WELLS FARGO
INVESTMENT INSTITUTE

Global Investment Strategy

Four Steps of Successful Investing

Tracie McMillion, CFA
Head of Global Asset Allocation Strategy

Sameer Samana, CFA
Senior Global Strategist

Key takeaways

- *Uncertainty is nothing new; it's always part of investing. One key to success is how you deal with it.*
- *We recommend four steps for investors to prepare for what could be ahead.*
- *Start with a plan, which involves defining your goals and determining a strategic asset allocation—how your portfolio is diversified—to help you achieve them.*
- *Construct your portfolio based on your chosen allocation.*
- *Globalize your portfolio to include appropriate levels of international investments in addition to U.S. investments.*
- *Maintain alignment to your plan over time to help ensure your investments adhere to your allocation in spite of market movements and the passage of time.*

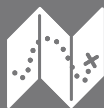
Investment and Insurance Products: ▶NOT FDIC Insured ▶NO Bank Guarantee ▶MAY Lose Value

Dealing With the Certainty of Uncertainty

Investors have many questions weighing on their minds these days, ranging from whether the positive returns in the global equity markets will continue to when and how quickly U.S. interest rates may increase to whether the global economic outlook is healthy. While these are important questions, and the answers could have great bearing on the direction of financial markets, what many investors may really want to know is how each of these factors will impact their individual financial circumstances today and tomorrow.

For some investors, it may seem the issues they face today are much more complex and daunting than those in the past, and in some ways that may be true. However, investors invariably have to deal with an element of uncertainty. Although the specific questions and concerns investors face may change over time, the timeless nature of uncertainty in investing is why we encourage investors to focus on the basics. We believe the biggest risk investors face is not a market downturn but the risk of not meeting their financial goals. We have identified four steps we believe will help investors meet their financial goals. In this report, we describe each of these steps.

Four Steps of Successful Investing



STEP 1
Start With a Plan

STEP 2
Construct Your Portfolio

STEP 3
Globalize Your Portfolio

STEP 4
Maintain Alignment to Your Plan

STEP 1

Start With a Plan

Each investor is unique. Just as you chose your career and lifestyle according to your personality, you should work with your advisor to develop an investment plan that is compatible with your own personal style. You want a plan that is durable enough for the long term. In other words, you don't want one you will abandon out of fear when times get tough. And while you want a flexible plan to accommodate big life changes, you want to stay focused on your goals.

What are your goals?

In developing your plan, you will first need to identify your financial goals. Each of these goals can be matched to a time when you will need to access funds to accomplish the goal. Some will be near-term goals, like establishing a "rainy day fund" to help with paying the day-to-day bills should you experience an interruption in your income. Others may be intermediate-term goals, such as paying for a child's college tuition or buying a new or vacation home. Still others may be longer-term goals, like helping finance a comfortable retirement or perhaps leaving something for future generations or charitable organizations.

Starting with shorter-term goals means identifying how much liquidity, readily accessible funds, you need to cover day-to-day expenses should you experience an interruption in your regular income or a significant unexpected expense. Carving out a cash fund to meet household expenditures can help you financially prepare for such events by allowing you to pay these expenses for a period of time. Having sufficient cash reserves set aside should allow you to avoid selling investments that have fallen in value before they have a chance to recover.

We call this cash fund your "number," or the amount of cash you need to set aside so you can remain committed to your longer-term investment plan. Some investors might consider one or two years' worth of living expenses as a reasonable "number." For others, six to nine months' worth of living expenses may be sufficient. Like the investment plan, this "number" is unique for each investor.

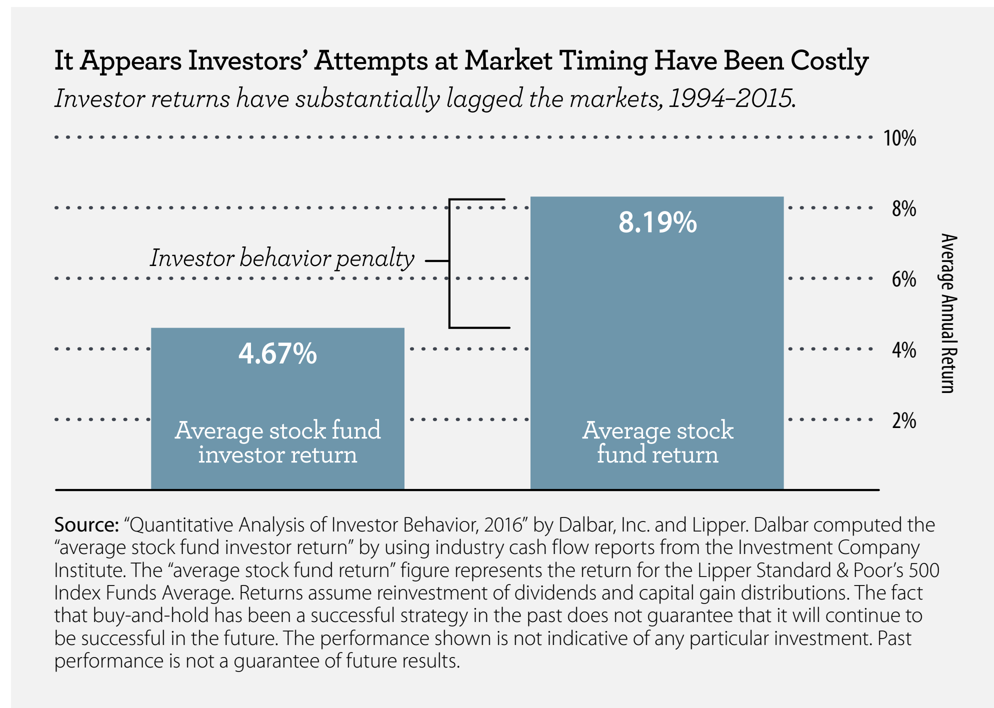
With this cash set aside for emergencies, you can focus on your intermediate- and longer-term goals. Keeping in mind what goals your money is targeted to accomplish can help you decide what types of assets are appropriate for funding each of your goals. For example, if you're saving for college tuition for a newborn child, then stocks may be an appropriate choice. If stocks should plunge in value, as they did in 2008-2009, there are plenty of years remaining for the market to potentially recover before your child will need the funds. And if you are investing in stocks regularly over time, you should be buying more shares at lower prices. On the other hand, money you plan to use for a down payment on a house in two years would be better left in cash or short-term fixed income.

