WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee March 15, 2021

[1] OPEC+ is the Organization of the Petroleum Exporting Countries and others such as Russia.
[2] Alpha is excess return over a benchmark.

Asset Allocation spotlight

Veronica Willis
Investment Strategy Analyst

Mike Taylor, CFA
Investment Strategy Analyst

The impact of behavioral bias in investing

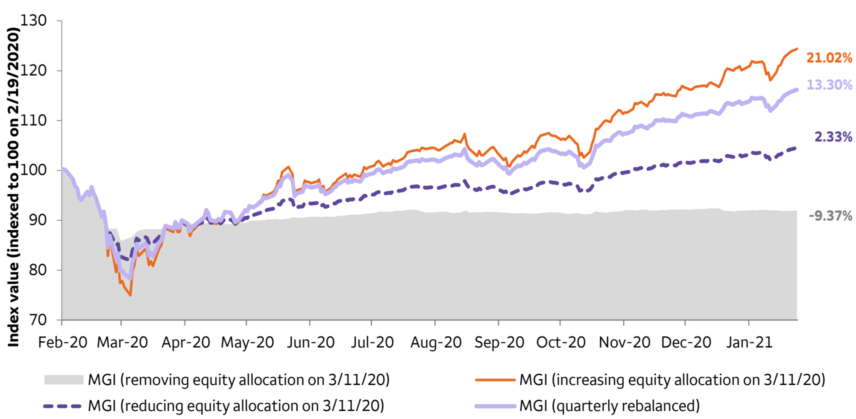
Behavioral finance considers the role that psychology and emotions play in investment decision-making. Behavioral finance aims to identify the factors that can cause investors to diverge from purely rational decision-making while accounting for the fact that all investors are not equally informed. These factors can affect asset valuations, create or exacerbate short-term price distortions, and influence an investor's choice between reward and risk. Although investors might be unable to completely free themselves of biases, being aware of one's biases can help keep them in check.

Two common behavioral biases are chasing winners and losers and recency bias.

Chasing winners and losers — Chasing the previous year's top-performing asset class (winners) or worst-performing investment (losers) is a strategy that some investors have tended to follow. We have found that historically, following the best-performing asset class (hot-hand fallacy) and worst-performing investment (gambler's fallacy) did not result in performance that exceeded remaining disciplined in a diversified allocation.[3]

Recency bias — Investors tend to use recent experience as a baseline for risk and return expectations instead of considering a long-term view in which the market fluctuates. As a bull market charges ahead, some investors forget about the times when it was not in place. Recent memory could suggest that the equity market should continue increasing. Consequently, such investors continue to purchase assets at high prices; then, suddenly, the stock market drops. Investors may experience a similar situation in down-trending markets by assuming that the market will continue to decline when it could be reaching a bottom. Recency bias tends to be exacerbated during large market swings, whether up or down. Investors should consider both possibilities (market rallies and downturns) as potential outcomes and plan accordingly. We believe sticking close to an investment plan, rebalancing regularly, and taking advantage of tactical opportunities can be more impactful than investing based on emotion. The chart below demonstrates that recency bias may have been costly for investors after the market lows in March 2020. Either holding the allocation steady or increasing equity exposure outperformed reducing or removing the equity allocation in our hypothetical scenario since March 2020.

Avoid emotionally investing by rebalancing or considering tactical trends



Sources: ©2020 - Morningstar Direct[1] and Wells Fargo Investment Institute. Daily data: February 19, 2020-March 5, 2021. MGI = Moderate Growth & Income. Performance results for the portfolios are hypothetical and are presented for illustrative purposes only. Hypothetical results do not represent actual trading. An index is unmanaged and not available for direct investment. **Hypothetical and past performance do not guarantee future results.** Please see end of report for the portfolio compositions, risks associated with the representative asset classes and index definitions.

[3] *Asset Allocation In Depth Report*, "Why asset allocation matters in uncertain times", February 4, 2021.

Common behavioral biases displayed by investors during the pandemic

The COVID-19 pandemic and ensuing economic and market downturn in 2020 likely tested investors' resolve. Certain behavioral biases may come to light as a result of the pandemic that investors should be aware of.

