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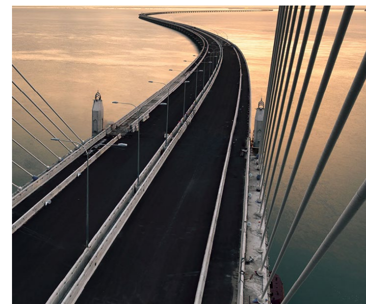
Investment Strategy



Weekly guidance from our Investment Strategy Committee **June 26, 2023**

Asset Allocation Spotlight: Staying disciplined amid apparent tailwinds 2

- We believe that the 60% stock/40% bond mix should perform well over the next year, as indicated by past Federal Reserve (Fed) tightening cycles.
- We expect that equities will likely be volatile in the near term, while fixed-income performance should return to normal.

Equities: Why we upgraded Materials and downgraded Information Technology 4

- Our June 13 Materials sector upgrade from neutral to favorable was driven by positive trends and attractive valuations.
- We also downgraded Information Technology from favorable to neutral. Given the significant outperformance of the sector this year, and related lofty valuations, we believe it prudent to lock in some of those gains and bring the allocation from overweight to a full market weight.

Fixed Income: Leveraged loans: Potential headwinds ahead 5

- Leveraged loans have performed better than other major fixed-income asset classes year-to-date (through June 16). But the tide may begin to turn, especially as we expect interest rates to remain higher for longer.
- We currently have an unfavorable stance on leveraged loans. We believe investors can now find better opportunities in other areas of fixed income, like long-term government bonds.

Real Assets: El Niño is back in 2023 6

- El Niño is a weather phenomenon that causes severe shifts in weather conditions, including rising Pacific Ocean surface temperatures, droughts, and even floods in some regions.
- Agricultural commodity prices can be highly sensitive to El Niño, as unfavorable weather conditions can lead to lower crop yields and higher prices.

Alternatives: Hedge fund strategies — Mixed results through May 2023 7

- The 2023 performance of hedge funds remains mixed. In general, through May, strategies with more exposure to equity market volatility have outperformed those with more diversifying and defensive attributes.
- We continue to believe caution is warranted at this point in the cycle and favor more defensive strategies that can help preserve capital or capitalize on dislocations that may arise in a recessionary scenario.

Current tactical guidance 8

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Asset Allocation Spotlight

Jeremy Folsom
Investment Strategy Analyst

Michael Taylor, CFA
Investment Strategy Analyst

Staying disciplined amid apparent tailwinds

Following the recent equity market rally, investors may have reason to be optimistic. On June 8, S&P 500 Index gains exceeded 20% from their October 2022 lows — the conventional yardstick to determine a bull market. This upsurge was bolstered by perceived tailwinds, including a pullback in inflation and pause in the Federal Reserve's (Fed) rate-hiking campaign. Yet, we see more volatility ahead as the descent of inflation is likely to be uneven, potentially necessitating further Fed action. The economic slowdown that we anticipate would put further pressure on an earnings recession already underway, while wage costs would likely weaken margins. In this environment, we encourage investors to avoid overexposure to equities due to our expectation of equity-market volatility and a reversion to more traditional fixed-income performance.

Last year, fixed-income returns plumbed historical lows, while their strongly positive correlations with stocks limited typical diversification benefits. In the past 25 years, stocks and bonds have posted negative returns concurrently only 8% of the time. 2022 was the first year in many decades that stocks and bonds showed negative returns for more than two consecutive quarters; in fact, the first three quarters of 2022 rank as the three worst-performing quarters for bonds since 1980 (see Table 1 below).

We view 2022 as an aberration rather than a new norm. Last year, we observed an aggressive Fed battle the highest inflation since the 1980s. The pace of rate hikes was swift, impeding both equity and fixed income performance. The low level of yields from an extended period of low federal funds rates and longer durations[1] left fixed-income classes vulnerable to the rapid rise of interest rates.

