AJ Bell Passive funds – Q4 2018 review

Introduction

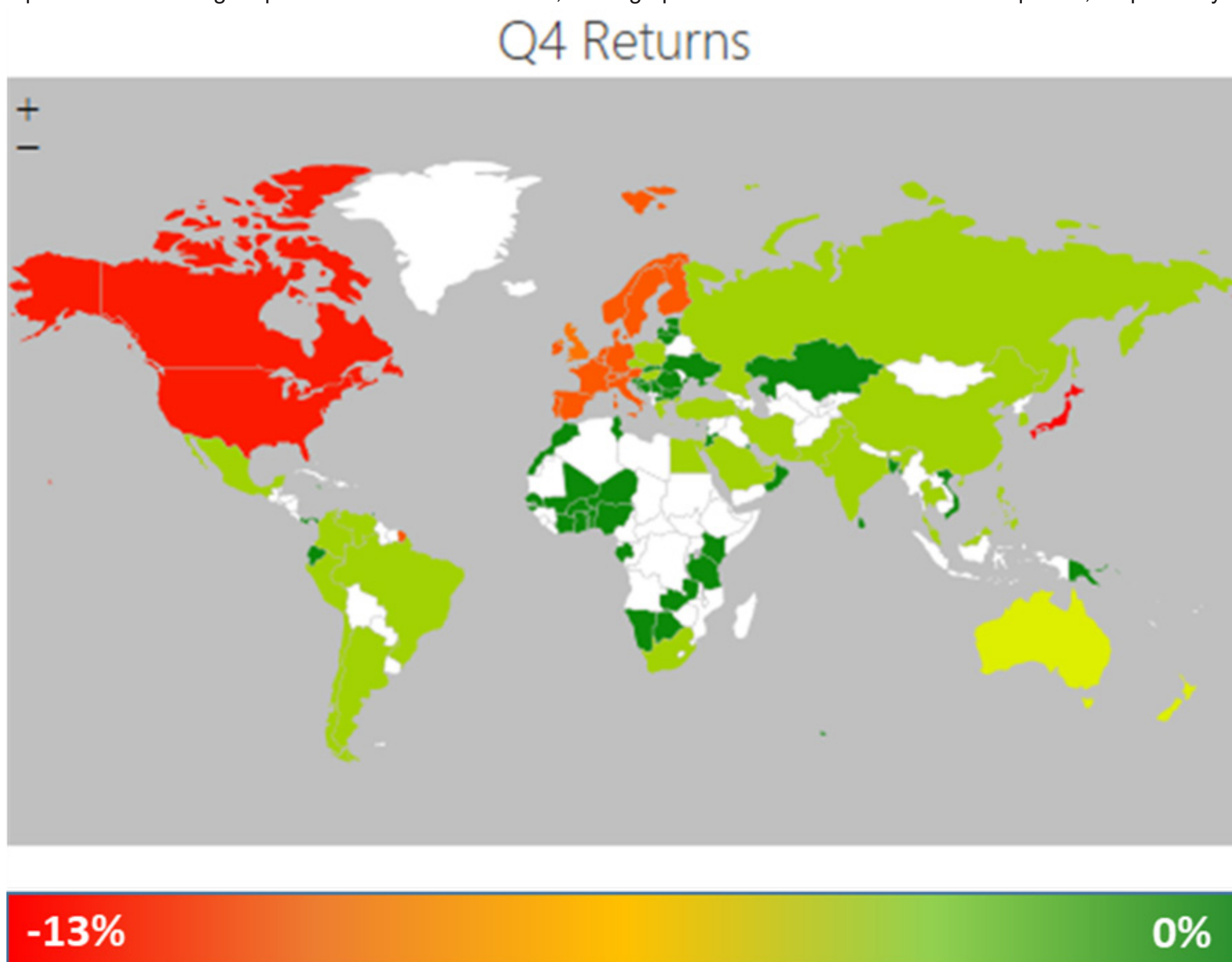
We are delighted to bring you the latest quarterly report from AJ Bell Investments.

This report is designed to keep you up-to-date on what is happening with your AJ Bell Passive 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

A tough end to 2018 saw almost all stock markets in the red for Q4, as investors grappled with a swath of bad political news, amidst slowing global growth.