Loss aversion — After experiencing losses during a downturn, investors may begin to try to avoid losses at the expense of gains. This can result in holding on to underperformers too long and selling outperformers too soon, particularly in volatile markets. When the pandemic struck, many investors sold assets out of fear. The brevity of the February–March 2020 bear market worked against investors who sold when the market entered bear territory. Those investors may have struggled to recover as quickly as investors who remained disciplined during the recovery.

Regret aversion — Investors experiencing regret aversion may avoid or delay decision-making out of fear of making mistakes. This can lead to holding a portfolio that may be too conservative for an investor's goals. In the aftermath of the pandemic, many investors feared reentering the market and remained on the sidelines while markets surged to new all-time highs. Investors with regret aversion likely could not keep up with the fast pace of the market recovery and risk not being able to meet their goals.

Status-quo bias — Investors resisting change may fail to make adjustments to their portfolios. Some investors were overwhelmed by the outbreak and resisted making any investment decisions. Investors should recognize that the landscape is transforming. We believe some trends are emerging that may persist in the post-pandemic investing landscape and investors should be willing to adjust their portfolio strategy if appropriate.

Overconfidence bias — This bias stems from believing that one's judgment is better than it is. This can result in underestimating risk or overestimating expected returns. This bias can lead to attempts to time the market, which is a difficult strategy to do successfully.

Confirmation bias — Investors who look for views or beliefs that align with their own may suffer from confirmation bias. In the post-COVID-19 environment, the two prominent views — optimism and pessimism — are becoming increasingly polarized. As investors gravitate to market views that match their own, emotions such as fear or greed may lead to suboptimal decision-making.

Investors may encounter one or more of these behavioral biases. We believe it is important for investors to be aware of which behavioral biases most resonate with them as a first step towards taking actions to make sure their portfolio does not suffer from these biases. We believe that investors should remain disciplined in an investment plan and not let emotional reactions to headline hyperbole or unfounded market fears derail a disciplined investment strategy. Remaining diversified and rebalancing at least annually can also be beneficial in our view. Over the next 12–18 months, we anticipate further upside in U.S. and emerging market equities. Consequently, our recent changes in tactical guidance suggest increased exposure to equities at the expense of fixed income.

Equities

Chao Ma, PhD, CFA, FRM
Global Portfolio and Investment Strategist

Information Technology: What does the future hold?

With the S&P 500 Information Technology Index receding in recent weeks, there is a fear in the market that the sector may experience a major correction on the horizon.

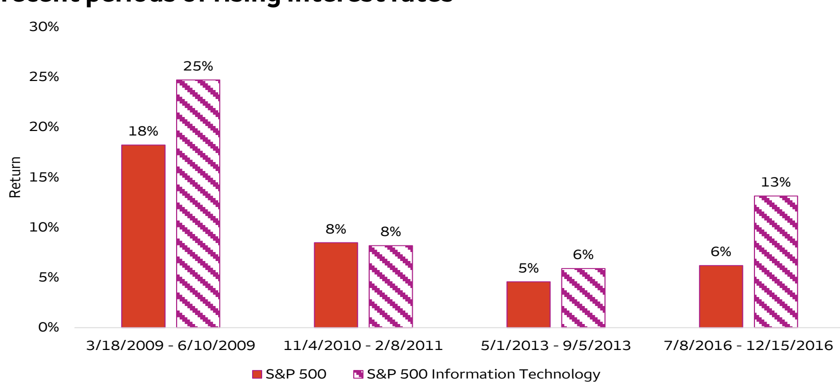
The Information Technology sector has become relatively expensive after multiple years of outperformance, a potential catalyst for recent market dynamics. The rise in the 10-year U.S. Treasury rate has been a headwind for the sector as well. However, historically, the Information Technology sector has been less correlated with interest rate movements than many other sectors that are more capital intensive.

As shown by the chart below, the Information Technology sector performed similar to or better than the broader S&P 500 Index during recent periods when interest rates increased by 100-150 basis points (100 basis points equals 1%), including the 2013 Taper Tantrum. Perhaps the biggest headwind for the Information Technology sector is a shift in investor preference toward cyclical sectors, driven by the continued fiscal stimulus and the potential for record economic growth in 2021.

