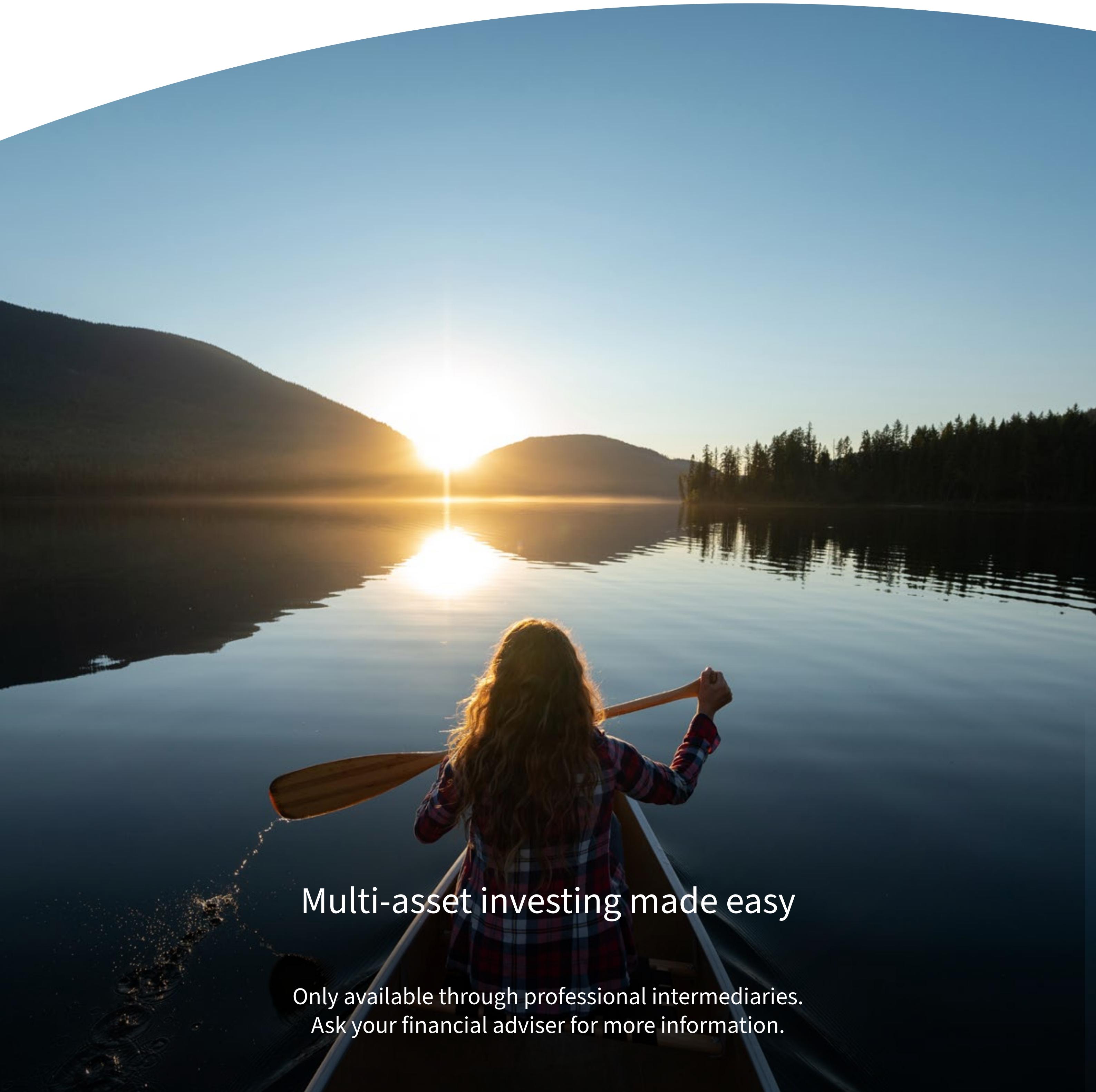
AJ BELL INVESTMENTS

Strategic Asset Allocation 2024



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Introduction

Welcome to the asset allocation update for the AJ Bell Funds and MPS range. This document is designed to explain the changes being made to the AJ Bell range of investment solutions for 2024, which consider the current market conditions and long-term economic outlook for different asset classes around the world.

