Proactive Portfolio Approaches Under Market Uncertainty

**Key takeaways**

- Historically, defensive assets and strategies have helped mitigate equity market losses, particularly when equity markets have experienced significant drawdowns.
- Trading driven by day-to-day news may produce poor investment outcomes and potentially create emotional stress.

**What it may mean for investors**

- We recommend investors incorporate defensive strategies into portfolios to help navigate through uncertain times.
- We also suggest that investors choose prudent investment plans based on their goals and sensitivities to market events.

As of October 2019, the U.S. economic expansion has lasted 126 months, the longest expansion in U.S. recorded history since the mid-19th century. Simultaneously, the S&P 500 Index has sustained its longest trend of rising prices without a decline of 20% or more. While we do not expect an imminent end to the current economic expansion, the economy is beginning to slow, and we foresee significant bouts of equity market volatility in the coming year.

During periods of uncertainty and equity market volatility—especially late in an economic expansion—there are strategies that can potentially mitigate volatility in portfolio returns. Such assets typically have lower association to the broad equity market and may outperform when equities experience significant pullbacks. We favor these strategies when allocating among asset classes and when selecting securities.

Strategically allocating assets involves identifying assets with a return profile that is less sensitive to equity market volatility. Between January 1926 and September 2019 (see chart), U.S. Treasury bonds, precious metals (such as gold), and certain hedge fund strategies outperformed equities from the 12 months before a recession and up to the first half of a recession. Over this period, these assets maintained positive returns—even when equities experienced significant loss.
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Within equities, certain investment styles and securities also tend to outperform during periods of equity volatility. High quality, low price volatility, low market beta (volatility), and high-dividend equities historically have weathered late-cycle economies and recessions well (see chart).1 We also favor equity sectors that are likely to benefit from continued economic growth and that rank highly in measures of quality. Those sectors include Information Technology, Consumer Discretionary, and Financials. Our preference for quality also applies to corporate bonds.

Whether allocating in broad asset classes, or particular sectors, we believe that investors could position their portfolios to manage during uncertain times by:

1. **Diversifying to help mitigate risks:** The chart below shows that equities and bonds tend to move opposite to one another. Higher quality and low volatility equities also typically outperform broad equity indices in the year before a recession and during the first half of a recession. Historically, this diversification has supplemented portfolio returns as broad equity indices declined.

2. **Rebalancing becomes more important:** Rebalancing back to strategic targets is a standard tool of portfolio management and becomes even more important late in an economic expansion. As equity prices rise, the share of equities in the portfolio may also rise. Given that the S&P 500 has risen over 350% since 2009, the share of equities in a portfolio may be significantly higher than investors originally planned. By taking profits in equities and reallocating towards other asset classes while the S&P 500 is near a record high, investors can potentially adjust equity exposures towards planned levels.

3. **Using cash opportunities created from volatility:** As rebalancing progresses, investors may generate cash. Instead of stockpiling cash, investors may consider deploying it. The chart below illustrates the differences in equity performance before and during a recession. Today, with the S&P 500 near a record high, investors have an opportunity to trim positions and reallocate cash towards asset classes and areas that may outperform a large and broad equity exposure in the coming year.

4. **Knowing what you own:** “Know what you own” means that if expected returns look too good to be true, they probably are. It can also mean accounting for overlapping exposures or concentration risk. For example, some growth-oriented equity funds were not as diversified as they seemed in the late 1990s because growth-oriented equities as a group broadly became overvalued. Over the last 20 months, we have favored incrementally reducing portfolio exposures to U.S. small-cap equities and U.S. high-yield debt. We continue to expect that the potential next 12-month return may look less than the past price declines for these two asset classes.

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1 “Quality” may have a variety of meanings, but here we are referencing companies with high return on equity invested, persistent earnings growth, and low financial leverage.
5. **Leveraging centrally managed portfolio programs**: We provide portfolio recommendations for many centrally managed investment programs. These programs are tailored to satisfy various investment objectives. We select investment products with a conservative emphasis, such as high quality, low volatility, or high-dividend yield, and include them in investment portfolios to create a conservative security and style positioning. Centralized portfolio programs are managed to achieve diversification and are rebalanced periodically.

