AJBell

AJ Bell Passive funds - due diligence FAQ

Smarter investing made easier

January 2019

Contents

Fund overview

	VT AJ Bell ICVC
Fund range name	VT AJ Bell Passive Cautious VT AJ Bell Passive Moderately Cautious VT AJ Bell Passive Balanced VT AJ Bell Passive Moderately Adventurous VT AJ Bell Passive Adventurous
Launch date	18 April 2017
Currency	GBP
Structure	OEIC within a UCITS
Domicile	UK – regulated by the FCA
ISA / SIPP qualifying	Yes
ISIN	VT AJ Bell Passive Cautious - GB00BYW8RV97 VT AJ Bell Passive Moderately Cautious - GB00BYW8VJ55 VT AJ Bell Passive Balanced - GB00BYW8RX12 VT AJ Bell Passive Moderately Adventurous - GB00BYW8VL77 VT AJ Bell Passive Adventurous – GB00BYW8VG25
Income or accumulation	Accumulation
Dealing	Daily, 12 noon
Fees	Initial charge – none Ongoing charges – 0.50% capped Exit fee – none Performance fee – none Charges – taken from income
Minimum investment	£1,000 (lower via platforms)
ACD	Valu-Trac
Depositary	National Westminster Bank
Custodian	Bank of New York Mellon
Auditor	Johnston Carmichael LLP
Accounting dates	30 September 31 March

Overview of AJ Bell

1. History and ownership

AJ Bell was founded in 1995 and has grown to become one of the UK's largest investment platforms. In 2016, AJ Bell Investments was launched to design and manage a range of investment solutions for our customers.

AJ Bell is privately owned by its management team and has three external investors. The company provides a range of investment platforms, as well as bespoke SIPP and SSAS products and white label SIPP products for third parties.

With 224,600 customers and £50.7 billion of assets under administration, we succeed by providing award-winning investment products, backed up with excellent service and online functionality at a low cost.

At AJ Bell our purpose is to help people invest, and we do this by following a set of guiding principles that define the company. These principles inform everything we do, creating a culture in which we strive to think like our customers, make investing easier and lead our markets. The guiding principles state that we are:

- Straightforward
- Intelligent
- Personal
- Principled
- Focused
- Energetic

2. Ownership structure

AJ Bell is privately owned by its management team and two institutional investors, Invesco Perpetual and Seneca Investment Managers.

3. Company structure

AJ Bell includes AJ Bell Holdings Limited and its wholly owned subsidiaries.

AJ Bell Asset Management Limited is authorised and regulated by the Financial Conduct Authority.

AJ Bell Management Limited is authorised and regulated by the Financial Conduct Authority and is the scheme administrator and operator of all AJ Bell's SIPPs.

AJ Bell Securities Limited is a member of the London Stock Exchange and is authorised and regulated by the Financial Conduct Authority. It is the plan manager for all of AJ Bell's ISAs and also provides AJ Bell's GIAs.

See website for full details.

Investment professionals

1. Who is responsible for the funds?

The investment process at AJ Bell Investments follows a team approach where investment solutions are managed collegiately. All investment solutions are overseen by the AJ Bell investment committee (see risk management section for more information).

Day-to-day oversight of the investment solutions sits with the investment team.

Investment philosophy and process

1. What is the investment philosophy underpinning these funds?

The VT AJ Bell Passive funds are a range of funds that aim to deliver specific outcomes through a risk-targeted multi-asset approach. They have been designed to give investors a long-term multi-asset portfolio using an investment approach that is based on robust academic principles.

The investment philosophy is based on the work of Barrie & Hibbert who, in 1995, launched their Economic Scenario Generator (ESG). This approach models the behaviours and relationship between different economic factors - such as interest rates, inflation and asset returns - to build plausible, forward-looking economic scenarios.

The work of Barrie & Hibbert builds on the work in 1952 of Harry Markowitz, who introduced the concept of Modern Portfolio Theory. This described the theory that having a number of different asset classes in a portfolio will result in a better risk-adjusted return as the portfolio will benefit from the lack of correlation between those asset classes. By forecasting the expected return, risk and correlation of each asset class, it is possible to mathematically model the most efficient portfolio i.e. the best combination of assets to maximise the risk adjusted return.

