AJBell Investcentre

Managed Portfolio Service – April 2019

Income Portfolio update

The AJ Bell MPS range consists of growth and income portfolios. In February 2019 we updated our growth portfolios as part of our annual strategic asset allocation review. It has now been over a year since we launched our Passive and Active Income MPS range, and on 8 April this year we launched fund versions of these strategies. We are now taking the opportunity to update the Income MPS ranges to harmonise with the asset allocation of the new funds, and update fund selections where appropriate.

As a reminder, the Income 1 portfolio aims to deliver a yield of around 4% whilst maintaining the overall capital value of the portfolio over a five-year horizon. The Income 2 portfolio also aims to deliver a yield of around 4%, however in addition it is designed to grow its capital in line with inflation in the longer term. In order to do this the Income 2 portfolio takes on more equity and currency risk compared to Income 1.

Asset allocation changes

Since launch, the passive and active ranges have operated with a consistent asset allocation to equities, fixed income, alternatives and cash. However, at the next level, when breaking down into regions, sectors and credit quality, the asset allocations deviated. This was necessitated by the differing investment opportunities within passive and active funds. Over the last twelve months the passive income investment universe has matured to allow cost-effective investments in sub-asset classes across regions. As a result we have taken the decision to align the strategic asset allocation across both Income MPS ranges. This ensures that no matter which implementation route you choose, you can be assured of consistent performance from asset allocation decisions.

Unlike our growth portfolios, which target a specific risk level, our income portfolios aim to deliver a target income and capital return over a five-year horizon whilst minimising the overall risk of the portfolio. This means that as bond and dividend yields change our asset allocation may change.

Over the course of 2018 we saw a proliferation of new funds offering a low-cost route to international fixed income markets, widening our range of investible asset classes. Bond yields in the UK have fallen over the last twelve months, whereas dividend yields have nudged up. Alternatives such as property and infrastructure are heavily linked to bond yields, and as such have seen a squeeze over the last year, leading to lower expectations of future returns. It is these moves that have led to a reduction in alternatives in all portfolios. For the lower-risk Income 1 portfolios we have increased the fixed income weights to reflect our ability to now invest in higher income international bonds. In Income 2 the portfolio now has a higher weighting in equities. Both portfolios continue to operate with low levels of cash.

The new asset allocations are:

MPS	Income 1	Income 2
Strategic cash	2%	2%
Fixed income	67%	0%
Equity	28%	73%
Alternatives	3%	25%

This represents the following change from the previous asset allocation:

MPS	Income 1	Income 2
Strategic cash	0%	0%
Fixed income	27%	0%
Equity	-10%	5%
Alternatives	-17%	-5%

Fixed Income

The Income 2 portfolio remains a 'bond-free' portfolio. Within Income 1 a shift has been made towards an increase in international fixed income, with a reduction in UK corporate bonds in favour of Asian government debt, US treasuries and corporates (investment grade and high yield). The new asset allocation continues to have an exposure to short maturity UK gilts, emerging market government bonds and global high yield bonds. The higher yield on offer for international markets is attractive compared to the lower levels in the UK. A US corporate bond index currently yields around 3.7%, compared to 2.7% for a UK equivalent. This yield pick-up is despite lower interest rate risk, with the average maturity of a UK corporate bond 20% higher than the equivalent US index.

Equities

The changes within equity regions varied between passive and active ranges, given the differing starting asset allocations. The passive range decreased its exposure to global and European equities, in favour of Asian, US, and emerging market equity funds. In the Passive Income 2 portfolio the UK equity weighting was also increased. Within the active range the equity changes were more modest, given the starting asset allocation was already regionally allocated. The Income 2 portfolio across both ranges introduced a strategic allocation to UK mid-cap equities, although the active range already had some off-benchmark exposure here.

Alternatives

All three alternative classes were reduced across both ranges. This is due to lower expected future returns and lower yields, compared to the previous review point. Our allocation to alternatives includes UK property, global property and global infrastructure.

