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AJ Bell Funds – Q3 2020 report

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments covering the Growth Funds over Q3 2020.

This report is designed to keep you up to date on what is happening with your AJ Bell managed investments. It covers the major macroeconomic events of the past three months, looks at how these have impacted the portfolios and highlights any changes made in the period.

Summary

During the last three months, there were signs that some elements of normality were returning, with economic activity clearly picking up. However, as the end of the quarter approached, an upsurge in the number of COVID-19 cases has again created huge uncertainty, as elements of lockdown have returned – not just in the UK, but in many other parts of the world too. With so many people affected by this virus, the thoughts of everyone at AJ Bell continue to be with all of those impacted by the global pandemic.

Looking ahead, central banks will continue to do what they can to support economies around the world but, as various support schemes ease, there will be clear damage and job losses across many industries. The next quarter brings us a US election and Brexit, just in case investors didn't have enough to deal with. As a result, more volatility seems to be a sensible assumption in the coming months.

Economic and market review

After the huge falls in Q1 and the strong rebound in Q2, the third quarter was relatively subdued in comparison, while still showing a wide variety of returns across asset classes and regions. Markets rallied or fell back on every bit of COVID-19 news, while central banks looked to reassure investors that they would do all they could to support economies around the world. Overall, the quarter ended with the MSCI World index up 3.2%.

In the UK, economic activity showed signs of recovery over the summer months, as many took advantage of the 'Eat out to help out' scheme to get some money flowing through the economy again. The second quarter GDP figures showed a 20.4% fall compared to Q1 but, within that figure, both May and June registered increases which look to have continued through the summer, with retail sales and PMI data all positive. As the quarter came to an end, the Government looked to tighten restrictions to try and control the spread of the virus, and workers were advised to work from home if they could. It's too early to say what impact this will again have on the economy but expectations were managed that restrictions were likely to stay in place for six months, which at least gave some element of clarity. With the Autumn Budget cancelled, Chancellor Rishi Sunak announced further support to try and protect jobs, with the unemployment rate so far contained by the furlough scheme. However, expectations are for a significant increase over the winter. The FTSE All-Share index was once again the laggard of major markets over the quarter, as its focus on 'old' industries and fears as the Brexit deadline looms kept investors away from UK equities. Over the quarter, the index fell 2.9%; sterling was again volatile during the quarter, strengthening by 10% against the US dollar at one stage before ending the quarter up 4.8% against the US dollar, which held back overseas returns.

Source: Bloomberg, September 2020

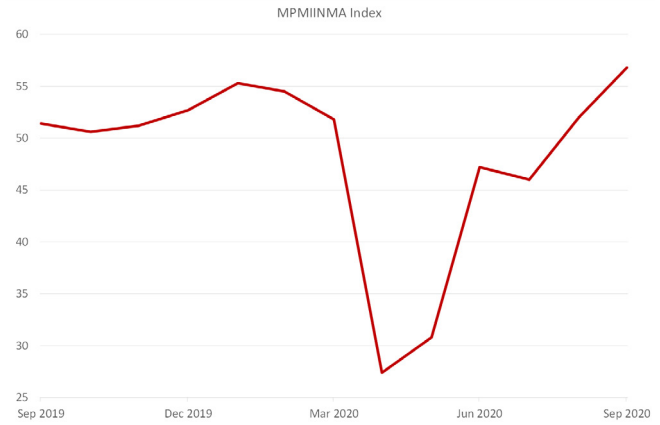
There was much less volatility in the bond market, as central bank intervention kept yields in check. However, during the quarter, a change in policy from the Federal Reserve in the US, where it announced a loosening of its inflation targeting, was matched by the Bank of England. In the period, the yield of the 10-year Government bond moved from 0.17% to 0.22% and this saw the FTSE Actuaries UK Conventional Gilts All-Stocks index fall by 1.2% over the quarter. Corporate bonds were a little stronger, with the iBoxx UK Sterling Corporate All Maturities index increasing by 1.6% over the period, while high-yield bonds were even stronger, with the Bloomberg Barclays Global High Yield Bond GBP Hedged index increasing by 3.7%.

