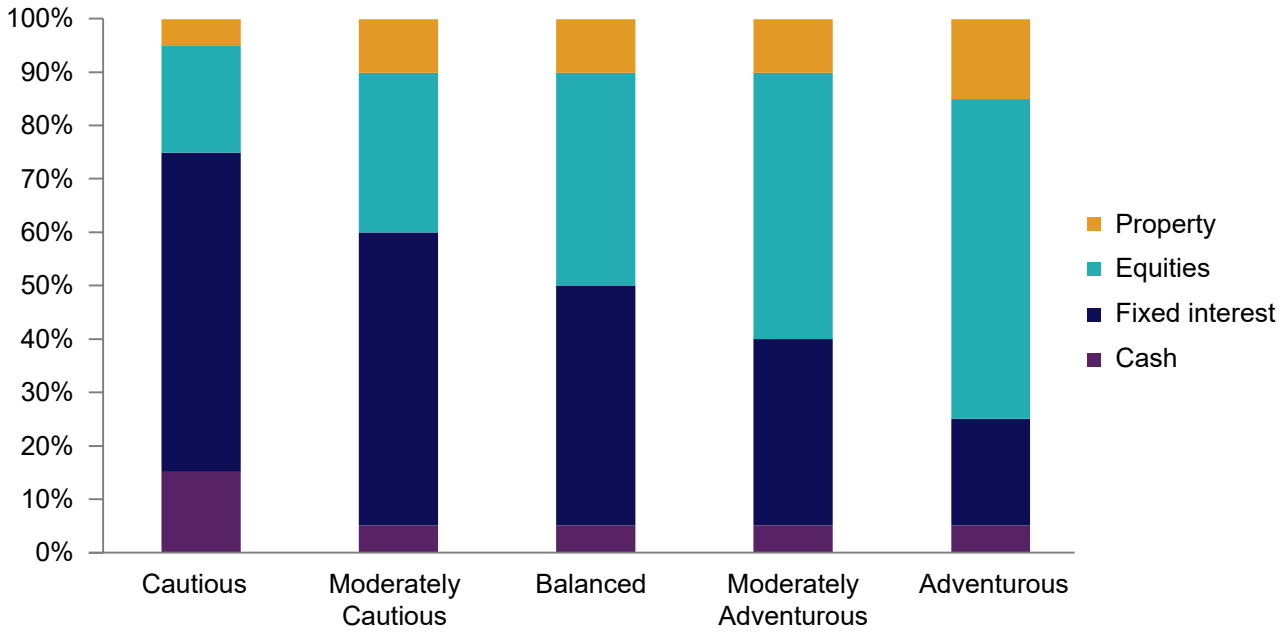
As the funds have only recently been launched, we are unfortunately not able to comment on their early performance. We look forward to providing this information once the funds have been in existence for one year.

While not commenting specifically on fund performance, it is worth highlighting the performance of sterling over the quarter as this had a major bearing on the performance of certain assets. With the Bank of England hinting at higher interest rates, sterling moved sharply higher against the Japanese yen and more importantly the US dollar, with both moving around 3% over the period.

Currency exposure within these funds is unhedged in line with the long-term approach from our partner Moody's Analytics, who provide the long-term strategic asset allocation. With a significant amount of assets in the funds denominated in foreign currencies, the moves in these currencies will always have an impact on overall performance. Put simply, weaker sterling will boost performance of overseas equities once they are translated back in GBP while stronger sterling will be detrimental to performance. While over the long term it is our belief that the currency market operates in equilibrium, over short periods, these moves may be beneficial or detrimental to overall returns.

Given that the funds have only recently been launched, it is unsurprising that we have not seen fit to make any changes to the asset allocation or underlying investments. We are very conscious of not incurring unnecessary transaction costs and therefore take a long-term approach to investing. However, we still maintain a constant focus on the investments to ensure they remain appropriate. As and when changes are made to the funds, these will be covered in this report to ensure that investors are fully aware of how the funds are managed.

Asset allocation



Market volatility

Each fund has an expected level of risk, measured by volatility. This is a statistical measurement of how widely the returns of each fund vary from its average over time. This is measured over rolling 36 month periods and is used to help you understand the level of risk taken in each fund.

	Expected Volatility
VT AJ Bell Passive Cautious	4.2 – 6.3
VT AJ Bell Passive Moderately Cautious	6.3 – 8.4
VT AJ Bell Passive Balanced	8.4 – 10.5
VT AJ Bell Passive Moderately Adventurous	10.5 – 12.6
VT AJ Bell Passive Adventurous	12.6 – 14.7

Currently, volatility across the market is very low and as a result, the volatility level for the funds is lower than we would normally expect. While we could increase the risk to correct this in the short term, we do not believe this is the right approach and expect that over the long term volatility will return to normal levels, bringing the funds back into line. This will continue to be monitored by the portfolio management team and should it be decided that action needs to be taken, then the funds will be adjusted accordingly.

Our approach

The VT AJ Bell Passive funds are a range of funds that are designed to deliver specific outcomes to investors through a risk-targeted multi-asset approach. These funds have been designed to give investors a long-term multi asset portfolio using an investment approach that is based on robust academic principles.

The investment philosophy is based on the work of Barrie & Hibbert who in 1995 launched their Economic Scenario Generator (ESG). This approach models the relationship and behaviours between different economic factors such as interest rates, inflation and asset returns to build plausible forward-looking economic scenarios.

The ESG approach from Barrie & Hibbert allows a long-term approach that is focused on plausible economic outcomes incorporating the complex interactions between different asset classes. The long- term focus allows a consistent framework that avoids short-term behavioural biases to dictate investment outcomes.

This approach is designed to give a more predictable outcome for investors, with a range of funds built using a consistent approach that allows each fund to operate within a set risk target. This structure sits alongside leading industry risk profiling tools to give advisers confidence that each fund has been designed and is managed in a way that should lead to more predictable outcomes and avoids the risk that the risk profile of each fund will fluctuate as markets move.

This fund range has been designed to give broad market exposure and is focused on passive instruments to give this exposure in order to minimise ongoing and transaction costs.

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

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