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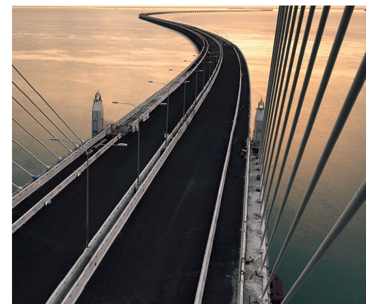
Investment Strategy



Weekly guidance from our Investment Strategy Committee **November 6, 2023**

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- A blend of 60% stocks/40% bonds has performed well over many past environments, but stock and bond prices sometimes decline together and have done so recently.
- Qualified investors could consider adding an allocation to alternative investments which may offer greater diversification and potentially improved risk-adjusted returns.

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- The Health Care sector has underperformed in 2023. Medical device companies, in particular, have felt the impact of glucagon-like peptide-1 (GLP-1) drugs for obesity, despite strong third-quarter results from the leading companies.
- While the data has been encouraging for GLP-1 drugs, we believe it remains early to draw conclusions about their long-term safety and effectiveness.

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- Higher interest rates, wider credit spreads, and several credit events have all served to create a difficult backdrop for the preferred sector for the past few years.
- With the recent increase in interest rates, we believe income-oriented investors should consider adding to their preferred exposures, focusing on higher quality issuers.

Real Assets: Consolidation makes waves in the Energy sector..................... 6

- Large-scale consolidation is picking up within the Energy sector. We believe this is a sign of a maturing U.S. Energy industry.
- We maintain our favorable view of integrated oil companies and believe that consolidation improves the quality of the sector as a whole.

Current tactical guidance 7

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Alternatives Spotlight

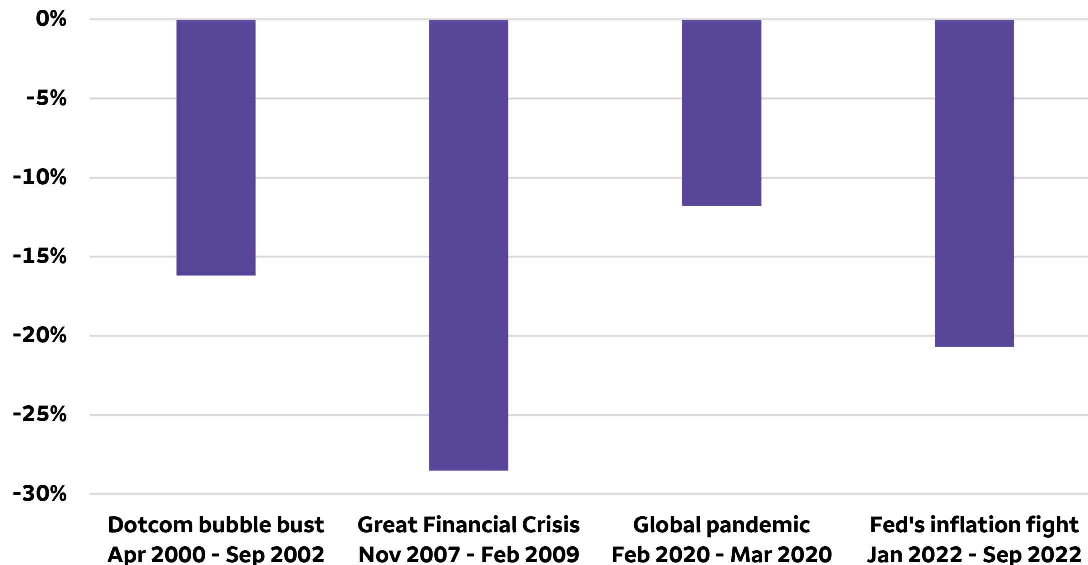
Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

Rethinking diversification

Research has shown that diversifying across asset classes generally has been a prudent method of mitigating risk. For the past several decades, a blend of 60% stocks and 40% bonds[1] (60/40 blend) has been a benchmark mix of a typical diversified portfolio. The 60/40 blend has historically performed well in many different market environments. Stocks typically provided the return-enhancing attributes, while bonds provided ballast via a generally stable income stream with the potential to offset fluctuations in stock market returns.

However, during recent market drawdowns, the two asset classes have at times moved more in tandem, often declining and rising at similar times. During the market decline in 2022, the 60/40 blend recorded one of its worst performance periods to date, as both stocks and bonds fell throughout the year, leaving investors with few places to hide. As highlighted in Chart 1, the traditional 60/40 blend fell over 20% through the third quarter of 2022 as both stocks and bonds faltered. In our view, additional approaches to diversification may help investors stay diversified and limit overexposure to any particular market risk.

