September 17, 2018

Time for a Portfolio Tune-up

Chris Haverland, CFA
Global Asset Allocation Strategist

Key takeaways

» *Portfolio drift can occur when markets have substantial appreciation. Without regular, periodic rebalancing, this can lead to an asset allocation that does not align with an investor's risk profile and goals.*

» *After the longest U.S. equity bull market in history, portfolios that have not been rebalanced are likely overweight in riskier assets.*

What it may mean for investors

» *This may be an ideal time for a portfolio tune-up, and rebalancing, to align your investments with your goals and risk tolerance.*

It's recommended that you schedule a periodic tune-up for your car to increase efficiency and help avoid potential breakdowns. Investors should follow a similar philosophy when it comes to their investment portfolios. Fine-tuning one's asset allocation on a regular basis or when life events occur will help to align investment goals with risk tolerance and time horizon. Even if nothing has changed personally, the financial markets likely have moved since the last check-up, which can cause alterations to a portfolio's composition. This is often called portfolio drift—and it can be addressed by periodically rebalancing allocations back to strategic target weights.

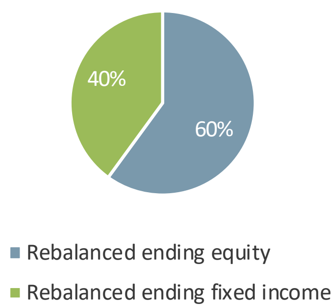
The concept of regular rebalancing often can facilitate "selling high and buying low" without emotional influence, by the sheer discipline of periodic reallocation. How we feel about the markets should take a back seat to market fundamentals. However, our emotions can take control, often leading to poor investment decision-making. In some cases, it can promote market timing, which can be extremely difficult—with most investors picking the wrong time to move in and out of markets. Setting a rebalancing schedule normally (whether it is quarterly or annually) is one of the best ways to remain engaged in the financial markets while maintaining your preset investment risk profile.

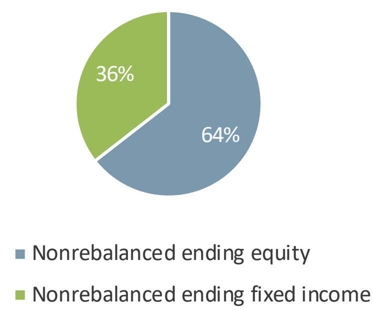
Asset Group Overviews

Time for a Portfolio Tune-up

The past 12 months have been volatile for the equity markets—with most major indices experiencing a correction (a loss of 10% or more). Over this period, there has been a stark contrast between U.S. equity returns (many in the double digits) and international equity returns (flat to slightly positive), while fixed income generally has been flat to slightly negative. These divergences have provided potential opportunities for investors who employ tactical asset allocation and for those who rebalance their portfolios on a regular basis. In Chart 1, the first pie chart shows how a hypothetical 60% S&P 500/40% Bloomberg Barclays U.S. Aggregate Bond Index allocation that was rebalanced might have looked after the past year. The second pie chart shows this same initial investment mix when the portfolio was not rebalanced. The allocation to riskier assets increased in the portfolio that was not rebalanced—likely causing a mismatch to an investor's original risk profile. This drift is also evident when isolating the equity allocation. When the portfolio has not been rebalanced, it likely has an overallocation to U.S. equities relative to international equities. Furthermore, the magnitude of this misalignment could be even more pronounced if investors haven't rebalanced during the current U.S. equity bull market.

Chart 1. Portfolio drift—Comparing hypothetical rebalanced and nonrebalanced portfolios—year ended August 31, 2018

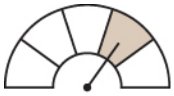




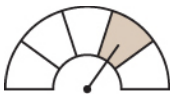
Source: Morningstar Direct, September 12, 2018. *For illustrative purposes only.* There is no guarantee systematic rebalancing will capture greater returns. All investing involves risk including the possible loss of principal. The S&P 500 Index is a market capitalization-weighted index generally considered representative of the US stock market. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based index that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment.

