

Investment Strategy

Weekly guidance from our Investment Strategy Committee

December 14, 2020

Real Assets spotlight: Diversification is alive and well2

- When building an investment portfolio, flexibility can be key. What worked for you last year, or last decade, isn't necessarily going to work for you in the future.
- Staying on top of investments, being open to new ones, and re-balancing your portfolio, when needed, are simple strategies aimed at investment success.

Equities: The stock market is risk-on4

- As the stock market returned to rally-mode, it also rotated to favor small and value companies in November.
- In our view, the sustainability of the rotation will rely on future fiscal and monetary support, a broad U.S. economic recovery, and continued risk appetite in the market.

Fixed Income: High-yield corporate default expectations in 20215

- We believe corporate default rates may peak by the end of the first quarter of next year — around 11% — and then begin a declining trend in the remaining months of 2021.
- Recovery rates on high yield defaults have tended to climb back closer to 50% 12 months after they reach their cycle trough. We believe this will be the case in this recovery. We remain favorable on high yield.

Alternatives: Using funds of funds to access private equity6

- Private equity funds of funds (FoFs) offer qualified investors an option for a diversified portfolio with primary funds, secondary transactions, and co-investments in strategies including buyouts, venture capital, growth equity, and special situations.
- We believe FoFs can generate attractive returns and may be an option for qualified investors to access private equity, especially for smaller investors and those who are new to the asset class.

Investment and Insurance Products: NOT FDIC Insured ► NO Bank Guarantee ► MAY Lose Value

Real Assets spotlight

Diversification is alive and well

“Man is a creature of the era he lives in; very few can raise themselves above the ideas of the time.”

—Voltaire

When building an investment portfolio, flexibility can be key. What worked last year, or last decade, isn't necessarily going to work in the future. Staying on top of investments, being open to new ones, and re-balancing portfolios, when needed, are simple strategies aimed at investment success.

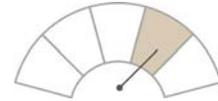
Staying on top of each investment is the toughest part of this recipe, because investments come in all shapes and sizes — stocks, bonds, real estate, currencies, gold. Some are much easier to understand than others. Portfolio success often requires a mix of different assets blended together – both easy-to-understand assets and those that are not so easily understood. History says that blending different, unconnected assets together can be crucial to better risk-adjusted returns and ultimately hitting financial goals. This is Asset Allocation 101.

The chart below is “proof in the pudding” as it were. It highlights the long-term performance differences between four of the major asset classes since 1900. Commodities are shown in the first panel (green line), stocks in the second panel (blue line), housing in the third panel (purple line), and bonds in the fourth panel (red line). Each of these asset classes have gone through good times and bad. The shaded areas in each panel represent the bad times, called bear markets. The white areas in each panel represent the good times, called bull markets. Stepping back looking at the full chart, you'll see that all the shading creates a “checkerboard” look. This tells us that these four major asset classes do not always move together over the long term.

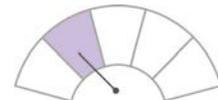
Assets behaving differently over the long-run, while it sounds simple, is not always an easy concept to grasp. The reason is that all assets are tied to the economy in one way or another. It is easy to argue, at least in theory, that if the economy is doing well, so should the majority of assets. But this clearly isn't the case. If it were, the chart would not be so checkered, and all assets would be in sync with one another. Our advice is to stay diversified.