Prepare to manage your emotions amid changing circumstances

An important consideration when choosing an appropriate mix of assets is your risk tolerance. Understanding your own tolerance for risk is essential to sticking to your plan. Ask yourself how easily you begin to panic when market volatility surges and the value of your portfolio fluctuates significantly. How prepared are you to look beyond short-term market dips and ride out the bad times without abandoning your long-term strategy?

Human emotions, especially fear and greed, play an important role in investor behavior. Unfortunately, these emotions often do not lead to good investment decision-making. Consider Dalbar's well-respected annual study that calculates the returns for average investors and compares them to the mutual fund universe and equity market returns. Interestingly, it turns out the average retail investor fares much worse than both the mutual fund universe and the broader market (see chart below). This result is due mainly to performance-chasing behavior, in which investors allocate more funding to assets that have done well recently and ignore those that have done poorly. We call this tendency the "investor behavior penalty."

An example of this phenomenon at its most extreme is the collective investor behavior following the 2008-2009 financial crisis. More specifically, our research suggests cash alternative levels of investor portfolios still remain elevated and investors' allocation to equities, as an asset class in well-diversified portfolios, remains below recommended levels. This type of risk-averse behavior can keep investors from achieving their financial objectives and most likely is an indication that their fears are getting in the way of sound decision-making.

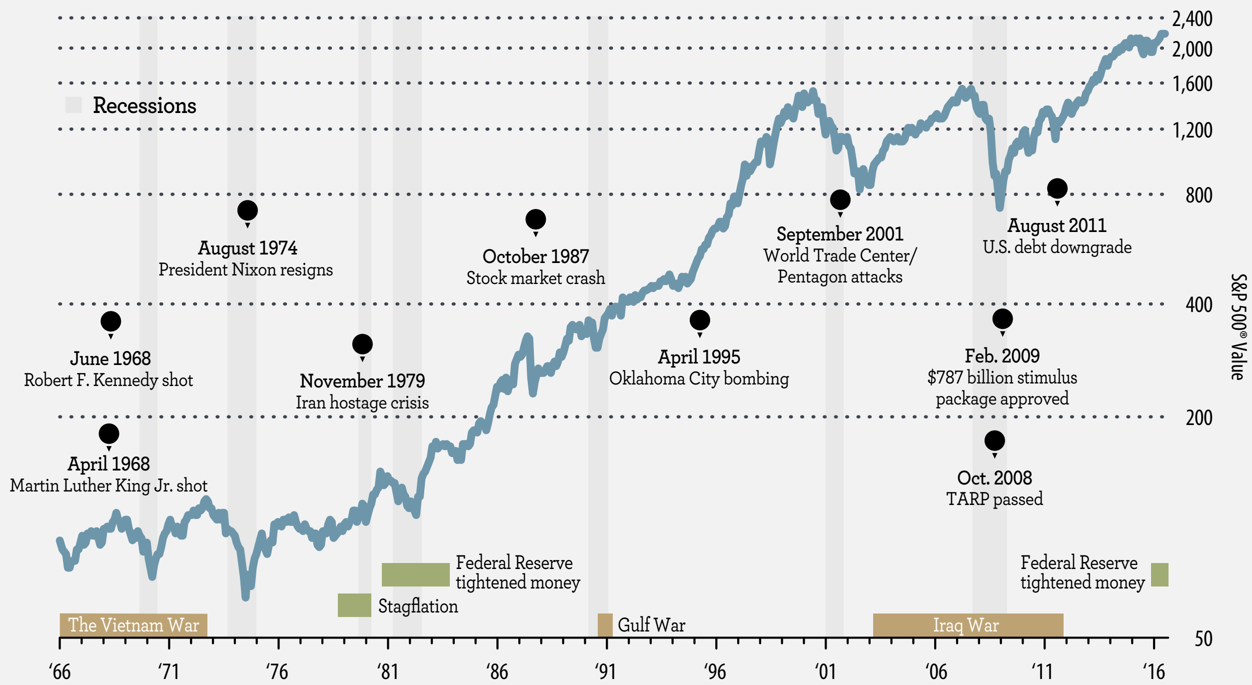


Source: "Quantitative Analysis of Investor Behavior, 2016" by Dalbar, Inc. and Lipper. Dalbar computed the "average stock fund investor return" by using industry cash flow reports from the Investment Company Institute. The "average stock fund return" figure represents the return for the Lipper Standard & Poor's 500 Index Funds Average. Returns assume reinvestment of dividends and capital gain distributions. The fact that buy-and-hold has been a successful strategy in the past does not guarantee that it will continue to be successful in the future. The performance shown is not indicative of any particular investment. Past performance is not a guarantee of future results.

