AJ Bell Growth Funds – Q4 2019 report

Introduction

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

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 funds and highlights any changes made in the period.

Summary

With signs of political stabilisation in the UK and elements of a partial trade deal between the US and China, equities finished 2019 in very strong fashion. With a further interest-rate cut from the Federal Reserve and stimulus from the likes of China and the ECB, investors continue to pin their hopes on central bank support and this drove equity markets higher.

In the UK, the deadlock in Parliament was broken with the General Election and now the Brexit process moves on to the trade negotiations. Those hoping that the Withdrawal Agreement would be the end of the process were rapidly reminded it was just the end of the beginning! Nonetheless, with some element of clarity, bond yields moved higher as the immediate risk of a hard Brexit subsided.

Economic and market review

The fourth quarter of 2019 saw equity markets climb higher but most of this pick-up in equities came in the last couple of weeks when the traditional 'Santa rally' seemed to be in full swing following the outcome of the UK General Election. Returns were even stronger in local currency terms but a rise in sterling in the final quarter held back returns in overseas equities. This positive end to the year brought to a close a phenomenally strong year for equities, which started 2019 on the back foot and finished it with the MSCI World Index up 22.7%. It wasn't just equities that had a strong year, with bond markets performing well too as central banks around the world continued to provide positive conditions for all assets.

It was a remarkable quarter in the UK with the political landscape dramatically shifting, with Prime Minister Boris Johnson first managing to renegotiate the Brexit deal with the EU, then seeing his 31 October deadline pushed back to the end of January 2020 and then finally getting the General Election he craved. When the election came, it was the Conservative Party securing a large majority that finally looks to have brought some stability to politics in the UK. Investors welcomed this, with sterling strengthening sharply, hitting 1.35 against the US dollar at one point, up from 1.23 at the start of the quarter. Domestically-focused equities also rallied hard, with the FTSE 250 ex IT Index gaining over 6% in the two days following the election, as investors hoped that the handbrake would be released on the UK economy, which has shown GDP growth of 1.1% for the year. However, investors are well aware that attention will now turn to the trade negotiations with the EU and – with an ambitious timetable of just 11 months for completion – it wouldn't be a surprise if some degree of uncertainty returned to the UK during 2020, as it is remembered that the Brexit process remains in its early stages. Over the quarter, the FTSE All-Share Index gained 4.2%.

Source: Bloomberg LP, AJ Bell Investments, January 2020

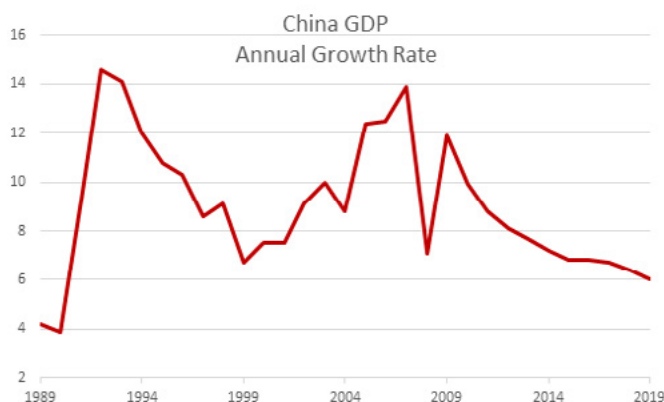
As some degree of clarity appeared in the UK over the quarter, the 10yr gilt yield climbed sharply, starting the quarter at just 0.49% but ending the quarter at 0.83%, representing a significant sell-off as fears of an immediate hard Brexit reduced. This saw the FTSE Actuaries UK Conventional Gilts All Stocks Index fall back by -3.9% over the quarter, while UK corporate bonds performed somewhat better with the iBoxx UK Sterling Corporate All Maturities Index, but still delivered a negative return of -0.2%. With investors having confidence, it was a strong quarter for high-yield bonds with the Bloomberg Barclays Global High Yield Bond GBP Hedged Index growing strongly with a return of 2.4%.