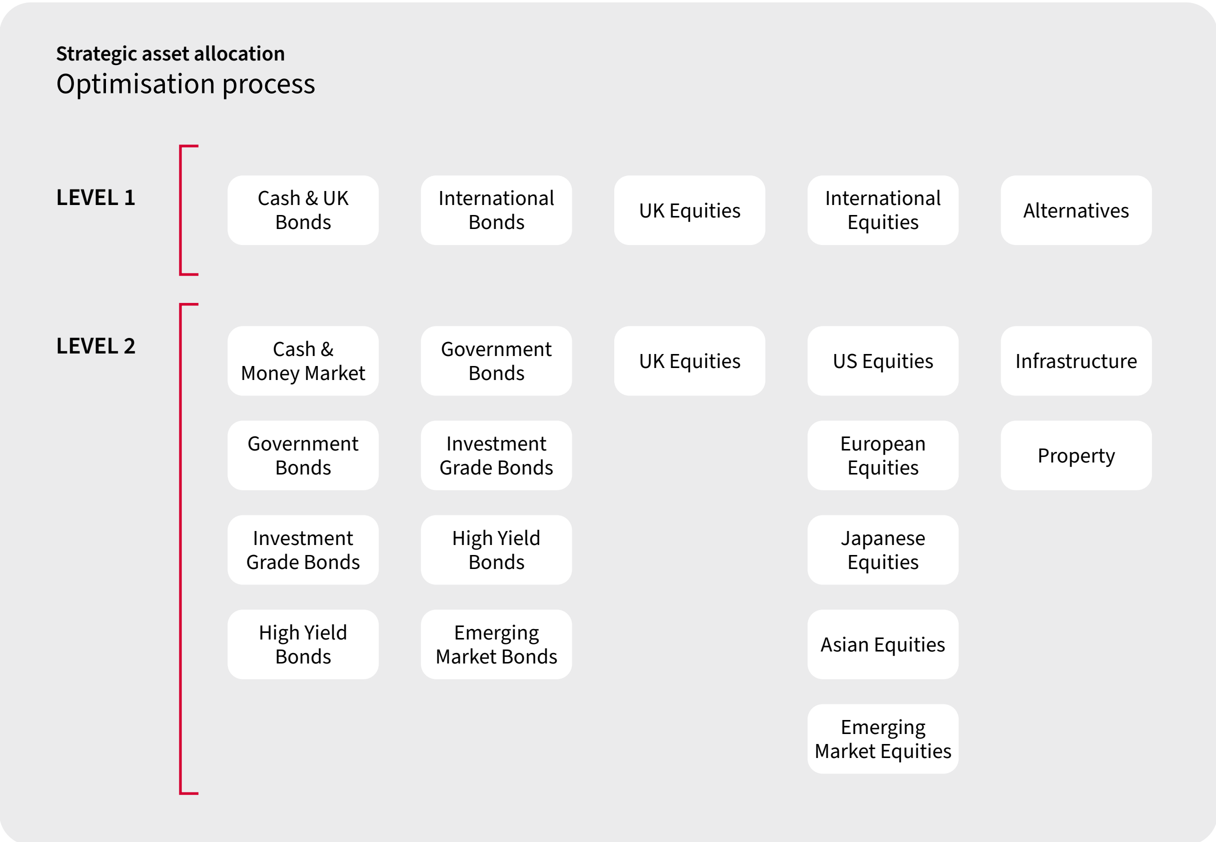
A reminder of the investment approach

The AJ Bell Funds and MPS are designed to behave in a predictable manner around pre-defined levels of risk as measured by volatility. Our Investment Team uses a set of Capital Market Assumptions (CMAs) for selected asset classes to construct a range of portfolios that sit on or close to the efficient frontier using a Mean Variance Optimiser (MVO).

