AJ Bell Income Funds – Q3 2020 report

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments covering the Income 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

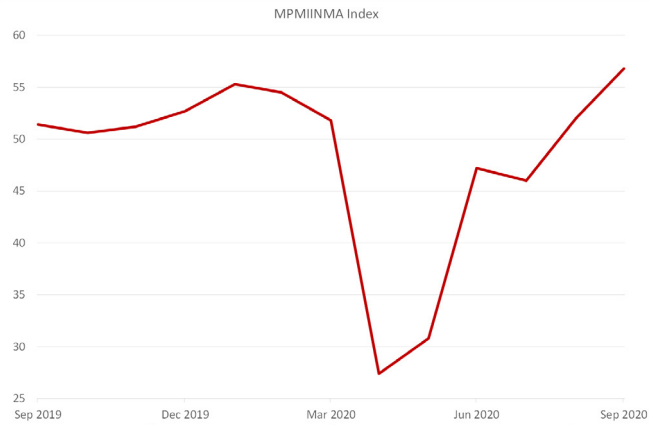
There was much less volatility in the bond market, as central bank intervention kept yields in check. However, during the quarter, a change in policy from the Federal Reserve in the US, where it announced a loosening of its inflation targeting, was matched by the Bank of England. In the period, the yield 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%.

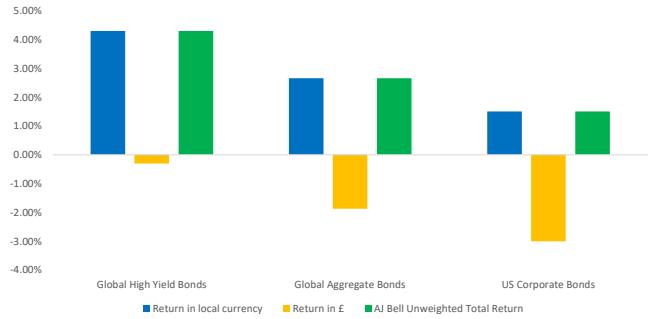
All market performance figures are in GBP.

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. The uncertain economic picture meant companies were forced to batten down the hatches, retaining as much cash as possible by suspending/cancelling dividend programs and also trimming costs, by furloughing underemployed staff and cutting back on operations. In a complete reversal, Q2 then saw some hope return and, allied to huge support and stimulus programs from authorities, the market 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. Equity income, however, remained a bruised element of investments, with many companies not willing, or able, to return cash to shareholders in the immediate future.

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; emerging market government bonds (denominated in dollars) were up 2.9%, but off -1.7% in sterling; whilst US corporate bonds were up 1.5% in local currency, but down -3.0% in sterling terms. Whilst we hold a sterling-hedged position in global high-yield bonds in both the Income fund and Income and Growth fund, insulating us from the effects of a stronger pound, we hold unhedged currency positions on EM bonds and US corporate bonds, meaning the portfolios suffered the full impact of the currency translation on these positions.



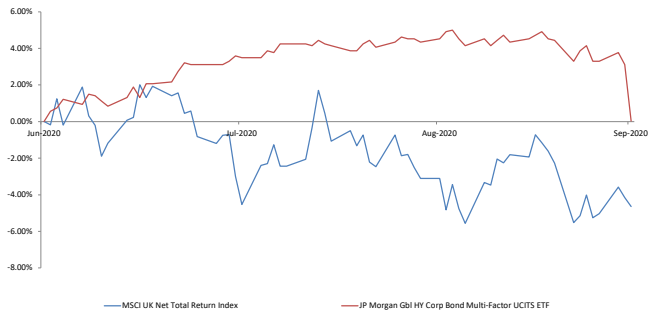
Selected asset class returns for Q3 2020. Source: AJ Bell Investments, Bloomberg LP, October 2020.

Furthermore, with the earnings of so many of the FTSE 100 members being from overseas, a strong period for the pound, allied to the sharp cuts to dividend programs, saw UK stocks significantly underpeform versus their international market peers. Our income funds do have an element of equity home bias inbuilt, as an output of our risk budgeting and due to the historically high yield on the FTSE 100 index and, as such, both portfolios were hampered by this strengthening in sterling and weakness in UK stock market performance.

At launch, the income products were designed with similar yield targets, but different capital aims: the Income fund sought a yield of between 3–5% and capital protection, whilst the Income and Growth fund sought a yield of between 3–5% and capital growth (to protect from the eroding power of inflation). To achieve these aims, the Income fund had an equity, fixed income, global infrastructure and cash asset mix. The Income and Growth fund eschewed fixed income in favour of higher equity weights (swapping yield for more equity income), added to cash, property and global infrastructure.