The Times When It's Hardest to Invest May Be the Best

Historically, difficult periods have proven to be good times to invest in stocks.

Performance of the Standard & Poor's 500® Composite Index, 1965-2016



Logarithmic scale

Sources: Wall Street Journal, Haver Analytics, and Wells Fargo Investment Institute

Looking at the chart above, we can see that some of the best years for stock market performance were fraught with concern. The last eight years are a testament to this principle as investors who have avoided stocks due to fear of another crisis may have missed out.

Other poignant reminders of how stocks can outperform during periods of crisis include 1991, amidst the Iraq War and a U.S. economic recession, and the years following the September 2001 terrorist attack. Even after the stock market appreciation of the past eight years, our outlook for corporate profits and further gains in equities is still positive while the prospects for cash alternatives holdings earning near-zero yields remain unattractive. We recommend investors work with their financial professionals to develop a plan to reallocate excess cash holdings as time spent in the markets is much more important than timing markets.

Clearly, investors may doubt their investment decisions in a downturn when portfolio value is declining and become too conservative. Conversely, in a rising market, investors may become overconfident and end up investing too aggressively. Both of these are examples of failing to stick with an investment plan to the detriment of future financial goals.

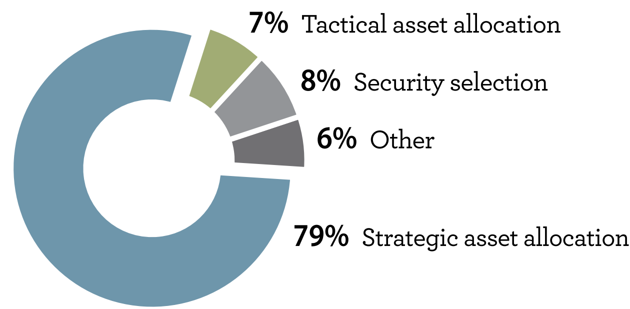
STEP 2

Construct Your Portfolio

Each of your financial goals has different attributes: priority; time horizon; and the need for liquidity, income, or growth. As a result, each goal has a unique investment objective—and a distinct combination of assets that is most likely to help achieve the goal. Establishing this combination (or strategic allocation) is your most important investment decision. The strategic allocation is by far the biggest determinant of portfolio return variability (the year-to-year variation in returns).

Asset Allocation Is Your Most Important Investing Decision

Studies have shown asset allocation is often a crucial determinant of portfolio performance. The other factors shown have proven to have much less impact on the variability of returns over time. Strategic asset allocation has a 10- to 15-year horizon while tactical asset allocation has a 6- to 18-month time horizon. Strategic allocation, therefore, deserves considerable focus and effort.



Wells Fargo. The Journal of Wealth Management, Vol. 8, No. 3, "Strategic Asset Allocation and Other Determinants of Portfolio Returns," August 2005, data updated February 2010.

Asset allocation/investment timing cannot eliminate the risk of fluctuating prices and uncertain returns.

The capital markets offer a variety of investments that perform different functions. In general, growth = stocks, income = bonds, stability = short Treasury bonds, and inflation protection = gold. But this oversimplified view ignores the benefits of broader diversification. For example, income can come from a variety of sources beyond bonds, such as high-dividend stocks and real estate investment trusts (REITs), and commodities beyond gold can provide a hedge against inflation. For this reason, we recommend a wide range of asset types for a portfolio.

Even so, investors may be tempted to look for a singular investment strategy, such as holding an entire portfolio in cash alternatives because the market is near an all-time high or investing entirely in U.S. stocks since the rest of the world seems worse off. Such strategies would likely be counterproductive, however, because markets rarely maintain a trend for very long. The "quilt chart" on the next page shows that, just as a performance trend becomes established for an asset class such as emerging markets or fixed income, we frequently observe a sharp reversal of that trend.

Notice the moderate growth and income portfolio (in white) has never been either the best nor the worst performer in any given year. It comprises a variety of asset classes that together create a smoother return path even though, individually, the components may be quite volatile from year to year. Combining different assets in a diversified portfolio can help investors benefit from the overall upward trend in markets but with lower levels of volatility.

The Value of Asset Allocation

Being diversified has helped stabilize portfolio performance.