Barrie & Hibbert's ESG allows a long-term approach that is focused on plausible economic outcomes, incorporating the complex interactions between different asset classes. The long-term focus allows a consistent framework that avoids short-term behavioural biases to dictate investment outcomes.

This approach is designed to give a more predictable outcome for investors, with a range of funds built using a consistent approach that allows each fund to operate within a set risk target. This structure sits alongside leading industry risk profiling tools to give advisers confidence that each fund has been designed and is managed in a way that should lead to more predictable outcomes and avoids the problem of the risk profile of each fund fluctuating as markets move.

This fund range has been designed to give broad market exposure and is focused on passive instruments to give this exposure.

2. What is the investment process?

The AJ Bell Passive funds are underpinned by a two-stage investment process that separates the determination of asset allocation from the underlying instrument selection.

The asset allocation approach utilises the Economic Scenario Generator from Barrie & Hibbert, now part of Moody's Analytics, to give a robust, consistent long-term approach that has academic rigour at its heart. The investment team at AJ Bell work together with Moody's to determine the asset allocation that underpins each of the funds.

The responsibility for the selection of underlying instruments sits with the investment team at AJ Bell, which uses a process of analysis and review of passive strategies to construct each of the funds.

Ongoing responsibility remains with AJ Bell through the element of portfolio construction and risk management.

3. How is the asset allocation determined?

Each of the funds has a long-term risk target that is used to inform the long-term strategic asset allocation.

A strategic asset allocation specifies the proportion of specific asset classes in a portfolio designed to provide an investor with an appropriate risk/return profile over the long term. Our strategic asset allocation framework specifies a range of allocations appropriate for five levels of risk tolerance. For example, investors with a lower risk tolerance will tend to have lower exposure to more volatile, higher-risk assets such as equities, and greater allocations to less volatile, lower-risk assets, like bonds and cash.

The modelling is driven by long-term return and risk expectations for the various asset classes. Although markets tend to be volatile and returns often diverge sharply from year to year, viewed over the longer term, the returns tend to become more stable, with gains in some years offsetting losses in other years.

A robust process of estimating long-term risk and return expectations should therefore not be unduly impacted by near-term activity. In fact, frequent changes to long-term risk and return expectations could seriously undermine the investment discipline provided by a strategic asset allocation framework.