The strategic asset allocation process is focused on five defined high-level ‘buckets’ (Level 1) that see the level of exposure varied depending on the level of risk being taken:

- Cash & UK fixed interest
- International fixed interest (unhedged)
- UK equities
- International equities
- Alternatives

Sitting underneath these core asset classes, 16 sub-asset classes (Level 2) are then optimised using the MVO to build the most efficient portfolio possible for the given level of risk, taking into account the constraints that have been built into the optimisation process.



Tactical intervention

It's important to remember that the optimiser is an unemotional beast that lacks context around current market conditions. Instead, it simply takes the inputs of long-term expected returns, correlations and volatility and gives its most efficient portfolio i.e. the one with the highest annual return for the level of risk being taken. However, there are occasions when manual intervention is required in the form of tactical adjustments.

Where our Investment Team sees an opportunity to enhance the risk adjusted return, either by increasing the return or reducing the risk, a tactical adjustment may be made to the strategic asset allocation. Importantly, these are not short term 'calls' on the market, but well-evidenced adjustments that take into account current market or macro-economic conditions that are outside the scope of the optimiser.

These adjustments are relatively infrequent given clear mispricing of risk or returns is not a regular occurrence. In all instances, the adjustments are implemented within strict 'tramlines' to ensure that each risk-targeted portfolio doesn't stray outside of its designated risk band.

Capital Market Assumptions (CMAs) – where are we today

Entering 2023 there was a widely-held belief amongst investors that it would be the 'year of the bond'. This call proved to be slightly too early, with yields on many bonds, particularly government and high-quality corporates, staging another move higher throughout the year. The driving force behind this has been the persistence of inflation and the associated continuation of interest rate hikes from three major central banks (the Federal Reserve, the Bank of England and the European Central Bank).

At the start of our SAA process in late 2023 the yield available on cash deposits had moved significantly higher, compressing the risk premium (i.e. the return available for taking additional risk). Government and high-quality corporate bonds, on a yield-to-maturity basis, face stiff competition from the cash rates. The expected return available from equity markets has seen some flux, with most major markets higher year-on-year and forecast earnings growth deteriorating in places. Overall, equity markets look less attractive when compared to the return available from cash and assets with much lower volatility.

Alternative assets and their valuations tend to have a relatively-easily-observed relationship with interest rates. Property company valuations have been under pressure for some time and in 2023 they also had to contend with a higher cost of debt. This additional drag on earnings potential has seen a slight moderation in return expectation and as with equities the competition from lower-volatility asset classes is fierce.

Strategic Asset Allocation – the year ahead

It might come as a surprise to see the overall allocation to equities within portfolios largely unchanged this year (save for the lowest-volatility portfolio that gets an additional percentage point of equity risk). This is predominately a factor of the process employed at AJ Bell and the focus on volatility targeting, which is designed to achieve outcomes associated with a given volatility profile over the long term. Being too reactionary, or short term, in the SAA process can lead to an alteration that is detrimental to long-term performance. In other words, we accept that we do not know what 2024 will bring (neither does anyone else for that matter) and we have avoided making dramatic changes to the equity / bond split of portfolios, a major determinant of how they will perform in different market environments.

Where the SAA process can be more nuanced is in its selection between asset classes that offer similar volatility (i.e. Level 2 assets within any given Level 1 allocation). Starting with cash and bonds, where the range of expected returns can be more easily defined by yields to maturity, the MVO would prefer to stock up on cash, earning a return that is unheard of in the post-GFC era with little in the way of volatility. Government and high-quality corporate bonds are more volatile but offer similar headline expected returns (yields), making them less favourable when constructing a portfolio on or near the efficient frontier.

The yield on Global high yield bonds as of late 2023 is comparable with long-term realised and expected returns for many equity markets but offers lower volatility. In a volatility-targeted portfolio high yield bonds offer an irresistible sweet spot for an MVO, particularly for portfolios that do not require the higher volatility of equities to meet their targets.

Within equities, the SAA has dragged allocations to the US lower, where indices are being skewed by the valuations of an exceptional group of companies. Europe ex UK and Japan have been favoured for their higher prospective return and similar / slightly higher volatility profile.