We expect increased equity volatility in the coming 12 months. Eventually, an economic recession is likely, although probably not in the next 12 months. Recessions are a normal and expected part of economic and market cycles. Fortunately, we see potential opportunities to help mitigate risk and possibly increase return amid volatility—even late in the economic cycle. However, investors who react emotionally or out of fear may elect large cash positions that, over time, could impair their longer-term potential returns and endanger their financial goals. We favor a more proactive approach, taking control of the portfolio by thoughtfully and regularly considering where diverging valuation and price may create excessive risk.

**Historical asset performance is diverse at turning points in the business cycle**

> Sources: Wells Fargo Investment Institute, Bloomberg, Morningstar, AQR, October 1, 2019. Chart shows average return before, during and after past recessions from January 1926 to September 2019. Market indices: Large-cap stocks - Ibbotson large stock Index; Treasury bonds – Ibbotson Government bond index; Gold – Bloomberg Gold Index; Hedge Fund – Macro – HFRI Macro Index; Equity defensive sectors – average of S&P 500 Consumer Staples, Health Care, Utilities, Communication Services sectors; High quality stocks – AQR Quality Index; Low volatility/low beta stocks – MSCI USA Minimum Volatility Index; High dividend stocks – MSCI USA High Dividend Index. An index is unmanaged and not available for direct investment. *Past performance is no guarantee of future results.*
Notes on growth versus value

Over the last six weeks, value stocks have outperformed growth stocks. This has been a counter-trend move compared to the previous 5+ years when growth dramatically outperformed (see table below). Growth stocks typically are expected to grow earnings well in excess of the average company. Value stocks, on the other hand, often feature an attractive dividend yield and trade at a price below what investors might consider “fair value.” Value stocks also tend to be more sensitive to the ebb and flow of the economy.

The Information Technology and Consumer Discretionary sectors have a large concentration of growth stocks. The Information Technology sector is the best performer on a year-to-date (YTD) basis. More recently, some of the largest capitalization companies in this sector have underperformed as traders took profits in the wake of YTD outperformance and negative global growth risks. In addition, companies in the Financials and Energy sectors carry a heavy weighting in value indices. Both sectors have outperformed recently.

We have moved to a more neutral equity position over the last six months as the S&P 500 Index has traded to what we consider fair value, and negative risks to our outlook have increased. We recommend investors allocate funds more in line with their strategic targets. We currently favor growth sectors such as Information Technology and Consumer Discretionary along with the value-biased Financials sector. We prefer this “barbell” approach at this time and recommend a more neutral growth versus value position with an emphasis on quality.

Key takeaways

- Traders have taken profits recently in some of the big-cap technology and consumer growth names while value-biased financial and energy names have outperformed.
- For now, we recommend a neutral growth versus value position.

Performance: Growth versus Value Indices

<table>
<thead>
<tr>
<th>Index</th>
<th>Price return</th>
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<tr>
<td></td>
<td>1-month</td>
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<tr>
<td>S&amp;P 500</td>
<td>-1.3%</td>
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<tr>
<td>S&amp;P 500 Pure Growth</td>
<td>-2.8%</td>
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<tr>
<td>S&amp;P 500 Pure Value</td>
<td>1.4%</td>
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<tr>
<td>Russell 1000 Value</td>
<td>0.0%</td>
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Sources: Bloomberg, Wells Fargo Investment Institute, October 2, 2019. *5-year returns are annualized. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results.
Why are we seeing negative yielding debt?

The amount of global negative yielding debt has been building up at a slow, but consistent pace since 2014. It has displayed a strong increase this year, peaking in late August at around $17 trillion and currently standing near $14 trillion. Close to 70% is concentrated in government bonds from Japan, France, and Germany, but there are also corporate issues (non-U.S. dollar) currently trading at a negative yield to maturity.

As uncertainty increases, due to fears of a global economic slowdown and unresolved trade disputes, investors may begin to demand assets perceived as “safe havens.” Typically, government securities from Japan, Germany, and the U.S. are perceived as safe. This investor preference, coupled with a pivot from the Federal Reserve and European Central Bank to cut interest rates, have caused several bonds to trade at a negative yield (meaning prices have increased). If times of distress persist, we expect to see further negative yields in those bonds as investors continue to demand those assets.

