AJ Bell

AJ Bell Income Funds – Q4 2020 report

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments covering the AJ Bell Income Funds over Q4 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

The final quarter of 2020 turned out to be one of the most tumultuous in history, with COVID-19 vaccines, a Brexit trade deal and a new US President. Each of these would be significant in its own right but to have all three in just three months gave investors plenty of food for thought. All three of these events were received positively by investors and that drove markets higher as the end of the year approached. However, with further lockdowns, rising virus numbers and a very challenging Christmas, it was a reminder of the terrible human cost the virus has brought in 2020. 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.

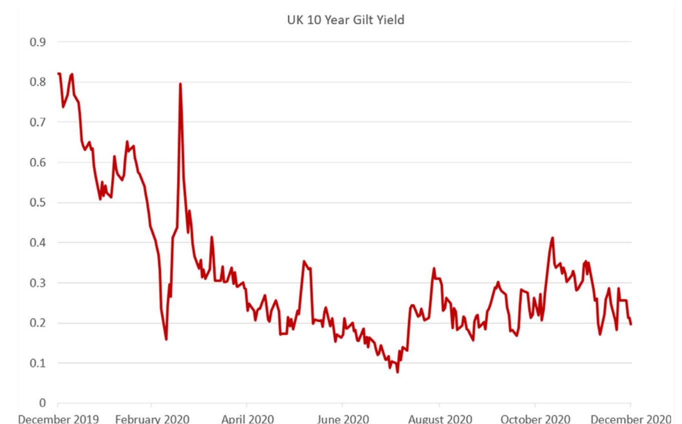
Looking ahead though, it appears things are a little brighter. Vaccines are being delivered and, despite that dark days of winter, the second half of 2021 looks to inspire more hope that we may be able to return to some kind of normality. A Brexit deal has certainly brought some clarity to the UK despite the inevitable bumps in the road, while central banks continue to support economies around the world.

Economic and market review

In 1959, Dinah Washington sang her beautiful song 'What a difference a day makes' and, in the context of this terrible year, Monday 9 November represents that day – when Pfizer announced its breakthrough vaccine in the fight against COVID-19. In the bleakness of winter, with Britain in the grip of the feared second wave, it seems uncomfortable to write positively about the effect it had on stock markets but the reality is that this gave investors a strong boost as it ignited hopes that 2021 could see a return to some normality. With a long-awaited Brexit deal and a new US President, it was a hugely eventful quarter to end a truly historic year. Overall, the MSCI World index finished the quarter up 7.8%, which resulted in a total return for the year of 12.3% – an outcome totally unthinkable just a few short months ago.

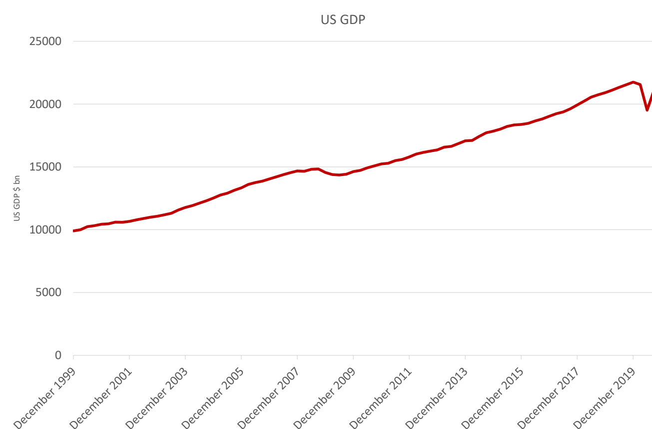
In the UK, a flash news conference on Christmas Eve took the nation away from wrapping their final presents with the announcement that a trade deal with the EU had finally been agreed. While the devil is no doubt in the detail within the 1,000+ page document, investors breathed a sigh of relief that there was finally some clarity on the future trading relationship with the EU. However, the backdrop of further lockdowns across the country highlighted the economic challenge that remains and, in the face of a tough winter, the Chancellor Rishi Sunak had little option but to extend the furlough scheme until April as unemployment ticked up month on month. With the UK locked down during November, retail sales unsurprisingly fell after six straight months of growth, however, manufacturing PMI data hit a three-year high as factory orders picked up, albeit potentially due to stocking up ahead of Brexit. The FTSE All Share index has been a major laggard for a number of years but news of vaccines saw UK shares bounce back strongly and they then received a further boost with the EU deal. As a result, the index increased by 12.6% over the quarter, but over the year, it was by far the worst performing market, falling back 9.8%.