The portfolios after the optimisation step of the process are shown in the Level 1 allocation in Table 1. They had lower allocations to Non-GBP Bonds and a slightly lower allocation to Alternatives, replaced by a hefty weighting towards cash (within GBP Cash & Bonds). Equity allocations were rotated as noted above, however they occupied a similar overall allocation to last year's SAA. The SAA formally sets the 'Level 1' allocation of portfolios within which we can deviate using TAA.

Table 1

L1 2024 AJB Positions	AJB 1	AJB 2	AJB 3	AJB 4	AJB 5	AJB 6
GBP Cash & Bonds	60.0%	46.0%	31.0%	17.0%	9.0%	9.0%
Non-GBP Cash & Bonds	13.0%	10.0%	10.0%	10.0%	3.0%	
GBP Equities	6.0%	12.0%	16.0%	20.0%	25.0%	23.0%
Non-GBP Equities	17.0%	28.0%	39.0%	50.0%	60.0%	65.0%
Alternatives	4.0%	4.0%	4.0%	3.0%	3.0%	3.0%
Changes from 2023 SAA						
GBP Cash & Bonds	+4.0%	+4.0%	+3.0%			
Non-GBP Cash & Bonds	-4.0%	-3.0%	-2.0%			
GBP Equities						
Non-GBP Equities	+1.0%					
Alternatives	-1.0%	-1.0%	-1.0%			

Tactical Asset Allocation

The output of the SAA sparked several enquiries regarding risks that may not be apparent in the CMAs. Across Level 2 asset classes, the SAA reduced credit risk in UK and Global corporate bonds, however left the allocation to high yield bonds untouched because of the latter's favourable return / volatility profile in the eyes of the MVO. The team felt this somewhat uneven reduction in credit risk was unjustified given the tightening of credit spreads throughout 2023 and the likely uptick in defaults on the horizon given the slowing global economy.

The SAA also called for a significant increase in the cash allocation, which in turn reduced overall portfolio duration. At this point, with interest rates deemed near their peak, the reinvestment risk of cash can be high and denying the portfolios the opportunity to participate in any possible re-steepening of the yield curve would be to deny them the traditional downside protection from Government bonds in a wider 'risk-off' environment. We are not forecasting the latter but having portfolios that can navigate downside shocks at any given time is a consideration.

The two risks, credit risk and duration, not specifically accounted for in the MVO were addressed via TAA. Firstly, the allocation to Global high yield (GBP Hedged) has been reduced in favour of UK corporate bonds, balancing the reduction in credit risk and in turn nudging duration slightly higher. Secondly, the additional allocation to cash was moderated and reallocated to UK Government bonds and some UK corporate bonds. This moved the duration back towards the 2023 SAA, however the Investment Team wanted to go further.

Throughout the third and fourth quarters of 2023 we started to focus on opportunities emerging in US Treasuries, in particular the possibility of picking up additional yield and lowering credit risk relative to the Global Government bond benchmark (which has over 50% allocated to Europe, Japan and China). As this also presented an opportunity to remove the asymmetry of bonds anchored at low yields (i.e. Japanese Government bonds), the 2024 SAA rebalance is a natural opportunity to act. As mentioned, as the wider SAA took place the appetite to increase the duration of the portfolios grew, and US Treasuries were identified as a cheap implementation method for longer duration. Therefore, the Global Government bond allocation has been replaced with US Treasuries that have longer duration than the benchmark.

The TAA decisions only impact risk profiles 1 to 4. The 5 and 6 risk profiles do not hold an allocation to the Level 2 asset class in question (i.e. Global Government bonds or cash greater than the minimum 2% allocation) and the trade-off with Global high yield bonds is not to be considered versus other higher-quality bond allocations but against equities.

Within equities, there was no strong reason to reject the regional allocations produced by the SAA and therefore we have not interfered.