John LaForge

Head of Real Assets Strategy

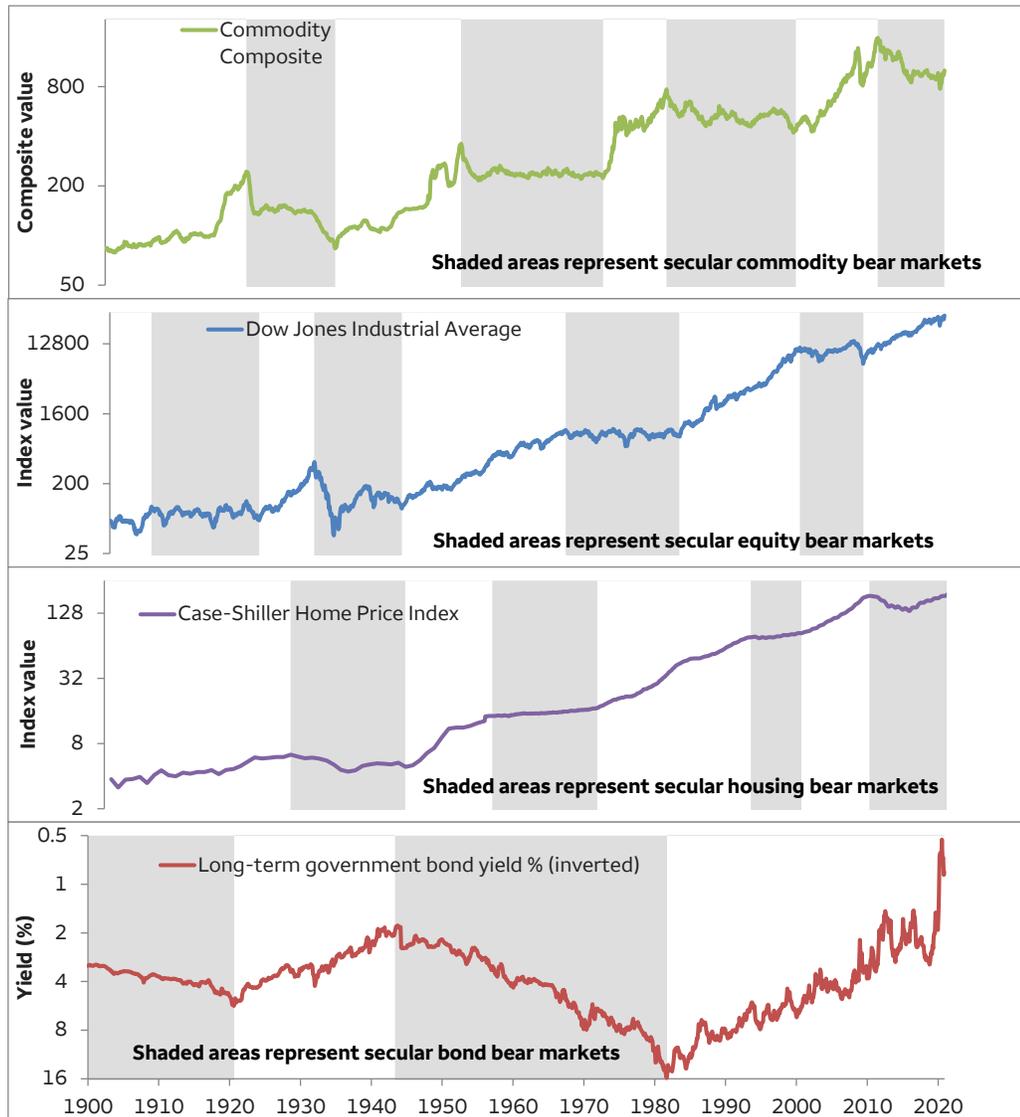


Favorable
Commodities



Unfavorable
Private Real Estate

Commodities, stocks, housing, and bonds — Secular bears



Sources: Bloomberg, Prices by G.F. Warren and F.A. Pearson, Bureau of Labor Statistics (BLS), Bureau of Economic Research (NBER), S&P CoreLogic Case Shiller, Wells Fargo Investment Institute. Monthly data January 31, 1900 – November 30, 2020. Data shown in log scale. Long-term government bond yields consist of: American Railroad bond yields high grade from 1900-1919, the yield on long-term U.S. Bonds from 1919-1953, and the yield on 10-year U.S. Treasury bonds from 1953 - today. Yields represent past performance and fluctuate with market conditions. Current yields may be higher or lower than those shown above. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for risk considerations and the definitions of the indexes.

