AJ Bell Passive funds – Q1 2018 report

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.

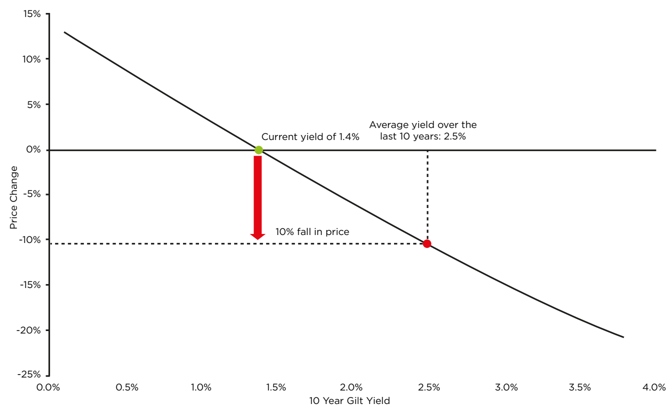
Summary

Although 2017 contained many shocks and surprises – a snap general election in the UK, rising tensions between the US and North Korea and the ongoing Brexit negotiations to name a few – the global financial markets seemed to take it all in their stride. Despite three rate rises in the US and one in the UK, major central banks across the globe continued to keep interest rates near record lows and, alongside stable economic conditions, the low interest rates supported equity markets as the availability of cheap financing helped boost company profits through increased borrowing. Against this backdrop, investors have been willing to pay up for higher share prices rather than accept the meagre returns on offer in government bonds.

At the start of 2018, President Trump replaced Janet Yellen with Jerome Powell as the Chair of the Federal Reserve, the US central bank. With the new Chairman holding a positive view on the US economy, he immediately set to it, increasing interest rates at his first FOMC meeting in order to stave off inflation fears, marking the possible beginning of the end to the extraordinary low interest rate environment that has been in place in the US and beyond since 2009. With a potential US/China trade war brewing, markets have been less forgiving so far this year, as market participants realise they may no longer be able to rely on support from the central banks. This has seen the return of volatility in equity markets and as a result, global equity and bond markets have fallen.

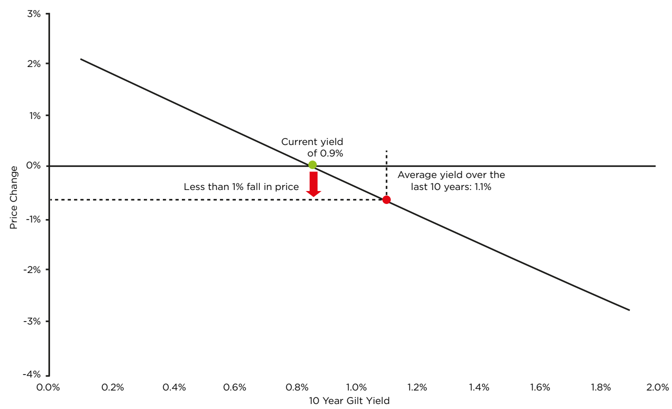
Economic conditions remain strong and, as such, we view this merely as a wobble for equity markets, which we believe will continue to be supported by strong dividend yields, with the FTSE 100 having paid out 4.6% over the last 12 months, above its 10-year average yield of 4.1%. We are, however, far more concerned about the effect of rising interest rates on bond prices. The yield on a 10-year gilt is currently 1.4%, over 1% below its 10-year average of 2.5%, and a return to the average level would lead to a price fall of over 10% as it stands. Investing in traditional passive gilt ETFs achieves similar characteristics to a 10-year gilt. We have made changes to the portfolios this quarter to protect against this, moving our entire gilt exposure into shorter-dated gilts (average maturity of three years), which are less sensitive to changes in interest rates. We have not exited gilts altogether to ensure the portfolios remain at the right risk levels.