In Q2, we advised that we had made a tactical change to the asset allocation of the Income and Growth fund, due to the severity of the dividend cuts, meaning that equity income was depressed and the yield target of the product would potentially not be met. As a result, the decision was taken to reduce the UK equity component by 10% and invest this into global high-yield bonds (sterling hedged). High-yield bonds are an interesting asset class, straddling the gap between equity and fixed income, since they generally react to the same economic drivers as equities, but the income they pay is contractual, being coupons rather than dividends. Whilst there was extensive media coverage on the blowout in spreads and risk of defaults in high-yield bonds, our research showed that, generally, yields blow out first and then recovery in value is usually well under way by the time defaults peak, with a lag of around 12 months. Therefore, the team felt it was a risk worth assuming, to reduce our equity component in favour of global high yield, giving us more stability in income payments whilst also offering the potential for capital appreciation (albeit not the uncapped potential upside in equity) should spreads compress back down from the wide levels they were at. More detail on our thinking on this can be found here.

It was pleasing, therefore, in Q3 to see global high yield show up as the highest contributing asset class we held in the Income fund and in the top three in the Income and Growth fund, with the sterling-hedged position discussed earlier, meaning we were protected from the currency erosion due to sterling strength and were able to fully participate in the rally seen in the high yield space. As an additional factor, UK equity, which was the asset class we reduced to fund the allocation in the Income and Growth fund, was the worst-performing asset class we held in both funds, meaning our tactical call has given additional positive returns for the Income and Growth fund. The differing performance of the two areas can be seen in the following graphic:



MSCI UK Net Total Return Index and Baillie Gifford High Yield Bond Fund returns for Q3 2020. Source: AJ Bell Investments, Bloomberg LP, October 2020.

The team continues to monitor the progress of this tactical position for signs it may be approaching an attractive exit and we will update in due course, should we make any changes to the positioning of the portfolios.

Asset allocation – top contributors

Portfolio		
Top Contributors	Income	Income & Growth
1	Global High Yield (£ Hedged)	Asia Pacific ex-Japan Equities
2	Emerging Markets Equities	Emerging Markets Equities
3	Asia Pacific ex-Japan Equities	Global High Yield (£ Hedged)

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

AJ Bell Income Funds review – Q3 2020

Fund performance

Equities were the big winners in the portfolios 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 EM and Asia Pacific regions in both funds, with only the Income and Growth fund having a US exposure. However, Income and Growth has significantly higher weightings here and therefore benefited more than the Income fund.

In the main, gilt and international bond holdings in the portfolios 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 a large position in US corporate bonds, for instance, via the **Vanguard USD Corporate Bond UCITS ETF** in the Income fund and this holding saw loss of over 3%, in sterling terms, over the quarter, making it the second-worst detractor from performance after UK equity. There were some bright spots, however, such as UK corporate bonds, which we access via the **TwentyFour Corporate Bond Fund**, which was able to post a positive return along with, as highlighted already, our currency hedging on some positions in fixed income, meaning that we were able to retain local currency gains in these asset classes. Our global high-yield allocation, for instance – which we express via the **Baillie Gifford High Yield Bond Fund** and hold in both the Income and Income and Growth funds – saw gains of 3.1%, which would have been transformed into a negative return, had we not held a hedged position.

Global infrastructure – which we hold via the **Legg Mason IF ClearBridge Global Infrastructure Income Fund**, and which is held in both Income and Income and Growth funds – had quite a volatile ride in the quarter, being up over 2% in July, before falling to almost -5% down in early September, before settling to close marginally down for the full period at -1.7%. Elsewhere in the funds, global property faced a challenging quarter, as the impact of lockdowns on high street and prime business district property and rents bit into valuations of the asset class. In the Income and Growth fund, we hold the L&G Global Real Estate Dividend Index Fund for our global property allocation and this fell almost 2% in the period, making it the third-worst detractor from returns in the fund.

All other areas of the portfolios performed in line with expectations and, whilst both funds posted small falls in the period, when compared to the extremely sharp falls seen in Q1, especially in Income and Growth fund, the returns could be said to be reasonably flat and not out of the ordinary in scale.

Portfolio changes

In the funds, there were no changes to be seen in the quarter in terms of asset allocation, nor to any of the underlying products we use to express our positions. We maintain a watching brief on developments, particularly in the passive ETF and indexing space where providers continue to compete aggressively 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 (both funds)

	3 months	6 months	1 year	Inception*
VT AJ Bell Income	-1.13%	8.20%	-3.18%	1.99%
VT AJ Bell Income and Growth	-0.69%	11.66%	-11.56%	-7.92%

Both funds launched on the 8 April 2019. 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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