In the US, there was significant activity at both an economic and political level of the quarter. With some signs early in the quarter that the US economy was slowing, the Federal Reserve cut interest rates for the third time this year amid concerns of slowing job creation and lower consumer confidence. The trade war continues to be the main focus for investors and there were positive signs in October when President Trump announced a 'phase one' trade deal with China. However, it is recognised that this element of the trade deal is relatively limited and much more serious talks will be needed to find a proper resolution. US corporate performance remained solid over the quarter, with earnings growth surpassing expectations while GDP growth came in at 2.1%. The major political development over the quarter was the impeachment of President Trump over allegations that he sought help from Ukraine to boost his re-election hopes. This will see a trial held by the Senate in January that will decide whether or not Trump is found guilty and potentially removed from office. Investors were relatively unmoved by the initial decision, although this may change in January once the trial gets underway. Over the quarter, equities increased sharply, with the S&P 500 Index increasing by 1.3% and hitting record highs. This performance meant that the index has delivered a remarkable 25.7% during 2019. Despite the interest-rate cut, the US 10-year Treasury yield increased from 1.67% at the start of the quarter to 1.91% at the end of the quarter, as expectations of further cuts in 2020 reduced.

Source: Bloomberg LP, AJ Bell Investments, January 2020

In Europe, data remained mixed as the major economies continued to be held back by the ongoing trade war and slowing growth in Asia. The quarter saw Mario Draghi step down as Chairman of the ECB with Christine Lagarde talking his place; in her first speech she made it clear that the region could no longer rely on exports for growth and had to boost domestic demand with a clear expectation that government spending should increase. These comments seemed particularly directed at Germany, which has been reluctant to unleash some of its huge budget surplus. With manufacturing data showing the largest decline for seven years and new orders declining for the 15th month in a row, it is clear that it will take a concerted effort from both the ECB and domestic governments to help the Eurozone out of its malaise. Despite challenging economic conditions, the MSCI Europe ex UK Index increased by 0.9% over the quarter.

In Asia, the continued unrest in Hong Kong dominated the news agenda as the protests and violence seemed to pick up pace. Chinese GDP growth came in at 6%, which initially sounds very healthy, but is actually the slowest growth since 1992, as the trade war continued to bite. There has long been talk of slowing growth in China, not least because of the pure size of the economy making it inevitable that growth has to moderate as it readjusts from an export-led economy to one more domestically focused. The Chinese central bank continues to support the economy and cut the reserve requirement for banks twice in quick succession. In South Korea, retail sales fell back sharply after signs of improvement over the summer, not helped by a steady pick-up in unemployment, while in India, the central bank cut interest rates, with investors hoping for further tax reforms to help boost the economy. Over the period, the MSCI AC Asia ex Japan Index rallied strongly, increasing by 4.0%, and, although over the year the index was up 13.6%, this actually made it the poorest performing region in the world.



Source: Bloomberg LP, AJ Bell Investments, January 2020

In Japan, consumption tax was increased at the start of October and this combined with a huge typhoon saw retail sales fall sharply in October, however these rebounded in November. Annual GDP growth came in at 1.7%, much higher than had been seen for the previous year, while there were tentative signs that inflation was picking up after falling back in the first half of 2019. However, there were mixed signals from business and consumer confidence, with the former falling back and the latter increasing. Over the quarter, the Topix Index delivered a positive return of 1.2%.

Source: Bloomberg LP, AJ Bell Investments, January 2020

In the emerging markets, equities were helped by a weakening of the US dollar and supportive central banks and commodities. In Russia, central banks cut interest rates by more than expected in October and then again in December on the back of lower inflation expectations, while higher gas prices drove the commodity-sensitive market higher. In Brazil, interest rates were cut to 5%, their lowest ever level, while significant pension reform was passed that sees the pension age rise to 65 for men and 62 for women. Argentina continued to be volatile but saw some signs of stabilisation following the presidential elections in October. Over the period, the MSCI Emerging Markets Index delivered a positive return of 4.0%, while emerging markets fixed interest had a tough time, down sharply for much of the quarter before rallying strongly in December. As a result, the JPMorgan GBI Emerging Market Global Composite Bond Index fell back by -1.9% over the period