Chart 1. Performance of a blend of 60% stocks and 40% bonds during past market drawdowns



Sources: Bloomberg and Wells Fargo Investment Institute. Total returns as of October 30, 2023. Bonds = Bloomberg U.S. Aggregate Bond Index. Equities = S&P 500 Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Consider adding alternative investments

While the 60/40 blend may have served investors well in the past, qualified investors today may consider adding alternative investments to a traditional portfolio of stocks and bonds. We believe alternative investments may have the potential to further diversify or complement a traditional portfolio through the types of investments owned or the techniques employed. The term alternative investments include a wide array of hedge fund and private capital strategies.

*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.

[1] Bonds are represented by the Bloomberg U.S. Aggregate Bond Index. Equities are represented by the S&P 500 Index.

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In general, alternative investments fall into one of the following categories:

- Hedge Fund strategies: Equity Hedge, Global Macro, Relative Value, and Event Driven
- Private Capital strategies: Private Equity, Private Debt, and Private Real Assets

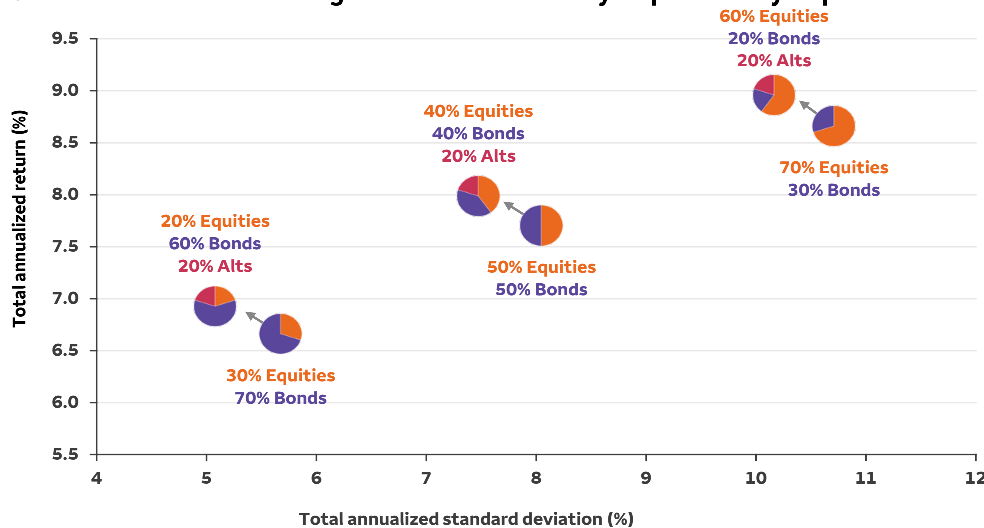
Each strategy type offers its own unique return, risk, and income attributes that may have the potential to enable a portfolio to withstand the next challenging market environment. Potential benefits of adding alternative strategies include:

- May provide exposure to a broader range of investment opportunities and strategies
- Offer the potential for improved risk-adjusted returns
- Provide greater diversification potential and access to strategies that might have the potential to generate positive returns regardless of market direction

Chart 2 compares allocations of traditional stocks and bonds with those that included an allocation to alternative investments. Since 1990, a 20% allocation to alternative strategies achieved higher overall returns with less risk, as measured by standard deviation (a measure of volatility).

Moreover, the growing prominence of a handful of stocks in the broad markets may lead to greater risk in the future. The "Magnificent Seven"[2] group of stocks that consist of mega-cap technology-related names now comprise more than 20% of the overall S&P 500 Index. Investors who hold S&P 500 Index exposure thinking that they are broadly diversified may be surprised to find out they are concentrated in a select handful of growth-oriented stocks. Alternative investments may help provide additional diversification by accessing a large universe of private companies, or by employing hedging techniques that seek to dampen the overall return volatility and mitigate unintended risks.

Chart 2. Alternative strategies have offered a way to potentially improve the overall risk-adjusted returns



Sources: © 2023 – Morningstar Direct, All Rights Reserved[3], and Wells Fargo Investment Institute. Bonds = Bloomberg U.S. Aggregate Bond Index. Equities = S&P 500 Index. Alts = HFRI Fund Weighted Composite Index. Data from January 1, 1990, to September 30, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Our view

The rising popularity of alternative investments has been due in large part to growing realization of the potential benefits they may provide. While the stock market rebound in 2023 may have led to complacency on the part of many investors, we believe now may be an opportune time for qualified investors to consider adding alternative strategies to further diversify as growing economic uncertainty and geopolitical events may introduce additional risk to markets.