Table 1. Quarters when U.S. stocks and bonds showed negative returns

Period	U.S. bond performance	U.S equity performance
Q1 2005	-0.5%	-2.1%
Q2 2006	-0.1%	-1.4%
Q2 2008	-1.0%	-2.7%
Q3 2008	-0.5%	-8.4%
Q1 2018	-1.5%	-0.8%
Q1 2022	-5.9%	-4.6%
Q2 2022	-4.7%	-16.1%
Q3 2022	-4.8%	-4.9%

Sources: Bloomberg and Wells Fargo Investment Institute, as of June 13, 2023. This table represents quarters in the past 25 years where both U.S. stocks and U.S. bonds had negative returns. U.S. bond performance is represented by the Bloomberg U.S. Aggregate Bond Index. U.S. equity performance is represented by the S&P 500 Total Return Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

1. Duration is a measure of interest-rate sensitivity.

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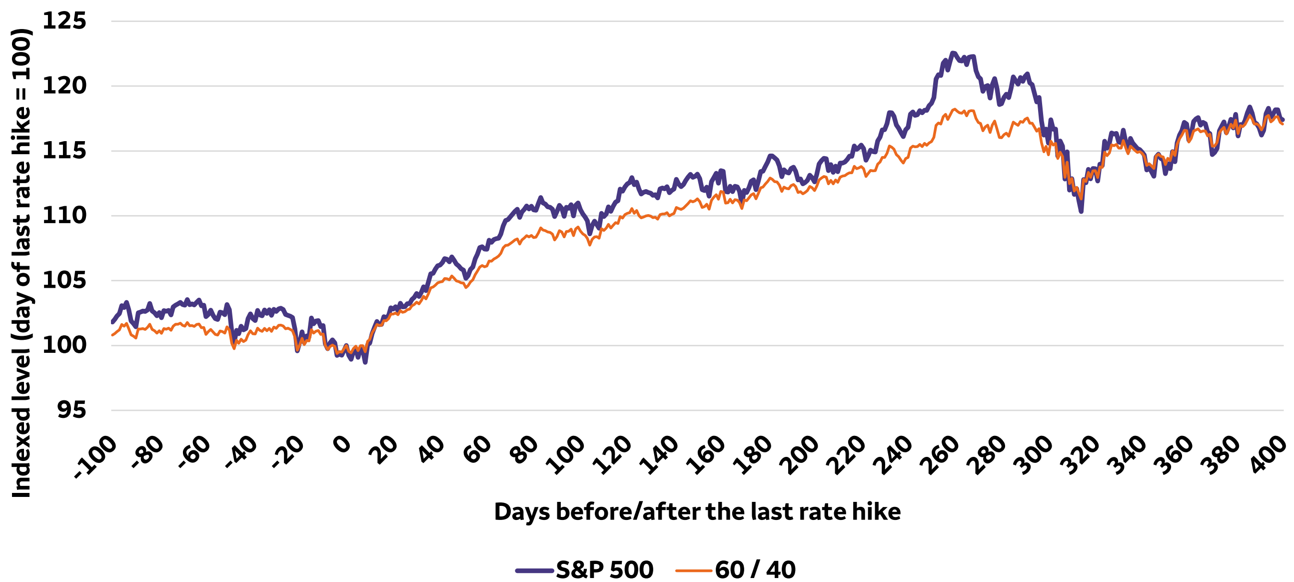
Near-term expectations for the 60/40 blend

Looking ahead, we expect fixed income to be an important contributor for portfolios in the near term, particularly from the income portion. The high yields among short-term securities are attractive in our view, and investors can also lock in long-term yields at nearly the highest levels we've seen in a decade. Unlike the previous few years, we expect bonds to become less correlated with stocks, providing a good counterbalance to equities and adding diversification benefits to portfolios.

Looking at an asset mix comprised of 60% stocks and 40% bonds, average performance following the final interest-rate hike of each of the past four Fed tightening cycles has been roughly in line with stocks (as measured by the S&P 500 Index) but with less equity market risk (see Chart 1 below). This demonstrates the value that diversification can provide, particularly during periods of economic uncertainty and market volatility.

