AJ Bell Passive funds – Q3 2018 review

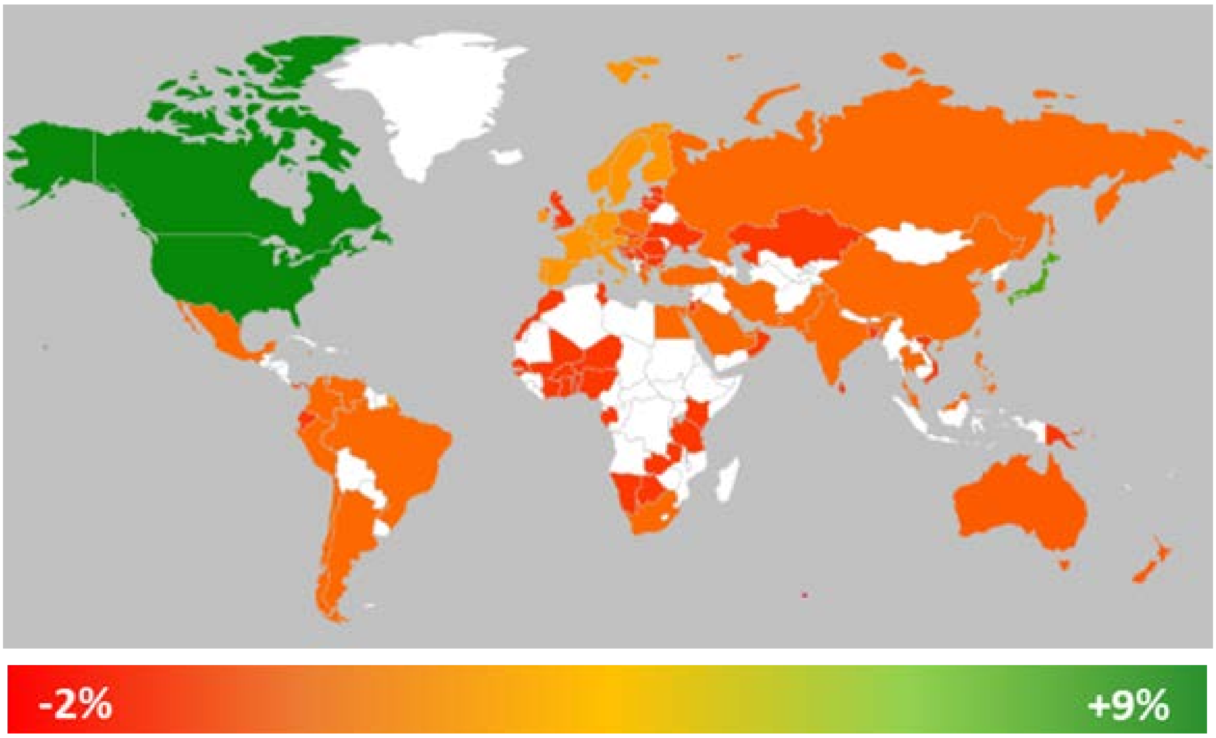
Introduction

We are delighted to bring you the latest quarterly report from AJ Bell Investments.

This report is designed to keep you up-to-date on what is happening with your AJ Bell managed funds. It covers the major world events of the past three months, looks at how these have impacted the funds, and highlights any changes made in the period.

Market Performance & Outlook

Japan and the US defied the mediocre returns seen across financial markets in the third quarter of the year. US stock markets were up 9% and Japan was up over 7%, whereas other major markets delivered returns between -1% and +1%. Meanwhile, UK gilts fell by nearly 2%, in a quarter that saw the Bank of England raising its base interest rate to 0.75%.



Heat map of global equity returns by region, Source: Bloomberg, AJ Bell

So what influenced market returns this quarter?

- Strong US company profits
- Japanese PM Abe re-elected as party head
- Brexit discussions

Strong US Company Profits

In December last year, President Trump managed to achieve what many thought almost impossible – a major overhaul of the US taxation system. Amongst the raft of changes, the rate of tax paid by US companies on the profits they make, known as corporation tax, was slashed from 35% to 21%.

