AJ Bell Income Funds – Q4 2019 report

Introduction

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

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

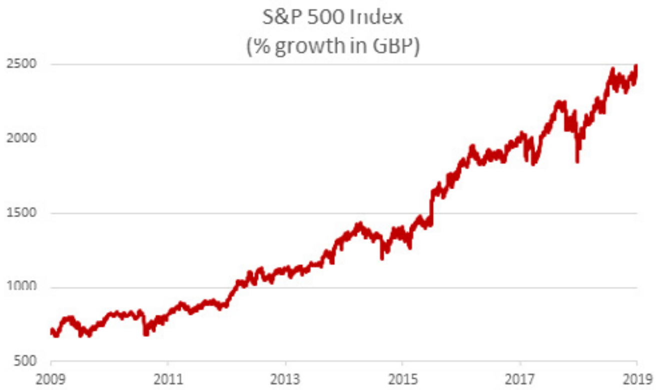
The fourth quarter of 2019 saw equity markets climb higher but most of this pick-up in equities came in the last couple of weeks when the traditional 'Santa rally' seemed to be in full swing following the outcome of the UK General Election. Returns were even stronger in local currency terms but a rise 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%.

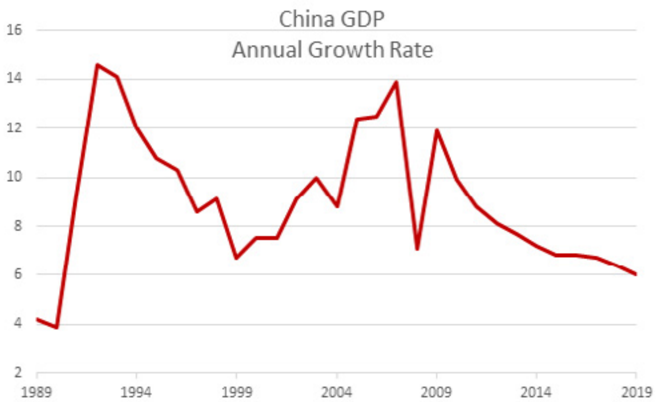
In the US, there was significant activity at both an economic and political level for the quarter. With some signs early in the quarter that the US economy was slowing, the Federal Reserve cut interest rates for the third time this year amid concerns of slowing job creation and lower consumer confidence. 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

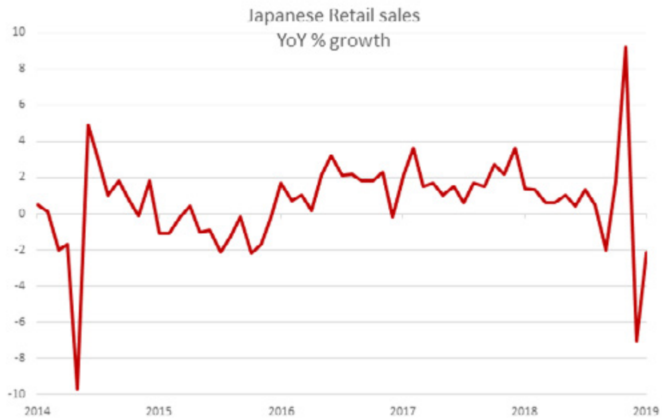
In Europe, data remained mixed as the major economies continued to be held back by the ongoing trade war and slowing growth in Asia. The quarter saw Mario Draghi step down as Chairman of the ECB with Christine Lagarde talking his place; in her first speech she made it clear that the region could no longer 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.

All market performance figures are in GBP.

Asset allocation and positioning

When designing income products, the main decision to take as part of the asset allocation is what will be the asset class that provides the main income stream to investors. Will it be fixed income, whereby investments in bonds provide fixed coupons to generate a yield, or will it be equity income, wherby earnings from business, paid as dividends, will provide the yield? This decision is an important element in the performance seen in any income product, since in ordinary market circumstances, the inverse releationship of fixed income to equity, means that if one of these asset classes is favoured by the market over the other, the experiences of a portfolio with predominantly fixed income yield, will perform very differently to that of a portfolio with predominatly equity income yield. In Q3, nervousness around the prospects for the global economy saw investors prefer fixed income assets, in the midst of geo-political headwinds in the form of a US-China trade war, Brexit and a UK general election but, in Q4 we saw a reversal of this theme, with Q3's losers becoming Q4's winners as easy central bank policy and a sanguine view of the political stories, saw investors regain their confidence and push into 'risk on' assets.