The bond market saw some significant volatility, particularly in the UK where Government gilts fluctuated seemingly on a daily basis as the trade talks between the UK and the EU ebbed and flowed. Having started the period at 0.22%, the 10-year Government bond sold off to 0.42% on news of the vaccines but traded in sharply as the year ended, to finish almost flat at 0.18%, resulting in the FTSE Actuaries UK Conventional Gilts All-Stocks index increasing 0.6% over the quarter. Corporate bonds were more stable, with the iBoxx UK Sterling Corporate All Maturities index increasing by 4.0% over the period, while high-yield bonds were even stronger, with the Bloomberg Barclays Global High Yield Bond GBP Hedged index increasing by 6.0%. This brought 2020 to a close with all three indices delivering a strong total return for the calendar year.



Source: Bloomberg, December 2020

In the US, Joe Biden won the US Presidential race as a variety of legal challenges from Donald Trump petered out. Markets were relatively unaffected by the vote, with many focusing on the race for the Senate which will be determined by two run-off elections in early January. If the Republicans win one of these seats, Congress and Senate will be divided, which will limit how much the President is able to accomplish. This outcome is viewed favourably by investors as it should stop major corporate tax rises and give more certainty to the important healthcare sector. The economy continued its strong bounce back with record GDP growth of 33.4% in Q3, while Congress approved a $892 billion stimulus package, including direct payments to most American citizens to keep the economic recovery moving. In December, Tesla became the largest company ever to be added to the S&P 500 index. Following the announcement, Tesla added over $270 billion of market cap as index funds bought the stock. To put this in context, Tesla added more value in five weeks than the value of every other car maker in the world added together! Overall, the S&P 500 index increased by 5.9% over the period, which made it a return of 14.1% for the year.



Source: Bloomberg, December 2020

Having unlocked their citizens for the summer holiday season, European countries took the opposite view as the second wave of COVID-19 started to bite. Unsurprisingly, this resulted in a hit to the major economies, with weak consumer confidence and unemployment forecast to move above 9% early in the New Year. In response, the European Central Bank announced it was increasing its quantitative easing programme by a further €500 billion and extending the programme to the end of March 2022. This takes the total for the stimulus programme to nearly €2 trillion, however implementation remains delayed due to political arguments between countries which need to approve the spending. Investors received news of a trade deal with the UK positively, helping boost markets into the end of the year, with the DAX index in Germany hitting a record high. As a result, the MSCI Europe ex-UK index increased by 9.0% over the quarter.

In Asia, the recovery continued to take hold, with Chinese GDP expanding 4.9% year on year, helped by retail sales and industrial production hitting their highest levels this year. The big story over the quarter in Asia was the cancellation of the Ant Financial IPO in November, which was on track to be the largest in history at over $300 billion. However, just days before the float, the Chinese Government cancelled it and subsequently launched an investigation into the business and its parent company, Alibaba – which owns 32% of Ant – ordering changes to the business which will in all likelihood slow future growth. Since peaking in late October, Alibaba, China's biggest company, has fallen back around 30%, as investors digest the moves by the Chinese authorities to manage risk in their financial system. Despite this headwind, both Asia and emerging market indices performed well over the quarter with the MSCI AC Asia Pacific ex-Japan index and MSCI Emerging Markets index increasing by 12.7% and 13.2% respectively. As a result, the Asian index ended the year as the best performing region with a total return of 18.7%, outstripping the US. In emerging market fixed interest, bonds provided steady returns over the quarter with the JPMorgan GBI Emerging Market Global Composite Bond index increasing by 3.8% over the period.