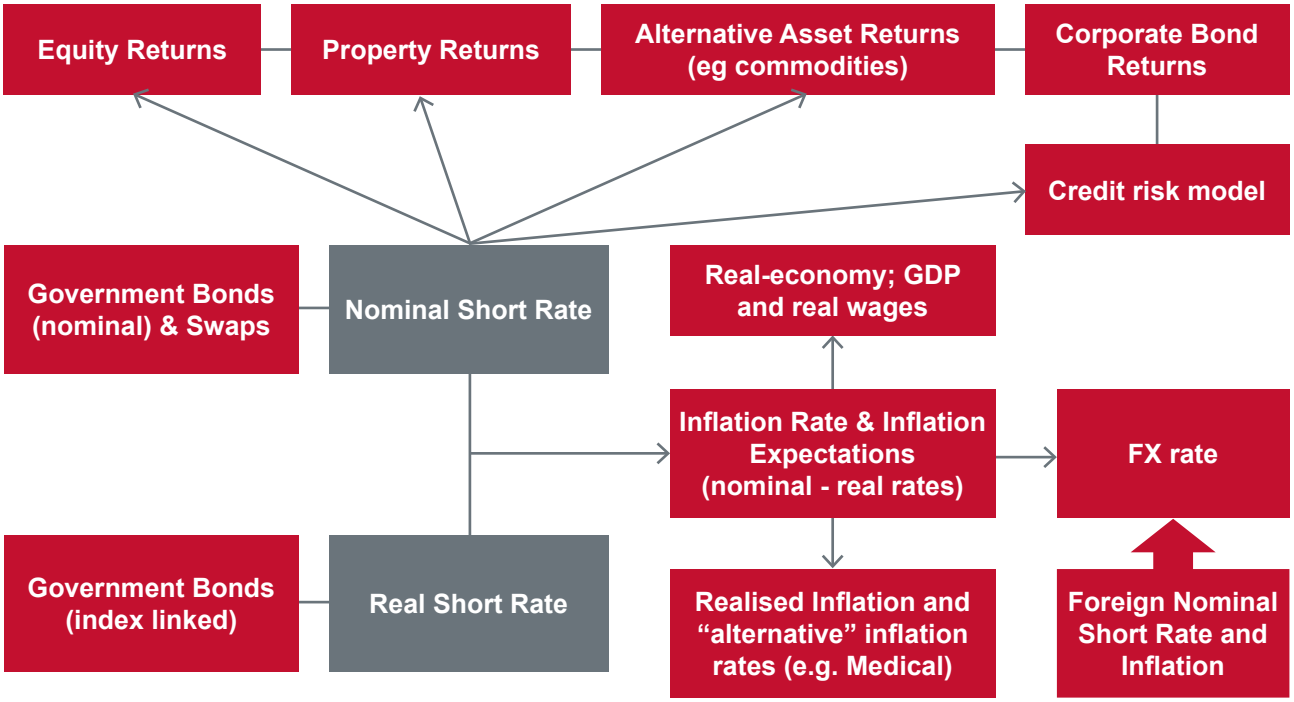
Central to Moody's Analytics capabilities is a stochastic economic model, the Economic Scenario Generator (ESG) engine. This is comprised of a series of mathematical equations which describe the behaviour of different economic risk factors – interest rates, inflation, asset returns – and captures the relationships between them.

At the core of the ESG is the nominal risk-free interest rate, with asset returns modelled in excess of this. This means that the risks associated with different asset classes are clearly isolated, allowing each of them to be considered separately. Moreover, it means that it is easier to investigate the distinctive features of different asset classes from a risk management perspective.

The model generates plausible forward-looking scenarios for the joint behaviour of these economic risk factors using a Monte-Carlo simulation – a technique that involves using random numbers and probability to solve problems. We consider a number of different risk metrics:

1. The distribution i.e. upside potential, downside potential, median of the portfolio value
2. Maximum expected losses in any of the years in the selected time horizon
3. Volatility
4. Performance versus low risk benchmark (three month government bills)

This enables us to capture the relationships between these risk factors and determine the returns on our selected asset classes.



Source: Moody's Analytics

The modelling conducted with Moody's incorporates a number of asset classes:

- Equities
- Fixed interest
- Property
- Commodities
- Cash

By using the ESG framework, a forward-looking outlook of the risk, return and correlation of each of these asset classes is made. The asset classes are then optimised to give the most efficient portfolio for the specified level of risk.

At a sub-asset class level, the following assets are modelled:

Equities	Fixed interest	Alternatives	Cash
UK equities	UK government bonds	UK property	GBP cash
US equities	UK index-linked bonds	Global real estate	
European equities	UK corporate bonds	Commodities	
Japanese equities	Global high yield bonds		
Asian equities Global emerging market equities			

The asset allocation for each fund is reviewed on a quarterly basis, however, given the long- term approach from Moody's Analytics, it is expected that the asset allocation should remain broadly stable over time.

4. How are the underlying holdings selected?

Asset allocation for the AJ Bell Passive funds is implemented using passive investment strategies. At the heart of the investment approach is a desire to ensure that the asset allocation is executed in the most efficient way possible, with the intention to keep implementation and transaction costs to a minimum.

The funds have the ability within the prospectus to use all investment instruments, including collective investments, Exchange-Traded Funds, futures and derivatives, however, some of these instruments will only be appropriate when the funds reach a certain scale. As such, in the early life of the funds, it is expected that the investment strategy will predominantly be implemented using OEICs and Exchange-Traded Funds.

