Time Is on Your Side

**Key takeaways**

» It’s important for investors to keep their eyes on the future rather than focusing on short-term noise that could lead to poor investment decision-making.

**What it may mean for investors**

» We don’t expect the current cycle to end in 2020, and we recommend that investors remain invested in a diversified mix of assets—while keeping their time horizon in mind when there is heightened market volatility.

The Rolling Stones released their version of the song “Time is on my side” in 1964, and it went on to become the band’s first top 10 hit in America. Although Mick Jagger was singing about a relationship, the phrase can be applied to many facets of life, including investing. We often talk about time horizon in investment management—which refers to the period investments are held until they are needed (or when an investor will need to access their money). This time frame often is long term in nature, with investors saving for goals like retirement, college, or philanthropy. Even those near (or in) retirement will need to plan for a potentially long retirement. Therefore, it is important for investors to keep their eyes toward the future, rather than focusing on short-term noise that could lead to poor investment decision-making.

When we think about various time horizons, it’s critical to consider how it will impact an investor’s overall strategy. Time horizon has a direct impact on risk tolerance, which helps to determine an investor’s asset allocation mix. Key time frames to consider when investing include:

- **Strategic**—Long-term periods (10+ years) that span at least one, if not two, market cycles. An investor’s strategic asset allocation has been shown to be the dominant driver of portfolio return variability.

- **Cyclical**—Medium-term periods (3-5 years) that capture several years within a market cycle. If an investor’s time horizon is less than five years, a cyclical investment approach may be appropriate.

- **Tactical**—Short-term periods (6-18 months) that exploit a temporary market mispricing or opportunity to mitigate risk.
We’ve all experienced short-term market volatility and wondered—should I be selling, should I be buying, or should I simply stay put? The answer partially depends on an investor’s time horizon, risk profile, and comfort level with tactical investing. As Chart 1 shows, staying the course over the past 30 years has been rewarding for investors. Even with multiple recessions, bear markets, corrections, and a “lost decade” in the 2000s, the S&P 500 Index has averaged a 10% annualized total return per year. Investment-grade bonds held their own, averaging a total return of nearly 6% during the same period. Meanwhile, a diversified portfolio (the Four Asset Group without private capital portfolio) averaged a 9% annualized total return with much less volatility than the S&P 500 Index.

Chart 1 also shows that the past decade was an excellent time to be invested in U.S. equity markets. The beginning of that period marked the end of the “financial crisis” and one of the worst U.S. recessions in modern history, leaving equity valuations at extremely cheap levels. What followed was an extended economic expansion that was accompanied by the longest bull market for stocks on record (that is still going). Needless to say, we’re in a different position at the start of this decade, with global growth slowing and equity valuations in a fair-value range. Expectations should be tempered over the next 10 years as we are likely closer to the end of this U.S. cycle (both business and market) than we are to its beginning. Even so, we don’t expect the cycle to end in 2020, and we believe that investors should remain invested in a diversified mix of assets, while keeping their time horizon in mind when there is heightened market volatility.

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Updating our equity targets and methodology

We recently adjusted our year-end targets—and our methodology for determining equity index target ranges.¹ Our new methodology utilizes expected volatility (measured by standard deviation) to determine bands around the midpoint price level for each equity index target. In the past, we used a 100-point spread for each target range. This approach allowed for an easily identified midpoint, but it did not account for the relative risk of each equity class or the current index value.

Let’s review the S&P 500 Index and Russell 2000 Index (small caps) under the old approach. A 100-point price spread translates into a +/- 1.5% price return from the midpoint to the upper and lower S&P 500 targets and a +/- 2.9% return for the Russell 2000. Historically, large-cap equities have been the least volatile equity class; but this 1.5% return spread doesn’t reflect the S&P 500 Index’s 16% expected volatility. The same holds true for the Russell 2000, which has 20% expected volatility. This approach assumed that all equity classes have similar index values as the S&P 500, which recently stood near 3300.

To better reflect relative volatility, we have calculated our ranges based on a percentage around the midpoint. The S&P 500 holds our narrowest target range of 5%, while the MSCI Emerging Markets Index reflects a 10% range around the midpoint (it has had the highest historical volatility). The remaining equity classes fall in between the large-cap low and the emerging market high.

Key takeaways

» We believe our new methodology better reflects volatility differences among equity classes. It also incorporates the current index values.

» The S&P 500 Index holds our narrowest 2020 year-end target range (by percentage), while the MSCI Emerging Markets Index has the widest range.