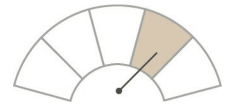
As a major and diversified sector that accounts for almost 30% of the S&P 500 Index market capitalization, we believe that the Information Technology sector will continue to be an important driver of broad market performance. We believe the Information Technology sector has a very healthy outlook for revenue, earnings, and free cash flow (the amount of cash that a company has left over after it has paid all of its expenses), which is generally favored in a low nominal growth world. The digitalization transformation that is taking place across many industries is expected to be another long-term tailwind.

We believe in a balanced sector investing approach that emphasizes both cyclical sectors (those that show an established upward technical trend and can benefit from a favorable macroeconomic backdrop), as well as diversified sectors, like Information Technology, which may provide the potential for stability and sustainable growth.

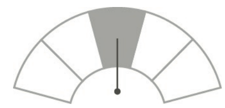
S&P 500 Index and Information Technology sector performance during recent periods of rising interest rates



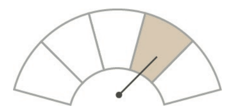
Sources: Wells Fargo Investment Institute, Bloomberg. Total return of S&P 500 Index and S&P 500 Information Technology Index is shown in the chart. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**



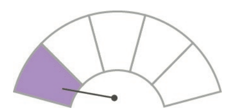
Favorable
U.S. Large Cap Equities



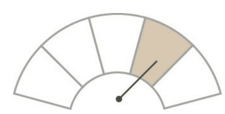
Neutral
U.S. Mid Cap Equities



Favorable
U.S. Small Cap Equities



Most unfavorable
Developed Market Ex-U.S. Equities



Favorable
Emerging Market Equities

Fixed Income

Bonds' place in a portfolio

We recently increased our interest rate targets in longer maturities. While we believe investors should be more defensive with their fixed-income positions, we believe there are good reasons to continue to hold fixed income in a portfolio. We recommend that you consider the following reasons fixed-income positions are still included in most asset allocation models.

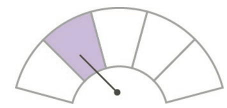
Diversification. The future is often uncertain. While we may have a strong feeling of what tomorrow will bring, unforeseeable events often alter reality. Taking too large a bet on any one particular outcome may increase your risk significantly. Investment strategies based on concentrated allocations are usually higher-risk.

Reduced volatility. One of the primary reasons to continue to own fixed-income investments, even if interest rates increase, is the lower volatility these investments typically offer when compared to stocks. Bonds, when used properly as part of a diversified investment strategy, may help smooth out your portfolio's overall performance over the long term.

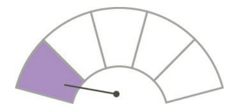
Liquidity. Most bonds have a maturity date at which the principal is returned to investors if the issuer has not defaulted. If you are able to anticipate future cash needs, purchasing high-quality credit instruments with maturities near those occasions can be an effective way to remain invested in the markets while maintaining some assurance that funds will be available when you need them.

Income. Income and cash flow are important needs for most investors. If you hold a bond to maturity and the issuer does not default, investors receive their expected cash flow regardless of whether interest rates have increased or decreased.

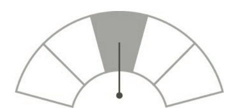
Brian Rehling, CFA
Head of Global Fixed Income Strategy



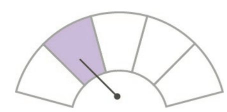
Unfavorable
U.S. Taxable Investment Grade Fixed Income



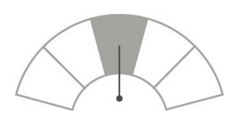
Most unfavorable
U.S. Short Term Taxable Fixed Income



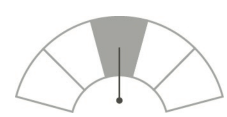
Neutral
U.S. Intermediate Term Taxable Fixed Income



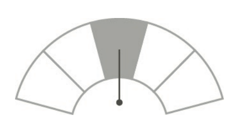
Unfavorable
U.S. Long Term Taxable Fixed Income



Neutral
High Yield Taxable Fixed Income



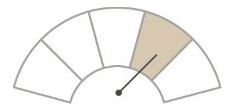
Neutral
Developed Market Ex.-U.S. Fixed Income