[2] "Magnificent Seven" consists of Alphabet Inc., Apple Inc. , Nvidia Corp, Meta Platforms Inc., Tesla Inc., Amazon.com Inc., Microsoft Corp.

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Equities

Greg Simpson
Lead Retail Investment Research Analyst

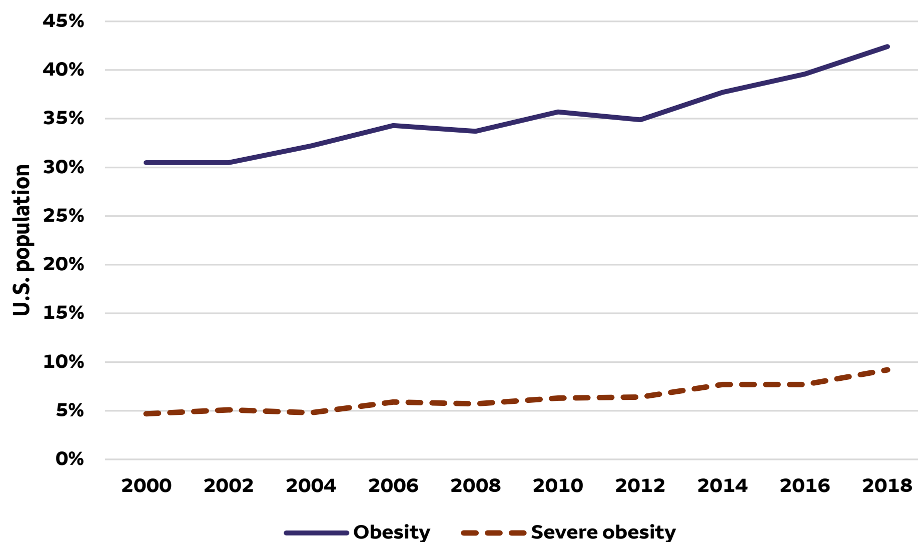
Why medical device stocks have been under pressure

The Health Care sector has underperformed in 2023 (through October 31), despite solid fundamentals and pent-up demand that we believe to be favorable. The sector's underperformance has been particularly apparent in medical device stocks (within the Health Care Equipment & Supplies sub-industry), which generally tend to combine defensive characteristics with attractive growth and high margins. This underperformance has accelerated during the back half of 2023, despite strong operating results from leading medical device companies.

The excitement surrounding GLP-1 (glucagon-like peptide-1) drugs for obesity has led to growing investor concerns as to the potential impact on the medical device industry, including markets for diabetes, orthopedic, and cardiovascular devices. Concerns increased substantially following the release of key trial data in early August, which suggested that GLP-1 drugs could significantly reduce cardiovascular risks for patients with obesity.

Given the rising rates of obesity and severe obesity (see chart), and the impact obesity has on many health-related conditions, we believe effective drugs for obesity could have negative long-term implications for medical device markets. Investors have aggressively discounted this possibility, which has weighed substantially on medical device stocks. While the data has been encouraging for GLP-1 drugs, we believe it remains early to draw conclusions about their long-term safety and effectiveness. Potential adverse events remain a risk. While we are optimistic about the effectiveness of GLP-1's, we note the example of Olestra, a fat substitute that promised to remove fat and calories from junk food. Olestra was approved by the FDA in 1996, but is now banned in many countries. It now exists as industrial lubricant and paint additive. For investors, the tale of Olestra is "food for thought."

Obesity trends in the United States



Sources: National Center for Health Statistics, National Health and Nutrition Examination Survey. Wells Fargo Investment Institute. Data as of October 30, 2023. Obesity defined as body mass index (BMI) over 30. Severe obesity defined as BMI of 40 or higher.