Wells Fargo Investment Institute: New 2020 year-end equity target ranges

<table>
<thead>
<tr>
<th>Index</th>
<th>Expected volatility</th>
<th>Lower target in range using new method</th>
<th>2020 rounded midpoint target</th>
<th>Upper target in range using new method</th>
<th>Percent range</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>16%</td>
<td>3,340</td>
<td>3,430</td>
<td>3,520</td>
<td>5%</td>
</tr>
<tr>
<td>Russell Midcap Index</td>
<td>17%</td>
<td>2,450</td>
<td>2,530</td>
<td>2,600</td>
<td>6%</td>
</tr>
<tr>
<td>Russell 2000 Index</td>
<td>20%</td>
<td>1,660</td>
<td>1,730</td>
<td>1,800</td>
<td>8%</td>
</tr>
<tr>
<td>MSCI EAFE Index</td>
<td>17%</td>
<td>2,040</td>
<td>2,110</td>
<td>2,170</td>
<td>6%</td>
</tr>
<tr>
<td>MSCI Emerging Markets Index</td>
<td>23%</td>
<td>1,110</td>
<td>1,170</td>
<td>1,230</td>
<td>10%</td>
</tr>
</tbody>
</table>

Sources: Wells Fargo Investment Institute, Bloomberg; January 29, 2020. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

¹ For details, please see the January 23, 2020, Institute Alert titled: “Adjusting U.S. Economic Growth and Equity Price Targets”. 

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Emerging market debt—rising credit quality and tighter spreads

January 31 marked the one-year anniversary of the inclusion of five Middle Eastern countries’ bonds in the emerging market (EM) sovereign debt index (JP Morgan Emerging Market Bond Index Global, or EMBIG). These countries were Saudi Arabia (with an A-/A1 rating), Qatar (AA-/Aa3), the United Arab Emirates (UAE, AA-/Aa3), Kuwait (AA/Aa2), and Bahrain (B+/B2). By January 24, 2020, their combined weight within this index stood at 16%.

These borrowers have a higher credit rating than that of the index (with the exception of Bahrain), and their debt issues generally trade on significantly lower yields than most bonds in the index. As a result of their inclusion, the weighted-average credit rating of the EMBIG has improved from BB+ (marginally high yield) to BBB- (investment grade). We analyzed the EMBIG index and found that—due to this inclusion of higher-credit, lower-yielding issues—the EMBIG index yield is approximately 27 basis points (0.27%) lower than it would have been if they were not included (4.73% versus 5.00%). As the chart shows, spreads over U.S. Treasury yields are similarly tighter (292 basis points, versus 320 basis points when these borrowers are excluded). This means that spread valuations, while still tight, may not be quite as expensive as they seem. The chart shows that—absent the change in index composition—EMBIG spreads would not yet have broken to new historical lows below the early 2018 levels.

Key takeaways

» In 2019, five Middle-Eastern sovereigns were added in EM-debt indices. Collectively, these five now compose approximately 16% of the index.

» Inclusion of these higher-credit-quality borrowers raised the EMBIG’s average credit rating by one notch; we found that it accounts for about one-third of 2019’s spread tightening.

Middle-East EMBIG additions tightened spreads by nearly 30 basis points

A commodity lesson from SARS—stay the course

The world, and markets, have been closely watching China’s coronavirus outbreak. No doubt by now, many of you have heard the comparisons to the SARS5 outbreak of 2003. We recently discussed the reportedly encouraging signs that the current coronavirus outbreak is not expected to be as severe as SARS—such as the significantly lower coronavirus fatality rate.6 Yet, we are still in the early days and much is uncertain. What can be learned from SARS’ impact on different markets, including commodities?

Markets tend to sell first and ask questions later. Consider this: the World Health Organization (WHO) issued its first global SARS alert on March 12, 2003. Oil prices dropped precipitously on the news, with the majority of the resulting price damage occurring by March 21. Meanwhile, copper, nickel, and aluminum bottomed in April, along with the Chinese and Hong Kong stock markets.7 Yet, each of these assets recovered most, if not all, of their value by June 2003. Using the SARS timeline template today, we believe commodities likely are near a bottom (see chart).

Given market tendency and past history, we believe that it is prudent to keep our commodity ratings and targets as they are for now—while still closely monitoring the coronavirus outbreak and its potential impact on commodity demand.

Key takeaways

» The coronavirus outbreak and its impact on commodity demand bear monitoring.
» Given past history and market psychology, we believe that it is prudent to maintain our 2020 targets at this time.