In a reversal of fortunes compared to the last quarter, US stock markets were finally dragged into the mire; going from being the last bastion of positive stock market returns amongst major developed markets prior to December, to posting the worst December in its history (starting 1957), falling over 9% in the month (and over 11% in the quarter). This despite a rip-roaring Boxing Day rally, which saw it up over 5% in one day! Japanese markets and the Technology sector were also down significantly, falling over 12% and 16% respectively, as last quarter's winners saw steep falls in Q4. Meanwhile, UK gilts and global government and investment grade bonds provided some bright spots for UK based investors, closing up over 2% and almost 4% on the quarter, respectively.



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

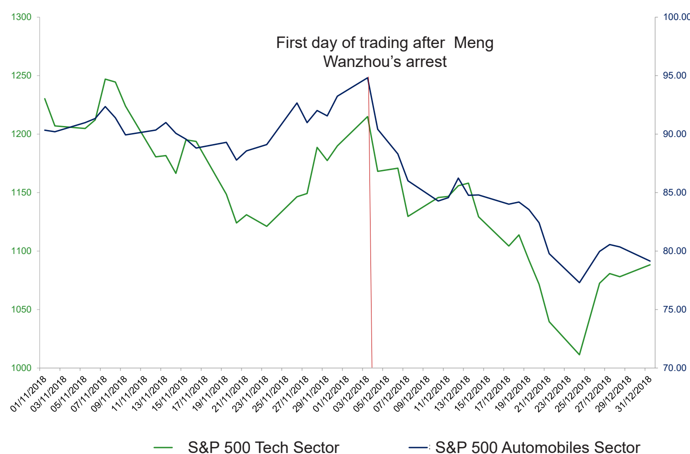
So what influenced market returns this quarter?

- **Trade Wars:** US & China continue to ratchet up the pressure
- **Italy/EU Budget Standoff:** EU discipline meets Italian populism
- **Technology Sector sell-off:** Big bites from Apple

Trade Wars

The trade war between the US and China, the world's two largest economies continues. The US has become far more vocal on China's unfair practices with Donald Trump's ascendancy to the White House and has continued to ratchet up the pressure on Beijing via a series of tariff introductions. The US has applied $253bn of tariffs on Chinese goods thus far and threatened another $267bn. In retaliation, China has responded with tariffs of $110bn on US goods.

When we wrote the piece at the end of June, we advised that we would be interested watchers of the events and will be alert for any escalation/negative fallout from the standoff. By the end of Q4, US tariffs had increased from $34bn at the time we wrote the Q2 report to today's $253bn and it looks as though we are beginning to see the impact on global trade and, as a result, global stock markets. Additionally, the tactics have begun to move beyond the imposition of simple tariffs to one directly targeting some of the largest companies in each respective economy, in particular Technology firms. On December 1st, as President Trump and President Xi were meeting at the G20 in Buenos Aires, agreeing to a temporary truce to allow trade negotiations, Canadian authorities arrested Meng Wanzhou, Huawei's Chief Financial Officer and daughter of the company's founder (and former officer in the Chinese military), Ren Zhengfei. Ms Meng is now facing extradition to the US, on charges relating to fraud and sanctions violations with respect to Iran. While on the surface not related to the trade disputes, the timing and perception of this action certainly rattled stock markets, as it potentially opened up a new front in the standoff between the two nations, such that on the day of the arrest, US carmakers and technology stocks, for instance, were the heaviest hit sectors. These are also, ostensibly, the two sectors which would be significantly impacted by continued trade spats and both sectors have seen further falls since the incident, with the technology sector down over 15% since the arrest and the automobile sector down over 11%.



S&P 500 Technology and Automobile Sectors, 01/11/2018 to 31/12/2018, Source: Bloomberg, AJ Bell