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Fixed Income

Michael P. White
Director of Fixed Income Research

When considering preferred securities, focus on quality

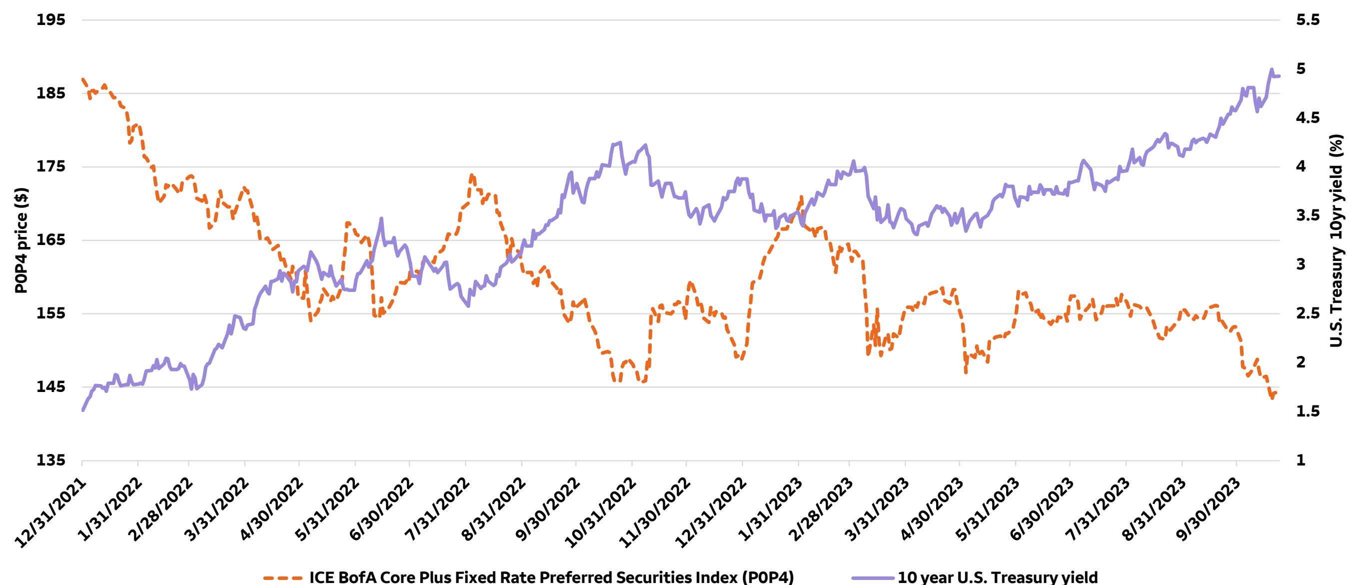
Increasing interest rates and credit spreads have pressured preferred security prices over the past few years due to their long duration.[4] We believe that price stability and the potential for any capital appreciation going forward will be heavily reliant on downward moves in the overall level of rates, particularly at the long end of the yield curve.

New preferred security issuance has been limited by the rise in interest rates — for issuers, refinancing callable issues at higher coupon levels would be imprudent. We see this trend continuing in the near term since many of the preferred securities issued over the past few years carry fixed-rate coupons well below 5%. This is particularly true for the larger, more frequent issuers.

The past 18 months offered several reminders that preferred securities are subject to company-specific credit events. In these cases, investment-grade securities became speculative-grade securities in a relatively short period of time, negatively impacting prices and trading liquidity. While difficult to screen for ahead of time, these instances serve as a reminder for investors to remain vigilant when holding individual securities.

With the recent increase in interest rates, we believe income-oriented investors should consider adding to their preferred exposures, focusing on higher quality issuers. We consider the yields available in the preferred sector to be attractive for income-oriented investors. Additionally, many preferred securities are currently trading at discounts to par value and could potentially provide some opportunity for price appreciation if interest rates decline in the future.

Preferred securities versus the 10-year U.S. Treasury



Source: Bloomberg and Wells Fargo Investment Institute. Data as of October 23, 2023. P0P4 is the ICE BofA Core Plus Fixed Rate Preferred Securities Index. CMTUSD 10 Index is the yield on the constant maturity 10 year treasury bond index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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4. Duration is a measure used to determine a bond's or bond portfolio's sensitivity to movements in interest rates. Generally, the longer the duration the more sensitive a bond or bond portfolio is to changes in interest rates.