Calendar-year asset class and Balanced Portfolio returns

Performance	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Best	REIT's 38.0%	EM-Mkt Stocks 34.5%	REIT's 42.4%	EM-Mkt Stocks 39.8%	Dev-Mkt Bonds 11.4%	EM-Mkt Stocks 79.0%	Small-Cap Stocks 26.9%	EM-Mkt Bonds 8.5%	REIT's 28.7%	Small-Cap Stocks 38.8%	REIT's 15.9%	Large-Cap Stocks 1.4%	Small-Cap Stocks 21.3%
	EM-Mkt Stocks 26.0%	Commodities 21.4%	EM-Mkt Stocks 32.6%	Commodities 16.2%	Inv-Grade Bonds 5.2%	High-Yield Bonds 58.2%	Mid-Cap Stocks 25.5%	Inv-Grade Bonds 7.8%	EM-Mkt Stocks 18.6%	Mid-Cap Stocks 34.8%	Large-Cap Stocks 13.7%	EM-Mkt Bonds 1.2%	High-Yield Bonds 17.1%
	Intl Stocks 20.7%	REIT's 15.4%	Intl Stocks 26.9%	Intl Stocks 11.6%	Treasury Bills 2.1%	Mid-Cap Stocks 40.5%	REIT's 20.4%	Dev-Mkt Bonds 5.9%	EM-Mkt Bonds 18.5%	Large-Cap Stocks 32.4%	Mid-Cap Stocks 13.2%	Inv-Grade Bonds 0.5%	Mid-Cap Stocks 13.8%
	Mid-Cap Stocks 20.2%	Intl Stocks 14.0%	Small-Cap Stocks 18.4%	Dev-Mkt Bonds 11.3%	EM-Mkt Bonds -10.9%	REIT's 38.3%	EM-Mkt Stocks 19.2%	High-Yield Bonds 5.0%	Intl Stocks 17.9%	Intl Stocks 23.3%	Inv-Grade Bonds 6.0%	REIT's 0.1%	Large-Cap Stocks 12.0%
	Small-Cap Stocks 18.3%	Mid-Cap Stocks 12.7%	Large-Cap Stocks 15.8%	Hedge Funds 10.0%	Hedge Funds -19.0%	Intl Stocks 32.5%	Commodities 16.8%	Large-Cap Stocks 2.1%	Mid-Cap Stocks 17.3%	Balanced Portfolio 9.9%	EM-Mkt Bonds 5.5%	Treasury Bills 0.0%	Commodities 11.8%
	Balanced Portfolio 14.0%	EM-Mkt Bonds 10.7%	Mid-Cap Stocks 15.3%	Balanced Portfolio 8.3%	Balanced Portfolio -25.2%	EM-Mkt Bonds 28.2%	High-Yield Bonds 15.1%	Treasury Bills 0.1%	Small-Cap Stocks 16.3%	Hedge Funds 9.1%	Small-Cap Stocks 4.9%	Intl Stocks -0.4%	EM-Mkt Stocks 11.6%
	Dev-Mkt Bonds 12.0%	Hedge Funds 9.3%	Balanced Portfolio 15.2%	Inv-Grade Bonds 7.0%	High-Yield Bonds -26.2%	Balanced Portfolio 27.3%	Large-Cap Stocks 15.1%	Balanced Portfolio -0.7%	Large-Cap Stocks 16.0%	High-Yield Bonds 7.4%	Balanced Portfolio 4.9%	Hedge Funds -1.1%	EM-Mkt Bonds 10.2%
	EM-Mkt Bonds 11.7%	Balanced Portfolio 8.8%	Hedge Funds 12.9%	EM-Mkt Bonds 6.3%	Small-Cap Stocks -33.8%	Small-Cap Stocks 27.2%	Balanced Portfolio 13.7%	Mid-Cap Stocks -1.5%	High-Yield Bonds 15.8%	REIT's 4.4%	Hedge Funds 3.6%	Balanced Portfolio -1.9%	Balanced Portfolio 9.0%
	High-Yield Bonds 11.1%	Large-Cap Stocks 4.9%	High-Yield Bonds 11.8%	Mid-Cap Stocks 5.6%	Commodities -35.6%	Large-Cap Stocks 26.5%	EM-Mkt Bonds 12.0%	Small-Cap Stocks -4.2%	Balanced Portfolio 12.3%	Treasury Bills 0.0%	High-Yield Bonds 2.5%	Mid-Cap Stocks -2.4%	Hedge Funds 5.6%
	Large-Cap Stocks 10.9%	Small-Cap Stocks 4.6%	EM-Mkt Bonds 9.9%	Large-Cap Stocks 5.5%	Large-Cap Stocks -37.0%	Hedge Funds 20.0%	Hedge Funds 10.2%	Hedge Funds -5.3%	Hedge Funds 6.4%	Inv-Grade Bonds -2.0%	Treasury Bills 0.0%	Small-Cap Stocks -4.4%	REIT's 5.0%
	Commodities 9.1%	Treasury Bills 2.9%	Dev-Mkt Bonds 6.8%	Treasury Bills 4.9%	Mid-Cap Stocks -41.5%	Commodities 18.9%	Intl Stocks 8.2%	REIT's -5.8%	Inv-Grade Bonds 4.2%	EM-Mkt Stocks -2.3%	EM-Mkt Stocks -1.8%	High-Yield Bonds -4.5%	Inv-Grade Bonds 2.6%
	Hedge Funds 9.0%	High-Yield Bonds 2.7%	Treasury Bills 4.7%	High-Yield Bonds 1.9%	Intl Stocks -43.1%	Inv-Grade Bonds 5.9%	Dev-Mkt Bonds 6.8%	Intl Stocks -11.7%	Dev-Mkt Bonds 0.8%	Dev-Mkt Bonds -5.1%	Dev-Mkt Bonds -2.5%	Dev-Mkt Bonds -4.8%	Dev-Mkt Bonds 1.9%
	Inv-Grade Bonds 4.3%	Inv-Grade Bonds 2.4%	Inv-Grade Bonds 4.3%	Small-Cap Stocks -1.6%	REIT's -47.7%	Dev-Mkt Bonds 3.9%	Inv-Grade Bonds 6.5%	Commodities -13.3%	Treasury Bills 0.1%	EM-Mkt Bonds -6.6%	Intl Stocks -4.5%	EM-Mkt Stocks -14.6%	Intl Stocks 1.5%
Worst	Treasury Bills 1.1%	Dev-Mkt Bonds -9.2%	Commodities 21.4%	REIT's -7.0%	EM-Mkt Stocks -53.2%	Treasury Bills 0.2%	Treasury Bills 0.1%	EM-Mkt Stocks -18.2%	Commodities -1.1%	Commodities -9.5%	Commodities -17.0%	Commodities -24.7%	Treasury Bills 0.3%