Price change of a 10 year gilt at different yield levels



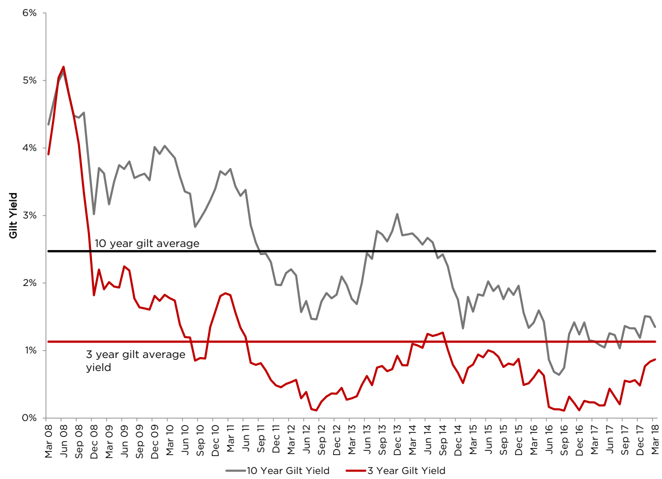
Source: Bloomberg LLP, AJ Bell Investments: April 2018

Price change of a 3 year gilt at different yield levels



Source: Bloomberg LLP, AJ Bell Investments: April 2018

Average 3 & 10 year gilt yields over the last decade

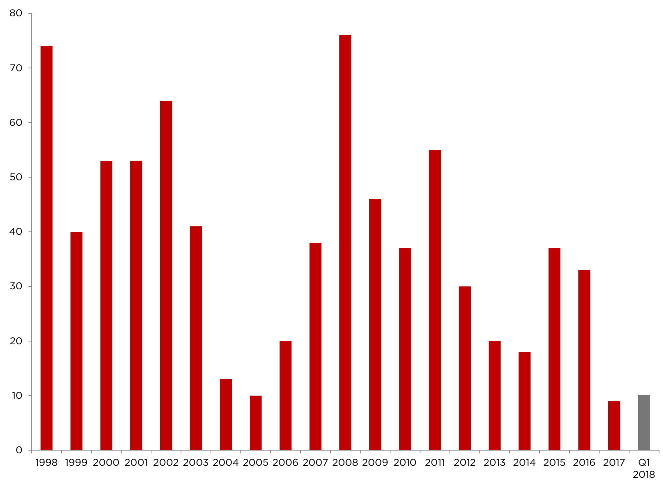


Source: Bloomberg LLP, AJ Bell Investments: April 2018

Economic and market review

The FTSE 100 experienced a single day fall of more than 1% ten times in the first quarter of 2018, which is more occurrences than the entirety of last year, highlighting the return of market volatility after a smooth ride for investors in 2017. When put in context with the past twenty years it looks more in line, but is a reminder that markets go down as well as up!

Falls of more than 1% for the FTSE 100



Source: Bloomberg LLP, AJ Bell Investments: April 2018

With the exception of a few regions and sectors, all major global equity and bond markets ended the first quarter lower than where they began.

Headlines may lead you to believe that the fall in equity markets in Q1 was due to the threat of a global trade war, sparked by President Trump's announcement of tariffs on imported steel and aluminium in the US. Although this did cause a sell-off at the end of February and again towards the end of March, these losses were short-lived as the market viewed the likelihood of an all-out trade war as low. Trump's actions are probably of a political nature as he recently announced his intention to run for a second term in 2020, with the tariffs' aim to consolidate his popularity in swing states such as Michigan and Ohio; where the main industry is steel production. An all-out trade war remains unlikely as the knock on effects would likely hurt Trump's popularity in other states, as higher import prices hurt consumers in general.

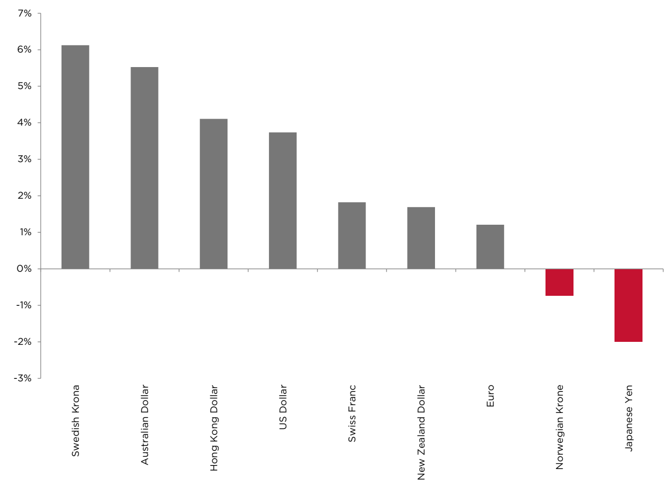
If the prospect of a trade war is not to blame, attributing the actual reason for the fall in equity markets this quarter is not straightforward. From the middle of January to the middle of February, the FTSE 100 index fell by almost 9%; this coincided with a general rise in global bond yields. The increase in yields was largely driven by expectations of higher interest rates in the US; where continued economic growth, a change in the Fed leadership and fears of inflation stoked by rising wages, saw market participants harden their view on rising rates. At the end of 2017 markets forecast that US interest rates would be at just over 2% at the end of 2019. Fast forward to the end of this quarter and this had risen to 2.5%. With the US remaining the largest economy in the world, changes in its policies and expectations here inevitably send ripples across the globe.