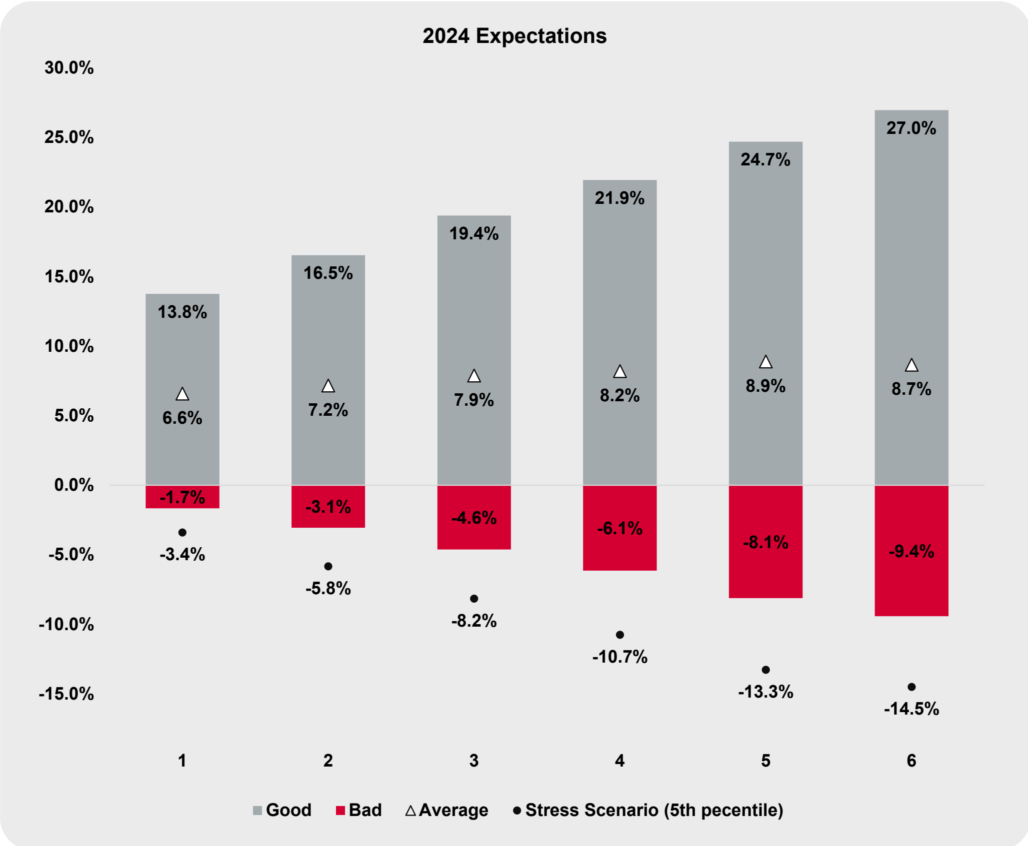
The resulting SAA and TAA portfolios can be viewed below, with the latest portfolio grids for the AJ Bell Funds and MPS showing the implementation.

