Wells Fargo Asset Management

Managing unintended risks—avoiding leaky bucket syndrome exposure

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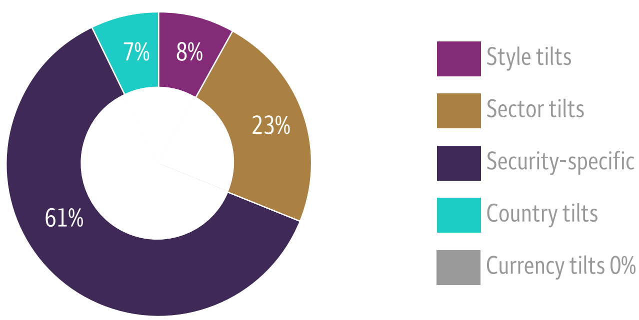
Why has the active management industry struggled to generate excess returns? Most investment teams focus myopically on their stock selection process, but returns created from good stock selection can quickly be erased by unintended risks entering the portfolio. These unintended (and unseen) influences can rapidly erode good stock selection if a portfolio is not constructed in a manner that neutralizes the undesirable exposures.

We all work hard to fill our excess return bucket, so why let it leak out due to unintended risks?

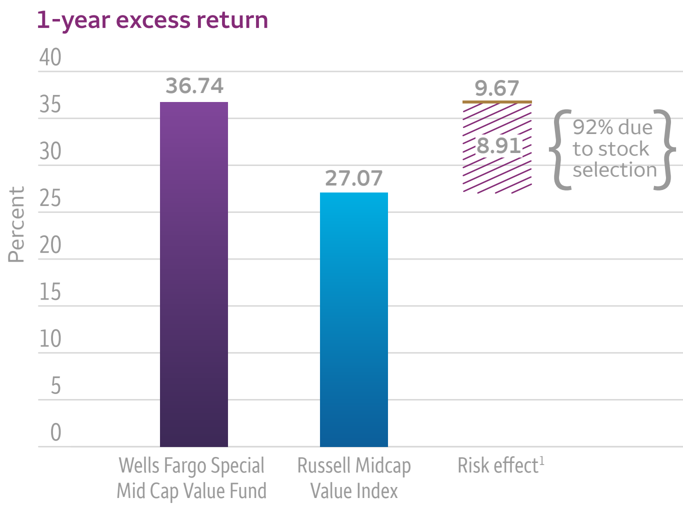
The Special Global Equity team's portfolio construction process uses Wells Fargo Asset Management's proprietary ex-ante and ex-post risk tools to create a portfolio with not only the proper amount of active risk but the proper type of active risk. The team monitors how style, country, and currency exposures and correlations across stocks influence active risk. Portfolios are constructed in a manner designed to neutralize these undesirable risks, allowing security selection to drive the portfolio's fate.

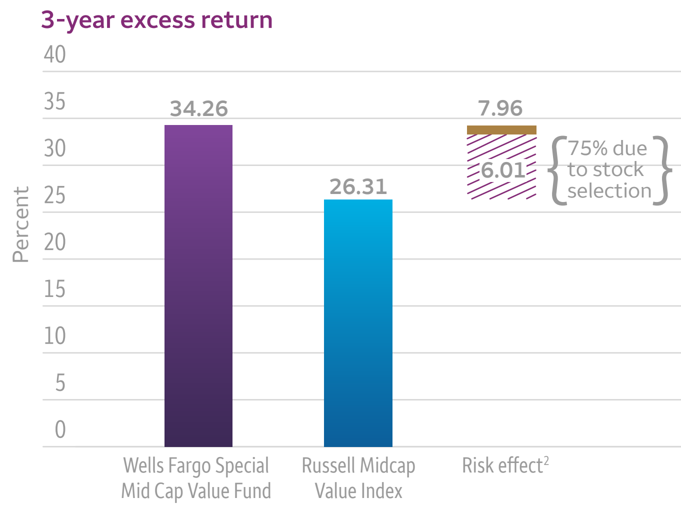
Sources of active risk for Wells Fargo Special Mid Cap Value Fund



Source: Wells Fargo Asset Management (WFAM) as of December 31, 2019

Knowing that the team's strength lies in its differentiated security selection rather than trying to predict macro events or winning style exposures, the portfolio managers intentionally construct the portfolio to neutralize the impact from any one style factor or macro event. This process has allowed the team to isolate the bulk of its active risk and the driver of excess returns to security selection, as evidenced by the historical attribution.