In the US, the big development over the quarter was the marked shift from the Federal Reserve in its inflation policy. Having previously targeted an explicit 2% level, Jerome Powell announced that going forwards it would target an average level of 2% and allow inflation to run higher than this level before considering interest-rate hikes. This can be interpreted as interest rates staying at near zero for a long period of time as the Federal Reserve tries to get inflation back in the system. Economically, the US announced its worst ever GDP contraction for Q2, however, leading indicators such as retail sales and home sales beat expectations through the summer, giving hope that the US economy would bounce back strongly. Attention now turns to the Presidential election on 3 November, with the outcome potentially having major repercussions for global politics, markets and, of course, US citizens. Overall, the S&P 500 index increased by 4.0% over the period but once again it was technology that led the way, with Tesla in particular enjoying a spectacular rally, climbing 99%. US Treasuries were stable over the quarter, ending the period with a yield of 0.66%.

Source: Bloomberg, September 2020

Europe started the quarter with the holiday season, with travel being allowed between EU countries without quarantine. This was positively received by investors with hopes that an uptick in economic activity would help protect businesses and jobs. After much discussion, the EU countries agreed to create a €750 billion recovery fund to boost GDP and productivity, however, this was smaller than originally planned after five countries objected to the structure of grants vs loans. Furthermore, it was agreed that payments would only start in the second half of 2021, which may come too late for many businesses struggling to survive through a second wave of COVID-19. Over the quarter, the MSCI Europe ex-UK index was up a little, increasing by 1.2%.

In Asia and the emerging markets, China was as ever at the forefront, with clear signs of recovering economic growth. Second-quarter GDP growth came in ahead of expectation at 11.5%, the strongest on record as the easing of lockdown restrictions was felt across the economy. The domestic market performed very strongly over the period, helped by technology-related companies that continued to drive the market higher. India also began to show signs of improvement in August, with the manufacturing PMI breaking back through the key 50 level, indicating expansion. This was the first expansion since lockdown restrictions in March. Brazil was another major country that showed strong signs of economic recovery, with three consecutive months of growth in manufacturing, and business confidence hitting a seven-month high. Over the quarter, the MSCI AC Asia Pacific ex Japan index and MSCI Emerging Markets index were the best performing across the world, growing by 4.6% and 4.7% respectively. Emerging markets fixed interest performed less well, with the JPMorgan GBI Emerging Market Global Composite Bond index falling back by 3.6% over the period.



Source: Bloomberg, September 2020

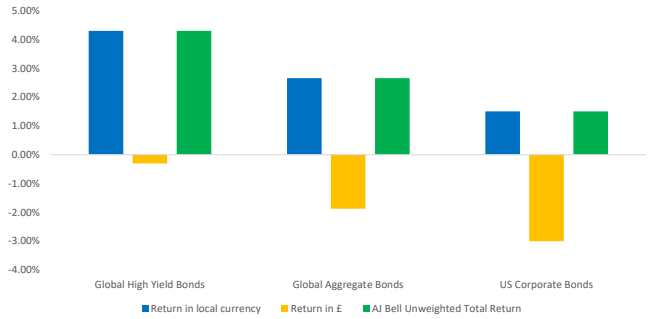
In Japan, news that Prime Minister Shinzō Abe was stepping down surprised investors and raised concerns as to whether his pro-market reform agenda would continue. Abe was Japan's longest-serving Prime Minister, having been elected in 2012, and has now been succeeded by Yoshihide Suga, who was formerly the Chief Cabinet Secretary. Importantly, Suga announced that he would continue with his predecessors' policy of 'Abenomics', with ultra-loose monetary policy remaining in place. Over the quarter, economic data remained weak, with little of the positive bounce-back seen in other parts of the region. Despite this, the Topix index was positive over the quarter, growing by 2.6%.

All market performance figures are in GBP.

Asset allocation and positioning

The first half of 2020 saw periods of extreme volatility in global financial markets as the coronavirus pandemic swept the world, prompting governments to take unprecedented actions to protect their citizens and help support their economies. With lockdowns being one of the measures that most governments instituted, large sectors of the economy were forced into shutdown in Q1, leaving financial market participants guessing as to the shape of the recovery into the future and with little option but to sell first and ask questions later. In a complete reversal, Q2 then saw some hope return and, allied to huge support and stimulus programs from authorities, the losses experienced in Q1, in the main, were recovered, leaving markets at a balance point coming into the third quarter of the year. It was pleasing, therefore, to see markets continue to take a somewhat sanguine view of the situation in Q3, despite massive uncertainty remaining in economic outlook, with most stock and bond markets showing positive returns in their local currency.