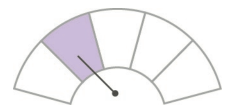
Neutral
Emerging Market Fixed Income

Real Assets

Austin Pickle, CFA
Investment Strategy Analyst



Favorable
Commodities



Unfavorable
Private Real Estate

"Whoever is happy will make others happy too." —Anne Frank

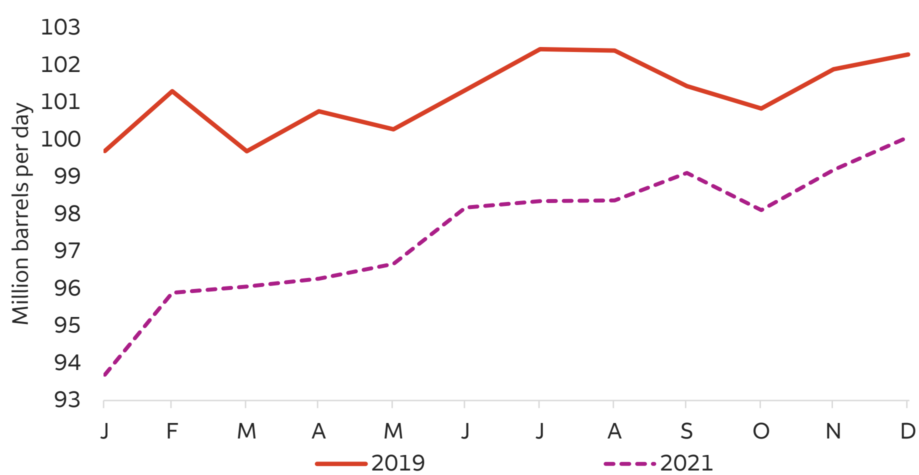
OPEC+ would rather overtighten than overwhelm

On March 4, OPEC+ met to decide near-term production quotas. After a tremendous increase in oil prices this year, market expectation heading into the meeting was that the group would agree to start producing incrementally more barrels in order to capitalize on higher prices. Imagine the collective surprise when OPEC+ announced that existing production cuts would be held steady at least through April. The shock of the announcement rippled through the market and oil prices jumped as much as 7% intraday. What are our thoughts?

OPEC+ willingness to forego oil revenues and market share in order to support price has impressed. Coming into 2021, we did not expect this level of resolve and patience from a group historically known for infighting and ignoring quotas. The March 4 announcement confirms that OPEC+ continues to be hesitant to increase production and would prefer to overtighten supply rather than risk overwhelming demand. This cautious approach is likely to support oil prices in the near term as oil demand struggles to recapture pre-pandemic levels (see chart below).

Yet, in our view, prices have now reached levels that will entice production from OPEC+, the U.S., and elsewhere. We expect economic growth and oil demand to prove resilient and OPEC+ to ease off their production restraint in the coming months. These extra barrels will likely be an oil price headwind as the year progresses.

World oil demand: 2019 versus 2021



Sources: Department of Energy (DOE), Bloomberg, Wells Fargo Investment Institute. Monthly data: January 31, 2019 - December 31, 2019 and January 31, 2021 - December 31, 2021. Oil demand includes total world crude oil and liquids consumption. Data and forecasts for 2021 are taken from the DOE's Short Term Energy Outlook released March 9, 2021. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Alternatives

Hedge fund strategies surge in February

Despite ongoing challenges from the economic turmoil of COVID-19, hedge fund strategies surged in February to extend January gains as interest rates, commodity prices, and expectations for the reemergence of inflation all increased. Early estimates indicate that the HFRI Fund Weighted Composite Index posted positive performance of 4.1% in February, significantly outperforming the return of global equities (MSCI World Index) by 1.5% and fixed income (Bloomberg Barclays U.S. Aggregate Bond Index) by 5.5%.

As the chart indicates, all of the major hedge fund strategy indexes posted positive performance in February, extending the strong performance experienced since equity markets bottomed in March 2020. In fact, hedge fund gains through February[4] mark the strongest four-month period in over 20 years as the drivers of performance widened to include not only Event Driven and Equity Hedge, but also captured strong positive contributions from trend-following Macro and interest rate-sensitive Relative Value Arbitrage strategies. Notably, hedge fund positioning in February appeared to normalize following the equity short squeeze during the last week of January that resulted in significant de-risking across hedge fund portfolios.