In terms of portfolio positioning, we recently guided investors in our *2023 Midyear Outlook*[2] to stay defensive in equities by focusing on quality, with a preference for U.S. Large Cap Equities over Mid Cap Equities and Small Cap Equities. For bonds, we favor a barbell approach with both short- and long-term fixed income in addition to moving up in credit quality ahead of our forecasted recession.

Chart 1. S&P 500 Index versus 60/40 blend: Before and after last rate hike, average of last four tightening cycles



Sources: Bloomberg and Wells Fargo Investment Institute, as of June 13, 2023. The bond portion of the 60/40 blend is represented by the Bloomberg U.S. Aggregate Bond Index. The stock portion of the 60/40 blend is represented by the S&P 500 Index. The represented tightening cycles had their final rate hikes on: February 1, 1995; May 16, 2000; June 29, 2006; and December 20, 2018. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

2. For full details, please see our *2023 Midyear Outlook: Navigating end-of-cycle turbulence*, June 13, 2023.

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Equities

"It is a bad plan that admits of no modification." — Publilius Syrus, Roman writer

Austin Pickle, CFA
Investment Strategy Analyst

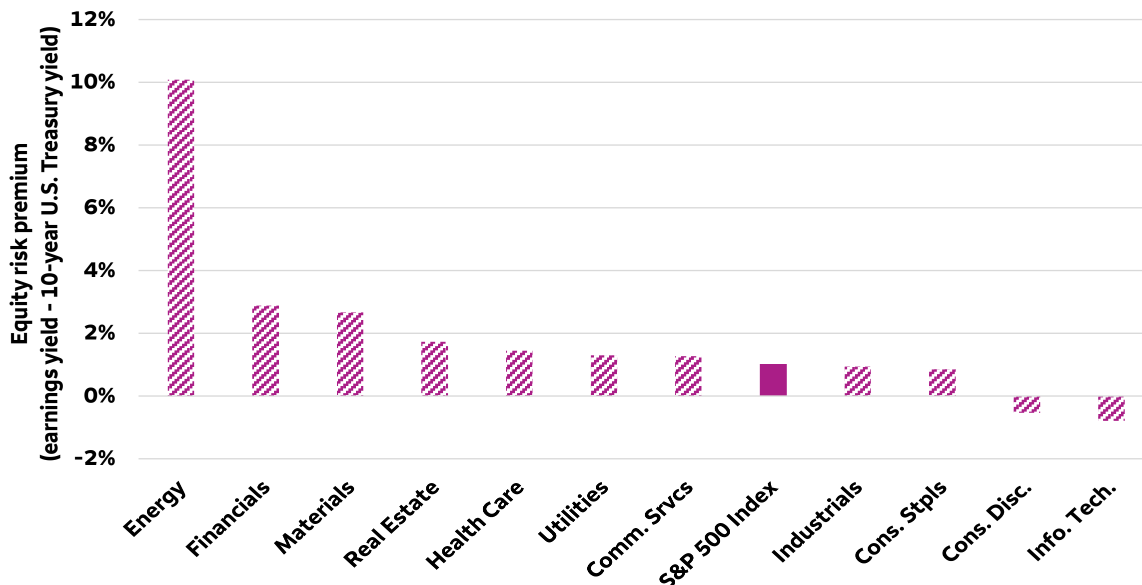
Why we upgraded Materials and downgraded Information Technology

On June 13, we made two sector guidance changes. We took the Materials sector from neutral to favorable and downgraded the Information Technology (Tech) sector from favorable to neutral. We recap the rationale below.

Outside of the Energy sector, Materials is the sector we believe is most levered to the overarching trends that we expect — higher commodity prices, China's ongoing reopening, and our outlook for a flat to weaker dollar over the tactical timeframe. Sector valuations are attractive in our view (see chart below), and the group scores well on quality metrics, such as low debt ratios. We believe the recent underperformance has provided an attractive entry point to upgrade Materials to favorable.

