WELLS FARGO
Investment Institute

Portfolio Strategy Insights

Understanding Portfolio Exposures

Global Portfolio Management

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Summary

- Considering what investors own and why they own it can help reduce costs and overlapping exposures that may lead to unintended risk and return consequences.
- Global Portfolio Management (GPM) uses an analytical process called "Look Through" during the portfolio construction and ongoing monitoring processes to evaluate the underlying investments within GPM portfolios.
- GPM uses portfolio tilts to reflect Wells Fargo Investment Institute's (WFII) market views and portfolio guidance.
- GPM portfolio tilts can be influenced by tactical asset allocation recommendations, sub-asset style/factor biases, or sector weights.

GPM's investment process

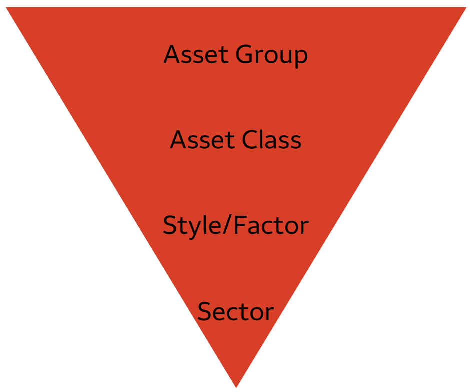
GPM's investment process focuses on why a position is owned versus what position is owned in a portfolio. Deliberate and intentional focus is on building portfolios with minimal overlap to ensure targeted exposures are reached and cost efficiency is achieved.

Portfolios are built utilizing an expanded set of analytic capabilities with the intent to optimize investment exposures and achieve favorable investment outcomes. Forming an investment thesis for why an investment is selected is at the core of GPM's investment philosophy and ensures targeted investments are not muted or negatively impacted by overlapping exposures and creating unintended risk.

GPM portfolio construction begins with macro asset allocation

GPM portfolios are constructed to align with the long-term Strategic Asset Allocation recommendations of Wells Fargo Global Investment Strategy (GIS). The Strategic Asset Allocation framework outlines the weights per asset group and asset class as well as the expected risk and return outcomes for a variety of investment objectives. This approach is a common way for investors to evaluate portfolio holdings and is referred to as "asset class" or "style box" portfolio construction.

Figure 1. Top-down allocation framework



However, constructing and/or evaluating portfolios based only on asset or style classification can create unintended investment outcomes such as:

- Over-diversification
- Concentrated exposures
- Fee and/or tax inefficiency
- Unexpected performance or risk

Knowing what you own

Understanding the actual exposures within a portfolio is a foundational tenet that can determine the success or failure of an intended investment objective. The holdings of money managers — also known as managers — can vary or be highly correlated (behave similarly), which can introduce unintended risk. GPM utilizes a proprietary analytical process called "Look Through" to assess the underlying holdings of each manager and/or exchange-traded fund (ETF). Look Through helps GPM portfolio managers blend investment products that can work together to generate return and reduce unintended redundancies and risks. The Look Through process provides details about investment exposures and risks from the underlying holdings level, driving portfolio performance. The Look Through process enables GPM to evaluate expected behaviors and increase the probability of achieving expected outcomes.