It is fairly simple to see why higher interest rate expectations led to lower bond prices. The coupon received and the final price of a bond are fixed at outset. Therefore, if a bond investor now requires a higher rate of return (yield) to compensate for the threat of higher interest rates in the future, the current price of the bond must fall to compensate. This has not only affected government bonds, but corporate and high yield bonds as well.

Following the global financial crisis in 2008, central banks cut interest rates to record lows and engaged in a programme of Quantitative Easing (QE); purchasing large quantities of bonds to ensure yields remained low. The purpose of keeping interest rates low was to encourage people to stop saving and start borrowing (and then spend it!), thus aiding the required economic recovery. However, with the banking sector in no position to lend (and with little incentive to lend at historically low rates), this led to the unintended consequence of pushing savers into riskier investments such as equities, in order to make sure savings goals could be met. The increased demand for equities from savers was further added to with companies using cheap debt to fund buybacks of their own shares, driving share prices higher and higher, and reducing future expected returns in the form of lower dividend yields and less potential for capital growth. However, as interest rates rise and bond yields increase, the machine basically goes into reverse; savers can again use bonds as their vehicle of choice as yields increase, whilst companies now have large debt piles to service on their balance sheets from borrowing to fund buyback programmes. The combination of these things makes equity investments look relatively less attractive, leading to price falls in the short term.

Sterling ended the quarter 4% higher versus the US dollar and 1% higher versus the euro as it continues to rebound following the initial fall after the EU referendum vote.

Currency moves against the pound in Q1 2018

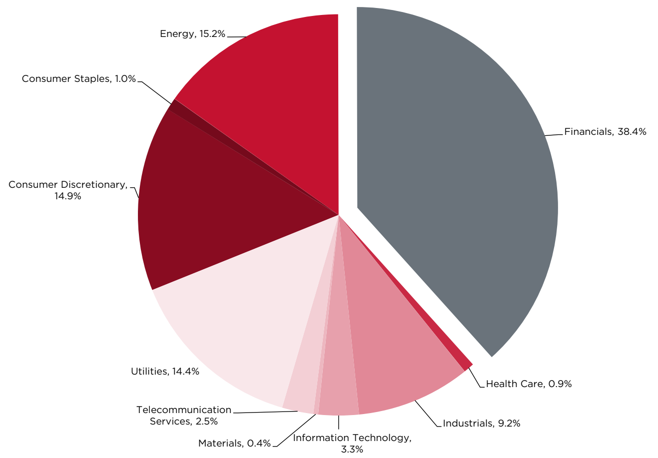


Source: Bloomberg LLP, AJ Bell Investments: April 2018

With the companies in the FTSE 100 earning the majority of their profits outside the UK, these profits translate into a smaller sterling amount as our currency strengthens. Because of this, the FTSE 100 was one of the worst-performing markets in the first quarter, down 8% to just above the 7,000 level. The FTSE 250 is a mix of large and medium sized companies, and as such more of the profits from this index are earned in the UK. As a result it faired relatively better, down 6% in the period.

Italy was the best-performing market in Europe as its elections concluded. Although the right wing Five Star Movement made gains, uncertainty has now reduced and technical factors in the Italian political system make it difficult for the Five Star Movement to actually lead the country. In addition to this, 40% of the Italian stock index is made up of financials and banks tend to be more profitable as yields rise, as their profit margins improve. Across the continent, the performance of European financials was only bettered by European technology companies over the quarter. The Swiss stock market was bottom of the European pile in the period. This market is more focused towards sectors where profits are more stable, such as consumer staples and healthcare (60% of the Swiss index) and these stocks are used extensively for income generation, hence valuations here are much more closely linked to bond prices.