1. 9.67 is total excess return for the fund over the benchmark and 8.91 is the amount that is due to stock selection.

2. 7.96 is total excess return for the fund over the benchmark and 6.01 is the amount that is due to stock selection.

Source: WFAM as of December 31, 2019

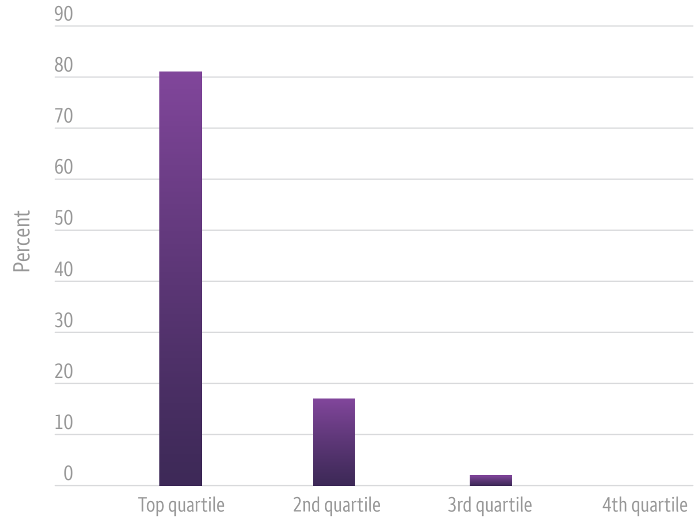
For example, in the mid-cap value space, several active managers have struggled to navigate the prolonged decline in interest rates given the Russell Midcap Value Index's heavy weighting in the bond-proxy sectors of real estate and utilities. Many managers have either had the wrong call on when interest rates would reverse or have simply succumbed to the belief that the index's interest rate tailwinds were too strong to overcome. The Special Mid Cap Value Fund was also underweight these bond-proxy sectors over the past 10 years due to its strict reward-to-risk valuation process. Instead, the team chose to reallocate the capital that the underweight produced toward specific stocks within the health care and consumer sectors that had similar factor exposures as the utilities sector (that is, these stocks should also do well if interest rates were to continue to decline) but were far more attractive per the bottom-up stock selection process and with far more attractive valuations. The portfolio's underweight to the interest-rate-sensitive banking industry at a time when individual company differentiation was limited by an increasing regulatory burden also served as a way to neutralize a further decline in interest rates. The outcome was the elimination of an undesired bet on the direction of interest rates relative to the benchmark's positioning and greater potential for excess returns via the stock selection process that truly makes the team unique.

A similar example has developed around the growth-versus-value debate within the value universe that managers misdiagnose as rich valuations but can be observed more clearly at the factor exposure level.

The result of this process is a high active share, low tracking error, style-pure approach

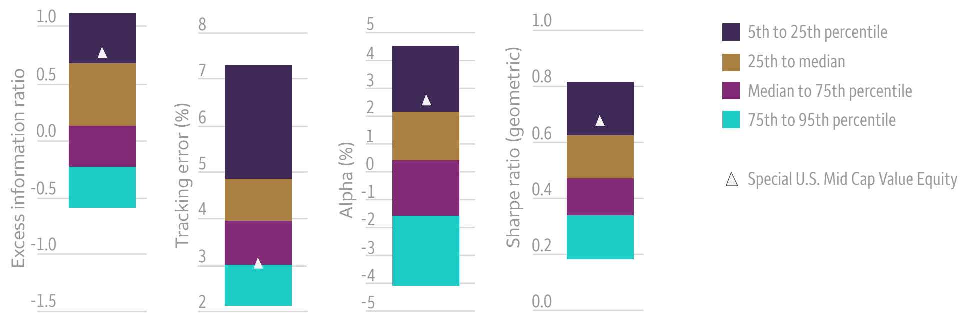
The Special Global Equity team believes this differentiated portfolio construction process has allowed them to deliver a less volatile and more predictable return stream for their clients while efficiently exposing clients to the team's strength of stock selection. By sourcing the portfolio's active risk primarily from security selection, the portfolio is able to look very different from its index while maintaining a lower tracking error than its peer group.