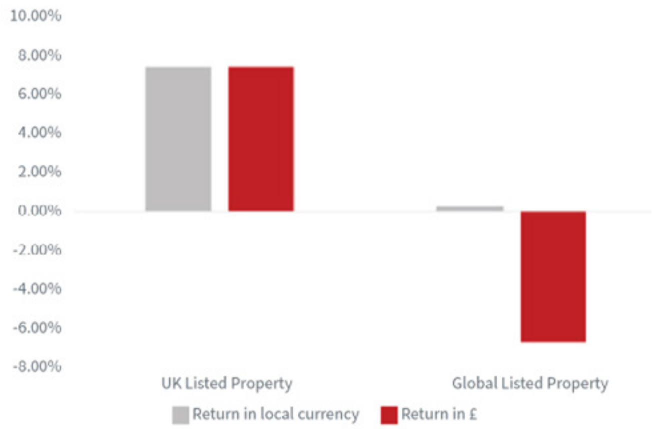
Our income funds are built around two distinct mandates, one that targets a yield of 3%-5% with a capital protection target and one that targets the same yield but with a capital growth element. Whilst it may not seem that these two mandates are that disimilar, they necessitate very different portfolio allocations in order to achieve their aims, with the lower-risk product including Fixed Income, Equities, Property and Cash, whilst the higher risk eschews Fixed Income, for a blend of Equities, Property, Global Infrastructure and Cash.

In Q4, with major asset classes experiencing very different performance, it was interesting to note the different outcomes for the two mandates. Equities being the best peforming asset class meant that the higher-risk product performed well in the quarter whilst, with Fixed Income, particularly in sterling terms, struggling in the quarter, we saw the lower-risk product hampered in the quarter.

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, potentially allowing him to bring some closure to the Brexit stalemate. Both income mandates have significant UK equity exposure built into the portfolios, with the UK having a good record of providing high and stable dividends, so this asset class was the single biggest contributor on a total return basis to the funds.

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 government debt, up 1.95% in local currency terms, saw falls of -5.2% in sterling terms. US corporate bonds and US High Yield were also big casualties of this situation, up 1.2% and 2.6% respectively in local currency terms, but down -4.5% and -5.9% in sterling terms for the period. These falls had an outsized impact on the lower-risk income fund, since the bulk of its assets are in fixed income.

In the higher-risk Income & Growth fund, the strong performance of equities in local currency terms, whilst hampered a little by sterling strength, helped performance, with all regions contributing positive performance in the quarter. With no fixed income held in the product, the rest of the allocation is made up of Global Listed Infrastructure and Listed Property (Global and UK). Global Infrastructure, with its defensive, almost fixed income-like characteristics, saw falls in the period of -2.2%, but it's relatively low weight meant it never had an outsized impact on returns. What was interesting to see was the diametrically opposite performances of global and UK property. With matching weightings in the portolio, relatively flat returns in local currency for Global Property, translated into falls of -6.7% in sterling terms, versus gains of 7.4% for UK Property, all driven by the asset class itself, since there were no currency impacts. This highlights the outsized impact of the election on the portfolio in that it not only drove returns directly in some asset classes, improving investor confidence toward UK property for instance, but also had currency effects in other, otherwise unrelated ones.



Selected asset class returns for Q4 2019, Source: AJ Bell Investments, Bloomberg LP, January 2020

AJ Bell Income Funds review – Q4 2019

Fund performance

Within the lower-risk Income fund the best-performing asset class was UK Equity, with our exposure here expressed solely via the **iShares FTSE 100 ETF**, which is used due to the favourabledividend yield seen on the index. Whilst mid-cap UK equities appreciated much more sharply than mega-caps post-election, the FTSE 100 still made respectable gains in the quarter, which helped performance. The biggest detractor in the fund was the holding of the **Vanguard USD Corporate Bond ETF**, as a challenging quarter for fixed income was further hampered by sterling appreciation, which saw the asset class post a loss of -5.5% in the quarter. In the higher-risk Income and Growth Fund, the best-performing asset class was again UK equities and with this being the largest single allocation in the fund, gains for the **iShares FTSE 100 ETF** and the active fund we also hold, **Man GLG UK Income Fund**, were significant additions to performance. On the negative side, the currency appreciation seen in sterling saw our holding in the **L&G Global Real Estate Dividend Index Fund** suffer, with falls of -5.7% for the quarter. This was offset, however, with a strong performance for our UK Property holding, the **iShares MSCI Target UK Real Estate ETF**, which was up 7.2% in the quarter.

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 of the portfolio that were driven by the team. However, two holding changes were applied to 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 the Income Fund 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. In addition, we held the **BMO Emerging Markets Income Leaders ETF** in the Income & Growth fund and, as a result, we took the decision to exit this holding and consolidate the proceeds into the active fund we already held alongside it, the **JP Morgan Emerging Markets Income Fund**, since it is a fund we were already comfortable with and using.

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 their range, with an announcement made to the market in Q4. This impacted some of our holdings; the **Vanguard FTSE Asia Pacific ex-Japan ETF**, held in both funds, saw its OCF fall from 0.22% to 0.15%, whilst the **Vanguard USD Corporate Bond ETF**, held in the Income Fund, saw its OCF fall from 0.12% to 0.09%, 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

The Income and Income & Growth funds only launched in April 2019, which means we can't yet give you a figure on how they have performed. A fund must be at least 12 months old, according to regulations, before we can share any specific performance data.

Both funds continued to perform in line with their stated objectives over the period.

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