PURSUING SUCCESSFUL OUTCOMES

With Three Principles of Investing
Challenges across the investment landscape

Major socioeconomic forces are changing how we all save and invest—how we think about money, how we make financial decisions, and even our expectations for the future.

- **Demographic changes:** A significant transfer of wealth is shifting investable assets to women and Millennials.
- **Increasing longevity:** The cost of retirement continues to rise for individuals and employers, along with a looming crisis of a retirement income shortfall.
- **Lower-return environment:** Investors face lower expected returns overall, with greater need for diversified returns, lower costs, and better risk management.
- **Information technology:** Investors are exposed to so much real-time information that it can be difficult to distinguish true insights from noise.
- **Wealth management service model:** The traditional model of portfolio advice is shifting toward providing a higher level of financial well-being.
- **Fiduciary’s role:** This responsibility is more complicated and more important than ever. Fiduciaries need insightful information and reliable products.
- **Rising rates:** After a decade of ultra low interest rates, institutional investors now need to manage long-dated obligations through this rising-rate environment.

How should investors address these challenges, and where are the opportunities? What tools and information do they need, and how can we help our clients succeed? These are the questions we focus on every day that establish the framework for how we solve for client needs.

In fact, this paper—and our investment principles behind it—started with client conversations with institutional investors, consultants, and investment professionals. As we learned more about the issues keeping our clients up at night, a clear pattern emerged, outlined in the three goals at right.

- **Build for successful outcomes**
- **Defend portfolios against uncertainty**
- **Create long-term financial well-being**
Three principles of investing

Investors share these common goals—whether they’re investing on behalf of a family, a university endowment, or a corporate retirement plan. How we help all types of investors reach their goals is the basis of our three principles of investing.

These principles support all of the decisions we make as a firm. It’s how we define our product set, how we conduct research and allocate resources, and how we motivate the kind of performance we expect from all of our team members.

Each of these principles is distinct in how it applies to our asset management approach, but all three are connected by a common purpose of focusing on the key challenges facing plan sponsors, consultants, and investment professionals.

1. **Build for successful outcomes by targeting specific exposures.**

   “Our work with clients focuses on their main objectives: growing assets, generating income, or preserving wealth. We build investment strategies to manage to these outcomes, individually or collectively. That requires a deep understanding of return drivers and how to target and diversify them.”

   **Nicolaas Marais, Co-CEO, Wells Fargo Asset Management**

2. **Defend portfolios against uncertainty by harnessing investment risk.**

   “Identifying and analyzing intended and unintended investment risk is crucial to achieving outcomes for clients. Our multidimensional risk process covers many factors, including industries, countries, and interest rate environments. Defending portfolios against uncertainty is a team effort across all levels of the organization—from oversight by the CIO to security research by analysts.”

   **John Hockers, Co-Head of Portfolio Risk Management and Analytics**

3. **Create long-term financial well-being by aiming for sustainability.**

   “I’m often asked what sustainability has to do with investing. I think it’s really the basis for ensuring long-term successful outcomes—whether that means investing in companies that generate strong returns along with a positive impact, or ensuring an employee’s retirement security, or preserving a family’s wealth across generations.”

   **Fredrik Axsater, Head of Strategic Business Segments**
Build for successful outcomes
By targeting specific exposures

Assets are more than just numbers on a spreadsheet. It’s what these assets represent that matters—securing a retirement plan, paying down debt, funding causes we care about—as we build the life we want to live. The same is true for investing. Ultimately, it is about meeting financial goals, not beating a benchmark.

Our asset management approach is rooted in this principle of building solutions for successful outcomes for investors. That takes a deep understanding of the components that drive returns, mitigate risk, and influence cost in order to grow assets, preserve wealth, or generate income.

Key insights for building successful outcomes

**Why manage to an outcome?**
Beating a benchmark is not very rewarding when that benchmark is down. What matters most is how an investment strategy helps advance financial goals. Focusing on the outcome provides discipline. It safeguards good investment choices for the long term. And it resists chasing after elusive investment trends.

**How do investors benefit from transparency?**
Transparency provides a better understanding of the manager’s rationale and is essential to ensuring that the portfolio is being managed as expected so that investors can be confident in meeting their longer-term financial goals.

**Is cost as important as risk or return?**
Performance doesn’t happen in a vacuum, and gross returns have no practical function. Investors need portfolios that wring out efficiency from every basis point, especially in a low-return environment.

**What does accountability add to the investment process?**
Accountability demands that asset managers not only express conviction but also bear full responsibility for their views. It must be incorporated into the investment process, protocols, and technology. Investors are accountable to their own families, investment boards, and other stakeholders; they should expect the same of their asset managers.