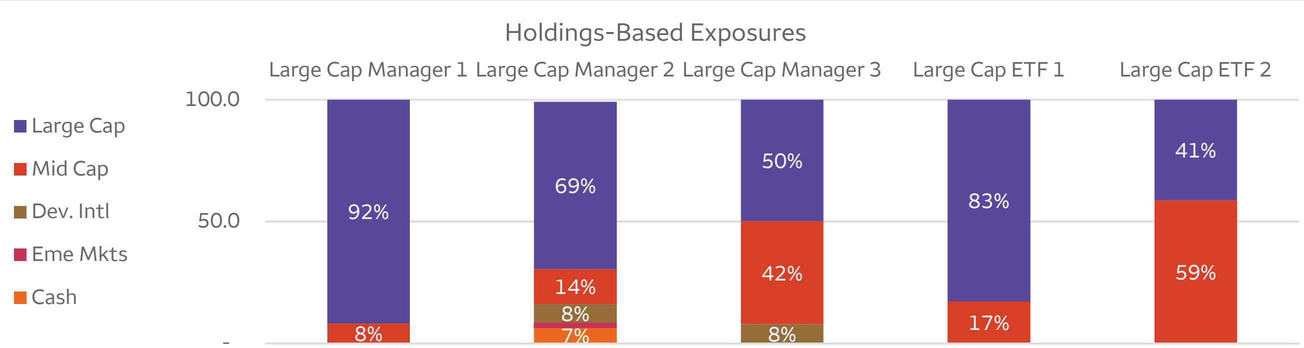
Look Through utilizes the underlying security data of managers and ETFs to allocate exposures as shown in Figure 2 by asset class, geography, sector and/or industry. Security-level analysis also provides the ability to review exposures by market capitalization, style, and factor. Managers and ETFs with classifications such as Large Cap, Mid Cap, and Small Cap are often considered solely based on market cap description, but there are frequently disparities between the descriptions and actual exposures among investment products and benchmark providers.

Figure 2. Look through holdings-based exposure analysis

Source: WFII.

When exposures are considered missing, overlapping, muted, or unnecessary, GPM adjusts exposure weights to adequately position the portfolio. Look Through is a key component of GPM's portfolio construction process and allows GPM to enhance the efficiency of portfolios, improve risk management, and supplement qualitative and return-based analysis to achieve desirable performance results. The value-add of the Look Through process increases control over intentional and unintentional exposures embedded within portfolios that are often overlooked when selecting investment products by classification alone. Chart 1 shows notable asset class differences between large-cap equity managers and ETFs although they are all classified as "Large Cap."

Chart 1. Holdings-based exposures product comparison

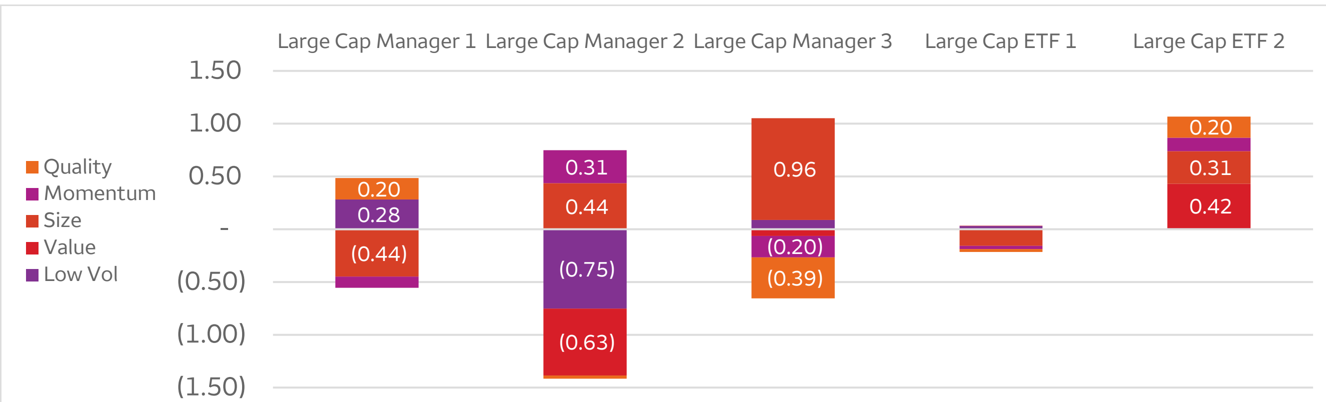


Source: WFII, © 2020 Morningstar[1]. Data as of 07/31/2020. Holdings based exposures are calculated based on holdings reported by fund managers. This information is hypothetical. It is not intended to represent any specific return, yield or investment. It is provided for illustrative purposes only and does not constitute a recommendation to invest in any particular asset class or strategy

Managers tend to have strict and disciplined investment approaches but utilize a broad investment universe in an effort to enhance opportunities. As an example, many Developed International Equity managers have material exposure to Emerging Markets Equity. Investors who are unaware of the underlying differences in country exposures when building their portfolios may experience unintended overweight exposure to emerging market equities. By not accounting for unintended exposures, additional risk can be incurred, which may lead to unfavorable performance results.