Many institutional investors may be unable to hold other types of securities (or even cash since they could incur additional storing and carrying costs) and may be legally obligated to buy those government bonds even if they display negative yields. Other speculative investors may believe interest rates will continue to decline and see this as a trading opportunity. Yet, if central banks continue implementing quantitative easing, some investors may feel owning these bonds bears a low loss risk since central banks could be the “last resort purchasers.”

Key takeaways

» The global negative yielding debt peaked this past August and currently stands near $14 trillion, mostly in government issues from Japan, France, and Germany.

» If times of distress persist, we expect to see further negative yields in those bonds as investors continue to demand those assets.

Global negative yielding debt has been increasing rapidly this year

**Where have all the MLPs gone?**

The energy Midstream landscape has transformed mightily in just a few short years. In the past, master limited partnerships (MLPs) dominated the space, but the universe of MLPs has shrunk. As recently as 2016, there were more than 90 energy MLPs listed on North American stock exchanges. As of October 2, 2019, there were 53. Much of this drop has been due to MLPs converting to C-corporations. Regulation, tax changes, and investors’ disdain for incentive distribution rights (IDRs) in the traditional MLP business model have combined to convince many MLP management teams to convert to a C-corporation. What does this mean for the future of MLPs?

We do expect more MLP to C-corp conversions. However, we are not calling for the end of the MLP model. The largest MLP names in the industry have actually come out in support of the model. Additionally, the main investor criticism of the MLP model, IDRs, have largely been eliminated in the remaining MLPs. And not to be overlooked, the potential tax benefits of the MLP structure versus C-corporations are still material.2 Obviously, a change in the tax law could tilt this outlook either towards MLPs or C-corps. What this means, however, is that investors are no longer able to gain a representative exposure of the entire Midstream asset class by only considering MLPs. For investors looking for the most diversified exposure to Midstream, we suggest considering C-corps in addition to MLPs.

**Key takeaways**

» The number of MLPs has dropped significantly these past few years.

» The MLP model is not dead, but we believe the increase in prevalence of C-corps argues that both structures should be considered by Midstream investors.

**Midstream asset class breakdown: MLPs versus C-corps**

![Midstream asset class breakdown chart]


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2 MLPs do not pay taxes at the company level, which avoids double taxation, and unitholders enjoy tax-deferred distributions on the majority of income received.

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Global Alternative Investment Strategist

How serious is the recent weakness in IPOs?

Several initial public offerings (IPOs) have been under pressure recently, leading some to claim a peak in IPO valuations. With a popular American commercial real estate company postponing its offering, not to mention significant post-offering price declines in several recent offerings, it appears that the public market is at odds with the private market. This is not a surprise to us as we have expected a moderate return for private equity strategies—especially large buyout—and our preference for investing in smaller, niche strategies instead.

The recent weakness in the IPO market can be seen in the chart below, with the Renaissance IPO Index down nearly 16% since its late-July peak. Although we have not yet seen significant weakness in the more illiquid venture capital benchmarks, there has been a noticeable decline in the returns of liquid, publicly traded venture capital-backed companies (represented by the Thomson Reuters Venture Capital Index). Interestingly, there is an even stronger correlation between IPO returns and buyout strategy performance (represented by the Thomson Reuters Private Equity Buyout Index). Given this relationship, we would not be surprised to see an ensuing decline in buyout strategies returns as well.

While it’s not unreasonable to expect further weakness in IPOs, accelerating allocation to private equity funds during turbulent times may prove beneficial. Recent IPO weakness could be a sign of frothy private market valuations, but further deterioration may result in an attractive opportunity for patient investors.

Key takeaways

» We feel that recent IPO performance has been disappointing, which may be a sign that private market valuations are out of sync with public markets.

» Further declines in IPO performance could signal an opportunity for investors to accelerate their private equity allocation and potentially take advantage of better valuations.

IPO weakness could affect private equity returns

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.