**What are signs of consistency in alpha?**
Outperformance can come from luck or skill. The problem is that it’s difficult to know whether a manager will be lucky or skilled in the future. The key is in identifying rigor and resources at the stock, sector, and asset-class levels. How a manager makes a decision is just as meaningful as the decision itself.
Successful outcomes depend on a precise combination of elements

Investors have different investment objectives, based on their financial goals. We aim to help investors achieve their investment objectives by focusing on outcomes, such as growing assets, preserving wealth, or generating income. That starts with an organizational culture that rewards initiative and expects autonomy with responsibility. It calls for high expertise from all investment professionals. It ensures a disciplined and efficient portfolio construction process to reduce the possibility of unintended consequences. Above all, it focuses these strengths in pursuit of investor needs.

CASE IN POINT

Advisors embrace a new challenge

Many financial advisors today have transitioned their business model from a transaction-based approach to goals-based wealth management. This change redefines how success is measured and results in changing client expectations. Client conversations become more focused on comprehensive investment strategies that directly relate to client goals. These goals change over time—typically from growing assets to preserving wealth and generating retirement income, and, ultimately, to transferring wealth. Whether the risk/return profile looks as if it will meet these goals over time and how efficiently it will do so is becoming an important component of how advisors choose strategies.
2 Defend portfolios against uncertainty
By harnessing investment risk

Risk is not just about standard deviations or correlations or other quantitative measures. Risk is personal—it is the uncertainty around whether an investor will be able to meet their goals—whether a loss will prevent them from buying a house, launching a new business, or funding retirement benefits.

Risk is directly connected to building successful outcomes because the real risk is the possibility of not achieving those goals.

Key insights for defending against uncertainty

**How can risk be avoided?**
Risk is inescapable. The answer is not to avoid all investment risk because that amplifies opportunity cost. Holding cash may have little downside risk, but there is limited growth potential. Risk management is about finding a balance that is most likely to lead to a successful outcome. That looks very different for an investor seeking to grow assets and another seeking to preserve wealth.

**What is the trade-off for managing risk?**
A portfolio that minimizes downside risk will likely sacrifice upside return potential. The optimal trade-off depends on the manager’s market insights and the investor’s goals.

**How can unintended risk be minimized?**
A comprehensive investment risk management process makes both intended and unintended risks transparent to portfolio managers and senior management and, ultimately, to investors. It delivers actionable recommendations that can potentially help add alpha and provides a consistent and unbiased framework for identifying, evaluating, and overseeing unintended risk.

**How does risk evolve over time?**
When markets are stressed, correlations between assets typically increase while liquidity risk and other forms of market risk spike. Perceptions of risk are also influenced by market environments. For example, investors who gravitate to high-risk assets in a low-yield environment may end up with portfolios that no longer reflect their longer-term goals.

The framework for risk management must be closely connected to a planned outcome, so that risk exposure reflects the investor’s goals. That requires casting a wider net for effective analytics across traditional market risks (sector, style, country, currency, duration, and credit quality) as well as nontraditional risks, such as environmental, social, and governance (ESG) factors. Combined with advanced statistical analysis—including artificial intelligence and simulation—this can help improve investment processes over time.
CASE IN POINT

Applying risk-based solutions more broadly

One positive outcome of the financial crisis is the deeper understanding of all facets of risk. All types of investors and investment consultants recognize a greater need for risk management techniques that target different components of the portfolio for different purposes. That runs the spectrum from using alternative risk premia, which have very low correlation to stocks and bonds, to dynamic hedging strategies. Risk has become part of most investment conversations, influencing how investors evaluate asset managers.

Risk trade-off for three common portfolio techniques

Every portfolio management technique involves a trade-off. Here, we illustrate three portfolio techniques and their trade-offs among 1) return potential (generating outperformance), 2) reactivity to drawdowns (avoiding losses), and 3) consistency of reaction (managing against uncertainty). How a strategy trades off these objectives should reflect the strategy’s desired investment outcome along with the manager’s insights, with the goal of improving the investment process—all along with investors’ outcomes—over time.
Investors’ definition of prosperity has changed. It’s longer term, more inclusive, and more goal-oriented. The way investors measure success is also more informed. It’s often centered around well-being and engagement. It’s about achieving a higher level of satisfaction and having an impact, financially and purposefully.

Financially: As retirement years increase, so does the burden of funding. Investors are confused about how much to save and how to invest, looking to employers and advisors for answers.

Purposefully: At the same time, investors are more aware of how they use their financial capital and of the potential to achieve strong returns along with a positive impact.

Key insights for creating long-term financial well-being

How can investment professionals solve the through-retirement challenge for investors?
Employers are making defined contribution (DC) plans more effective with improved plan features, and advisors are guiding investors toward healthier saving and investing behaviors that are in line with retirement goals. But there is still an important piece missing from the retirement puzzle: a guaranteed source of retirement income, either built into the DC plan or provided by an advisor, to limit an investor’s risk of outliving their savings.