Commodity performance around 2003 SARS and 2020 coronavirus outbreak

Sources: Bloomberg Wells Fargo Investment Institute. Daily data. Indexed to 100 as of the commodity peak prior to outbreak fears which correspond to March 7, 2003 and January 6, 2020. Commodities represented by the Bloomberg Commodity Index (Total Return), or BCOM. Past performance is no guarantee of future results.

5 SARS = severe acute respiratory syndrome.
6 Please see the January 27, 2020, Institute Alert; “A Chill Wind from China’s Coronavirus” for more information.
7 As measured by the MSCI China Index and MSCI Hong Kong Index.
Neutral Private Equity
Neutral Hedge Funds-Macro
Neutral Hedge Funds-Event Driven
Favorable Private Debt
Favorable Hedge Funds-Equity Hedge
Neutral Hedge Funds-Relative Value

The importance of manager selection in private equity

Assessing the skill of potential investment managers is an issue that most investors must contemplate, regardless of asset class. Yet, the need is particularly acute in private equity, due to differing (and often proprietary) information and skill among private equity fund managers. Successful managers can outperform their peers by leveraging distinct organizational capabilities that include: 1) domain expertise, 2) industry networks that enable advantaged deal flow and industry insight, and 3) operational know-how that can help to drive growth and operational improvement at portfolio companies. Top-performing managers lean into their strengths to identify the most promising deals and create value throughout the investment holding period.

The chart highlights the importance of manager selection to venture capital and leveraged buyout fund performance for vintage years 2007 to 2016. The vertical bars show first-quartile performance of venture capital and buyout funds as measured by the net total value to paid-in capital (TVPI). The lines depict the spread between first and third-quartile TVPI by strategy—illustrating the performance differential between the top and bottom performers in each vintage year. For the 10-year period analyzed, the average first-quartile TVPI was 2.1x and 1.8x for venture and buyout funds, respectively, while the average interquartile range was 0.8x for venture and 0.5x for buyout. The result is an average first-quartile TVPI that is 65% higher for venture funds and 34% higher for buyout funds than the average third-quartile TVPI for each strategy.

Key takeaways

» Due to the highly differentiated nature of capabilities and skill sets among private equity fund managers, manager selection is critical to performance.

» The average first-quartile TVPI relative to the average third-quartile TVPI for vintage year funds between 2007 and 2016 is 65% and 35% higher for venture capital and buyout funds, respectively.

The difference between the “haves” and “have nots” in private equity

![Chart showing TVPI spread from 2007 to 2016 for venture capital and buyout funds]

Source: Cobalt LP; Data as of September 30, 2019. Cobalt LP is a private market data aggregation platform. Q1 = first quartile. Q3 = third quartile.

Past performance is no guarantee of future results. The data is based on the universe of funds Cobalt monitors. Buyout funds are defined as any PE fund that generally takes a control position by buying a company. Venture capital funds include all private markets funds focused on any stage of venture capital investing, including seed, early stage, mid stage and late stage investments.

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not suitable for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

TVPI is the ratio of a fund’s net asset value to the total paid-in investor capital.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Stock markets, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

Foreign investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Small- and mid-cap stocks generally more volatile, subject to greater risks and are less liquid than large company stocks. Bonds are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. High yield (junk) bonds have lower credit ratings and are subject to greater risk of default and greater principal risk. The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Index Definitions

Bloomberg Barclays U.S. Aggregate 1-3 Year Bond Index is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 1-3 years.

Bloomberg Barclays U.S. Aggregate 5-7 Year Bond Index is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 5-7 years.

Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.


Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB- or below. Included issues must have at least one year until final maturity.

The Bloomberg Commodity Index (BCOM) is a broadly diversified index comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity. It is unmanaged and not available for direct investment.
**JPM EMBI Global Index** is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (e.g. U.S.) and emerging market bonds.

**MSCI Developed and Emerging Market Country Indices** are designed to measure the performance of the large and mid-cap segments of the individual country markets and cover approximately 85% of the free-float-adjusted or equity universe in each country.

**MSCI EAFE Index** is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

**Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

**Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

**S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock’s weight in the index proportionate to its market value.

**HFRI Relative Value Index** maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types.

**HFRI Macro Index** is composed of a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. Although some strategies employ RV techniques, macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than realization of a valuation discrepancy between securities.

**HFRI Event Driven Index** maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance, or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative) with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

An index is unmanaged and not available for direct investment.

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