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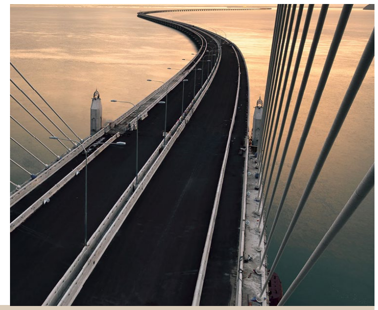
Investment Strategy



Weekly guidance from our Investment Strategy Committee **May 5, 2025**

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Alternatives Spotlight

Mark Steffen, CFA, CAIA
Global Alternative Investment Strategist

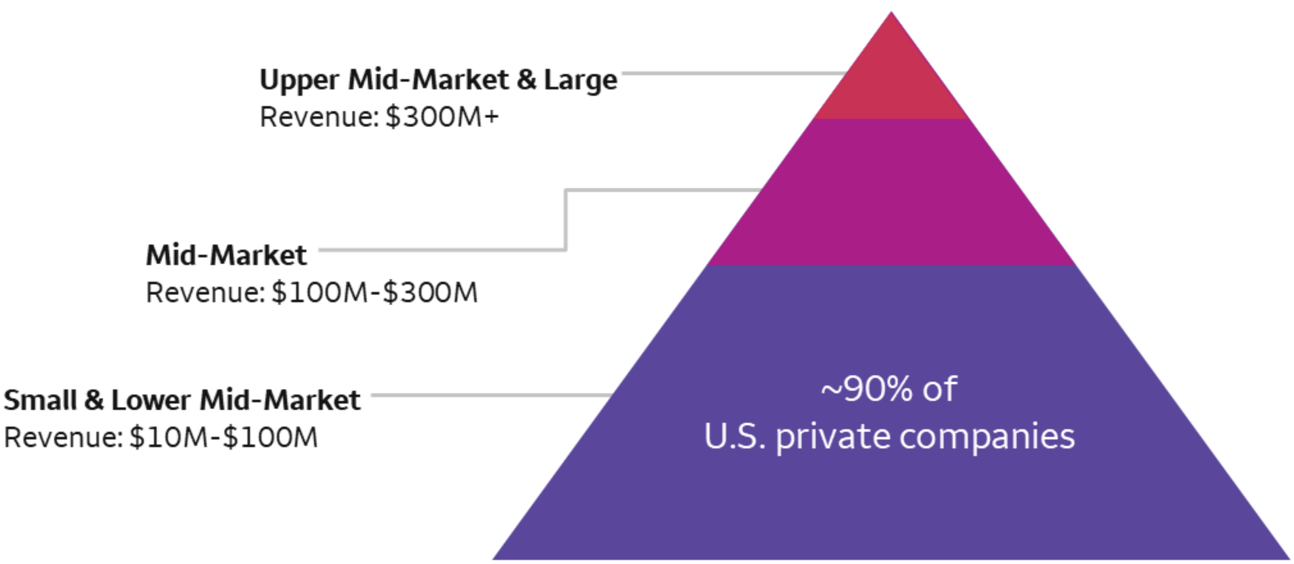
Small- and mid-market buyout presents opportunities

While publicly listed small-cap stocks continue to face headwinds, we believe an opportunity exists in Small / Mid Cap Buyout sub-strategies within the Private Equity strategy. Small and middle-market businesses are commonly defined as those generating revenues between $10 million and $1 billion. We believe that not only are there structural advantages that underscore the longer-term opportunity, but also several current market dynamics that help make the case for why investors may want to consider investing in this segment of the private-equity market.

Structural advantages[1]

- **Less competition**: Small- and mid-market companies alone vastly outnumber their larger counterparts. As Chart 1 shows, there are approximately 122,000 companies in the small- and mid-market segments, excluding the upper-middle-market private companies with revenues greater than $300 million. Yet, smaller buyout funds account for only about 15% of the capital raised, meaning fund managers can be more selective on the types of opportunities they invest in. We believe less capital chasing a greater number of opportunities can offer savvy fund managers the potential for high returns.

