AJBell

Passive Fund Review – Q4 2018

Introduction

We are delighted to bring you the latest quarterly report from AJ Bell Investments.

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

Over the course of the fourth quarter, market volatility picked up markedly as investors accepted that global growth was likely to slow into 2019, resulting in significant falls in equity markets. This slowing had become evident in economies around the world with the exception of the US but with the Federal Reserve indicating it expected growth to slow, it finally dawned on US investors that they were not immune to a slowing global economy.

Closer to home, once again it was Brexit that dominated the headlines, with huge turmoil affecting the UK government on its proposed withdrawal agreement. With UK politicians unhappy with the deal and the EU saying there was no hope of renegotiation, uncertainty picked up as to what the likely outcome of Brexit would be. It wasn't just the UK that suffered though with Germany, Italy and France all suffering from political challenges that impacted upon markets.

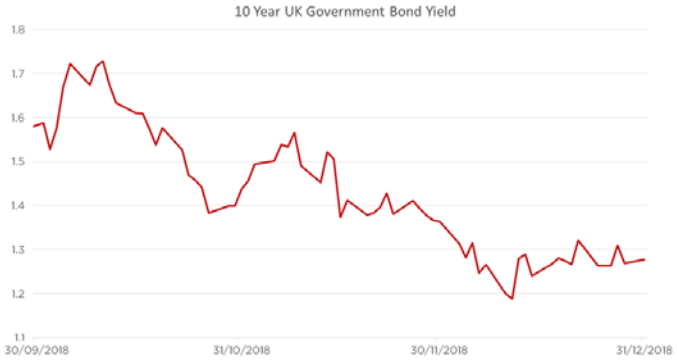
In Asia, slowing growth in China and Japan hit returns while Brazil benefited from pro-business reforms introduced by its new President. However, this was of minor consolation to global investors who suffered significant losses on equity investments, while fixed interest markets offered some protection from the worst of the volatility.

The sharp falls seen over the quarter meant that major equity markets saw their first annual falls since 2011 and brought their worst year since the financial crisis in 2008.

Economic and market review

The fourth quarter of 2018 represented a major shift in performance from that seen earlier in the year with significant falls across equity markets. While earlier in the year it was emerging markets and Asia that suffered, in the final quarter it was the turn of the developed markets with the UK, the US, Europe and Japan all registering double digit falls in their equity markets. Away from equities, fixed interest markets on the whole benefitted from this 'risk off' approach, performing better than for much of the year.

In the UK, it was impossible to escape the looming spectre of Brexit, with Theresa May's government struggling to maintain any coherence once the details of the withdrawal agreement with the EU were announced. With a number of resignations from the cabinet, a confidence vote from her own party and a clear rejection of her deal from MPs, Theresa May clung to her premiership by her fingernails. At this time, it is still unclear if and how the UK will leave the EU on 29 March 2019, with all possible outcomes still an option. Unsurprisingly, this level of uncertainty has not played out well with investors looking at the UK, and this was reflected by a weakening of sterling over the period as well as the FTSE All Share Index which fell by 10.3%. Economically, the UK appeared to be progressing reasonably well early in the quarter, with wage growth reaching its highest level since before the financial crisis, and third-quarter GDP coming in ahead of expectations helped by England's surprising progress in the World Cup! However, as the quarter progressed, momentum slowed, particularly for retail sales as the high street struggled in the run-up to Christmas and traditional Boxing Day sales events were brought forward significantly to before Christmas. The increased concerns over Brexit and economic challenges saw the 10-year government bond yield move from 1.60% down to 1.27% over the quarter, reversing the previous quarter's move, with the FTSE Actuaries UK Conventional Gilts All Stocks Index increasing by 1.9%. Corporate bonds were hit more by the uncertainty, with the iBoxx UK Sterling All Maturities Index falling back slightly over the quarter, while high yield bonds (that are more closely correlated with equities) were hit hard. The Bloomberg Barclays Global High Yield Bond Index fell by 4.2% over the period.