Source: Bloomberg, December 2020

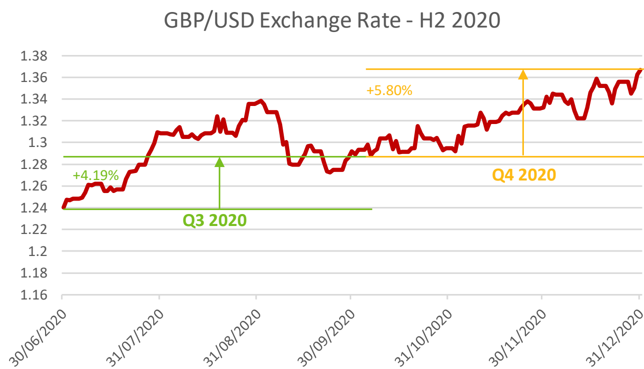
In Japan, new Prime Minister Suga announced a further round of stimulus after data showed that the economy suffered its largest quarterly contraction since WWII. The Y73.6 trillion package, equivalent to c.£530 billion, will be spent on direct programmes to boost consumption, including moves to shift to a carbon neutral approach by 2050. In the market, the Nikkei 225 index hit a 30-year high as the end of the year approached, while the more widely used Topix index ended the quarter with a gain of 7.5%.

All market performance figures are in GBP.

Asset allocation and positioning

As discussed in our last quarterly update, the team was pleased to have seen a much more constructive investment environment at the end of Q3, with both stocks and bonds managing to shrug off significant headwinds in the quarter itself, to post respectable gains. However, despite the better risk appetite, income products – particularly those aligned to equity income – still faced a relatively challenging quarter, as companies remained unwilling or unable to commit to dividend programmes and returning cash to shareholders. As we moved into Q4, however, we began to see some thawing of this position. For instance, in March 2020, with the outlook appearing very bleak at the height of the COVID-19 pandemic, the Prudential Regualtory Authority (PRA) forbade the big five FTSE 100 UK banks (HSBC, Barclays, Lloyds, Natwest and Standard Chatered) from paying out any dividends to shareholders in calendar year 2020. This was a grievous blow to UK equity income investors and was the start of a whole host of programmes being cut or suspended by FTSE 100 and FTSE 250 businesses, in the middle part of the year. In Q4 2020, however, it was pleasing to see the PRA relent on this position and give permission to banks to start returning cash to shareholders in 2021. This – allied with late-in-the-day positive news on the Brexit front, vis à vis a successfully negotiated trade agreement with the EU, and positive news on the rollout of a coronavirus vaccine – means that dividend expectations have recovered strongly, when one looks ahead to 2021, giving the team confidence that we may be past the worst of the dividend freezes.

In Q3, a significant driver of performance in the funds was the strength of pound sterling, especially against the US dollar, which fell over 4% against sterling, dampening returns to portfolios from overseas assets, as currency translation acted as a headwind. This continued to be a theme in Q4, again with sterling notably stronger than the US dollar by over 5%, as investors continued to be bearish the US currency as the scale of the US COVID-19 support programmes became headline news. 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 gains, due to being smaller in scale, were in some instances pushed negative, after translation. However, the double dose of positive news in Q4 – regarding COVID-19 vaccine breakthroughs and a Brexit trade deal being agreed – meant, somewhat counterintuitively, that despite the sterling strength, UK stocks which have for so long been out of favour for investors rallied strongly in the quarter. Our portfolios have an element of home bias, as a consequence of our risk budgeting and due to the historically high yield seen in the UK and, as such, although the sterling strength dampened returns from international assets and dividend payments were low in Q4, our significant UK equity and UK corporate bond positions performed admirably from a capital perspective in the quarter.



GBPUSD Exchange Rate – H2 2020. Source: AJ Bell Investments, Bloomberg LP, January 2021

As well as significant UK expsoures, we also allocate to higher growth regions and assets, such as the Asian Pacific region and emerging markets within both funds, with the Income & Growth fund having larger weights. This positioning was rewarded in the quarter, with these regions emerging from the COVID-19 slump strongly and also benefiting from the already-mentioned weakness of the US dollar. This is due to the dollar commonly being a funding currency for a lot of Asian Pacific and emerging market corporates. As a result, periods of dollar strength can weigh on the prospects for businesses and economies in this region, where dollars are scarce and they need them for debt repayments; conversely, when the dollar is weak and supply is plentiful, we generally see improved outlooks for stocks and bonds in these higher-risk, higher-growth areas, which was indeed the case this quarter.