Updated selection for Passive MPS

Income-based index tracking products tend to carry a higher ongoing charge when compared to ETFs tracking vanilla indices such as the FTSE 100. Therefore, in asset classes that naturally produce a higher income, such as UK equities, the team has blended together high income ETFs with cheaper trackers. This has allowed us to cut the blended ongoing cost of the underlying investments in the Income 1 portfolio by 36% to 0.21% and in the Income 2 portfolio by 21% to 0.28%.

Within the portfolios a number of new income-based equity ETFs were introduced, with providers including Invesco, SPDR, BMO and BlackRock. Each range has a different methodology, and therefore our focus was ensuring that the yield on each ETF was both competitive and sustainable. We believe each ETF strikes the balance between delivering a high yield and being suitably diversified across sectors and countries. Within our fixed income asset class, the incumbent ETFs were unchanged, with new asset classes implemented through our preferred ETF, with the aim to strike a balance between yield, cost, tracking and diversification.

Within UK property and global infrastructure our implementation remained unchanged. Within global property we switched from the Blackrock product to the L&G fund. This has a higher yield and a lower OCF.

The changes have led to a pick-up in yield, with both products delivering an income of just below 4%. This is slightly lower than the 4% target although this is a function of strong capital growth over the last twelve months, squeezing yields lower.

Underlying OCF	0.21%	0.28%
Indicated Yield*	3.78%	3.60%
No. of Holdings (exc. Cash)	13	11

Asset Type	Sub-asset Type	Long name	OCF	Indicated Yield*	MPS Income 1	MPS Income 2
Equity	UK Equity	iShares Core FTSE 100 ETF	0.07%	4.47%	12.0%	21.0%
		SPDR UK Dividend Aristocrats ETF	0.30%	3.95%		5.0%
	Europe ex-UK Equity	iShares MSCI Europe Quality Dividend ETF	0.28%	4.83%	8.0%	10.0%
	North America Equity	Invesco S&P 500 High Dividend Low Volatility ETF	0.30%	3.82%		7.0%
	Pacific ex-Japan Equity	Vanguard FTSE Asia Pacific ex-Japan ETF	0.22%	3.28%	4.0%	10.0%
		iShares Asia Pacific Dividend ETF	0.59%	5.66%		3.0%
	Emerging Markets Equity	BMO MSCI Emerging Markets Income Leaders ETF	0.38%	3.94%	4.0%	7.0%
	Global Equity	iShares MSCI World Quality Dividend ETF	0.38%	3.02%		10.0%
Fixed Income	UK Government Bonds	Lyxor FTSE Actuaries UK Gilts 0-5 Year ETF	0.07%	3.09%	15.0%	
	UK Corporate Bonds	SPDR Bloomberg Barclays Sterling Corporate Bond ETF	0.20%	2.67%	10.0%	
	International Bonds	Invesco US Treasury 3-7 Year ETF	0.06%	2.41%	4.0%	
		Vanguard USD Corporate Bond ETF	0.12%	3.76%	10.0%	
		SPDR Bloomberg Barclays 0-5 Year US High Yield Bond ETF	0.40%	5.61%	5.0%	
		Vanguard USD Emerging Markets Government Bond ETF	0.25%	4.87%	10.0%	
		iShares EM Asia Local Government ETF	0.50%	2.74%	3.0%	
		BMO Barclays Global High Yield GBP Hedged ETF	0.35%	4.68%	10.0%	
Alternatives	Property	iShares MSCI Target UK Real Estate ETF	0.40%	2.48%		10.0%
		L&G Global Real Estate Dividend	0.20%	3.03%		10.0%
	Absolute Return	iShares Global Infrastructure ETF	0.65%	2.15%	3.0%	5.0%
Cash	UK	Cash	-	-	2.0%	2.0%

Underlying OCF is the ongoing charges of the underlying positions of the portfolio and excludes the annual investment management charge.
**The indicated yield is based on historic and estimated yields, and is not a reliable indicator of future performance.*
Source: Bloomberg, Morningstar

Updated selection for Active MPS

Within the active range, the majority of changes are due to the updated asset allocation, with a reduction in current holdings where the asset class is being reduced, and vice versa for increases. For new asset classes a combination of passive and active products are being used. For the new fixed income asset classes, passive funds and ETFs have been selected. This is due to a combination of factors, including cost, diversification, expected alpha and availability of active funds.