Hedge Fund Indexes	February 2021	Year-to-Date
HFRI Fund Weighted Composite Index	4.1%	5.5%
HFRI Equity Hedge (Total) Index	4.9%	6.4%
HFRI Event Driven (Total) Index	3.6%	5.9%
HFRI Macro (Total) Index	3.6%	3.8%
HFRI Relative Value (Total) Index	2.3%	3.5%

Global Equity Index	February 2021	Year-to-Date
MSCI World Index	2.6%	1.6%

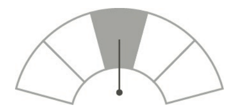
Fixed Income Index	February 2021	Year-to-Date
Bloomberg Barclays US Aggregate Bond Index	-1.4%	-2.2%

Commodity Index	February 2021	Year-to-Date
Bloomberg Commodity Index Total Return	6.5%	9.3%

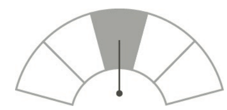
Sources: Hedge Fund Research, Bloomberg, Wells Fargo Investment Institute. March 2021. An index is not managed and not available for direct investment. **Past performance is not a guarantee of future results.**

As we look ahead, we believe that COVID-19 will have a long-lasting effect on the global economy, resulting in a more favorable opportunity set for hedge fund strategies. Whereas last year we were focused on strategies that offered the potential to minimize downside participation late in the cycle, we are now balancing that view with strategies that have the potential to capitalize on modest economic recovery, increased corporate deal activity, and asset reflation. Importantly, we believe that security selection will be ever more critical going forward as correlations drop and dispersion increases, which has typically been a good precursor to strong hedge fund returns.

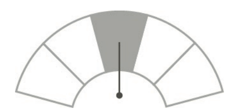
James Sweetman
Senior Global Alternative Investment Analyst



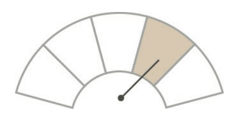
Neutral
Private Equity



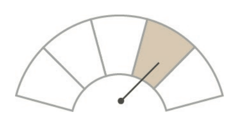
Neutral
Hedge Funds – Macro



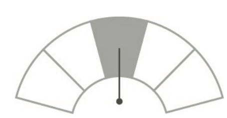
Neutral
Hedge Funds – Event Driven



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.

[4] HFRI Fund Weighted Composite Index, March 2021.

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. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Risks associated with the **Information Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. **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.

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.

Hypothetical Portfolio Compositions

Moderate Growth and Income: 3% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 32% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 21% S&P 500 Index, 12% Russell Midcap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 7% MSCI Emerging Markets Index.

Moderate Growth and Income (increasing equity allocation): 2% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 16.8% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 27.3% S&P 500 Index, 15.6% Russell Midcap Index, 10.4% Russell 2000 Index, 7.8% MSCI EAFE Index, 9.1% MSCI Emerging Markets Index.

Moderate Growth and Income (reducing equity allocation): 16.5% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 45.5% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 10.5% S&P 500 Index, 6% Russell Midcap Index, 4% Russell 2000 Index, 3% MSCI EAFE Index, 3.5% MSCI Emerging Markets Index.

Moderate Growth and Income (removing equity allocation): 30% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 59% Bloomberg Barclays U.S. Aggregate Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index.

Definitions

Bloomberg Barclays U.S. Aggregate Bond Index is a broad benchmark index for the U.S. bond market. The index covers all major types of bonds, including taxable corporate bonds, Treasury bonds, and municipal bonds.

Bloomberg Commodity Index is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index is representative of money markets.

Bloomberg Barclays U.S. Corporate High Yield Bond Index covers the universe of fixed-rate, noninvestment-grade debt.

HFRI Event-Driven (Total) Index consists of Investment Managers who maintain positions in securities of 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. ED exposure contains 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.

HFRI Equity Hedge (Total) Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Macro (Total) Index consists of investment managers who trade 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.

HFRI Relative Value (Total) Index consists of Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities Manager 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. RVA position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

JPM EMBI Global Index covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

MSCI EAFE Index is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

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