GPM has greater conviction in the targeted investment outcomes when specific risk and return drivers are aligned with expectations. The underlying security data supplements risk and other qualitative analytics to help GPM make decisions at a granular level. Fundamental characteristics derived from security data helps differentiate managers based on criteria such as security valuations and company profitability. Chart 2 looks at the Large Cap portfolios seen in Chart 1 and illustrates differences in holding characteristics or factors that can be key risk and return drivers of portfolio performance.

Chart 2. Factor-based exposures product comparison



Source: WFII, Morningstar. Data as of 07/31/2020. Factor-based exposures are calculated based on monthly return from the past 36 months. Beta (market sensitivity) exposures are shown in the chart that reflect the co-movements between factors and fund returns. Definition of factor indices can be found in appendix. This information is hypothetical. It is not intended to represent any specific return, yield or investment. It is provided for illustrative purposes only and does not constitute a recommendation to invest in any particular asset class or strategy

It's not just the "what", it's the "why"

During the portfolio construction process, many investors place emphasis on what investments are in the portfolio versus why selected investments have been considered. Why an investment has been included in the portfolio is more important than what has been included in the portfolio when evaluating risk and return as well as when setting performance expectations. GPM forms an investment thesis when constructing portfolios that details why a manager or ETF has been selected, the value that the manager or ETF delivers to the portfolio, and performance expectations given forecasted market views and investment themes.

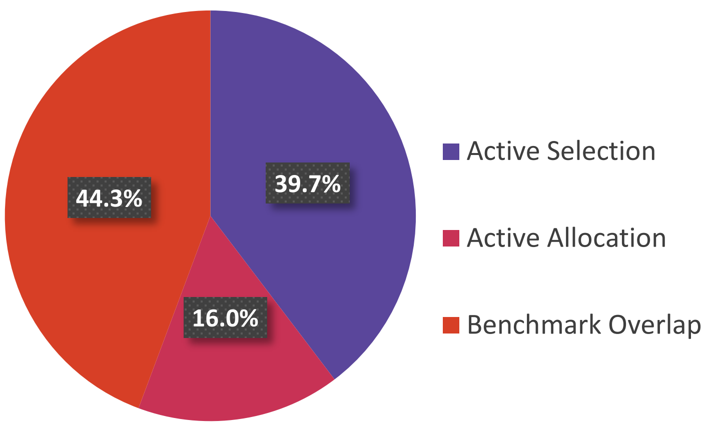
Managers and ETFs can each add intentional value to portfolios. When investments are combined to achieve specific outcomes, the mix — and weighting decisions — help control the level of intended volatility or active risk versus the portfolio's benchmark, which is referred to as tracking error management. Tracking error (the extent to which the fund's returns have differed from its index) is necessary for a portfolio to outperform its applicable benchmark. A manager with security or sector concentrations that is paired with a broad market or systematic ETF, with the same classification, can increase the portfolio's potential for alpha (the difference between benchmark and portfolio performance) and minimize unintended risk. The pairing of the selected manager and ETF can enable the portfolio to benefit from the manager's ability to select outperforming stocks (high tracking error) while the ETF (low tracking error) smooths portfolio performance if the manager's style becomes out of favor during a period of the investment cycle.

Combining two managers can magnify investment results positively or negatively depending on the underlying exposures and market movements. If the managers are highly correlated (move in a similar fashion), the diversification benefit may be limited based on management fees and/or the tax considerations. If correlations are low, manager pairings that cancel out exposures can limit the value proposition that each manager brings to the portfolio. Manager pairing can improve results, but investors should use caution to avoid over-diversifying without clear benefits.