Equities

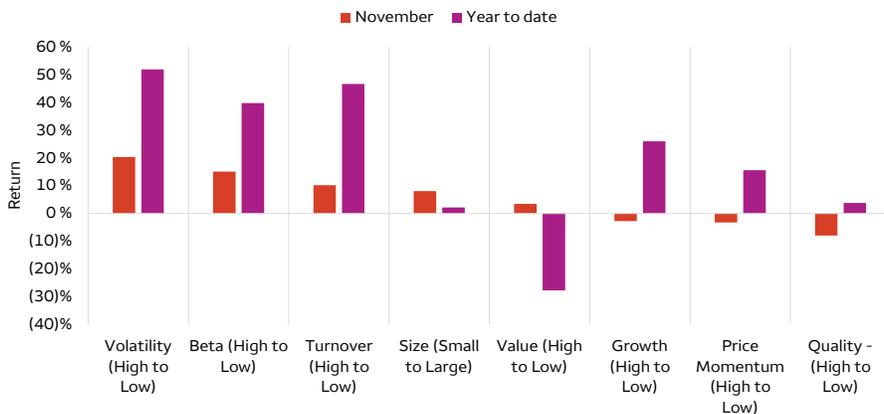
The stock market is risk-on

November was a month full of market-moving events, and we observed three important developments in the stock market.

- Major equity asset classes scored impressive returns between 9% and 18% — well above fixed income. Encouraging news around development of a COVID-19 vaccine and more muted political risk were top contributors.
- Further, the month also witnessed a style and factor rotation from a dominance of high momentum, growth, and quality stocks to small and value-oriented companies. As shown in the chart below, among U.S. stocks, the smallest 20% of companies outperformed the largest 20% by 8% in return, whereas high-quality stocks trailed their low-quality peers by a similar amount.
- The most persistent theme so far this year is driven by the high risk appetite of the market. Riskier stocks, characterized by high volatility, high beta (market sensitivity), and high trading activity, continued to outperform in November.

A style rotation to small and value stocks has typically taken place after recessionary periods. However, this time could be different. The deleveraging and creative destruction — catalysts to a persistent style rotation — has not happened in this recession. On the contrary, small and value companies with deteriorating fundamentals in recent years continued to see a higher financial leverage. An increasing number of these companies also have generated negative earnings in the pandemic. In our view, the sustainability of the small and value rally will rely on future fiscal and monetary support from the government, a broad U.S. economic recovery, and continued risk appetite in the market.

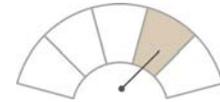
The U.S. stock market has a high risk appetite



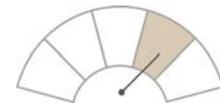
Sources: Bloomberg, Wells Fargo Investment Institute, December 7, 2020. Factor returns are calculated between the top 20% stocks and the bottom 20% stocks with in U.S. listed companies, ranked by a factor. Factor definition: Volatility – 1 year standard deviation of return, Beta – 2 year beta to U.S. equity, Turnover – Share turnover, Size – Market capitalization, Value – Book value to price, Growth – Earnings per share (EPS) growth, Price Momentum – 1 year return, Quality – composite of return on equity, equity/debt ratio and earnings variability. **Past performance is no guarantee of future results.**

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Global Portfolio and Investment Strategist



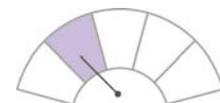
Favorable
U.S. Large Cap Equities



Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Unfavorable
Developed Market Ex-U.S. Equities



Neutral
Emerging Market Equities

Fixed Income

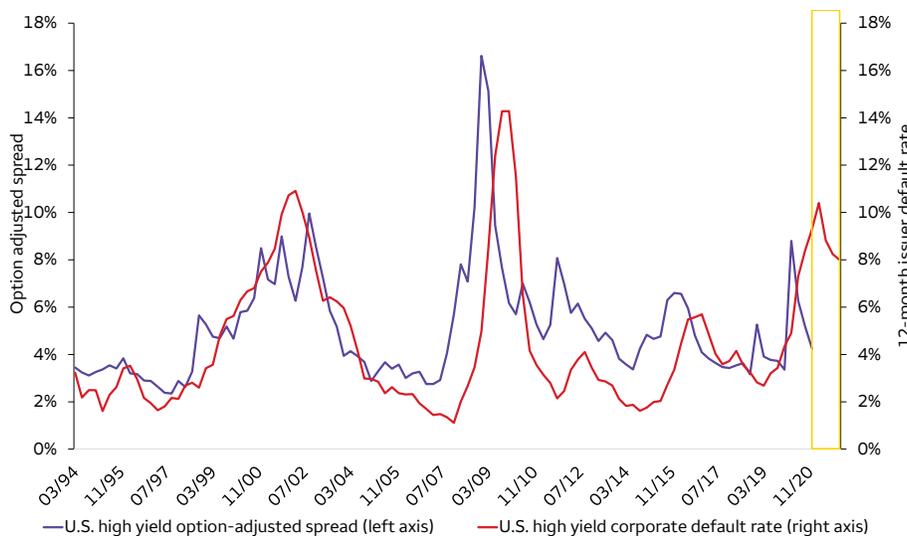
High-yield corporate default expectations in 2021