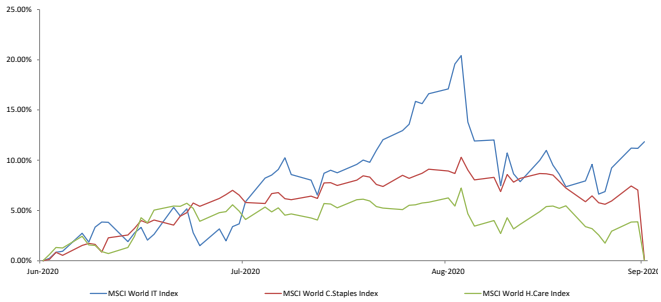
The big news of the quarter for UK-based investors, however, was likely the strength of the pound. A strong quarter, especially against the US dollar, dampened returns to portfolios from overseas assets, as currency translation acted as a headwind, weighing on returns originating outside the UK. This had an impact on asset classes across the board, with strong international equity returns being reduced in size but remaining positive, whilst fixed-income returns, due to being smaller in scale, were pushed negative after translation. For instance, global high-yield bonds, up 4.3% in local currency, were down -0.3% when converted back to sterling; global aggregate bonds (an extremely broad government and corporate bond index) was up 2.7% in local terms but off -1.9% in sterling; whilst US corporate bonds were up 1.5% in local currency, but down -3.0% in sterling terms. The team added a global aggregate allocation to the funds in 2020 and took the decision to hedge the currency exposure, and we also hold sterling-hedged versions of global high-yield and US corporate bonds in the funds, hence we retained the performance seen in the local currency:



Selected asset class returns for Q3 2020. Source: AJ Bell Investments, Bloomberg LP, October 2020.

Furthermore, with the earnings of so many of the UK's FTSE 100 members being from overseas, a strong period for the pound saw UK stocks significantly underpeform versus their international market peers, as the value of these earnings is eroded. Our funds have an element of equity home bias inbuilt, as an output of our risk budgeting and, as such, all funds were hampered by this strengthening in sterling, in particular those higher-risk funds with larger weightings in UK equity.

In previous quarters, we have drawn attention to the performance of some additional equity sectors which were introduced into the funds at the start of 2019, when global consumer staples and global healthcare were added to an existing global technology allocation. In Q3, the nature of and response to the threat, being a global pandemic and mandated lockdowns, meant that all three sectors – technology, consumer staples and healtcare – were additive to performance in the funds, with technology being the largest contributor, as a surge in homeworking required improved technology solutions, leading to a jump in valuations of global technology companies. At one point technology was up over 20% for the quarter, in what could perhaps be described as a bout of irrational exuberance given already heady valuations for the sector, but a sharp fall at the end of August saw returns come out at just under 12% in local currency and just over 7% in sterling for the quarter.



MSCI World Technology Net TR Index, MSCI World Consumer Staples Net TR Index & MSCI World Healthcare Net TR Index (all in local currency); 30 June 2020–30 September 2020. Source: AJ Bell Investments, Bloomberg LP, October 2020.

We hold healthcare in all risk profiles in the growth range, with consumer staples being held in all bar Global Growth and technology held in all, except Cautious and Moderately Cautious funds.

Asset allocation – top contributors

	Portfolio					
Top Contributors	Cautious	Mod. Cautious	Balanced	Mod. Adventurous	Adventurous	Global Growth
1	Global High Yield Bonds (£ Hedged)	Asia Pacific ex-Japan Equities	Technology	Technology	North America Equities	Emerging Markets Equities
2	Emerging Markets Equities	Global High Yield Bonds (£ Hedged)	Asia Pacific ex-Japan Equities	North America Equities	Technology	Asia Pacific ex-Japan Equities
3	Asia Pacific ex-Japan Equities	Emerging Markets Equities	Emerging Markets Equities	Asia Pacific ex-Japan Equities	Asia Pacific ex-Japan Equities	North America Equities

Source: AJ Bell Investments, Bloomberg LP, October 2020.