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Real Assets

Ian Mikkelsen, CFA
Equity Sector Analyst, Energy

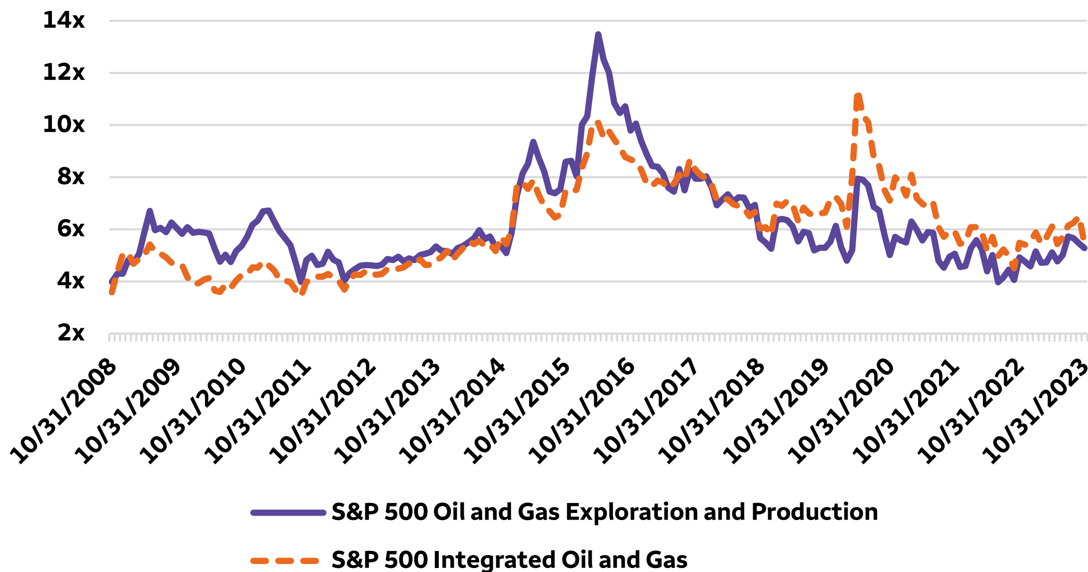
Consolidation makes waves in the Energy sector

Consolidation was the dominant theme in the Energy sector in October 2023. Less than two weeks apart, the two largest integrated oil majors each separately announced acquisitions of two of the largest independent oil and gas exploration and production companies (E&Ps). While merger activity has always been a theme of fits and starts within the Energy sector, we believe that these two acquisitions are particularly meaningful for the sector as a whole.

How did we get here? We believe that recent consolidation is a sign of the maturation of the U.S. oil and gas industry, as E&Ps have changed their stripes to prioritize value over growth. To be sure, we analyzed relative valuations of the E&P industry to integrated oil companies over time (see chart). In the early days of the "shale revolution," as new discoveries and technological breakthroughs enabled strong U.S. production growth, E&Ps were valued for their strong growth potential, which garnered a premium from investors. Over time, declining revenues from volatile commodity prices made it difficult for E&Ps to meet lofty growth expectations, and investor preferences shifted to favor the relative stability of integrated oil companies.

Although large deals within Energy have proven to be risky in the past, we view these two recent acquisitions as well balanced due to their all-equity structure, modest valuations offered, and the straightforward nature of the acquisition rationale. We believe that consolidation increases the overall quality of the Energy sector as a whole, and we maintain our favorable view of integrated oil companies.

Energy industry EV/EBITDA valuations over time



Sources: Factset and Wells Fargo Investment Institute. EV/EBITDA = Enterprise Value to Earnings Before Interest, Taxes, Depreciation, and Amortization. S&P 500 Oil and Gas Exploration and Production Sub-industry Index represents the oil and gas exploration and production sub-industry portion of the S&P 500 Index. S&P 500 Integrated Oil and Gas represents the integrated oil and gas sub-industry portion of the S&P 500 Index. Data range is from October 31, 2008 through October 31, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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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, November 6, 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

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

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. **Growth stocks** may be more volatile than other stocks and there is no guarantee growth will be realized. There are no guarantees that **value stocks** will increase in value or that their intrinsic values will eventually be recognized by the overall market. Both growth and value types of investing tend to shift in and out of favor. **Preferred securities** are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. **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.

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. The Energy sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather 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

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

U.S. equities = **S&P 500 Index** is a market capitalization-weighted index generally considered representative of the U.S. stock market.

Global equities = **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed markets including the United States.

Hedge funds = **HFRI Fund Weighted Composite Index** is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database.

ICE BofA Core Plus Fixed Rate Preferred Securities Index tracks the performance of fixed rate US dollar-denominated preferred securities issued in the US domestic market.

S&P Oil & Gas Exploration & Production Select Industry Index represents the oil and gas exploration and production segment of the S&P Total Market Index.

S&P 500 Integrated Oil and Gas represents the integrated oil and gas sub-industry portion of the S&P 500 Index.

S&P Total Market Index is designed to track the broad equity market, including large-, mid-, small-, and micro-cap stocks.

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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

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Investment Grade bonds - A rating that indicates that a municipal or corporate bond has a relatively low risk of default. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as "junk bonds".

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