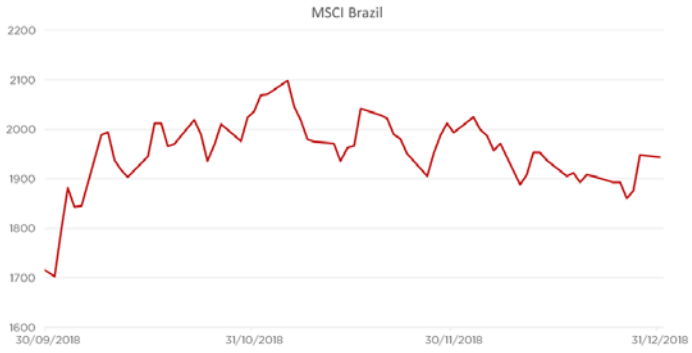
Source: Bloomberg LLP, AJ Bell Investments; January 2019

The US has been the standout performer over 2018 but in the fourth quarter this came to a juddering halt, with the S&P 500 Index falling by over 11%. For much of the quarter economic data from the US was strong, with third-quarter GDP growth coming in ahead of expectations at 3.5%, while unemployment fell back to close to a 50-year low. At the same time consumer confidence and spending were also robust, so it would be easy to ask why there were big falls in equity values. The main drivers for this are two fold; firstly, the concerns over global trade wars remained at the forefront of investors' minds over the quarter. While various comments from President Trump and President Xi of China at the G20 summit appeared to have de-escalated matters, investors remained unconvinced and took fright at how this trade war may disrupt global GDP growth in 2019. The second factor was comments from the Federal Reserve which indicated that it may have started to recognise a slower pace of US growth. While the Fed saw fit to increase the US interest rate in December, the fourth hike this year, it was the comments that accompanied the announcement that caused the concerns, with indications that the economy would need fewer rate rises next year than previously expected. The changing expectations of interest rates saw major volatility in the US 10-year Treasury yield. which climbed to above 3.2% early in the quarter but fell back sharply to 2.7% at the end of the period.

Source: Bloomberg LLP, AJ Bell Investments; January 2019

European economies showed signs of weakness over the period, with even the powerhouse that is Germany struggling. It saw its third-quarter GDP contract for the first time since early 2015, with impacts from new emissions standards for its car industry hitting output. In addition, Chancellor Angela Merkel suffered a significant weakening of her authority in regional elections and announced she would not seek re-election in 2021. Having been in power since 2005, this represents significant uncertainty in the next couple of years for Germany at a crucial time for the EU. Away from Germany, Italy also struggled with slow growth and a political stand-off between the government and the EU, which rejected its initial budget. This impasse created significant volatility in Italian bond and equity markets, particularly for financial companies. In France, President Macron faced huge social unrest as protests - initially at rising fuel prices, but latterly at his overall economic policy - turned into numerous riots in Paris. The 'yellow vests' fought repeated battles with the police and demanded an end to tax cuts for the rich, along with a host of other reforms. Macron caved in on a number of areas but unrest has continued and economic output and confidence in France has taken a major shift downwards. Over the periods, the MSCI Europe ex UK Index fell back 11%.

The emerging markets have seen significant volatility over the course of the year and this continued during the fourth quarter. For much of the year, emerging markets were hurt by a strengthening US dollar and the potential consequences of a trade war between the US and China and this continued to play a major role as the end of the year approached. However, during December, with the US Federal Reserve softening its stance on interest rate rises and the 10-year US Treasury yield falling, emerging markets actually had some respite. While in absolute terms, emerging markets still fell back sharply with the MSCI Emerging Markets Index dropping by 5.3%, they significantly outperformed other global markets. Some of this improved performance came from Brazil where new President Bolsonaro has helped improve both consumer and business confidence with his reform policies. In China, third-quarter GDP came in at 6.5% year-on-year, slightly below expectations but clearly still very strong. The People's Bank of China has recognised the risks from the trade war and implemented some monetary stimulus along with a cut in the reserve requirement for banks in an attempt to boost lending. In India, political risk increased in December when the head of the central bank unexpectedly quit following rumours of interference from central government. Looking at fixed interest in the region, the JPMorgan GBI Emerging Market Global Composite Bond Index increased by 4.9% over the period.



Source: Bloomberg LLP, AJ Bell Investments; January 2019

A series of natural disasters over the summer caused the economy in Japan to decline over the third quarter by 0.3%, although with the government spending significant sums on rebuilding, this was expected to rebound in the fourth quarter. Economic data over the period was mixed, as while manufacturing output continued to grow and new orders also increased, business confidence fell for the seventh month in a row as businesses looked ahead to next year's planned increase in consumption tax and what this will do to an already fragile economy. Over the quarter, the Nikkei 225 Index fell over 12.9%, the first time in eight years that the index has been negative.

Source: Bloomberg LLP, AJ Bell Investments; January 2019

All market performance figures are in GBP.

Market outlook & our positioning

In the last quarterly review, we highlighted that some major risks existed below the surface in the global economy that were perhaps being ignored by equity investors. Over the fourth quarter it would certainly appear that some of these risks have risen rapidly to the surface.