The Tech sector still scores high in our analysis of quality characteristics, including relatively low debt levels, high free cash flow generation (cash remaining after expenses are paid), and the return of cash to shareholders in the form of share repurchases. We believe these qualities should serve investors well if economic growth continues to deteriorate, as we expect. However, the sector's outperformance has lifted valuations to levels that we find unattractive at present (see chart below), while higher-for-longer interest rates may also be a headwind for this long-duration sector. In our view, these two negatives strike a rough balance with the positive quality characteristics, as well as the potential of artificial intelligence. We therefore downgraded our rating for this sector to neutral. It is important to emphasize that a neutral rating corresponds with a full allocation, which currently sits at over 25% of the S&P 500 Index.

S&P 500 Index and sector equity risk premiums



Sources: Bloomberg and Wells Fargo Investment Institute, as of June 20, 2023. Earnings yield is calculated as the trailing 12-month earnings per share divided by the current price. The Real Estate sector instead uses funds from operations divided by price (FFO yield). An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

Luis Alvarado
Global Fixed Income Strategist

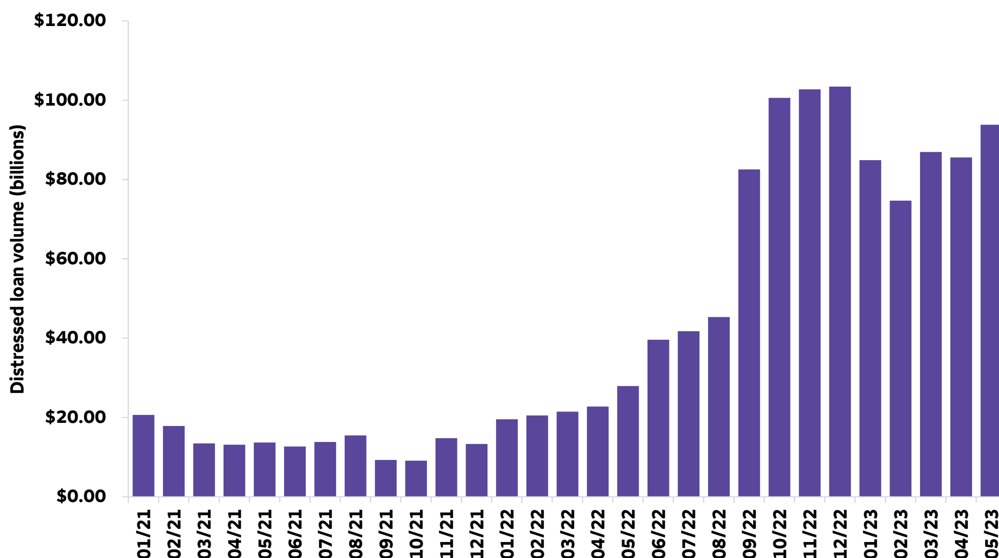
Leveraged loans: Potential headwinds ahead

Leveraged loans are senior secured bank loans made to companies that have a below-investment-grade rating, often outside the Financials sector. Investors tend to like the floating-interest-rate nature of this asset class, especially during periods of rising rates. Investor appetite for this asset class was evident through April 2022, as fund flows remained positive. However, the pace of flows has remained negative over the past 13 months, as investors have been expecting headwinds ahead.

Despite the decline in prices and increase in yields in 2022, leveraged loans have performed better — up 5.77% year-to-date (through June 20) — than other major fixed-income asset classes (for example, high-yield corporate bonds are up 5.24% and investment-grade corporate bonds are up 3.23%).[3] But the tide may begin to turn, especially as we expect interest rates to remain higher for longer. Leveraged loan default rates have climbed continuously over the past six months, marking the highest levels since June 2021, and we expect distress levels to continue to rise (see chart below). Tightening credit conditions and rapidly rising funding costs have placed renewed focus on leveraged credit risk.

We currently have an unfavorable stance on leveraged loans, along with high-yield corporate bonds, and we continue to advocate for selectivity and active management in this space. In addition, given the uncertain outlook ahead, we believe investors can find better opportunities in other areas of fixed income, like long-term government bonds, especially ahead of an anticipated economic slowdown.