We expect increased financial-market volatility in the coming months due to trade headlines, the midterm elections, monetary policy actions, and seasonal weakness. Investors can prepare for elevated volatility through proper investment strategy. History shows that this is a better approach than trying to time the best entry and exit points. This includes setting aside cash for immediate needs, understanding your time horizon, designing an investment allocation based on your goals and risk tolerance, diversifying among multiple asset classes, and employing a consistent rebalancing plan. Once an investor has an investment plan, it is important to stick with it. Deviating from the target asset allocation can add unwanted risk to a portfolio and reduce the probability of an investor meeting long-term investment goals. Now may be a good time for investors to revisit their overall investment plan and determine if their portfolio is properly tuned and aligns with their goals and risk tolerance.

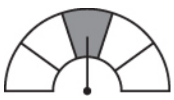
Audrey Kaplan
Head of Global Equity Strategy



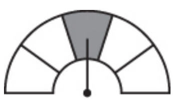
Favorable
U.S. Large Cap Equities



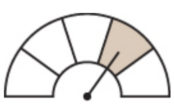
Favorable
U.S. Mid Cap Equities



Neutral
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Favorable
Emerging Market Equities

The VIX and the "new normal" for volatility

As we had anticipated, the CBOE Volatility Index® (VIX®) has been higher year to date than it was last year. While the VIX reached a 2018 peak closing price of 37.32 on February 5 during a volatile week for U.S. equities, it has only averaged 13.04 to date in this quarter. This is about two-thirds of its long-term average and compares with its average of 14.56 over the past five years. The VIX reflects a market estimate of future S&P 500 Index volatility, but it often moves "with" volatility (as it did in February). We correctly anticipated additional market choppiness as the recovery since the financial crisis has extended beyond the typical economic expansion length. Future volatility may be higher than it is today, due to geopolitical and trade concerns, the Federal Reserve's (Fed) future rate-hike path, and other issues. As with any extended recovery, volatility is par for the course.

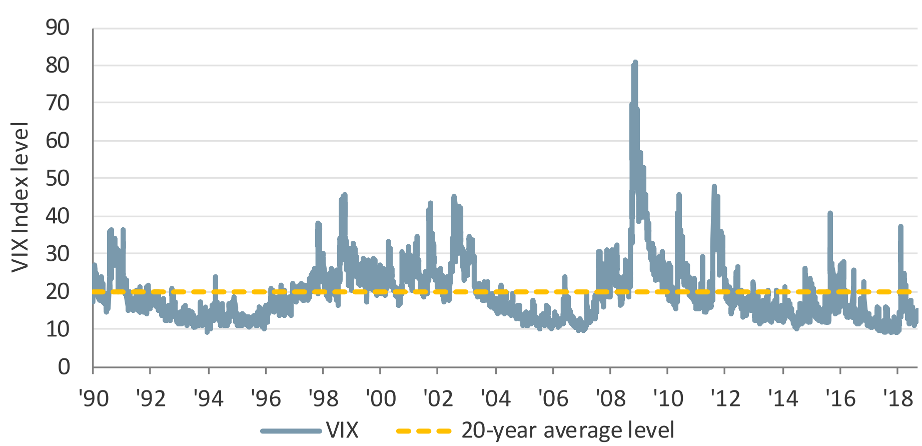
For long-term investors, the VIX may not provide much useful information. It may signal that market participants expect more choppiness ahead than in the recent past, but it doesn't indicate whether that will come in the form of long-term price appreciation or depreciation. The persistent low volatility we have seen has been rather abnormal, by historical standards, and the VIX is still far below its 20-year average of just over 20. Rising volatility may reflect a more "normal" market that is no longer supported by uncharacteristically low interest rates and large government economic-rescue packages in the U.S. and overseas.

Key takeaways

» A rising VIX may indicate that the U.S. equity market is getting back to normal. We believe this change should not be feared.

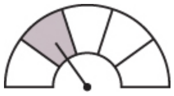
» Market volatility is typical late in the economic cycle. It also may matter more for short-term investing than it does for long-term investors.