What is keeping plan sponsors from making retirement income solutions a standard feature?
Much of the progress made with DC plans has been on the accumulation side—improving participation, contributions, and asset allocation. As the workforce ages, the focus now is shifting to the decumulation phase. Retirement income solutions are now more flexible, more effective, and easier to implement for plan sponsors, and they are easier to use for participants. Employers are also more aware of the need to improve financial well-being as part of their strategic workforce management, while employees are more aware of their need for help in managing longevity risk.

Why should investment professionals consider including environment, social, and governance (ESG) strategies?
ESG investing connects investors’ personal values with making progress toward their financial goals. This can create a powerful investment experience and may motivate investors toward better decisions in their DC plans and their personal investment accounts. Education is a key component to explaining the potential benefits and guiding investors who are interested but do not know where to begin. Advisors are seeing strong current growth with high-net-worth investors (who want their investments to provide more than a financial return) and expect future growth with Millennials (who are committed to ESG issues but whose investable assets are still low). And for institutional investors—including foundations, endowments, and retirement plans—ESG strategies can demonstrate to stakeholders that investments are aligned with their purpose but not at the expense of potential returns.
There is a sound business case for long-term sustainability. It’s not about lowering return expectations. It’s about modernizing the investment approach and broadening the definition of performance. Sustainability provides another lens with which to view and weigh options in pursuit of long-term financial well-being for all types of investors.

Research highlights: Wells Fargo/Gallup Investor and Retirement Optimism Index

1. **Financial wellness:** Research conducted by Wells Fargo and Gallup in 2017 suggests that 98% of nonretired investors in the U.S. are looking for an additional guaranteed income stream beyond Social Security and have no idea how to achieve it.
   - 61% are willing to give up access to some of their savings for guaranteed income.
   - 75% also want flexibility in spending their savings, even if it means they might outlive savings.

   The good news is that investors know they need some income guarantee and they want it.

2. **Investment purpose:** ESG strategies may deliver sustainability for investors’ retirement goals along with the causes they care about most. But there is still a need for education on the investment objectives and potential benefits of ESG strategies. Interest doubles across all participant segments when investors understand and connect with the impact on ESG issues.

   Although this survey was conducted with U.S. investors, we see these trends toward a greater need for financial security, flexibility, and investment purpose as more global in nature.

**Investors are interested in doing good**

- 78% of surveyed investors expressed interest in protecting the environment, including fighting climate change and supporting innovations in energy, pollution, and waste management.
- 76% of surveyed investors expressed interest in doing social good, such as promoting diversity and inclusion, improving education, and protecting human rights.
- 74% of surveyed investors expressed interest in responsible corporate governance, including ethics and other behaviors.

**CASE IN POINT**

**Making financial well-being a strategic workforce priority**

Most organizations have watched their workforce change dramatically over the past 20 years. The average employee is older and represents higher retirement costs. But that also can come with a higher level of specialization that strengthens the business.

These are the kinds of issues that fall within strategic workforce planning. Organizations that succeed in building a framework that aligns their human capital with their strategic priorities will create significant efficiencies. They will be able to maintain the right kind of benefits packages that attract top-quality talent, which supports future growth. That will build more awareness about the importance of financial wellness for employees and their families. For many, that will be life-changing.

**Interest more than doubles when investors understand and can connect with ESG’s impact**

- 33% of surveyed investors are interested in ESG investments.
- 76% of surveyed investors are interested, on average, in ESG themes when specific impact is expressed.
- 59% of surveyed investors are interested in doing good with their investments while achieving financial objectives.
For more asset management insights

Working together is key to success for our shared mission of helping clients achieve their financial goals—whether planning for retirement, finding investments that align with personal values, or building portfolios for the fluctuating markets of today and tomorrow. To continue a discussion on how we can work together to meet these objectives, please refer to the following Wells Fargo Asset Management contacts:

• To reach our U.S.-based investment professional partners, please contact your existing client relations director or regional sales director at 1-888-877-9275.

• To reach our U.S.-based retirement partners, please contact Nathaniel Miles, Head of Defined Contribution at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.

• To reach our international partners, please contact your existing regional client relations or sales director, or call Ben Foley at +44 20 7518 2947.

• To discuss environmental, social, and governance (ESG) investing solutions, please contact Jessica Mann, Head of ESG at Wells Fargo Asset Management, at jessica.mann@wellsfargo.com.
Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

Stock values fluctuate in response to the activities of individual companies and general market and economic conditions. Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable.

Investing in ESG carries the risk that, under certain market conditions, the investments may underperform products that invest in a broader array of investments. In addition, some ESG investments may be dependent on government tax incentives and subsidies, and on political support for certain environmental technologies and companies. The ESG sector may also have challenges such as a limited number of issuers and liquidity in the market, including a robust secondary market. Investing primarily in responsible investments carries the risk that, under certain market conditions, an investment may underperform funds that do not use a responsible investment strategy.

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