U.S. leveraged loan distressed volume



Sources: Pitchbook Data, Morningstar LSTA US Leveraged Loan Index, and Wells Fargo Investment Institute, as of June 16, 2023. Monthly data from January 2021 to May 31, 2023. Distressed debts are those where the issuers cannot meet a large number of their financial obligations and usually have credit spreads that are 1000 basis points (10%) above the risk-free rate or are trading below 80 cents on the dollar. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

3. Based on the S&P LSTA Leveraged Loan Index, Bloomberg U.S. Corporate High Yield Index, and the Bloomberg U.S. Corporate Bond Index as of June 20, 2023.

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Real Assets

"Everybody talks about the weather, but nobody does anything about it." — Charles Dudley Warner, American essayist and novelist

Mason Mendez
Investment Strategy Analyst

John LaForge
Head of Real Asset Strategy

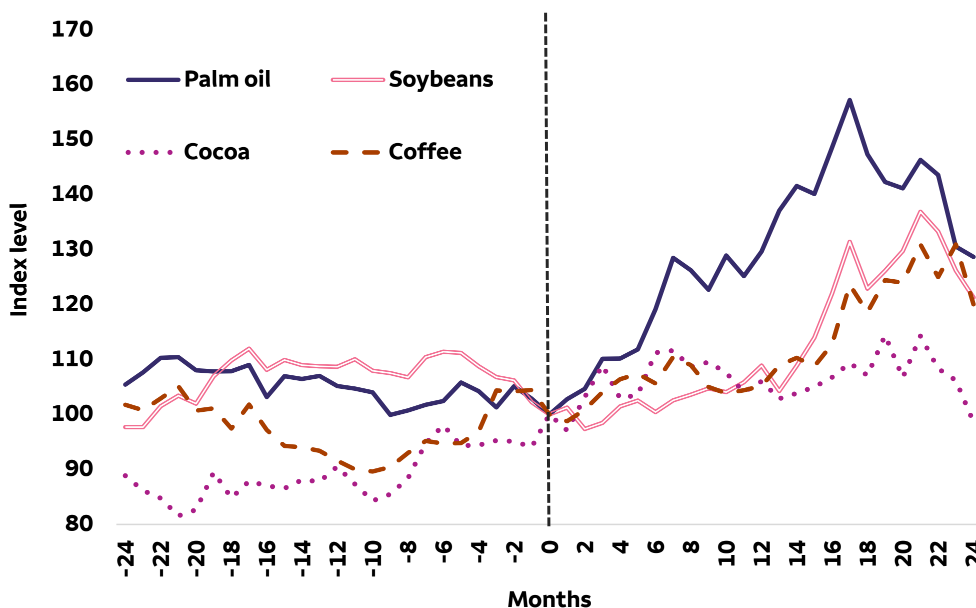
El Niño is back in 2023

Agricultural commodities are performing well in 2023, outperforming the broader Bloomberg Commodity Index by 11.8% year-to-date.[4] There may be even more upside still as the weather phenomenon El Niño, which has a reputation of lowering global crop yields, is about to kick in.

In early June, the U.S. National Oceanic and Atmospheric Administration (NOAA) announced that El Niño conditions were already starting to form in the Pacific Ocean and were expected to strengthen over the coming months. Historically, El Niño has brought with it extreme weather conditions, such as rising surface temperatures in the Pacific Ocean, droughts, and even floods. The end result has often been lower crop yields in key growing regions, which ultimately has led to tighter global supplies and higher agricultural prices.

While past El Niños have impacted other commodities, too, agricultural commodities have typically experienced the greatest volatility. Over the past seven El Niños, since 1997, palm oil, soybean, cocoa, and coffee prices have generally tended to rise in the months following the start of El Niño (see chart below). The most vulnerable crop to past El Niños has been palm oil, which is produced mainly in Southeast Asia (87% of global production) — a region prone to severe droughts during El Niño. As a result, average prices were up nearly 30% in the 12 months that followed. In our view, a strong El Niño season could support higher agriculture prices through the remainder of 2023 and into 2024.