Although it is rising, the VIX remains below historical averages

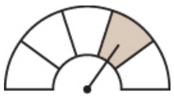


Sources: Bloomberg, Wells Fargo Investment Institute, September 12, 2018. Chart shows the CBOE Volatility Index, or VIX. The VIX shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge." An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

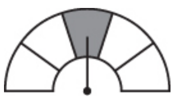
Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy



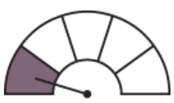
Unfavorable
U.S. Taxable Investment Grade Fixed Income



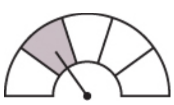
Favorable
U.S. Short-Term Taxable Fixed Income



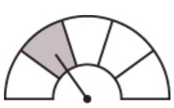
Neutral
U.S. Intermediate Term Taxable Fixed Income



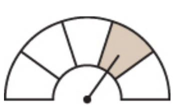
Most Unfavorable
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



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

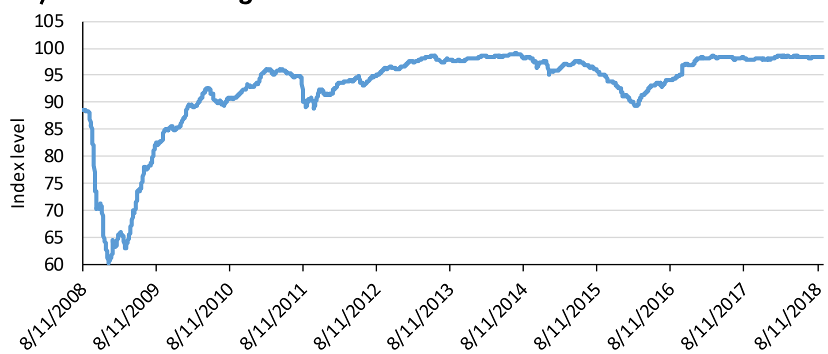


Favorable
Emerging Market Fixed Income

Income generation—considering bank loans

Bank-loan investments typically provide a variable income stream that is based on an interest rate which floats over a specific benchmark, such as the three-month London Interbank Offered Rate (LIBOR). Bank loan floating-rate debt is generally below-investment-grade. While bank loans can help to reduce the interest-rate sensitivity of a portfolio, they also can increase a portfolio's exposure to credit risk.

S&P/LSTA Leveraged Loan Index



Source: Bloomberg, September 12, 2018. The S&P/LSTA Leveraged Loan Index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included represent a broad cross section of leveraged loans syndicated in the U.S., including dollar-denominated loans to overseas issuers. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Investment implications

At present, we hold an unfavorable view of high-yield debt, which would include exposure to bank loans. Within the high-yield debt class, we have a neutral rating on the bank-loan sector. Our bank-loan investment view is based on several factors, including expensive valuations (negative); our expectation that default rates are unlikely to change materially in 2018 (neutral); and our belief that the Fed will continue to slowly raise rates (positive)—providing additional income potential for floating-rate investments. Bank loans can help an investor to diversify within their high-yield allocation. Yet, investors should avoid becoming overconcentrated in the bank-loan debt sector.

Key takeaways

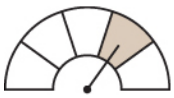
- We have an unfavorable view of the high-yield debt class. Within this fixed-income class, we hold a neutral view of bank-loan investments.
- Bank loans can help to diversify a high-yield debt portfolio.
- Despite increasing credit concerns, bank loans can provide investors with an attractive yield opportunity and little duration risk.[1]

It is important to note floating rate bank loans are generally below investment grade quality (high-yield securities or "junk" bonds) and should be viewed as speculative. There is a limited trading market for floating rate bank loans. As such, investors may not be able to buy and sell these securities at certain times and at certain prices. Floating rate bank loans are also subject to economic risk. In the event of a recession, the bank loan sector may suffer increased defaults which would drive down the value of existing floating rate bank loans.

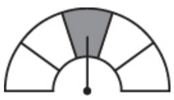
[1] Duration measures a bond's price sensitivity to interest-rate changes.