- **Balanced Portfolio:** See below
- **Treasury Bills:** Bloomberg Barclays U.S. Treasury Bills (1-3 month) Index
- **Commodities:** Bloomberg Commodity Index
- **International Stocks:** MSCI EAFE (Europe, Australasia, Far East) Index
- **Emerging Market Stocks:** MSCI Emerging Markets Index
- **Investment Grade Bonds:** Bloomberg Barclays U.S. Aggregate Bond Index
- **Hedge Funds:** HFRI Fund Weighted Composite Index
- **High-Yield Bonds:** Bloomberg Barclays U.S. Corporate High Yield Bond Index
- **Developed Market Bonds:** JP Morgan Global Ex United States Index
- **Emerging Market Bonds:** BofA Merrill Lynch Global High Yield & Emerging Market Index
- **Large-Cap Equity:** S&P 500 Index
- **Mid-Cap Equity:** Russell Mid-Cap Index
- **Small-Cap Equities:** Russell 2000 Index
- **REIT Equity:** FTSE EPRA/NAREIT Equity Index

Sources: Wells Fargo Investment Institute and Morningstar Direct. As of Dec. 31, 2016. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment. Different investments offer different levels of potential return and market risk. Please see pages 14-15 for the descriptions of the risks associated with these asset classes and definitions of the indices. The historical returns for the Balanced Portfolio are rebalanced monthly to target allocations at the beginning of each period. Representative performance figures do not reflect actual trading or material economic and market factors that would affect decision-making. Performance results in actual portfolios will be reduced by fees, actual trading costs, and other expenses. Returns assume reinvestment of dividends and other distributions.

Balanced Portfolio: 3% Bloomberg Barclays U.S. Treasury Bills 1-3 Months; 19% Bloomberg Barclays U.S. Aggregate Bond Index; 5% Bloomberg Barclays U.S. Corporate High Yield Index; 5% JPM GBI Global Ex-U.S. Index; 5% JPM EMBI Global Index; 16% S&P 500 Index; 6% Russell Mid Cap Index; 3% Russell 2000 Index; 10% MSCI EAFE Index, 6% MSCI EM Index, 7% FTSE EPRA/NAREIT Developed Index; 5% Bloomberg Commodity Index; 4% HFRI Relative Value Arbitrage Index; 2% HFRI Macro/CTA Index; 4% HFRI Event Driven Index.

STEP 3

Globalize Your Portfolio

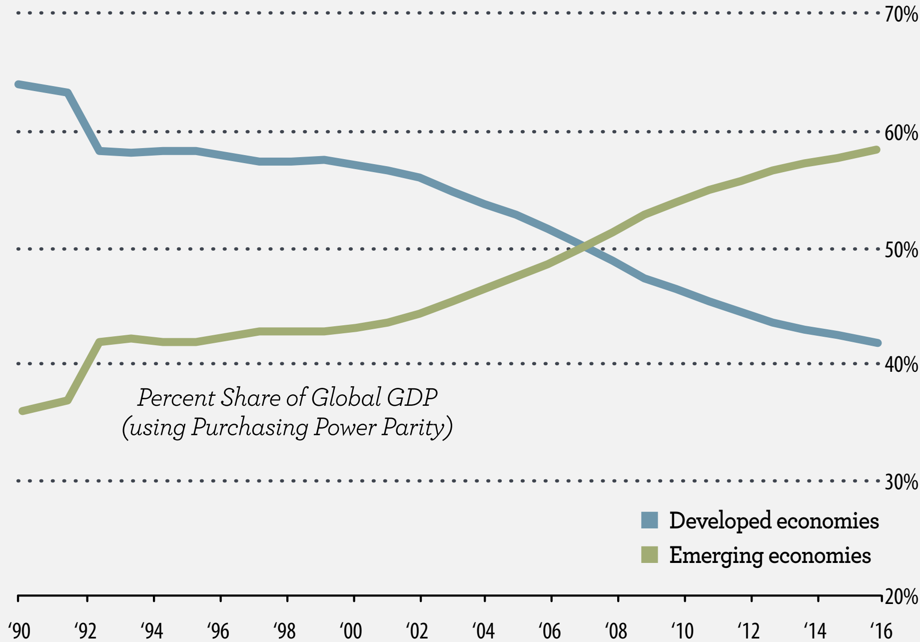
Building a diversified portfolio often means adding appropriate levels of international assets. Yet, many investors gravitate toward easily recognizable domestic companies. Interestingly, globalization has led to many large multinationals becoming household names in the U.S. Products from international companies like Nestlé, Unilever, Royal Dutch Shell, BMW, and Toyota, are seen everywhere we look. While the U.S. economy may continue to outperform most other developed markets over the next few years, rankings in relative economic performance constantly change, and it is hard to see a scenario in which international stocks will not benefit from a strengthening U.S. and global economy. We encourage investors not to become too discouraged by the recent negativity surrounding certain regions, such as the euro area, and focus on the long-term positive outlook for global economic growth.

Exposure to faster-growing emerging markets can add another layer of diversification to a portfolio. As seen in the chart on page 9, emerging markets are contributing more to global economic growth than ever before. Countries like China, India, and Brazil are making their presence felt on the global stage. The emergence of this economic powerhouse is a major shift that has occurred in the past decade and is likely to continue as rapid population growth combined with a younger population's desire for a higher standard of living leads global consumption and production in the coming decades. Because these markets are under-developed and their governments tend to be protective of local companies generally, one way for many investors to participate in this growth potential is through emerging-market equities and bonds.