Asset allocation – top contributors

	Portfolio	
Top Contributors	Income	Income & Growth
1	UK Large-Cap Equities	UK Large-Cap Equities
2	Europe ex-UK Equities	Asia Pacific ex-Japan Equities
3	Asia Pacific ex-Japan Equities	Emerging Markets Equities

Source: AJ Bell Investments, Bloomberg LP, January 2021

AJ Bell Income Funds review – Q3 2020

Portfolio performance

Equities were the big winners in the funds in Q4, with all regions and sectors within the asset allocation showing positive gains for the period. As discussed already, UK stocks had a very strong quarter (although were still negative for the year), despite a stronger sterling, with the FTSE 250 up almost 19% in the quarter and the larger cap FTSE 100 up just over 11%. The improved risk appetite amongst market participants, in the face of continued headwinds, also saw strong gains accrue to our Asia Pacific and emerging market holdings, with the **Vanguard FTSE Developed Asia Pacific ex-Japan ETF** and the **JPM Emerging Markets Income Fund** up 18.8% and 18.3% respectively. We hold allocations to these regions in both funds, but the riskier Income & Growth fund has notably higher weightings here and therefore benefited more than the Income fund.

In the main, gilt and international government bond holdings in the portfolios struggled, especially when one accounted for the sterling translation on international bond holdings, which made weak performances worse. We hold a position in US Treasuries via the **Invesco US Treasury 3–7-year ETF** in the Income fund, and this holding saw losses of -5.5%, in sterling terms, over the quarter. On a brighter note, our global high-yield allocation – which we hold as part of the SAA in the Income fund and which we introduced to the Income & Growth fund on a tactical basis in Q2 – continued to reward our investors, with the **Baillie Gifford High Yield Bond Fund** seeing gains of 2.1% in local terms, which would have been transformed into a negative return, had we not held a currency hedged position.

Global infrastructure, which we hold via the **Legg Mason IF Rare Global Infrastructure Income Fund**, and which is held in both funds, had a strong quarter, climbing over 6% for the period. Elsewhere, we hold allocations to UK and Global Property in the Income & Growth fund, and these positions had a much better time of it this quarter than in Q3. For our UK property exposure, we hold the **iShares MSCI Target UK Real Estate ETF** and for our global property exposure, we use the **L&G Global Real Estate Dividend Index Fund**. These returned 5.3% and 6.4% respectively, as the sector bounced back in the final quarter of the year, with COVID-19 vaccine news giving hope for an end to lockdowns and the return to business of high street shops and businesses.

All other areas of the portfolios performed in line with expectations, with both portfolios posting welcome gains in the period, relative to the falls we'd seen in the portfolios in the challenging periods of Q2 and Q3.

Portfolio changes

In the portfolios, the team held off on any drastic asset allocation changes to the income fund range in 2020, choosing only to add some global high-yield exposure in favour of a reduction in UK equity to the Income & Growth fund in Q2, due to the uncertainty around the environment for equity income this year. The feeling was that whilst yields were depressed, the portfolios were still well positioned and sufficiently diversified from an asset class, geographic and industry basis to deliver their yield and total return targets and, as such, we preferred to get more certainty on the outlook before we locked in changes. As such, there were no changes in Q4. However, we are currently in the process of reviewing the strategic asset allocation on the income fund range and will update you accordingly on any changes to the allocation or implementation in due course.

We maintain a watching brief on developments in the income investing space as providers continue to evolve their products and 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 (both funds)

	3 months	6 months	1 year	Inception*
VT AJ Bell Income	4.03%	2.85%	1.32%	6.10%
VT AJ Bell Income and Growth	9.32%	8.57%	-5.70%	0.66%

Both funds launched on 8 April 2019. All performance is net of fees.

Source: Morningstar, AJ Bell Investments, January 2021

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.

AJ Bell Management Limited (company number 03948391), AJ Bell Securities Limited (company number 02723420) and
AJ Bell Asset Management Limited (company number 09742568) are authorised and regulated by the Financial Conduct Authority.
All companies are registered in England and Wales at 4 Exchange Quay, Salford Quays, Manchester M5 3EE. See website for full details.