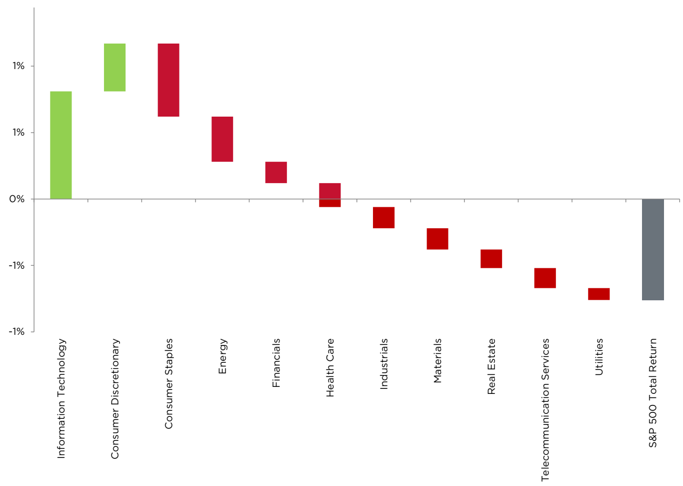
Breakdown of the Lxyor FTSE MIB Index



Source: Bloomberg LLP, AJ Bell Investments: April 2018

Although on the surface the US markets fared better, with the S&P 500 index down 1% in its own currency, this was all down to the strong performance of technology stocks (despite the sell-off in the last few days of March), with consumer discretionary the only other sector showing positive performance. The technology sector appears to be immune to recent bond yield rises, with the focus on this sector being very much around the potential profit growth of the companies, rather than valuations. As we move to an internet-connected society, companies such as Intel, Netflix and Amazon, amongst others, are viewed as the best potential beneficiaries and all delivered double digit returns in the first quarter of the year. The sell-off in the last few days, however, does show the sector is not entirely immune from changes in investor sentiment.

Composition of S&P 500 Q1 Return



Source: Bloomberg LLP, AJ Bell Investments: April 2018

Equity markets in Asia and across the Emerging Markets were also down in sterling terms, although they did perform better than those in the West. The Yen has strengthened against the dollar, due to its perceived safe haven currency status, and therefore tends to perform well in times of uncertainty. The MSCI Emerging Markets index was up 1% in dollar terms. Over half of this index is made up of technology and financials, the best-performing sectors over the quarter across the globe, and the region was also aided by the weakness in the US dollar, which lowers the debt burden of many Emerging Market countries that tend to borrow in dollars. The outlook for commodities was mixed, with oil prices up and industrial metals down, however, the moves were not big enough to have a discernable effect on the Asian and Emerging Markets complex.

Market outlook

Overall it was a tough quarter for markets, however, after nearly a decade of low interest rates, it is no surprise that a return to some sort of normality will cause some wobbles. The equity markets appear to have taken the brunt of the pain so far, however, in the long run they should be supported by continued profit growth (and tax cuts in the US), already highlighted by the technology and financial sectors this quarter. On the other hand, 10-year gilt yields were as high as 4.5% only a decade ago and now stand a shade below 1.4% at the end of this quarter.

The headlines would lead you to believe that the technology sector has led the sell-off this quarter. Indeed it has experienced large drawdowns and exhibited high levels of volatility. However, it has still been the best-performing sector over the quarter. Over the remaining part of the year and beyond we expect the journey in this asset class to be bumpy, but we do not think valuations in the sector have become particularly stretched, especially given the benefits it will receive from the US tax cuts and a steady economic backdrop. As such we continue to hold a position in this sector across the higher- risk portfolios, as we believe it will outperform the market in the longer run.

Despite the recent increases in interest rates, there is still potential for a significant rise back towards historical levels, should inflation become entrenched across the globe and this would lead to significant capital losses. That being the case, we keep a cautious outlook for bonds across the globe, and, where they are held in portfolios for diversification purposes, shorter-dated bonds are being used.

Passive funds review – Q1 2018

Over the quarter we made changes to our long-term asset allocation in the funds. Technology, UK Mid-Cap, Emerging Market Debt and International Debt were all added, whereas Index-Linked Gilts and Global Property were removed.

As well as the changes to the long-term asset allocation, we made our first tactical asset allocation decision. A holding in gilts was maintained to ensure the portfolios remained at the appropriate risk level, however, all gilt holdings were moved into short-term gilts (1-5 years), where the price sensitivity to interest rate increases is much lower.

The funds are still less than one year old, so it is still too early to discuss the performance specifically, however they are behaving as we would expect – all funds have seen a decline over the quarter, but this is not a surprise given the performance of the markets.

Fund	Cash	Fixed Income	Equity	Alternatives
Cautious	11%	61%	20%	8%
Moderately cautious	5%	48%	39%	8%
Balanced	2%	33%	57%	8%
Moderately Adventurous	2%	21%	70%	7%
Adventurous	2%	6%	86%	6%

Target asset allocation as at 31 March 2018

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.

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.