Chart 1. Number of private companies in small and middle markets dwarf larger-market peers



Source: Gerber Taylor, "The Role of Private Equity in Portfolios," Sean Montesi and Kojo McLennon. Data as of October 2021. M = million.

- **Lower valuations**: Smaller buyout deals have often traded at lower valuations (relative to large buyout deals), allowing fund managers to buy at a lower price, grow the business or make it more efficient, and potentially sell at a higher valuation. The increased use of leverage in the larger buyout market often results in buyers' willingness to pay higher prices.
- **Greater ability to add value:** Small- and mid-cap buyout fund managers generally have more opportunities to add value by recruiting talented management teams to streamline operations and drive productivity

1. All data referenced in this Structural Advantages section come from: RCP Advisors, "The Case for Small Buyouts Part I: Observed Structural Advantages in the Lower Middle Market," July 17, 2024 & Pitchbook, "U.S. PE Middle Market Report – 2024 Annual," March 13, 2025.

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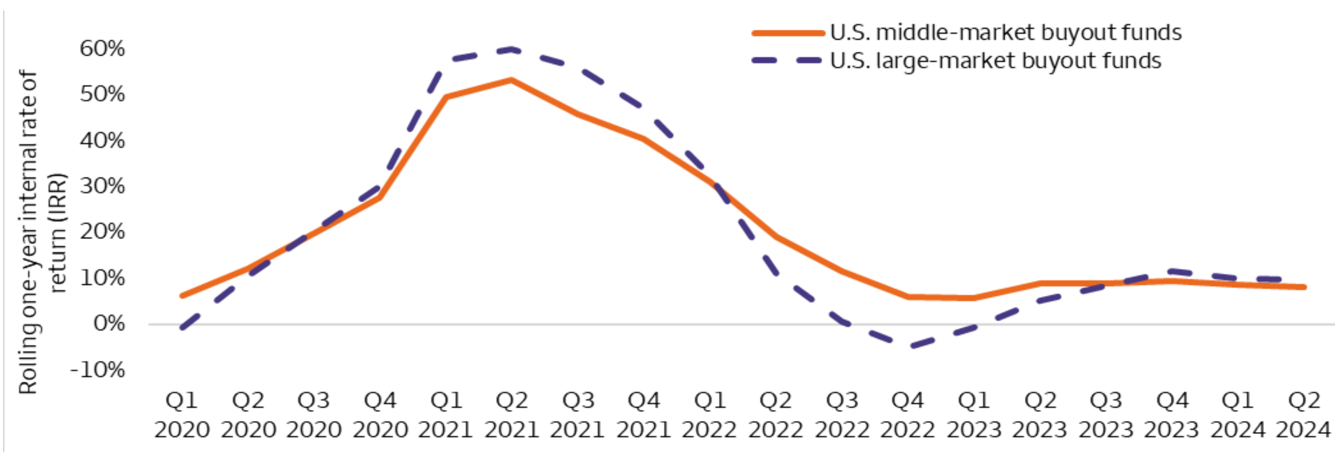
gains. Many businesses in this segment may be family owned or closely held companies that lack well-established policies, procedures, or controls and governance, unlike their more established peers in the larger buyout markets.

Why now?[2]

- **Greater access to debt:** While bank lending standards have loosened since 2023, the recent market volatility and ongoing economic uncertainty may serve to limit the availability of debt in the larger buyout market. Yet, well-capitalized private-credit providers have continued to originate new loans for small- and middle-market deals despite the recent market turbulence.
- **Improving exit environment:** More recently, private-equity firms have generally preferred smaller deal sizes, often favoring more easily financed deals in the small and middle markets. Moreover, the ample supply of dry powder (or cash) available, specifically in the larger buyout arena, in our view suggests fund managers may be looking for investment opportunities in the year ahead. As they begin to deploy more capital, the larger buyout funds may provide consistent demand for small- and mid-market opportunities that have graduated from the category.
- **Forecast for lower rates:** As we currently forecast three Federal Reserve (Fed) rate interest-rate cuts by year-end 2025, we expect lower financing costs should provide an additional tailwind for increased buyout deal activity in general, including small- and middle-market-focused strategies.