Economic data has changed significantly over the past three months, with investors now accepting that it is highly likely that global economic growth will slow during 2019. This has been recognised by the Federal Reserve in the US which has now indicated a more gradual increase to interest rates is expected next year. Investors have realised, with hindsight, that equity markets had got ahead of themselves over the summer and that a more realistic view should be taken, particularly as this global cycle is already longer than most investors have seen before.

Many of the risks that existed in the summer have not gone away, particularly the trade war that continues to be a headwind to global growth, especially when President Trump gets anywhere near his Twitter app! In addition, risks have escalated in Europe, with political issues spreading to Germany and France while the great unknown in 2019 remains Brexit.

With equity markets having fallen back sharply and valuations now on more realistic levels, it is entirely possible that, should the trade wars dampen down and a path to a soft Brexit be found, equities could well be primed to rally sharply, but of course both of those issues represent a rather large 'if'! However, UK equities are certainly unloved and out of favour given the uncertainties that exist, and as a result, dividend yields have increased significantly. For some, this will make equities an attractive proposition and may well provide a useful cushion against further volatility into 2019.

In fixed interest markets, we continue with our UK gilts exposure being held entirely in short duration bonds, i.e. gilts that mature in less than five years. While this position is designed to cushion the blow from rising interest rates, it also helps protect from significant volatility in the bond market. As a result, we remain very comfortable with this position given the risks that we believe will persist into 2019.

Passive Fund Review – Q4 2018

In Q4, we maintained our focus on lowering the cost of investment in the funds and are pleased to see continued progress for our efforts. While a lot of this progress is around the efficiency of our dealing and execution processes, we have also been working on the OCF of the funds and are pleased to see that at the end of Q4, the largest fund in the range, the Balanced Fund had an OCF of 0.40%, down from 0.50% at the end of Q1. We hope to continue the progress on cost compression across the range and, as the funds grow, we are committed that any benefits of the increased scale will automatically be passed to investors, as a result of the structure we now have in place on the funds.

As a reminder, Investcentre custody fees were waived until January 2019 on the fund range, therefore, these will be reintroduced as of January 1st 2019, as already advised.

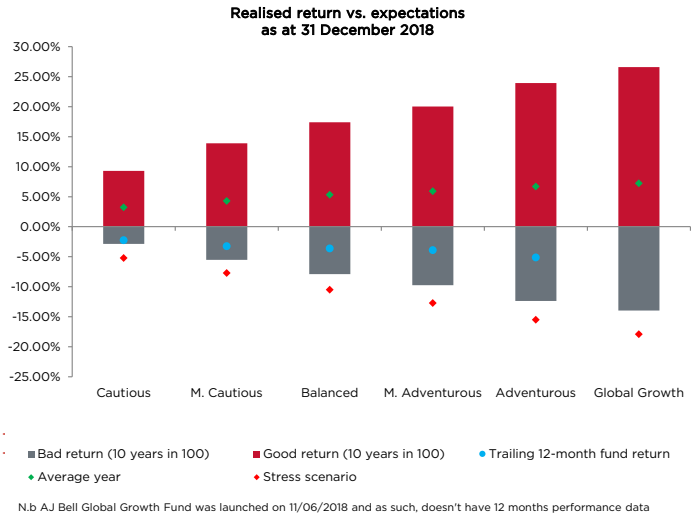
Performance & Fund Updates

With the performance of the funds being a function of the assets held within them, a tough period for financial markets across the board in Q4, meant performance for the range was held back. With market participants forced to digest various unsettling situations in the quarter; US/China trade wars, Brexit uncertainty, French fuel protests and EU/Italy budget standoffs, relatively few asset classes escaped unscathed.

Equities in particular were punished over the period, with all of the major stock markets in the red for the quarter, although, in our portfolios, the worst of the falls were offset by a weaker sterling which cushioned the blow for UK based investors. UK mid-caps were the worst performer, as investors deserted the UK while Brexit uncertainty persisted, with the domestic focused FTSE 250 Index down over 13% on the quarter. Our funds are structured with a bias to the UK, versus a market portfolio based on the respective size of global markets and, as such, a poor period for the UK detracted from returns. However, within this UK overweight, the funds are tilted to the large cap, internationally focused FTSE 100 Index, which performed better than the FTSE 250 Index, helping to mitigate some of the fall. Hot on the heels of the FTSE 250 Index was Japan (down over 12%) and Europe (down over 10%) as optimism around global growth waned and the concerns of a trade war between the world's largest economies, the US and China escalated. All of the funds, with the exception of Global Growth Fund, are overweight Japan, so from helping performance last quarter, this positioning weighed on performance in Q4. The trade war rhetoric, allied to a rate hiking cycle in the US, saw the S&P 500 Index shift from being the last bastion of positive stock market returns amongst major developed indices prior to December, to posting the worst December in its history (starting 1957), falling over 9% in the month (and over 11% in the quarter), despite a rip-roaring Boxing Day rally, which saw it up over 5% in one day! With all of our funds underweight the US, again versus the market portfolio, they avoided the worst of the falls in US stock markets and the ensuing volatility. Lastly, one of the year's best performing sectors, Technology, saw a reversal of fortunes, falling over 15% in Q4, to leave it clinging onto a positive return for the year. Our risker funds have notable weightings toward this sector and, as such, sell offs here hindered fund performance.