2024 AJB Positions	Growth Risk Profile 1	Growth Risk Profile 2	Growth Risk Profile 3	Growth Risk Profile 4	Growth Risk Profile 5	Growth Risk Profile 6	Income Risk Profile 1	Income Risk Profile 2
GBP Cash	20.0%	12.0%	7.0%	2.0%	2.0%	2.0%	7.0%	2.0%
UK Government Bonds	16.0%	10.0%	5.0%				5.0%	
UK Corporate Bonds	19.0%	18.0%	15.0%	12.0%			15.0%	
Global High Yield Bonds (GBP Hedged)	5.0%	6.0%	4.0%	3.0%	7.0%	7.0%	4.0%	7.0%
GBP Cash & Bonds	**60.0%**	**46.0%**	**31.0%**	**17.0%**	**9.0%**	**9.0%**	**31.0%**	**9.0%**
Global Government Bonds	5.0%	3.0%						
Global Corporate Bonds	8.0%	7.0%	7.0%	7.0%			7.0%	
Global High Yield Bonds								
Emerging Market Bonds			3.0%	3.0%	3.0%		3.0%	3.0%
Non-GBP Bonds	13.0%	10.0%	10.0%	10.0%	3.0%	0.0%	10.0%	3.0%
UK Equities	6.0%	12.0%	16.0%	20.0%	25.0%	23.0%	16.0%	25.0%
GBP Equities	6.0%	12.0%	16.0%	20.0%	25.0%	23.0%	16.0%	25.0%
Europe ex UK Equities		3.0%	3.0%	5.0%	7.0%	9.0%	3.0%	7.0%
US Equities	7.0%	9.0%	10.0%	16.0%	20.0%	9.0%	10.0%	20.0%
Japan Equities	5.0%	7.0%	7.0%	7.0%	6.0%	3.0%	7.0%	6.0%
Asia Pacific ex Japan Equities			7.0%	8.0%	10.0%	17.0%	7.0%	10.0%
Emerging Markets Equities	5.0%	9.0%	12.0%	14.0%	17.0%	27.0%	12.0%	17.0%
Non-GBP Equities	17.0%	28.0%	39.0%	50.0%	60.0%	65.0%	39.0%	60.0%
Infrastructure								
Property	4.0%	4.0%	4.0%	3.0%	3.0%	3.0%	4.0%	3.0%
Alternatives	4.0%	4.0%	4.0%	3.0%	3.0%	3.0%	4.0%	3.0%

Changes								
GBP Cash	+2.0%	+2.0%	+1.0%				+1.0%	
UK Government Bonds	+6.0%	+4.0%	+2.0%				+2.0%	
UK Corporate Bonds	+2.0%	+4.0%	+5.0%	+4.0%			+5.0%	
Global High Yield Bonds (GBP Hedged)	-6.0%	-6.0%	-5.0%	-4.0%			-5.0%	
GBP Cash & Bonds	+4.0%	+4.0%	+3.0%				+3.0%	
Global Government Bonds	-2.0%							
Global Corporate Bonds	-2.0%	-3.0%	-2.0%				-2.0%	
Global High Yield Bonds								
Emerging Market Bonds								
Non-GBP Bonds	-4.0%	-3.0%	-2.0%				-2.0%	
UK Equities								
GBP Equities								
Europe ex UK Equities		+3.0%	+3.0%	+2.0%	+2.0%	+4.0%	+3.0%	+2.0%
US Equities		-4.0%	-4.0%	-4.0%	-4.0%	-4.0%	-4.0%	-4.0%
Japan Equities	+1.0%	+1.0%	+1.0%	+2.0%	+2.0%		+1.0%	+2.0%
Asia Pacific ex Japan Equities								
Emerging Markets Equities								
Non-GBP Equities	+1.0%							
Infrastructure								
Property	-1.0%	-1.0%	-1.0%				-1.0%	
Alternatives	-1.0%	-1.0%	-1.0%				-1.0%	

Managing expectations – a range of outcomes

Each of the AJ Bell Funds and MPS portfolios is designed to maximise the return for a specific level of risk. However, returns will vary over time as the market moves. The chart below shows the long-term expected returns alongside the variability of these returns based on the 2024 asset allocation.



Summary

The last 12 months have seen significant change in the global economy, and it now looks like the painful interest rate rising cycle that we have seen in developed markets has come to an end. This provides a more positive backdrop for investors, particularly those towards the more cautious end of the risk spectrum who have taken the pain of falling fixed interest prices over the past year. As a result, the opportunity to add exposure to fixed interest where yields now look appealing feels like an appropriate move for 2024. Within equities, the situation is more nuanced, however, valuation dispersions remain wide and therefore adjustment away from the US and towards lower PE markets such as Europe and Japan again feels appropriate. In all portfolios, there remains significant diversification to ensure that no one type of risk dominates. This approach is fundamentally at the heart of the AJ Bell investment philosophy.

As ever, it's important to remember that no one has a crystal ball for what lies ahead. The positioning for the AJ Bell Funds and MPS for 2024 reflects the blend of unemotional long-term optimisation alongside careful adjustment, taking into consideration the current economic situation and risks that may appear in the months ahead.

Thank you for your support.

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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.

Target yields are not guaranteed and can fluctuate.

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