Middle-market buyout funds outperformed their larger counterparts for six consecutive quarters ending in the third quarter of 2023. Since that time, however, the larger buyout peers have outpaced smaller-market funds by a narrow margin, in part due to the large-cap equity rally providing a boost to recovering valuations in the large buyout market. Yet, given the structural advantages as well as the greater access to credit and continued improvement in the exit environment, we believe that small- and middle-market buyout strategies have the potential to regain the advantage soon. In summary, we remain favorable on the Small / Mid Cap Buyout sub-strategy and believe now may be an opportune time for qualified investors to consider adding exposure as a complement to a well-diversified alternatives portfolio.

Chart 2. U.S. middle-market buyout funds underperformed their larger-market peers in recent quarters, yet they may be poised to regain momentum



Source: Pitchbook, as of June 30, 2024. U.S. large market buyout funds = buyout funds included in the Pitchbook database that are $5 billion or greater in size. U.S. middle market funds = buyout funds included in the Pitchbook database that are between $100 million and $5 billion in size. **Past performance is no guarantee of future results.**

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws.

2. All data referenced in this Why Now section is sourced from Pitchbook, "U.S. PE Middle Market Report – 2024 Annual," March 13, 2025.

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Equities

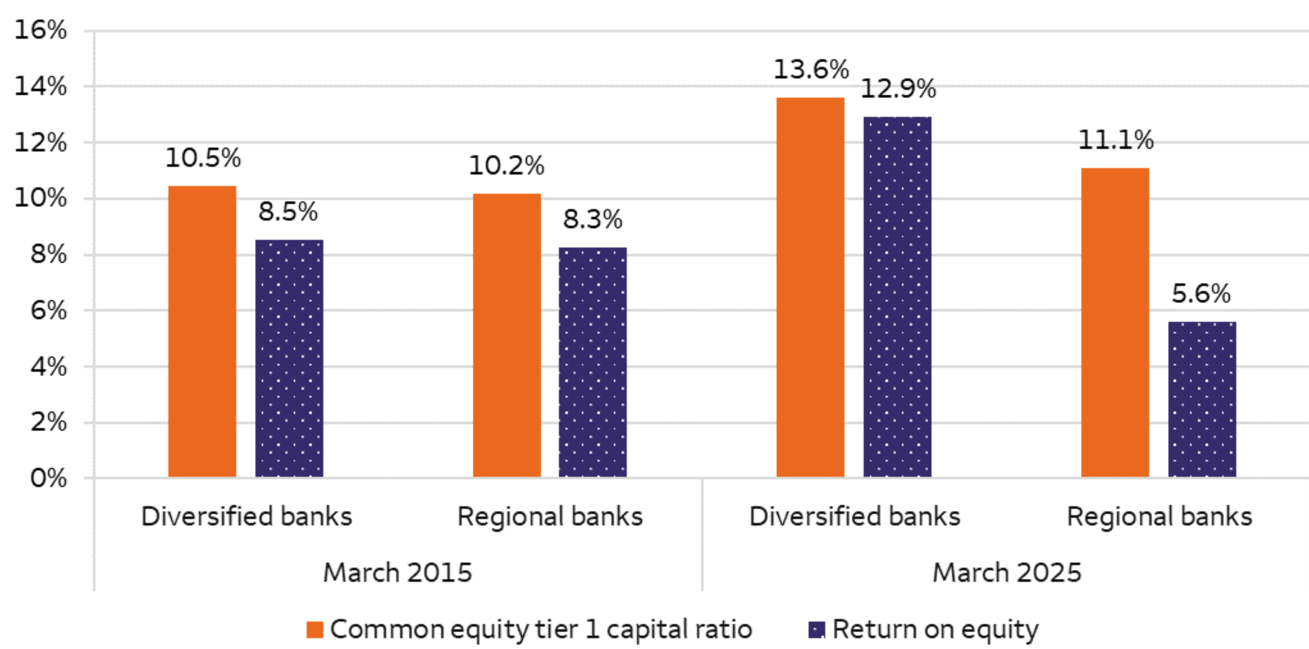
Alex Sagal
Equity Sector Analyst

Implications of diversified banks' strong capital position

Banks can either help absorb or exacerbate extreme market volatility with the ability to provide liquidity and access to credit in times of crisis or uncertainty. Despite the volatility experienced so far in 2025, we believe banks have successfully provided liquidity to the system, supported market making, and facilitated trading — helping markets function effectively as stock prices, interest rates, and currencies have oscillated wildly. We attribute some of this success in part to the fact that, broadly speaking, banks are in a much stronger capital position than they were a decade ago, as shown in the chart. This capital build was shaped from long-running regulatory efforts, such as Basel III Endgame, to strengthen bank balance sheets. While the new administration may completely rework the terms of Basel III Endgame, the capital has already been built as the rule had previously been expected to go into effect in July 2025.

Bank investors often view reserve capital as the enemy of returns as every dollar that is held on the balance sheet cannot be used for loans, investments to create efficiency or scale, and share buybacks and dividends. Despite higher aggregate capital levels at banks, diversified banks (also known as money-center or large-cap banks) have increased return on equity by nearly 4.5 percentage points over the past decade, while regional banks have struggled to overcome rising regulatory costs, increased competition, and a relatively less diversified revenue opportunity set. Given our view that capital levels at diversified banks are not likely to rise much further, we anticipate that excess earnings will increasingly be returned to shareholders through share buybacks and dividends.