In fixed income markets, things were slightly brighter with UK short dated gilts showing positive returns around 1% in the quarter, while global government and investment grade corporate bonds were up over 3.5%. With our funds deliberately more exposed to global fixed income, as opposed to the usual UK gilts and UK corporate bonds seen in most UK based multi-asset funds, it was pleasing to see good performance here, which subsequently translated into the funds. In particular, this helped our lower risk mandates, where weightings to defensive asset classes are higher. Hard currency emerging market debt i.e. debt denominated in US dollars, while falling in local terms, also showed positive performance, when translated back to sterling, showing gains of almost 2% for UK based investors and again, helping performance. Despite gains in fixed income in the main, one area that didn't participate was global high yield, which fell over 4% in local terms and 2% in GBP terms, as the same concerns that hit stock markets, also fed into the riskier fixed income assets.

While the funds have suffered in the face of challenging markets this quarter, it should be noted that the returns for the year are in line with the range of expectations that the team advise of in the "Passive Funds - Adviser FAQ" documentation (see graphic below). While these expectations are based on statistical analysis and are not guaranteed, it is further worth noting that performance has remained in the range of "normal" expected outcomes and are not close to the stressed scenarios that we also test for, which should put some context to the moves we've seen recently. Although the market moves have been uncomfortable this quarter, especially given the relatively calm markets we've experienced and became accustomed to over the last few years, we are nowhere near the sort of stress we've seen in the past, 2008 for example and, that being the case, keeping some perspective that these are normal market moves is advised.



**AJ Bell Passive funds - Trailing 12 month return as at 31/12/2018. The 'Average Year' and range of expected returns are forward-looking and based on a five year time horizon. Source: Bloomberg, AJ Bell*

Portfolio Changes

In the main, Q4 has been a quarter of taking stock as well as monitoring and researching potential updates for 2019. With all of the major passive providers looking to cut costs to gain market share and with notable new entrants into the space in 2018 (L&G's ETF offering, for instance) the team are in the midst of a full market review to ensure that the holdings within the funds are best of breed, while the models themselves are as cost and operationally efficient as possible, in order to always offer value for money to investors.

The one notable change to the funds in Q4 was around the allocation to strategic cash. This stands at 11% in Cautious, 5% in Moderately Cautious and 2% in all of the other funds. Traditionally, the funds held cash on deposit with our custodian, except on the Cautious fund, which had a 9% allocation to a sterling liquidity fund. As a result of the change to our custodian in Q2, the team gained the ability to utilise a cash sweep function, in which cash in the funds is swept into the service and invested in a panel of liquidity funds and remains there until such time as required ensuring all cash is working as hard as possible. The team instituted this service in November 2018, effective on all funds, with the exception of the Moderately Cautious fund. Here, the cost of the service, at the 5% cash weighting would have raised the overall cost of the fund, without seeing an equivalent or better return profile than that provided by deposit cash and, as such, the sweep will be enabled on this fund once the return from the sweep is at a level that makes it a net benefit for the fund investors, which we anticipate being early 2019.

Performance Summary (All Funds)

Fund name	3 months	6 months	1 year	Inception*
VT AJ Bell Passive Cautious	-2.75%	-2.48%	-2.25%	-0.24%
VT AJ Bell Passive Moderately Cautious	-4.45%	-3.64%	-3.25%	0.20%
VT AJ Bell Passive Balanced	-6.29%	-5.08%	-3.63%	0.99%
VT AJ Bell Passive Moderately Adventurous	-7.41%	-6.10%	-3.91%	1.41%
VT AJ Bell Passive Adventurous	-8.68%	-7.18%	-5.12%	0.84%
VT AJ Bell Passive Global Growth	-	-	-	-

*All the funds launched on 18th April 2017, with the exception of the Global Growth Fund, which had an inception date of 11th June 2018. As a result, performance cannot be displayed for this fund, until we have a full year of data.

This report provided general information about the AJ Bell Passive funds. 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.

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