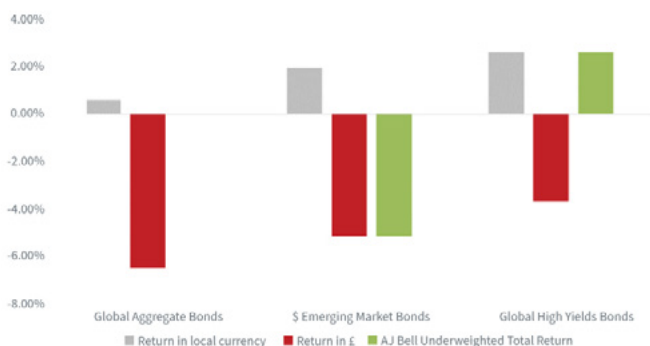
Asset allocation and positioning

Over the first half of 2019, we saw the situation of all major asset classes being up together, an unusual state of affairs and one we were sure would be unlikely to last. This indeed turned out to be the case after Q3, with fixed income and defensive sectors such as consumer staples being the best performers, whilst 'risk-on' assets such as growth equities, whilst still gaining, lagged behind the performance of bonds, as markets weighed up a number of threats to global growth and contended with ongoing political headwinds from a US/China trade war and a Brexit-led political logjam in the UK. It was interesting then, in Q4, to see market participants change tack, with most of Q3's winners becoming the laggards, as risk-taking and optimism returned to markets.

The big news of the quarter for UK-based investors was likely that of the General Election in December, in which Boris Johnson's Conservatives secured a significant majority, bringing an end to a Parliament led by a minority Government and riven with division and entrenchment, thus potentially allowing Johnson to bring some closure to the Brexit stalemate. Our funds have an element of equity home bias inbuilt, as an output of our risk budgeting and, as such, all funds benefitted from the pop in UK equities, in particular those higher up the risk spectrum, with not just larger weightings in UK equity, but also larger mid-cap exposures.

One corollary of the improved political landscape in the UK was a much improved sterling, which climbed sharply on the news, as investors saw the election result as a sign of increased stablilty and confidence. In contrast to last quarter, where a falling pound was a

boon to our holdings overseas, this quarter we saw the opposite, as currency translation acted as a headwind to portfolios, weighing on returns originating outside the UK. This had an impact on asset classes across the board, with international equity returns being reduced in scale, whilst some local currency fixed-income gains were also significantly impacted. For instance, dollar-denominated emerging market debt, up 1.95% in local currency terms, saw falls of -5.16% in sterling terms; Global High Yield, up 2.62% in local currency was down -3.72% when converted back to sterling; and, finally, Global Aggregate (an extremely broad government and corporate bond index) up 0.58% in local terms but off -6.53% in sterling. The team took the decision to remove Global Aggregate index exposures from our strategic asset allocation at the start of 2019, meaning we had no exposure to this asset class, in what was a tough quarter, whilst we also took the decision to hold sterling-hedged versions of the Global High Yield positions in the funds, hence we retained the performance seen in the local currency:



Selected asset class returns for Q4 2019.

Source: AJ Bell Investments, Bloomberg LP, January 2020

As part of our process in considering asset allocation, in the main, we are trying to avoid being too heavily exposed to any one theme or asset class and instead utilise the multi-asset nature of our mandate to try and ensure we are sufficiently diversified and always have some elements working for us, even when others aren't. Last quarter, we drew attention to the performance of some equity sectors which were introduced into the portfolios at the start of 2019, when Global Consumer Staples and Global Healthcare were added to Global Technology. Last quarter, Consumer Staples was a big winner in the portfolios, as the defensive nature of the sector saw it outperform as investors were more risk averse, in general. Q4, however, saw Consumer Staples struggle for traction, whilst another ostensibly defensive sector, Healthcare, was a notable outperformer. The drivers behind this improvement in Healthcare were sector specific, as investors saw the sector as cheap, with constructive earnings and an improving environment going into the US Presidential Nominee race:

MSCI Global Consumer Staples Index & MSCI Global Healthcare Index returns; 1 July 2019–31 December 2019.

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

This barbell approach to sectors, with some benefitting from defensive, risk-off environments (Consumer Staples and Healthcare) and others benefitting from more constructive, risk-on environments (Global Technology), as well as their own unique industry drivers, demonstrates our work to improve the diversification and risk-adjusted performance of the portfolios we run, such that there should always be something receiving the baton, as other areas of the portfolio are struggling. We hold Global Healthcare in all risk profiles in the growth fund range.