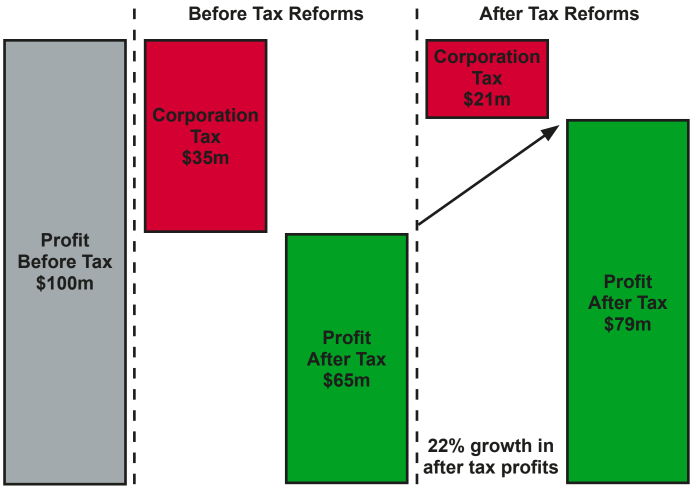
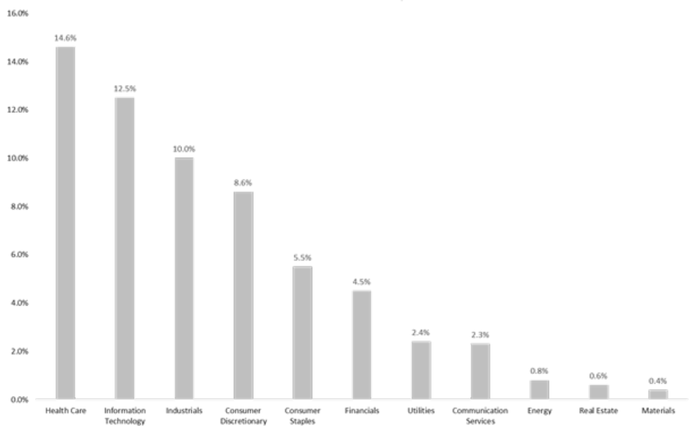


Illustration of US tax reforms, Source: AJ Bell

The US markets rose both in anticipation of the reforms, and in the immediate aftermath, because as our example shows, a reduction in the tax bill leads to a one time jump in after tax profits earnt in the US of around 22%. The US stock market fell significantly earlier in the year on the back of fear of a trade war and tensions with North Korea; however as these have subsided (or at least reduced in magnitude) the focus returns to what really drives the level of stock markets – the profitability of public companies.

The boost is only to profits earned in the US, therefore it affects different sectors in varying ways. Healthcare, Technology and Industrial stocks performing particularly well, all up by over 10% in the last three months.



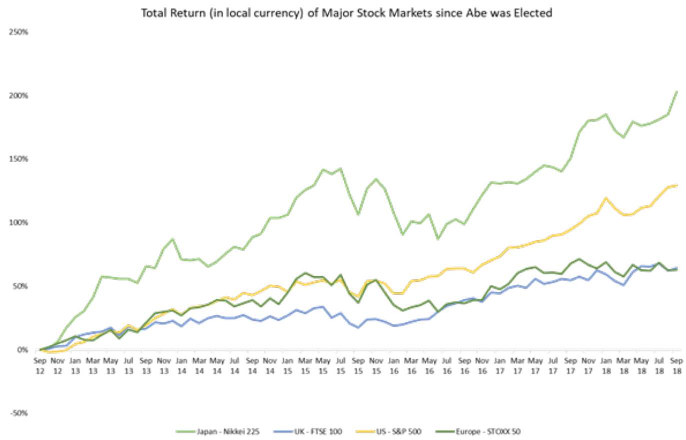
S&P 500 total return by sector, Q3 2018, Source: Bloomberg

Our View

The reforms to the US taxation system certainly provide a short term boost to company profitability, providing a 'permanent' one-off boost of over 20% for any earnings made within the US. Unlike the FTSE 100 Index, where much of companies' profits are earned overseas, it is estimated that around three-quarters of the S&P 500 earnings, the major US stock index, are earned within the Americas region. In the last 12 months the S&P 500 Index has risen by 18%, roughly equating to the boost in profitability that the reforms have driven. It is therefore clear why the US markets have outperformed the rest of the world over the last 12 months, however, it will get tougher to repeat. The tax reforms will have a significant hit on the revenue generated by the US government and may lead to higher borrowing, inflation and interest rates. It does not concern us at the moment as company revenues are also still rising; unaffected by the tax reforms - however we retain a tight grip on the steering wheel, ready to navigate away from the US if we see signs of any negative fallout.

Abe Re-elected

The Japanese stock market has delivered stellar returns since the end of the Great Financial Crisis in 2008. This is largely down to the policies of its Prime Minister Shinzo Abe, elected in September 2012. Indeed the Nikkei 225 Index (the Japanese equivalent to the FTSE 100 Index) has beaten all major stock market returns; at least when measured in its own currency, in the 6 years since Abe was elected.



Performance of Major Stock Indices since Abe's Election in Sept 2012, Source: Bloomberg

His 'Three Arrows' policy has helped to stimulate the Japanese economy and in particular share prices. However, in the first half of 2018 the Japanese stock market struggled, down 2% when measured in Yen. This was on the back of several scandals in Japan, leading to Abe facing a no confidence vote and a leadership challenge.

He has however come out the other side and was re-elected as the leader of the ruling party on the 20 September. This will allow investors to instead focus on the strength of the economy – a higher than expected GDP growth rate has helped the Japanese stock market increase by 7% over the quarter, the best performing major market after the US.