When considering what the most appropriate passive strategy to implement is, a number of criteria are considered:

Criteria	Rationale
Preferred index to track	The key is to look to replicate the index that is used by Moody's Analytics to model the asset class. This ensures a purity of approach and avoids unintended economic influence that has not been considered by Moody's.
Replication method	There is a preference for physical replication wherever possible to ensure that the efficiency of the tracking instrument is maximised. However, there may be certain times or asset classes where this is not possible or deemed to be the most efficient approach.
Ongoing charges	The ongoing charges of the underlying instrument are important, particularly in the early stages of the fund when assets are smaller. However, headline cost is not viewed in isolation.
Tracking error	The ability of the instrument to effectively track the chosen index is critical.
Strategy size	There is a preference for large strategies to ensure there is sufficient capacity and liquidity.
Liquidity	Similar to strategy size, there is a focus on the actual liquidity of the strategy to ensure that it is possible to trade in effectively.
Transaction costs	The importance of transaction costs cannot be overestimated and therefore this is a key consideration. Spread on trading is assessed in conjunction with the overall cost to understand the total cost of ownership.

When conducting analysis on the above criteria, the investment team look to employ a best of breed approach on the basis that no one provider is market-leading in tracking all asset classes and regions. As a result, each fund has exposure to world-leading investment managers such as Vanguard, iShares and State Street.

The assessment is done on an ongoing basis and uses a mix of proprietary quantitative analysis alongside data from Bloomberg and Morningstar.

5. Are tactical investment decisions made?

The investment philosophy underpinning these funds is to gain and benefit from long-term market exposure. As a result, no tactical decisions are made in these funds, instead the rigorous long-term approach of Moody's Analytics is allowed to drive investment returns.

6. How are sell decisions made?

The investment approach is long-term in nature with a desire to minimise transactional activity wherever possible. As a result, the expected turnover of the underlying managers is low, particularly given the passive implementation approach. However, should existing holdings start to no longer be the most efficient method of gaining exposure to an asset class, those holdings will be replaced.

The passive market continues to evolve and therefore the market is kept under review to ensure that potential new holdings are identified and researched.

As the funds grow in size, it is expected that the underlying holdings will move from collectives and ETFs to futures and direct holdings. However, this shift will only be made when the cost/benefit analysis shows the move to be in the best interests of investors.

7. How is currency exposure managed?

Moody's Analytics' approach to currency is that over the long term, the currency market operates in equilibrium. As a result, the funds gain their equity exposure on an unhedged basis. In addition, global high yield corporate bonds are also accessed on an unhedged basis. As a result, it is possible that large shifts in currency movements could have a large impact on overall returns. This could be beneficial or detrimental at any point in time.

Implementation

1. How are investment decisions implemented?

The investment team is agnostic as to the instrument type used to implement the investment strategy. As outlined in the investment process, the full spectrum of instruments are available and the investment team constantly assesses the market to determine if there is a more efficient and/or cheaper method of gaining market exposure.

2. How are brokers selected?

Brokers are selected using a due diligence process to ensure that they have the requisite skill to execute transactions with operational excellence and in line with the AJ Bell Best Execution policy.

3. How are transaction costs monitored?

Transaction costs are monitored by the ACD with information available at any point to the investment team. In addition, bid/offer spread levels are monitored by the investment team to ensure that the brokers used are executing efficiently.

4. How often are the portfolios rebalanced?

The funds are managed on a daily basis with cash flow used to ensure the asset allocation remains in line with the target portfolio. This use of cashflow avoids the need for wholesale rebalancing that can incur unnecessary transaction costs.

On a quarterly basis, the long-term strategic asset allocation is updated. At this point, the investment team will look at the potential changes to determine whether the costs/benefit analysis warrants a change to the portfolio. This approach limits the risk of trading where there is no discernable benefit in incurring additional transaction costs.

Important information

For more information please contact:

AJ Bell Investments
4 Exchange Quay
Salford Quays
Manchester
M5 3EE

Telephone: 0345 250 5607

Email: funds@ajbell.co.uk

This brochure provides 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.

AJB/VT/AB/20190629