AJ Bell Funds review – Q3 2020

Fund performance

Equities were the big winners in the funds in Q3, with most regions and sectors held showing positive gains for the period, UK stocks being a notable outlier, despite a stronger sterling acting as a dampener on returns. The improved risk appetite amongst market participants, despite the coronavirus pandemic, saw strong gains in the US, Asia Pacific and emerging market regions. We hold allocations to these regions in all risk profiles, but the riskier funds have significantly higher weightings here and therefore benefited more than the lower-risk profiles. We hold allocations to a number of global equity sectors' ETFs in the funds and – rather than the global versions of those ETFs, which are more expensive (e.g. Xtrackers MSCI World Consumer Staples UCITS ETF at 30bps, versus 12bps for the US Consumer Staples product) – we hold the US versions as proxy, given the dominance of the US in the global, market cap weighted sector indices. It was pleasing, therefore, to see a performance uptick versus the global sector products in all instances, with the **Xtrackers MSCI US Consumer Staples UCITS ETF** we hold, for instance, up 5.6% in the period, versus the MSCI World Consumer Staples Net TR Index, which was up 3.1%. This 'passive alpha', getting more for less, is something which at times may go unnoticed by investors but, when sensibly employed and with an understanding of the potential trade-offs, it can enhance a portfolio's risk-adjusted returns and value for money.

In the main, gilt and international government bond holdings in the funds had a more challenging time, despite small gains across the board in local currency terms for the international assets, due to the sterling translation effect already discussed. We hold positions in US Treasuries via the **Invesco US Treasury 1–3 Year ETF** and **Invesco US Treasury 7–10 year ETF** in the lower-risk Cautious and Moderately Cautious funds and these products saw losses of -4.2% and -4.3% respectively, in sterling terms, over the quarter. However, as highlighted already, our currency hedging on some positions in fixed income meant that we were able to retain local currency gains in some of the allocations. Our global high-yield allocation, for instance – which we express via the **JPMorgan Global High Yield Corporate Bond Multi-Factor GBP Hedged UCITS ETF** and hold in all funds except the highest risk, Global Growth fund – saw gains of 3.2% in local terms, which would have been transformed into a negative return, had we not held a hedged position.

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 in Balanced through to Global Growth up almost 8% in the quarter, whilst the **iShares Automation & Robotics ETF**, which we hold only in Global Growth as an additional technology exposure, also showed good gains, up over 6% for the period.

All other areas of the portfolios performed in line with expectations and, across our Growth Funds, it was pleasing to see gains in all of the risk profiles. Returns were dispersed quite evenly through the risk scale, with those portfolios lower down the risk spectrum and with larger fixed income and defensive positioning seeing smaller gains, whilst those higher up the risk spectrum and with larger equity exposures and less fixed income saw larger gains.

Portfolio changes

In the portfolios, there were no changes to be seen in the quarter in terms of asset allocation, however the team did make a change in the product we use to express our property allocation. Previously, we have used the i**Shares UK Property ETF**, priced at 0.4%, blended with short-dated index-linked gilts, in order to gain our exposure. However, in July, we switched the ETF product we use to the **iShares Developed Real Estate Index Fund (GBP Hedged)**, with the fund carrying a charge of 0.2% plus hedge costs (approximately 0.03–0.04%). Whilst the geographical exposure of the products is different, with the new holding being more international versus a purely UK-focused fund, the use of the hedged product means the risk-adjusted return of the holding should be similar, whilst also giving us broader geographic diversity in the property asset class and at a cheaper price point.

Elsewhere, we maintain a watching brief on developments in the passive ETF and indexing space as providers continue to compete to gain market share. Whilst none of our holdings saw price cuts in the period, we believe this speaks more to the fact that we are already using some of the most efficient and best value products available in the marketplace, but we remain alert and will act to make changes should better priced or more efficient products become available.

Performance summary (all funds)

	3 months	6 months	1 year	Inception*
VT AJ Bell Passive Cautious	0.03%	6.90%	1.02%	10.51%
VT AJ Bell Passive Moderately Cautious	0.99%	10.24%	1.35%	13.75%
VT AJ Bell Passive Balanced	0.98%	12.77%	1.73%	17.40%
VT AJ Bell Passive Moderately Adventurous	1.18%	14.89%	0.07%	16.87%
VT AJ Bell Passive Adventurous	1.47%	16.50%	0.24%	17.35%
VT AJ Bell Passive Global Growth	1.74%	19.63%	0.63%	5.43%

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

Source: Morningstar, October 2020.

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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