Austin Pickle, CFA
Investment Strategy Analyst

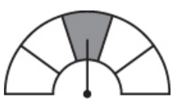
"Millions saw the apple fall, but Newton was the one who asked why."
-- *Bernard Baruch*



Favorable
Commodities



Neutral
Private Real Estate



Neutral
Public Real Estate

How do you take your oil? Light and sweet? Or heavy and sour?

The U.S. is producing and exporting historic amounts of crude oil. Yet U.S. crude-oil imports also have increased over the past few years. If the U.S. is producing (and exporting) record amounts of oil, why is the U.S. importing more crude oil? The answer boils down to history, economics, and crude-oil heterogeneity. Let me explain.

Crude oil is graded on how sweet or sour it is (a measure of sulfur content)—and also how light or heavy it is (a measure of density). Oil from different countries and even from different areas within the same country can have vastly different properties. The chart below from the Energy Information Administration details a number of the more well-known crude oil grades. Light/sweet crude tends to trade at a premium to heavy/sour crude oil, because it is easier to refine to yield high-value components such as gasoline and diesel. But as the U.S. was building its refining industry, the vast majority of available crude-oil supply leaned toward the heavy/sour spectrum (oil from the Middle East, Canada, Mexico, Venezuela, etc.). So, in order to satisfy the United States' oil appetite, refiners invested billions to be able to refine the most widely available crude oil, which was heavy/sour crude oil.

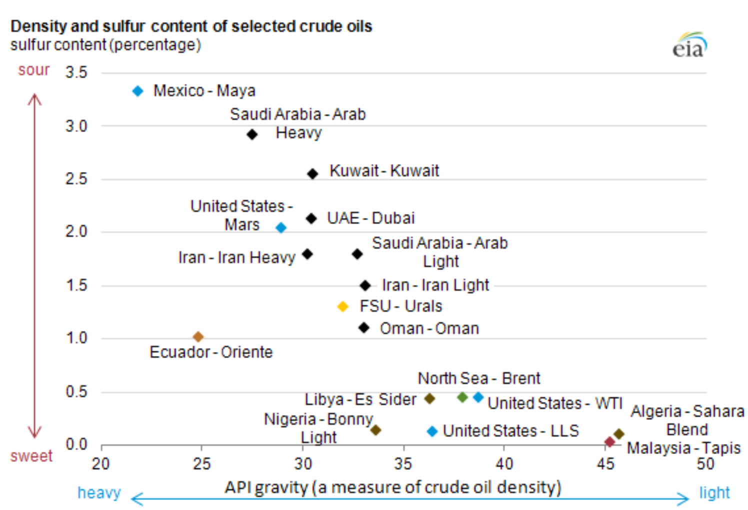
This creates an interesting dynamic. Despite the U.S. producing record amounts of mostly light/sweet oil, U.S. refiners still demand heavy/sour crude oil because it is cheaper, and they have equipment to process it. Foreign refiners demand light/sweet oil because it is simpler and cheaper to refine. This means that U.S. refiners will continue to import heavy/sour oil on the cheap at the same time that U.S. producers export their light/sweet oil for a premium.

Key takeaways

» Heavy/sour crude tends to trade at a discount to light/sweet crude oil.

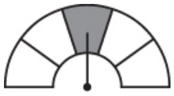
» U.S. refiners will continue to import heavy/sour crude oil despite record U.S. light/sweet oil production.

Select crude-oil grades

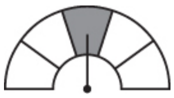


Source: Energy Information Administration, September 12, 2018.

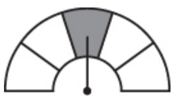
Ryan McWalter
Investment Research Analyst



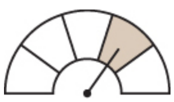
Neutral
Private Equity



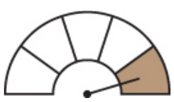
Neutral
Hedge Funds-Macro



Neutral
Hedge Funds-Event Driven



Favorable
Hedge Funds-Relative Value



Most Favorable
Hedge Funds-Equity Hedge

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.