The more informed you are about the spectrum of investments available to you as an individual investor, the more confident you should become about embracing a wide variety of asset classes for a diversified portfolio. Becoming more informed about different types of investments and their roles in a portfolio can also help you establish reasonable expectations and plan accordingly. Longer-term risk and return assumptions can be estimated based on the historical and current performance of different types of investments. When combined into a portfolio (the strategic allocation), reasonable expectations about future portfolio returns can be established. While expected returns are just that—expected—they can help an investor plan for an uncertain future.

Emerging Economies Have Overtaken Developed Economies

The percentage of global GDP contributed by emerging economies eclipsed that from developed economies several years ago.



The Purchasing Power Parity (PPP) exchange rate is defined as the amount of currency needed to purchase the same basket of goods and services as one unit of the reference currency, usually the U.S. dollar.

Sources: International Monetary Fund (IMF) and Wells Fargo Investment Institute, 12/16

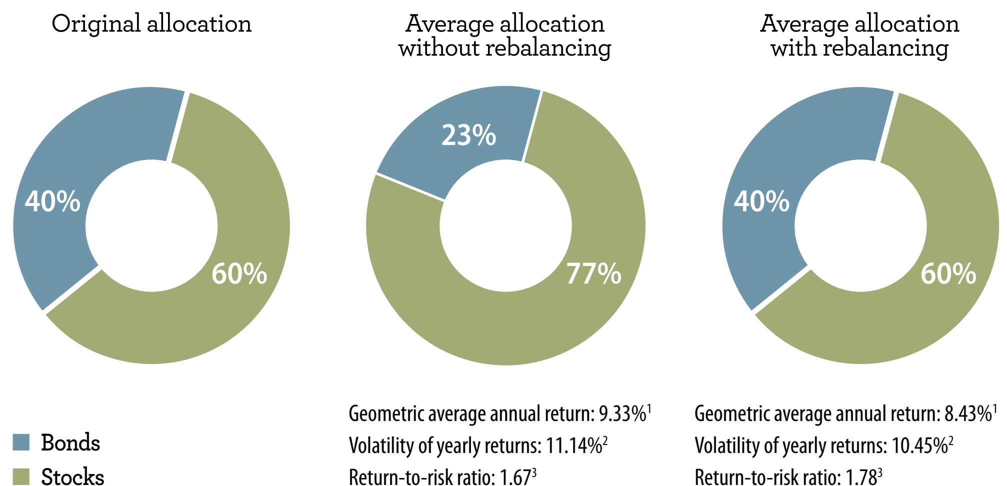
STEP 4

Maintain Alignment to Your Plan

Market movements and the passage of time should prompt a regular review of your portfolio. The big move higher in U.S. equities over the last eight years is a great example. While there may still be time for those investors who remain in cash alternatives to participate in the markets again, many others who have enjoyed the gains over the past few years may now reap the rewards. As an example, a moderate growth and income investor who did not rebalance their portfolio over the last eight years now likely has too much of their portfolio allocated to stocks, especially U.S. stocks, and too little allocated to international and fixed-income investments. If the stock market were to take a turn for the worse, a portfolio that has drifted far above its strategic equity allocations could exhibit considerably more volatility than a portfolio that adhered to its recommended allocation.

Rebalancing Has Brought Risk-Adjusted Returns

The center portfolio was allowed to drift away from its intended 40%/60% allocation (left portfolio). Although its return was higher, its volatility was greater than the portfolio that wasn't allowed to drift (right portfolio). The return-to-risk ratio is higher for the rebalanced portfolio.



Source: Wells Fargo Investment Institute. In this example, stocks are represented by the S&P 500, and bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond index. The indices are unmanaged and not available for direct investments. Illustrations for period 1/1/2009-12/31/2016.

[1]Geometric average return considers the effects of compounding and is the standard metric for conveying return performance for investments.

[2]Volatility is measured using standard deviation of monthly returns, which is a statistic that reflects the degree of risk surrounding the outcome of an investment decision. The higher the standard deviation, the more the risk.

[3]The return-to-risk ratio is the geometric average annual return divided by the volatility of yearly returns. As the ratio increases, the amount of return for the level of risk goes up.

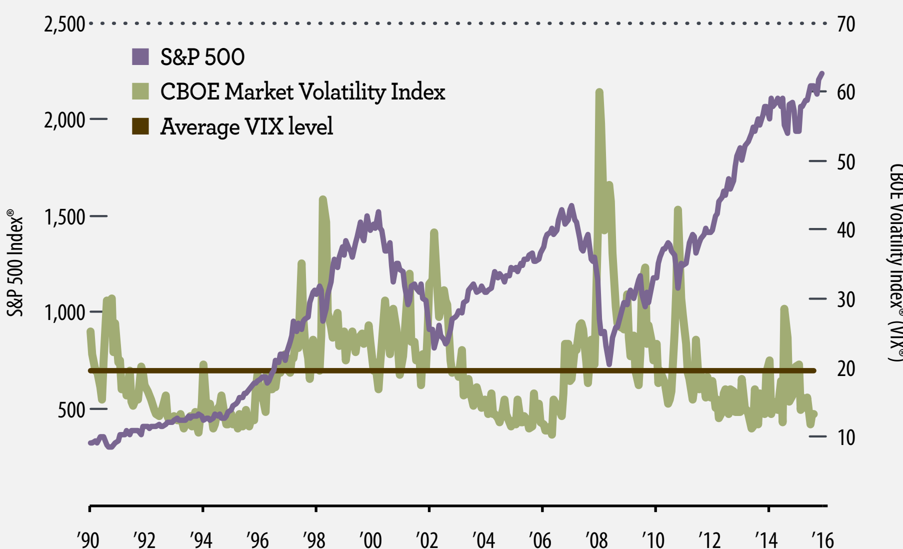
A good way to realign the portfolio is by periodically trimming those asset classes that have gained and investing in underperformers to get the asset allocation back in line with its targets. This is a simple version of the "buy low, sell high" rule. But it is important to recognize that rebalancing a portfolio may trigger capital gain taxes, so tax-sensitive investors need to take this into consideration. A more subtle way of rebalancing is to direct any new funds into asset classes that are underweighted and to fund any cash needs by selling asset classes that are overweighted.