A dedicated US equity position was introduced at the latest asset allocation review and we have therefore included JPM US Equity Income. The fund seeks to outperform the S&P 500 Index by investing in dividend-paying companies with attractive fundamental characteristics. Ultimately, the fund manager is striving to deliver a yield exceeding that of the S&P 500 Index yield by 1%.

Within Asian equities an additional position has been introduced in the Income 2 portfolio. Schroder Oriental Income is an investment trust which seeks to provide a total return from companies of the Asia Pacific region and offers an attractive yield. The investment approach is long-term in nature and has a strong valuation discipline combined with focusing on companies with visible earnings growth and sustainable returns.

The final change comes within infrastructure. We have switched from Premier Global Infrastructure Income to Legg Mason IF RARE Global Infrastructure Income, where we have increased conviction in the team and strategy. The fund seeks to provide a sustainable level of income, with a secondary investment objective of long-term capital growth. It invests in a diverse range of global listed infrastructure securities across a number of infrastructure subsectors such as gas, electricity and water utilities, toll-roads, airports, rail and communication infrastructure, and across different geographic regions.

The use of passive instruments within fixed income has led to a significant fall in OCF for the Income 1 portfolio, reducing by 21% to 0.49%. For the equity-based Income 2 portfolio, the OCF has seen a slight increase of 4% to 0.75%. This is due to a decrease in passive holdings, driven by the reduction in UK property, and the slightly higher cost of the new infrastructure fund. Both portfolios offer a yield of above 3.5%. This is slightly lower than the 4% target, although this is a function of strong capital growth over the last twelve months, squeezing yields lower.

Underlying OCF	0.49%	0.76%
Indicated Yield*	3.85%	3.55%
No. of Holdings (exc. Cash)	15	13

Asset Type	Sub-asset Type	Long name	OCF	Indicated Yield*	MPS Income 1	MPS Income 2
Equity	UK Equity	Man GLG UK Income	0.90%	5.06%	7.0%	12.0%
		Troy Trojan Income	0.87%	3.78%	8.0%	13.0%
		Montanaro UK Income	0.86%	3.60%		5.0%
	Europe ex-UK Equity	BlackRock Continental European Income	0.93%	3.82%	5.0%	6.0%
	North America Equity	JPM US Equity Income	0.90%	2.16%		7.0%
	Pacific ex-Japan Equity	Jupiter Asian Income	0.98%	3.73%	4.0%	9.0%
		Schroder Oriental Income	0.83%	4.07%		4.0%
	Emerging Markets Equity	JPM Emerging Markets Income	0.90%	3.79%	4.0%	7.0%
	Global Equity	Artemis Global Income	0.83%	3.33%		5.0%
		Newton Global Income	0.80%	3.10%		5.0%
Fixed Income	UK Government Bonds	Lyxor FTSE Actuaries UK Gilts 0-5 Year ETF	0.07%	3.09%	15.0%	
	UK Corporate Bonds	Royal London Corporate Bond	0.37%	3.39%	5.0%	
		TwentyFour Corporate Bond	0.35%	3.96%	5.0%	
	International Bonds	Invesco US Treasury 3-7 Year ETF	0.06%	2.41%	4.0%	
		Vanguard USD Corporate Bond ETF	0.12%	3.76%	10.0%	
		SPDR Bloomberg Barclays 0-5 Year US High Yield Bond ETF	0.40%	5.61%	5.0%	
		M&G Emerging Markets Bond	0.79%	5.02%	10.0%	
		L&G EM Government Bond Index Fund	0.35%	2.74%	3.0%	
		Baillie Gifford High Yield Bond	0.38%	3.74%	10.0%	
Alternatives	Property	iShares MSCI Target UK Real Estate ETF	0.40%	2.48%		10.0%
		L&G Global Real Estate Dividend	0.20%	3.03%		10.0%
	Absolute Return	Legg Mason RARE Global Infrastructure Income	0.93%	5.17%	3.0%	5.0%
Cash	UK	Cash	0.00%	-	2.0%	2.0%

Underlying OCF is the ongoing charges of the underlying positions of the portfolio and excludes the annual investment management charge.
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Source: Bloomberg, Morningstar

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