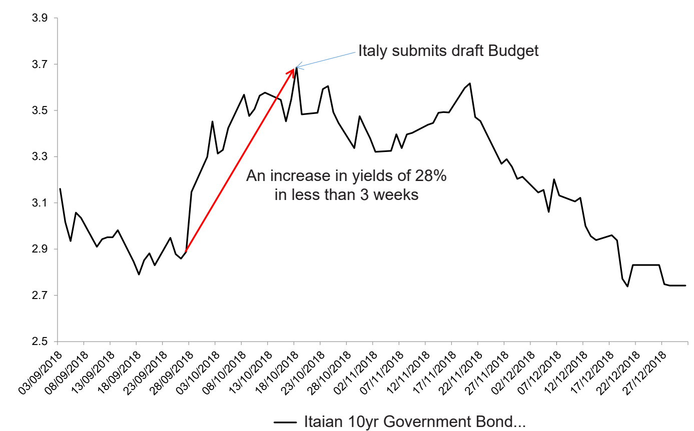
Our View

With the US and China standoff morphing from what appeared to be a threats of a trade war involving low level tariffs and posturing, to one of increasing entrenchment and a fraught political standoff involving individuals, global markets are right to be concerned at developments. Given the respective size of the economies involved, global trade cannot possibly escape unscathed, should this situation continue. We are considering the potential fallout and how best to position portfolios for further escalation, should a deal not be agreed in the 90 day "ceasefire" that was brokered on 1st December, between the two nations.

Italy/EU Budget Standoff

With a populist coalition (the left wing Five Star and the right wing League) taking control of Italy in the country's last general election in March 2018, the stage was set in Q4 for a showdown between the elected representatives of the new government, which rode to power on promises of increased public spending and the bureaucrats of the EU, who insist that Italy stick to the bloc's rules for fiscal discipline. With an initial draft of the Italian budget being submitted in October, including the promised tax cuts and the guaranteed income for the unemployed, , investors were nervous of the outcomes ahead of the submission. Inevitably, the plan was rejected by the EU authorities who demanded revisions. The Italian's led by the League's firebrand leader and now deputy PM, Matteo Salvini, refused to kowtow to the EU's orders, insisting no ground would be given. This tense state of affairs left market watchers concerned, since it re-opened up old wounds and new potential turmoil in the EU and across European markets, with echoes of the Greek crisis still lingering in the memory of investors.

Markets reacted to the situation, by selling off Italian debt, in a replay of the sort of actions we saw during the European sovereign debt crises in 2010-2012. With the yield on Italian debt at 2.88% on the close 27th September, by 18th October, it had reached a high of 3.7%. Almost a 28% increase in yields, for a country with a debt equal to 131% its gross domestic product (GDP). This blow out in yields fed into stock markets, with the Stoxx Europe 600, an index of Europe's 600 largest companies, falling over 11% between 1st October and December 18th. Thankfully, throughout November, rhetoric softened and on 19th December 2018, an amended budget from the Italian's, committing to a deficit of 2.04% of GDP was passed, enabling investors to breathe a sigh of relief, with Italian yields returning back to the levels seen prior.



Italian 10 year government bond yield, 01/09/2018 to 31/12/2018, Source: Bloomberg, AJ Bell

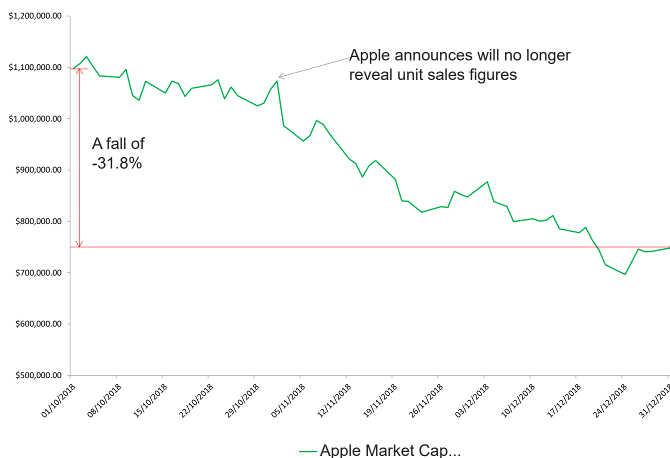
Our View

While the Italian budget standoff was concerning, the team did not feel that there was any danger of Italy potentially walking away from the Euro and the European Union. That being said, it's not certain that we won't see future bouts of turbulence in European markets, given the continued strong polling of populist parties, plus the fact that the Italian budget amendments simply delayed the increased spending. Italian yields have benefitted enormously from the European Central Bank's Quantitative Easing program, due to end this month and, therefore, are likely to be vulnerable to sell-offs in the coming years. The team will monitor Europe closely, especially in light of Brexit negotiations and will act to limit impact in the funds, should the situation warrant it.

Technology Sector sell-off

In the first three quarters of 2018, Technology stocks, particularly in the US, were some of the best performers in global markets, with the S&P 500 IT Sector up over 19% from 1st January 2018 to end of Q3 2018. However, as we moved into Q4, the run was brought to an abrupt halt, with the same sector falling over 18% on the quarter.