Don't let volatility steer you off course

While it is important to design a solid plan and then implement it using the right mix of assets and proper diversification, your efforts may be all for naught if you are unable to stick to the plan. This risk was less important over the past eight years as stimulative central bank policies helped create a rising tide that lifted nearly all assets higher amidst a backdrop of declining volatility. In the coming years, we expect greater divergence in monetary policy among major central banks, and this could help markets regain some semblance of normalcy. Unfortunately, this normalization process may be accompanied by a return to average levels of volatility (see chart below). In our opinion, any upsurge in volatility will occur alongside a continued rise in equity markets, but as market gyrations increase, investors' resolve may be tested. Starting the planning and implementation process now should allow investors to reposition portfolios and take better advantage of opportunities that additional volatility may create.

We Expect Choppier Waters

From 2009 through 2016, stock investors enjoyed rising markets and falling volatility. However, volatility, as measured by the CBOE Market Volatility Index (VIX), can quickly spike higher giving investors little time to react.



Chicago Board Options Exchange (CBOE) Market Volatility Index (VIX), 2016, 14.04;
S&P 500 Index, 2016, 2,238.83

Periodic reevaluation

There are legitimate reasons to change your investment plan. Life changes such as getting married, buying a home, starting a family and then supporting a child through endeavors such as college and marriage, and your own retirement are just a few examples of significant life changes. As you approach one of these types of life events, this offers an opportune time to reevaluate your investment goals and determine whether any changes are warranted to your overall investment strategy.

Material changes in net worth also provide a reason to reevaluate your investment asset mix. Recent strong performance in the equity markets may have put some investors' portfolios ahead of schedule. These gains could reduce the need for portfolio growth and may even allow less risk taking in the portfolio.

Turning Points That Can Affect Your Investment Plan

20s	30s	40s	50s	60s	70s
Pursuing an advanced degree	Buying a first home	Changing jobs	Losing a loved one	Starting retirement	Planning for charitable giving
Getting first job	Starting a family	Saving for retirement	Receiving an inheritance	Shopping for health care insurance	Changing residences
Getting married	Establishing an investment plan	Saving for children's education	Caring for a family member	Dealing with illness	
	Starting a business	Getting a divorce	Shopping for long-term care	Planning your legacy	

Examples are for illustrative purposes only and may not reflect someone's own experience.
Source: Wells Fargo Investment Institute

Summary and Recommendations

The recent questions on investors' minds we mentioned at the beginning of this report reflect today's economic and geopolitical uncertainty. Wars, disease, and changes in policy are just a few examples of issues that markets and individuals struggle to comprehend. A well-constructed investment plan based on your unique circumstances that is implemented, adhered to, and rebalanced as necessary can help alleviate the anxiety that market gyrations often cause investors. This will be especially helpful if, as we expect, the level of market volatility increases in the coming years.

We believe market volatility should be viewed as a potential opportunity rather than an obstacle for investors. If anything, the last few years of steady gains and low equity market volatility have overshadowed the benefits of discipline and patience. The end of this upward trend and the reemergence of more normal volatility levels could, once again, offer greater rewards to more patient and disciplined long-term investors. To take full advantage of these changes, investors should make sure their portfolios are aligned with their plan.

Is now a good time to embark upon investing, or should you wait for the markets to return to "normal," whatever that may be? It's human nature to long for normalcy. Some investors hesitate to invest during turbulent times. Yet historically, some of the best years for stock market performance also were fraught with concerns.

In our opinion, investors should reduce excess cash alternative holdings in their portfolios, as near-zero interest rates make the prospects for almost all other asset classes more favorable. Stock market valuations remain reasonable, and a combination of low bond yields and improving economic growth supports a positive outlook for corporate profitability. Bond yields, while at the lower end of the historical range, can offer good sources of income and help provide stability to a diversified portfolio. However, longer-duration fixed income instruments and less creditworthy investments, while usually boasting higher yields, come with greater risks. We recommend investors properly diversify within their fixed-income allocation to both traditional and higher-yielding areas, while targeting duration—akin to matching the average number of years to maturity on the bonds in your portfolio to your time horizon.

If you do not have an investment plan, we suggest you develop one with the help of an investment professional. If you already have a plan, check in with your investment professional about updating it for your financial circumstances and goals. Once your goals are identified and reviewed for reasonableness, they should serve as the basis for a well-constructed, long-term strategy. But having a proper investment plan is not enough; you also need to invest in line with the recommended allocations and maintain alignment with your plan over time. Comprehensive monitoring and maintenance of the plan should involve regular rebalancing to help preserve gains, incorporating an element of robustness through diversification, and limiting the amount of risk in your portfolio based on your ability and willingness to do so. Our outlook calls for further gains in equity markets, albeit with greater volatility, so now is a great time to make sure your plan is in place and your investments are appropriately aligned with your goals.