High-yield (HY) corporate bonds have outperformed many other fixed-income asset classes in the weeks after November 3, given the post-election rally and the positive news around a COVID-19 vaccine. In October, we wrote that we expected HY default rates to have peaked already in this downturn. However, given the resurgence in U.S. COVID-19 cases over the last month and the delay in fiscal stimulus, we now believe default rates may peak by the end of the first quarter of next year.

As long as the economic recovery keeps its momentum and corporate earnings continue to improve, we expect default rates to peak around 11% in March 2021 and then begin a declining trend. Our base case is that overall HY defaults will finish around 6%-7%, but with larger defaults in industries under current distress such as energy, retail, airlines, and hotels and leisure. Moody's estimates an average HY corporate default rate close to 9% for all 2021.¹

Recovery rates on HY defaults are currently hovering around 30%, but they improved in November. Looking at previous crises in HY, the trough in recovery rates was close to 27% in 2009 and 25% in 2016 but finished closer to 50% 12 months after reaching the trough. Our 12-month expected return forecast takes into consideration a 50% recovery rate and an additional compression in HY corporate spreads (over Treasury yields). With this in mind, we remain favorable in HY and recommend investors remain selective.

Lower HY spreads implicitly project a drop in default rates



Sources: Bloomberg, Moody's, Wells Fargo Investment Institute; December 9, 2020. Quarterly data from March 31, 1994 to September 30, 2020. Moody's estimates for the next 5 quarters highlighted in yellow box. Option-adjusted spread is the spread relative to a risk-free interest rate.

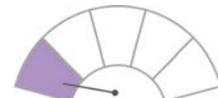
¹ Moody's Default Trends- Global: "October 2020 Default Report". November 10, 2020.
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Luis Alvarado
 Investment Strategy Analyst



Unfavorable

U.S. Taxable Investment Grade
 Fixed Income



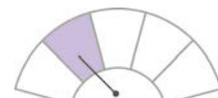
Most unfavorable

U.S. Short Term Taxable
 Fixed Income



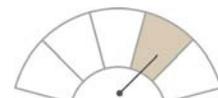
Neutral

U.S. Intermediate Term Taxable
 Fixed Income



Unfavorable

U.S. Long Term Taxable
 Fixed Income



Favorable

High Yield Taxable
 Fixed Income



Neutral

Developed Market Ex.-U.S.
 Fixed Income



Neutral

Emerging Market
 Fixed Income

Alternatives

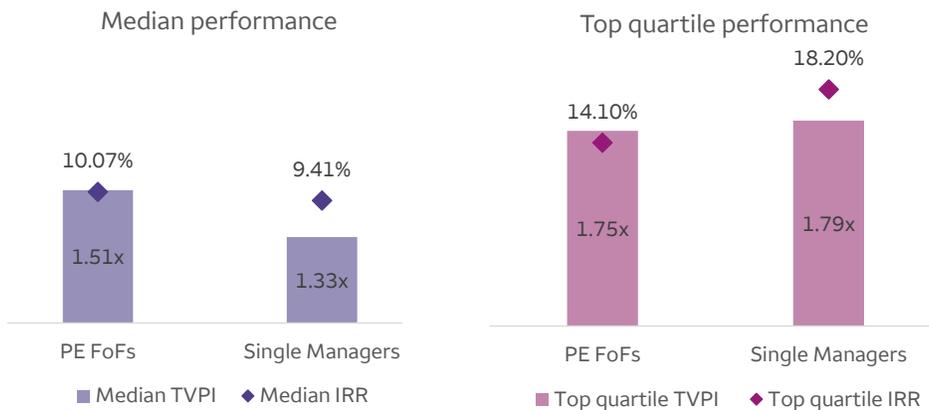
Using funds of funds to access private equity