Soft commodity performance around past El Niños



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data is from June 30, 1995 – October 31, 2020 and indexed to 100 as of the start of El Niño. Generic 1st future contract data was used to measure historical palm oil, cocoa, soybean, and coffee performance. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

4. As of June 20, 2023.

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Alternatives

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Hedge fund strategies — Mixed results through May 2023

The equity market has continued its rise, led by a narrow subset of artificial intelligence-related large-cap technology stocks, despite mounting evidence that leads us to believe that a recession remains on tap for late 2023. While hedge funds have not kept pace with the S&P 500 Index, up 9.6% year-to-date through May 2023, both Event Driven – Activist (+5.9%) and Equity Hedge – Directional (+3.6%) achieved positive results. Both hedge fund strategies tend to be more correlated with equity markets, a primary driver of their relative outperformance against the other hedge fund sub-categories.

The laggards year-to-date include the Event Driven – Merger Arbitrage (-4.0%) and Global Macro – Systematic (-2.0%) strategies. Declining merger and acquisition activity and heightened regulatory scrutiny have weighed on the performance of merger arbitrage strategies. Additionally, shifting trends across fixed income markets, particularly during the mini-regional banking crisis in March, contributed to significant declines in Global Macro – Systematic strategies year-to-date.

Relative Value strategies posted positive performance across all three sub-strategies. The increased volatility in fixed-income markets has benefited those strategies with the ability to hedge unintended risks, allowing them to better navigate challenging markets.

We believe caution is warranted at this point in the cycle and favor more defensive strategies in general. We prefer strategies with low correlations to traditional markets (Global Macro), strategies with the ability to limit down-market risks (Long-Short Credit, Arbitrage), and strategies that offer the potential to capitalize on opportunities that may arise during the later stages of the credit cycle (Distressed Credit).

Performance of hedge funds indexes

Hedge Funds	May 2023 return	YTD return
Equity Hedge	0.1%	2.6%
Directional	-0.9%	3.4%
Equity Market Neutral	-0.1%	0.4%
Event Driven	-1.2%	0.1%
Activist	0.1%	4.5%
Distressed Credit	-0.6%	0.2%
Merger Arbitrage	-2.4%	-4.0%
Global Macro	-0.2%	-1.8%
Discretionary	-0.6%	-0.6%
Systematic	0.8%	-1.9%
Relative Value	0.0%	1.7%
Arbitrage	-0.4%	1.4%
Long/Short Credit	-0.4%	2.1%
Structured Credit/Asset Backed	0.3%	2.2%

Sources: Bloomberg and Wells Fargo Investment Institute. Data as of May 31, 2023. YTD = year-to-date. Please see end of report for index definitions. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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

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Current tactical guidance

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	U.S. Intermediate Term Taxable Fixed Income High Yield Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income	U.S. Taxable Investment Grade Fixed Income	U.S. Long Term Taxable Fixed Income U.S. Short Term Taxable Fixed Income

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
U.S. Small Cap Equities	Emerging Market Equities	U.S. Mid Cap Equities Developed Market Ex-U.S. Equities	U.S. Large Cap Equities	

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments*

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Event Driven Hedge Funds—Equity Hedge Private Equity Private Debt	Hedge Funds—Relative Value Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, June 26, 2023.

*Alternative investments are not appropriate for all investors. They are speculative and involve a high degree of risk that is appropriate 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. Please see end of report for important definitions and disclosures.

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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. **Leveraged loans** are generally below investment grade quality ("high-yield" securities or "junk" bonds). Investing in such securities should be viewed as speculative and investors should review their ability to assume the risks associated with investments which utilize such securities. **U.S. government securities** are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market 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 appropriate 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

An index is unmanaged and not available for direct investment.

Bloomberg Agriculture Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on coffee, corn, cotton, soybeans, soybean oil, soybean meal, sugar and wheat. It reflects the return of the underlying commodity futures and is quoted in USD.

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

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

Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Morningstar LSTA US Leveraged Loan Index is designed to deliver comprehensive, precise coverage of the US leveraged loan market.

S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads and interest payments.

S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

S&P 500 Total Return Index is a total return index that reflects both changes in the prices of stocks in the S&P 500 Index as well as the reinvestment of the dividend income from its underlying stocks.