Asset class risk disclosures

Commodities: Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies, which may expose investors to additional risks.

Equity investments: Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

Fixed income: Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. Government bonds are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although government bonds are considered free from credit risk, they are subject to interest rate risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Foreign investments: Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Hedge funds: Alternative investments, such as hedge funds, are not suitable for all investors. Any offer to purchase or sell a specific hedge fund will be made by the product's official offering documents. Investors could lose all or a substantial amount of their investments in these products. Hedge funds are only available to persons who are "accredited investors" or "qualified purchasers" within the meaning of U.S. securities laws. Hedge funds are not required to provide investors with periodic pricing or valuation and are not subject to the same regulatory requirements as other investment products. Hedge funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences. An investment in a hedge fund involves the risks inherent in an investment in securities as well as specific risks associated with limited liquidity, the use of leverage, short sales, options, futures, derivative instruments, investments in non-U.S. securities, "junk" bonds, and illiquid investments.

Real estate: There are special risks associated with an investment in real estate, including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions.

Small- and mid-cap companies: The prices of small- and mid-company stocks are generally more volatile than large-company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification, and competitive strengths to endure adverse economic conditions.

Index definitions

An index is unmanaged and unavailable for direct investment.

Bloomberg Barclays U.S. Aggregate Bond Index is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities. The Bloomberg Barclays U.S. Government/Credit Bond Index is an unmanaged, market-weighted index generally representative of intermediate and long-term government and investment grade corporate debt securities having maturities of greater than one year. The Bloomberg Barclays U.S. Mortgage-Backed Securities Index is an unmanaged index of mortgage pools of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association.

Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

Bloomberg Barclays U.S. Treasury Bills (1-3M) Index is representative of money markets.

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

BofA Merrill Lynch Global High Yield & Emerging Markets Index tracks the performance of the below investment grade global debt markets denominated in the major developed market currencies.

FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

The HFRI Indices currently consist of eight single strategy indices, an asset-weighted Global Hedge Fund Index, and HFRI Equal Weighted Strategies Index, each calculated pursuant to an index methodology. Most HFRI Indices are priced daily. All HFRI Indices are re-balanced quarterly.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include funds of hedge funds.

HFRI Relative Value Index maintains positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types.

HFRI Equity Hedge Index maintains positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios.

HFRI Macro Index is composed of a broad range of strategies in which the investment process is 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 realization of a valuation discrepancy between securities.

HFRI Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is composed of eight strategies: convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.

HFRI Event Driven Index maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance, or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative) with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

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 report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, LLC. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

JP Morgan Global Ex United States Index (JPM GBI Global Ex-US) is a total return, market capitalization weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.

JPM EMBI Global Index is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

Lipper Standard & Poor's 500 Index Funds Average is an average of funds that are passively managed, have limited expenses and are designed to replicate the performance of the S&P 500 Index on a reinvested basis.

MSCI All Country World ex U.S. Index (MSCI AC World Ex U.S.) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S. The index consists of 45 country indices comprising 22 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

MSCI EAFE Index (Europe, Australasia, Far East) Index (MSCI EAFE NR) is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The index consists of the following 21 developed-market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI Emerging Markets Index (MSCI EM NR) is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. The index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value.

About the Authors

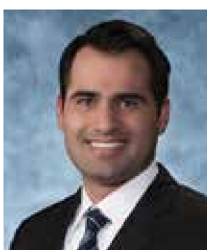
Tracie McMillion, CFA

Head of Global Asset Allocation Strategy

Tracie McMillion is the head of global asset allocation strategy for Wells Fargo Investment Institute (WFII). In her current role, Ms. McMillion leads the development of global investment strategy. She oversees the creation of asset allocation recommendations and writes economic and market commentary and analysis.

Ms. McMillion has more than 18 years of experience in financial services. Prior to her current role, she served as an asset allocation strategist and a senior investment research analyst for Wells Fargo and predecessor firms. Earlier in her career, she served as lead portfolio manager for Evergreen Private Asset Management where she managed assets for high-net-worth clients and philanthropic organizations.

Tracie earned a Bachelor of Arts in Economics and a Master of Business Administration from the College of William and Mary in Virginia. She is a CFA® charterholder and member of the CFA North Carolina Society.



Sameer Samana, CFA

Senior Global Strategist

Sameer Samana is a senior global strategist for WFII. Mr. Samana produces investment advice for the international, commodities, and currencies markets. Prior to joining the international strategy team in 2011, he served in a variety of roles including portfolio manager for the equity portion of Compass ETF portfolios and fixed income trader. He has more than 10 years of experience in financial services.

He earned a Bachelor of Arts in Business Administration with a concentration in Finance from Rhodes College and is a CFA® charterholder.

Wells Fargo Investment Institute, Inc. (WFII) is a registered investment adviser and wholly-owned subsidiary of Wells Fargo & Company and provides investment advice to Wells Fargo Bank, N.A., Wells Fargo Advisors, and other Wells Fargo affiliates. Wells Fargo Bank, N.A. is a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by the Global Investment Strategy (GIS) division of WFII. Opinions represent GIS' opinion as of the date of this report and are for general informational 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.

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 you existing portfolio, investment objectives, risk tolerance, liquidity needs, and investment time horizon.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company.

© 2015, 2017 Wells Fargo Investment Institute. All rights reserved.

0217-00143 [96250-v1BDC] ECG-3724901 e8061