Asset allocation contributors

	Portfolio					
Top Contributors	Cautious	Mod. Cautious	Balanced	Mod. Adventurous	Adventurous	Global Growth
1	Global Healthcare Equities	Global Healthcare Equities	UK Equities (Large Cap)	UK Equities (Large Cap)	UK Equities (Large Cap)	Emerging Markets Equities
2	UK Equities (Mid Cap)	UK Equities (Mid Cap)	UK Equities (Mid Cap)	UK Equities (Mid Cap)	UK Equities (Mid Cap)	UK Equities (Mid Cap)
3	UK Property (REITs)	UK Property (REITs)	Global Healthcare Equities	Global Healthcare Equities	Emerging Markets Equities	UK Equities (Large Cap)

Source: AJ Bell Investments, Bloomberg LP, January 2020

AJ Bell Growth Funds review – Q4 2019

Fund performance

Equities were the big winners in the funds in Q4, with most regions and sectors held showing positive gains for the period, despite a stronger sterling. The improved political climate in the UK saw notable gains in UK equities, with the UK mid-cap space posting strong quarterly gains of over 11%. We use the **Vanguard FTSE 250 Index ETF** in all of the funds, meaning all risk profiles saw gains from this holding in the quarter. Also posting strong performance were our Healthcare holdings, as discussed already and, higher up the risk spectrum, emerging market equities, which bounced back from a weak Q3 to post strong gains for the quarter. We use the **iShares Core EM IMI ETF** in order to gain our emerging markets exposure, with the riskier portfolios having significantly higher weightings here and the fund posted gains of 4.12% in the period, in sterling.

In the main, fixed-income holdings in the funds had a more challenging time, as investors regained confidence in growth and yields rose across most developed government bond complexes. We hold positions in short duration US Treasuries via the **Invesco US Treasury 1–3 Year ETF** in the lower risk Cautious and Moderately Cautious funds and this holding saw falls of -6%, in sterling terms, over the quarter. In addition, as highlighted already, hard currency emerging market debt holdings – which we express via the **Vanguard USD Emerging Market Government Bond ETF** and included in all funds from Cautious up to and including Moderately Adventurous – saw gains in local terms, but these became negatives when translated back into sterling.

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, Moderately Adventurous, Adventurous and Global Growth up over 6% 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 almost 5% for the period.

Lastly, those funds with UK Property exposure (Cautious through to Adventurous) saw gains in the quarter from their allocations, which involve us simultaneously holding a UK REIT ETF, blended with index-linked gilts, to reduce the volatility associated with REITS and as an asset class posted gains of over 7% in the quarter.

All other areas of the funds performed in line with expectations and, across our Growth Fund range, it was pleasing to see gains in all of the risk profiles. Returns were dispersed quite evenly through the risk scale, with those funds 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.

Fund changes

In the funds, there were no changes to be seen in the quarter in terms of asset allocation, nor were there any changes in the makeup to the portfolio that were driven by the team. However, one holding change was enforced on the portfolios, with the unexpected announcement by BMO of their intention to close their successful range of passive ETFs. We held the **BMO Barclays Global High Yield £ Hedged ETF** in all funds from Cautious to Adventurous and, as a result, we took the decision to switch this holding into the **iShares Global High Yield £ Hedged ETF**, which follows a similar index and closely matched the characteristics of the BMO product. Whilst the exposures we have via the switch will be very similar, the iShares ETF is, it must be said, a little more expensive than the BMO product we held, at 0.55% versus 0.35% but, at present, the universe of passive, sterling-hedged Global High-Yield products is relatively undeveloped. As a result, we are working with other providers to broaden the options available, as well as continuing to engage iShares on the price point of their product, with the aim being to bring the cost of our holding in this asset class back down to the same or below that of our former holding. We hope to be able to update you on successful outcomes here in due course.

Elsewhere, we maintain a watching brief on developments in the passive ETF and indexing space as costs continue to fall across the providers' various ranges. Vanguard was the latest to cut costs across its range, with an announcement made to the market in Q4. This impacted one of our holdings – held in the Global Growth fund – **the Vanguard FTSE EM ETF**, whose OCF fell from 0.25% to 0.22% as a result of the cuts. Whilst none of our other 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 products become available.

Performance summary (all models)

Portfolio	3 months	6 months	1 year	Inception*
VT AJ Bell Cautious	0.56%	3.01%	10.28%	10.01%
VT AJ Bell Moderately Cautious	1.06%	3.54%	13.19%	13.42%
VT AJ Bell Balanced	2.02%	4.66%	16.59%	17.74%
VT AJ Bell Moderately Adventurous	2.43%	5.08%	17.96%	19.63%
VT AJ Bell Adventurous	3.00%	5.21%	19.56%	20.57%
VT AJ Bell Global Growth	3.22%	4.33%	19.12%	8.14%

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

Source: Bloomberg LP, AJ Bell Investments, January 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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