Where we stand with the M&A environment and Merger Arbitrage strategy

Through mid-September, the number of merger and acquisition (M&A) deals and their dollar volume has surpassed 2017 levels. Higher M&A activity was anticipated, with elevated CEO confidence and high corporate cash levels. Yet, the volatility in merger-arbitrage spreads has been surprising.[2] In late 2017 and early 2018, spreads widened as complex mega-cap deals entered the market. Regulatory scrutiny and geopolitical tensions were critical drivers of the spread widening, indicating uncertainty around deals closing. This provided tactical Merger Arbitrage managers with the best opportunities in years.

The Merger Arbitrage strategy provided valuable downside protection early this year as the MSCI All Country World Index declined by -4.16% in February, while the HFRI ED: Merger Arbitrage Index returned +0.18%. Performance was better for more established merger arbitrage managers (with a three-year track record and at least $300 million in assets according to Hedge Fund Research) as each of these managers avoided 70% or more of the equity-market decline.

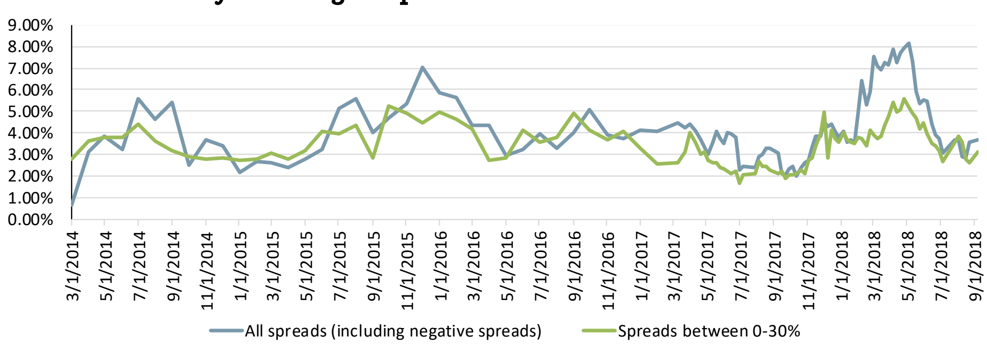
The strategy's uncorrelated returns can be valuable late in a market cycle, but it is important to realize the opportunity set will ebb and flow with spread volatility. Following the second quarter, spreads collapsed, returning to an average of 3.14% (below the historical 3.41% average). We would anticipate more muted Merger Arbitrage returns so long as spreads are at these levels. However, if history is any guide, spreads could increase again, due to regulatory and/or geopolitical uncertainty. We expect this possibility to remain as large mega deals continue to be announced, allowing for more idiosyncratic opportunities for managers to be patient and extract value.

Key takeaways

» Merger Arbitrage managers had ample trading opportunities in the first half of 2018, contributing to valuable downside protection.

» While the strategy can provide returns that are independent of broader market directionality, return expectations can fluctuate depending on deal-spread volatility.

Recent volatility in merger spreads



Sources: Citi and UBS, September 12, 2018. From March 2014 to February 2017, month-end data points were provided by Citi Event Driven Americas Trading Desk, and they include an average of approximately 45 deals each month. From March 2017 through September 2018, weekly data points were provided by the UBS Special Situations Team and include an average of approximately 63 deals each week. The main risk to investing in arbitrage strategies is transaction risk which is the risk that the deal may fail to close or it may close under terms that are different than those announced initially. Other risks include the risk that delays in the completion of a deal may impact fund returns negatively. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. Please see the end of this report for the definition of the HFRI ED: Merger Arbitrage Index.

[2] A merger arbitrage spread reflects the difference between a target company's current stock price and the acquisition price.

Risks 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. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

HFRI Event Driven: Merger Arbitrage Index - Merger Arbitrage strategies which an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations which pre-, post-date or situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross border, collared and international transactions which incorporate multiple geographic regulatory institutions, with typically involve minimal exposure to corporate credits. Merger arbitrage strategies typically have over 75% of positions in announced transactions over a given market cycle. An index is unmanaged and not available for direct investment.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.