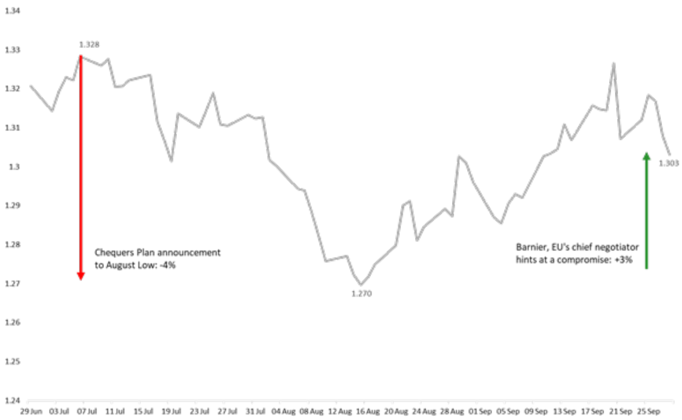
Our View

Much akin to the US; Japan appears to have been on a different path to the rest of the world over recent years, with stock returns out-pacing most regions. The Japanese stock market has performed well over recent years, helped by the policies set out by Abe. Despite this, it is still almost 40% below the levels hit at the end of 1980's as it has struggled with low inflation and high levels of borrowing. As different dynamics are driving returns here we hold a significant weight to Japan in our funds as it offers a different return profile – Japanese stock markets often rise when other parts of the world are falling and vice versa.

Brexit Discussions

Just as the quarter began, so did the acceleration of Brexit negotiations. On the 12 July the Government published what has become known as the ‘Chequers Plan’ (it even has its own Wikipedia page!). This provided a proposed blueprint for the UK’s relationship with the EU after it has formally left the union. This plan has proved controversial both sides of the Channel, with many within the Tory party (including Boris Johnson) claiming it does not go far enough; whereas the EU claimed much of it was unworkable at a summit in Salzburg. However, more recently there have been indications from key negotiators on the European side that a compromise could be met before the deadline.

The uncertainty has mainly been played out through volatile currency markets. The Pound originally fell significantly against the US Dollar, but recovered towards the end of the quarter as shoots of optimism emerged. In the end the Pound ended the quarter down 1% against the Dollar.



Pound versus the US Dollar, Q3 2018, Source: Bloomberg, AJ Bell

Our View

Much like a JK Rowling book, Brexit appears to be an enthralling saga that appears to just keep going on – in years to come it would be no surprise to see it made into a big screen blockbuster! In truth it is very difficult to predict which way the discussions will end, although it appears more and more likely that the result will be fairly binary on the financial markets – with moves not dissimilar to the magnitude we saw in the immediate aftermath of the initial Brexit referendum. In the event of a Hard Brexit we have drawn up plans for how we would change the composition of the fund holdings – we would shift a greater part of our holdings into international stocks and bonds, which would benefit from a weaker Pound. Conversely, in the event of a Soft Brexit we could potentially increase our holdings in UK domestic stocks through the FTSE 250 Index – this has underperformed other markets over the last couple of years.

Moderately Cautious

Performance

In Q3 the Moderately Cautious fund delivered a positive return of 0.85%, bringing its return over the last year to 4.66%.

The Moderately Cautious fund has 55% of its assets in cash and fixed income, these asset classes detracted from performance over the quarter as gilt yields rose. The majority of the positive performance was driven by the fund’s exposure to equities, especially those tilted towards the US and Japan. We are pleased to see the fund performing in line with our expectations.

Activity

After making significant changes to the fund over the first half of the year, the third quarter represented one of consolidation with the majority of trading focused around dealing with the inflows we saw into the Moderately Cautious Fund.

Outlook

At each quarter end it appears to be the same story at the moment – equity markets have in general moved upwards; whereas bonds have struggled as interest rates increase across the globe. We see no reason for this trend to stop, at least in the short term. However, as we highlighted at the end of the last quarter, stock markets are now up over 300% since the end of the Global Financial Crisis in 2008. A Trump tweet, a Hard Brexit or an unexpected conflict could be enough to bring the current bull market to an end. For now believe the best place is still in stocks and shares, however we remain ready to adjust the fund if we see signs of weakness or indeed a major global event affects the long term prospect of the global economy.

Fund Costs

We launched the AJ Bell Passive funds in April 2017 with the aim of providing competitively priced outcome-orientated funds. This means we do the work to invest across different regions and asset classes, with each fund offering a different level of risk and return potential. To keep the cost of investment low, we kept our management fee low and only invested in passive trackers.

We also took the decision to cap the fund OCF (ongoing charge figure) which you pay at 0.5%. As the funds grow over time, their OCF should come down. We’ve seen this happen already in three of the six funds – the lowest being the Balanced Fund, with an OCF of 0.42%.

The bigger the Passive funds grow, the smaller their OCF gets, so we’d like to thank you for your support so far.

From 1 January 2019, our normal custody charge will apply to the AJ Bell Passive funds, though we’ll continue to waive our standard online £1.50 dealing charge when you make any fund purchases. For more information, please take a look at our charges and rates.