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Relative Value. **HFRI Relative Value (Total) Index.** Strategy 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. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. Relative Value (RV) position may be involved in corporate transactions also, but as opposed to Event Driven (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.

Arbitrage. **HFRI RV: Multi-Strategy Index:** multi-strategies employ an investment thesis predicated on realization of a spread between related yield instruments in which one or multiple components of the spread contains a fixed income, derivative, equity, real estate, MLP or combination of these or other instruments. Strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager.

Long/Short Credit. **HFRI RV: Fixed Income — Corporate Index.** Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a corporate fixed-income instrument. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple corporate bonds or between a corporate and risk free government bond. They typically involve arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.

Structured Credit/Asset Backed. **HFRI RV: Fixed Income — Asset Backed Index.** Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a fixed-income instrument backed by physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments, which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery or other tangible financial commitments. Investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed-income instruments, broadly speaking. In many cases, investment managers hedge, limit, or offset interest-rate exposure in the interest of isolating the risk of the position to strictly the disparity between the yield of the instrument and that of the lower-risk instruments.

Macro. **HFRI Macro (Total) Index.** Encompass a broad range of strategies 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 on realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to Equity Hedge (EH), in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

Systematic Macro. **HFRI Macro: Systematic Diversified Index.** Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

Discretionary Macro. **HFRI Macro: Discretionary Thematic Index.** Strategies primarily rely on the evaluation of market data, relationships and influences, as interpreted by individuals who make decisions on portfolio positions; strategies employ an investment process most heavily influenced by top-down analysis of macroeconomic variables. Investment Managers may trade actively in developed and emerging markets, focusing on both absolute and relative levels on equity markets, interest rates/fixed income markets, currency and commodity markets; they frequently employ spread trades to isolate a differential between instrument identified by the Investment Manager as being inconsistent with expected value. Portfolio positions typically are predicated on the evolution of investment themes the Manager expects to develop over a relevant time frame, which in many cases contain contrarian or volatility-focused components.

Event Driven. **HFRI Event Driven (Total) Index.** Maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including 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. Exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental (as opposed to quantitative) characteristics, with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

Activist. **HFRI ED: Activist Index.** Strategies may obtain or attempt to obtain representation on the company's board of directors in an effort to impact the firm's policies or strategic direction and in some cases may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividends or share buybacks, and changes in management. Strategies employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently or prospectively engaged in a corporate transaction, security issuance/repurchase, asset sales, division spin-off or other catalyst-

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oriented situation. These involve both announced transactions and situations in which no formal announcement is expected to occur. Activist strategies would expect to have greater than 50% of the portfolio in activist positions, as described.

Distressed Credit. **HFRI ED: Distressed/Restructuring Index.** Strategies focus on corporate fixed-income instruments, primarily corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceedings or financial-market perception of near-term proceedings. Managers are typically actively involved with the management of these companies; they are frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments that are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

Merger Arbitrage. **HFRI ED: Merger Arbitrage Index.** Strategies primarily focus on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross-border, collared, and international transactions that incorporate multiple geographic regulatory institutions, typically with minimal exposure to corporate credits. Strategies typically have over 75% of positions in announced transactions over a given market cycle.

Equity Hedge. **HFRI Equity Hedge (Total) Index.** Equity Hedge: Investment Managers who maintain 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. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

Directional Equity. **HFRX EH: Multi-Strategy Index.** Managers maintain 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, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Managers typically do not maintain more than 50% exposure to any one Equity Hedge sub-strategy.

Equity Market Neutral. **HFRI EH: Equity Market Neutral Index.** Strategies employ sophisticated quantitative techniques to analyze price data to ascertain information about future price movement and relationships between securities. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies predicated on the systematic analysis of common relationships between securities. In many cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high-frequency techniques may be employed; trading strategies may also be based on technical analysis or designed opportunistically to exploit new information that the investment manager believes has not been fully, completely, or accurately discounted into current security prices. Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

Note: While the HFRI Indices are frequently used, they have limitations (some of which are typical of other widely used indexes). These limitations include survivorship bias (the returns of the indexes 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 indexes, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information hedge fund managers 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 indexes 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.

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