Look Through offers additional insight into the specific investment exposures versus benchmarks. Active Share has been the subject of academic studies and demonstrated to have an impact on the manager's ability to add value to the portfolio. Active Share is a measure that represents the degree of difference between holdings in a manager's portfolio relative to the respective benchmark. Active Share does not explain the reasons behind exposure differences. Active Share and Look Through can provide GPM an intricate view of how portfolios differ versus benchmarks and indicate specific region, sectors, and fundamental biases where they occur.

The pie chart below in Figure 3 highlights a hypothetical large cap equity growth manager and its positioning relative to its benchmark. In this example, the manager has a small percentage (16%) of holdings that overlap with the benchmark. The remaining portions of the portfolio (84%) are differentiated between security selections and allocation differences.

Figure 3. Sample manager overview



An assessment of the manager's expected results and an evaluation of the underlying exposures of the individual portfolio holdings has to be completed before portfolio construction begins. Exposure-based information provides a foundation for targeting intended or minimizing unintended drivers of risk and return when paired with the ability to evaluate quantitative returns-based exposures with underlying holdings based data. An increased focus on active exposures improves GPM's ability to intentionally and efficiently position portfolios.

Source: WFII, FactSet. As of 07/31/2020. Active share is calculated based on holdings reported by fund managers. This information is hypothetical. It is not intended to represent any specific return, yield or investment. It is provided for illustrative purposes only and does not constitute a recommendation to invest in any particular asset class or strategy

Summary

The investment industry uses many classification methodologies, and while these are important, there is a limited amount of information that explains the differences among investment products. Allocating products such as a manager and ETF based on classifications can unintentionally skew a portfolio towards specific asset classes or styles. A detailed exposure analysis of what is owned within these products supplement the quantitative and return-based analyses used during GPM's portfolio construction and on-going monitoring processes. This combination of Look Through and traditional portfolio construction evaluation methods help GPM provide optimal portfolios by understanding the behaviors of portfolios, enhancing risk management, seeking efficiencies, and positioning exposures for desired outcomes.

Risk Factors

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market and economic conditions and in different environments due to numerous factors some of which may be unpredictable. 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. Be sure your clients understand and are able to bear the associated market, liquidity, credit, fluctuations in yields and returns, style and sector specific risks and employment of complex trading strategies and aggressive investment techniques as well as the specific risks involved in an investment in a particular product.

Exchange Traded Funds seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. Exchange Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

Definitions

Tracking Error measures the extent to which a manager's historical returns have differed from its index. Ex-ante or forecast tracking error is a technique used to estimate the forecast tracking error of an investment, portfolio based on current holdings and risk factor models. It measures the standard deviation (volatility) of active returns based on portfolio manager decisions made today on the portfolio and requires the manager's ability to assess the possible effects of trading on a portfolio's performance relative to its benchmark and takes into account portfolio and benchmark weights, volatility of the assets and correlation across assets.

Size factor is defined by MSCI USA equal weight index, which equally weight large cap and mid cap US stocks.

Value factor is defined by MSCI USA enhanced value index, which captures large and mid-cap representation across the US equity markets exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: Price-to-Book Value, Price-to-Forward Earnings and Enterprise Value-to-Cash flow from Operations.

Momentum factor is defined by MSCI USA momentum index. It is designed to reflect the performance of an equity momentum strategy by emphasizing stocks with high price momentum, while maintaining reasonably high trading liquidity, investment capacity and moderate index turnover.

Quality factor is defined by MSCI USA quality index. It aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage

Low Volatility factor is defined by MSCI USA Min Volatility index. It aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe. The index is calculated by optimizing the MSCI USA Index, its parent index, in USD for the lowest absolute risk (within a given set of constraints). Historically, the index has shown lower beta and volatility characteristics relative to the MSCI USA Index

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