Private equity funds of funds (FoFs) invest in a portfolio of funds that make investments in privately-held companies. The underlying funds may invest in strategies such as buyouts, venture capital, growth equity, and special situations. With a single commitment to a private equity FoFs, investors get exposure to investments diversified in several dimensions, which we believe makes FoFs a great way to start investing in the asset class or to access new geographic regions or themes. In the highly-competitive private equity space, it is not uncommon for the best-performing managers to be quite selective in their limited partners (investors). Established FoFs managers can leverage relationships in the industry they developed over time to negotiate access to those sought-after investments.

As the chart illustrates below, median FoFs have outperformed single managers in both internal rate of return (IRR) and multiple (measured by total value to paid-in, or TVPI). There is a larger gap between single managers' top-quartile and median performances compared to FoFs. It emphasizes the importance of manager selection in private equity investing. Further, it is worth noting that the multiples of top-quartile FoFs and single managers are very close.

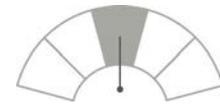
As the private capital market developed, FoFs expanded the portfolios to include co-investments and secondary transactions. Co-investments are usually made on a “no fee and no carry” basis, which can significantly mitigate the fee drag typically associated with FoFs. With funds acquired in a mature stage and the discount to asset value commonly applied at purchase, secondary investing can be a great way to mitigate the J-curve and boost overall portfolio IRR.

Median private equity funds of funds outperformed single managers



Sources: Burgiss, December 7, 2020. Performance as of June 30, 2020, net of all fees, including all 2000-2019 vintages, private equity funds and funds of funds. PE=private equity. **Past performance is no guarantee of future results.**

Xinxin Liu, CFA, FRM
Global Alternative Investment Strategist



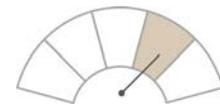
Neutral
Private Equity



Neutral
Hedge Funds – Macro



Neutral
Hedge Funds – Event Driven



Favorable
Private Debt



Favorable
Hedge Funds – Equity Hedge



Neutral
Hedge Funds – Relative Value

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.

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** are 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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a declining market.

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.

Definitions

Commodity Composite measures a basket of commodity prices as well as inflation. It blends the historical commodity index introduced by George F. Warren & Frank A. Pearson, former academics at Cornell, collected and published commodity price data in their book, *Prices*, and the producer price index for commodities (PPI-Commodities), and the National Bureau of Economic Research (NBER) Index of Wholesale Prices of 15 Commodities and the Reuters Continuous Commodity Index. The index components and weightings, from Warren and Pearson's *Prices*, change over time but the 11 commodity groups used from 1786-1932 are: Farm Products, Foods, Hides and Leather products, Textile Products, Fuel and Lighting, Metals and Metal Products, Building Materials, Chemicals and drugs, Spirits (stopped tracking 1890), House furnishing Goods, and Miscellaneous. The PPI-Commodities is compiled by the Bureau of Labor Statistics and shows the average price change from the previous month for commodities such as energy, coal, crude oil and the steel scrap. The NBER Index of Wholesale Prices of 15 Commodities is a measure of price movements of 15 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. The Reuters Continuous Commodity Index comprises 17 commodity futures that are continuously rebalanced: cocoa, coffee, copper, corn, cotton, crude oil, gold, heating oil, live cattle, Live hogs, natural gas, orange juice, platinum, silver, soybeans, sugar no. 11, and wheat.

The Commodity Composite connects the aforementioned components at the following years: Warren and Pearson- *Prices*: 1720-1932, BLS PPI-Commodities: 1933-1946, NBER: 1946-1956, Reuters Continuous Commodity Index: 1956-Current

Case-Shiller Home Price Index is the S&P CoreLogic Case-Shiller U.S. National Home Price Index and is a composite of single-family home price indices for the nine U.S. Census divisions and is calculated monthly.

Dow Jones Industrial Average is an unweighted index of 30 "blue-chip" industrial U.S. stocks

An index is unmanaged and not available for direct investment.

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