The falls were led by some of the biggest companies in the world, with Apple's recent travails particularly notable, losing it's position as the world's largest company by market cap, as it's value fell by over 31%, from a market capitalisation of over $1.1 trillion on 1st October, to around $750 billion by 31st December. The real warning signs for Apple investors first surfaced in November when the company revealed it would no longer disclose unit sales, a signal to the market that it wasn't seeing good sales numbers and investors reacted as expected, selling Apple heavily into year end. As at time of writing, the issues were confirmed on 3rd January, when Apple issued it's first profit warning since 2002, citing challenging Chinese sales, linked to the already discussed US-China trade wars and Trump's "America First" policy.



Apple Inc. Market Cap (US $), 01/10/2018 to 31/12/2018, Source: Bloomberg, AJ Bell

Our View

The rapid about face in the relentless ascent of Apple and, Technology stocks in general, marked a disappointing end to what was shaping up to be a very strong 2018 for the sector. It is the opinion of the team that Technology stocks had just priced in too much good news and future growth, a little too quickly and as such, short term holders have taken profits, leading to the recent pullback. Apple's travails, which are due to them struggling to find the next big thing to replace the very mature iPhone (now that smartphone market is saturated), are not reflective of the wider industry and the team still believes Technology stocks will offer strong opportunities for growth into the future. The increasing use of AI, Robotics and other cutting edge technology across all industries, led us to incorporate notable weightings of Technology in our higher risk funds and, while the pullback weighs on short term performance, it also presents opportunities for long term investors. With this in mind, the team remain comfortable with our exposures in this area, but will remain alert to any changes in the outlook.

Adventurous

Performance

In Q4, the Adventurous fund delivered a return of -8.68%, bringing its return over the last year to -5.12%.

The Adventurous fund has the majority of its assets in equities with an allocation of 86% and this detracted from performance, in particular our holdings in UK mid-caps, Japan and the funds significant holdings in Technology. The fund's holdings of bonds, however, helped shield the portfolio from the worst of the falls, as global bonds (government and corporate), into which we have consciously put larger allocations relative to peers, were up over 3.5%. While the negative quarter performance is disappointing, it should be noted that the falls are within the normal range expected by the team and, as such, should not be a cause for concern.

Activity

In the main, Q4 has been a quarter of taking stock as well as monitoring and researching potential updates for 2019. With all of the major passive providers looking to cut costs to gain market share and with notable new entrants into the space in 2018 (L&G's ETF offering, for instance) the team are in the midst of a full market review to ensure that the holdings within the funds are best of breed, while the funds themselves are as cost and operationally efficient as possible, in order to always offer value for money to investors.

The one notable change to the funds in Q4 was around the allocation to strategic cash. This stands at 2% in the Adventurous fund. Following a change to our custodian in Q2, the cash in the funds is now invested in a panel of liquidity funds and remains there until such time as required, ensuring all cash is working as hard as possible, improving diversification and returns.

Outlook

From each quarter seeming to show consistent equity gains and struggling bonds, it was interesting to see almost the exact reverse story in Q4. While it is disappointing to see what was good 2018 performance brought down, at the back end of the year, it is pleasing to see that the multi-asset nature of our funds meant when some areas were falling (stocks and property) others were helping (bonds and cash). The team are continuously monitoring global market developments and are conscious of the various headwinds that may present in 2019; no deal Brexit, escalation to trade disputes etc. and we remain ready to adjust the fund if we see signs of continued weakness or threats to the long term prospects of the global economy.

Fund Costs & Charges

In Q4, we maintained our focus on lowering the cost of investment in the funds and are pleased to see continued progress for our efforts. While a lot of this progress is around the efficiency of our dealing and execution processes, we have also been working on the OCF of the funds and are pleased to see that at the end of Q4, the largest fund in the range, the Balanced Fund had an OCF of 0.40%, down from 0.50% at the end of Q1. We hope to continue the progress on cost compression across the range and, as the funds grow, we are committed that any benefits of the increased scale will automatically be passed to investors, as a result of the structure we now have in place on the funds.

From 1 January 2019, our normal custody charge applies 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.

This report provides general information about the AJ Bell Passive funds. It should not be read or constructed as investment advice. It is your responsibility to assess your circumstances and make sure it is suitable for your needs.

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.

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AJB/F-QR-A/20190116