Return rank, % of 5–year rolling periods



Sources: Zephyr, Morningstar U.S. mid-cap value category, December 2019

3–year information ratio, tracking error, alpha, and Sharpe ratio as of 12/31/2019



Universe: eVestment Alliance U.S. Mid Cap Value Equity

	Information ratio	Information ratio rank	Tracking error	Tracking error rank	Alpha	Alpha rank	Sharpe	Sharpe rank
Special U.S. Mid Cap Value Equity	0.74	22	2.98	74	2.43	22	0.69	21
Number of observations[3]	92	–	92	–	92	–	92	–
Universe (5%)	1.36	–	7.28	–	4.54	–	0.86	–
Universe (25%)	0.64	–	4.99	–	1.82	–	0.63	–
Universe (Median)	0.02	–	3.82	–	0.10	–	0.48	–
Universe (75%)	-0.22	–	2.90	–	-1.40	–	0.36	–
Universe (95%)	-0.82	–	2.13	–	-4.82	–	0.14	–

3. An "observation" represents the number of strategies included in the universe.

Source: eVestment Alliance database via MPI. Performance is gross of fees.

1-, 3-, 5-, and 10-year performance as of December 31, 2019 (%)

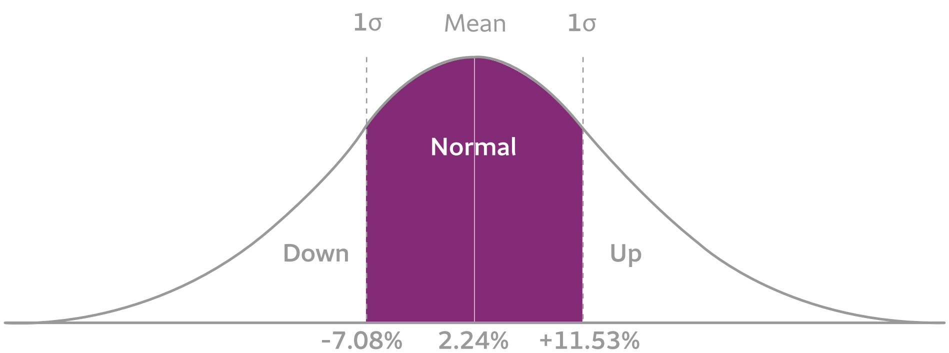
Name	1-year total return	3-year annualized total return	5-year annualized total return	10-year annualized total return
Wells Fargo Special Mid Cap Value Fund–Inst	35.53	9.39	9.14	13.16

Figures quoted represent past performance, which is no guarantee of future results, and do not reflect taxes that a shareholder may pay on a fund. *Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted and assumes the reinvestment of dividends and capital gains. Current month-end performance is available at the funds' website, wfam.com. Institutional Class shares are sold without a front-end sales charge or contingent deferred sales charge.*

Performance through the market cycle[4]

Wells Fargo Special Mid Cap Value Fund[5] vs. Lipper peers

January 1, 2008–December 31, 2019 (current cycle)



Source: Wells Fargo Asset Management. All figures are shown in USD. As of December 31, 2019.

4. Market type (normal/up/down) determined by performance relative to one standard deviation from the benchmark quarterly mean during the time period

5. Net fund returns

Past performance is not a reliable indicator of future results.

	Normal market	Up market	Down market
Number of quarters outperform peers	23	4	7
Total quarters	32	8	8
% of quarters outperform peers	**72**	**50**	**88**
Average quarterly excess return vs. peers (%)	0.53	-0.79	2.13
Total return of Special Mid Cap Value Fund (%)	115.72	112.63	-93.35
Total return of Lipper peers (%)	98.73	118.98	-110.36
Total excess return (%)	**16.99**	**-6.35**	**17.01**

The Special Global Equity team's focus on reducing unintended risks while using an accounting-based approach to identify companies with a durable asset base, flexible balance sheet, and strong free cash flow has resulted, in our opinion, in an all-weather portfolio.

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit wfam.com. Read it carefully before investing.

Stock values fluctuate in response to the activities of individual companies and general market and economic conditions. Smaller-company stock tend to be more volatile and less liquid than those of larger companies. Consult the fund's prospectus for additional information on these and other risks.

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