Source: Bloomberg, September 2019. The Renaissance IPO Index reflects approximately the top 80% of newly public companies based on full market capitalization, is weighted by free float capitalization and imposes a 10% cap on large constituents. The Thomson Reuters Private Equity Buyout Index seeks to replicate the performance of the Thomson Reuters Private Equity Benchmark Index through a combination of liquid, publicly listed assets. The Thomson Reuters Venture Capital Index seeks to replicate the performance of the Thomson Reuters Venture Capital Benchmark Index through a combination of liquid, publicly listed assets. An index is unmanaged and not available for direct investment. Past performance is no guarantee of future results.
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. There are no guarantees that growth or value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The return and principal value of stocks fluctuate with changes in market conditions. The growth and value type of investing tends to shift in and out of favor. 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. Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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. Investments in gold and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments. 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. Risks associated with the Consumer Discretionary sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. 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. Investing in the Financial services companies will subject a investment to adverse economic or regulatory occurrences affecting the sector. Risks associated with the 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 smaller, less-seasoned companies, tend to be more volatile than the overall market.

Investment in Master Limited Partnerships (MLPs) involves certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from Net Asset Value and other material risks.

Sovereign debt is generally a riskier investment when it comes from a developing country and tends to be a less risky investment when it comes from a developed country. The stability of the issuing government is an important factor to consider, when assessing the risk of investing in sovereign debt, and sovereign credit ratings help investors weigh this risk.

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.
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Definitions

An index is unmanaged and not available for direct investment.

**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.

**Ibbotson Large Stock Index** is a market-capitalization-weighted index of the large cap U.S. publicly traded companies.

**Ibbotson Government Bond Index** is an unweighted index which measures the performance of five-year maturity U.S. Treasury Bonds.

**Bloomberg Gold Index** is a commodity group subindex of the Bloomberg Commodities Index composed of futures contracts on Gold.

**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 EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

**S&P 500 Consumer Staples Sector Index** is a market capitalization weighted index of consumer staples companies within the largest 500 U.S. publicly traded companies.

**S&P 500 Health Care Sector Index** is a market capitalization weighted index of health care companies within the largest 500 U.S. publicly traded companies.

**S&P 500 Utilities Sector Index** is a market capitalization weighted index of utilities companies within the largest 500 U.S. publicly traded companies.

**S&P 500 Communication Services Sector Index** is a market capitalization weighted index of communication services companies within the largest 500 U.S. publicly traded companies.

**AQR Quality Index** comprises listed U.S. stocks and weights companies by composite of profitability, growth, safety and payout.

**MSCI USA Minimum Volatility Index** comprises listed U.S. stocks and weights companies by standard deviation of total returns.

**MSCI USA High Dividend Index** comprises listed U.S. stocks and weights companies by dividend yield.

**S&P 500 Pure Growth Index** is a style-concentrated index designed to track the performance of stocks that exhibit the strongest growth characteristics by using a style-attractiveness-weighting scheme.

**S&P 500 Pure Value Index** is a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme.

**The Renaissance IPO Index** reflects approximately the top 80% of newly public companies based on full market capitalization, is weighted by free float capitalization and imposes a 10% cap on large constituents. Sizeable IPOs are added on a fast entry basis and the rest are added during scheduled quarterly reviews. Companies are removed two years after their initial trade date, when they become seasoned equities.

**Russell 1000 Index** measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

**Russell 1000 Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

**Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

**Thomson Reuters Venture Capital Index** replicates the performance of the Thomson Reuters Venture Capital Benchmark Index with liquid, publicly listed assets and is published daily.

**Thomson Reuters Private Equity Buyout Index** is an index made up of independent portfolios intended to track the return of the private equity universe by replicating movements in the Thomson Reuters Private Equity Benchmark Index.
Thomson Reuters Venture Capital Benchmark Index measures the aggregate gross returns of the US venture capital industry by tracking the performance of individual US venture capital-backed private companies, which are not available for public investment, using Thomson Reuters Private Company Data and is published quarterly.

Thomson Reuters Private Equity Benchmark Index seeks to replicate the return profile of the private equity buyout asset class by constructing a combination of sector portfolio returns.

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