Capital and returns for diversified and regional banks now versus 10 years ago



Sources: FactSet and Wells Fargo Investment Institute. Data as of March 31, 2025. Diversified banks represented by the companies in the S&P 500 Diversified Banks Index. Regional banks represented by the companies in the S&P 500 Regional Banks Index. The common equity tier 1 capital ratio compares a bank's capital against its risk-weighted assets to determine its ability to withstand financial distress. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Fixed Income

Eric M. Jasso, CFA
Taxable Analyst

As BBB interest coverage declines, selectivity is paramount

The period of corporate credit quality benefiting from the pandemic era's ultra-low interest rates has come to an end entering the first quarter of 2025 earnings. BBB-rated corporate credit has seen interest coverage materially below long-term averages across almost every sector. This has come despite strong earnings growth in 2024 as the pace at which interest expense has risen has stripped away the healthy cushion seen in interest coverage over the past few years.

We expect this trend to continue through 2025 as more debt from 2020 comes due and is refinanced at higher rates. Absent earnings deterioration, we do not see this as unmanageable as most investment-grade companies have typically shown discipline in curtailing generous shareholder reward programs and capital investments to maintain credit quality. However, we see rising risk — particularly among cyclical industries exposed to a changing trade and regulatory environment — that some issuers could see longer-term credit pressure from increasing capital intensity and reduced profitability.

Given expected macroeconomic headwinds, pressured metrics, and rich valuations among BBB-rated issuers, we recommend investors exercise selectivity when investing in lower-rated investment-grade credit. Specifically, we favor issuers within the Financials, Health Care, and Telecommunications sectors that are relatively insulated from uncertain trade policy and have exhibited strong financial discipline with leveraged balance sheets through previous economic cycles. Further, we would exercise caution with issuers impacted by trade policy uncertainty — particularly in cyclical sectors such as the Automotive, Consumer Discretionary, and Industrials sectors — despite valuations that might appear cheaper than other investment-grade sectors.

Interest coverage across BBB-rated corporate credit falling

	Fourth quarter 2024	Year over year	3-year average	10-year average
BBBs	5.23	-0.43	6.11	5.94
Basic Industry	9.17	2.32	10.87	7.64
Capital Goods	7.59	0.31	8.07	7.71
Communications	3.67	0.10	3.86	4.50
Consumer Cyclical	7.58	-1.22	9.46	9.23
Consumer Non-Cyclical	6.33	-0.51	7.26	7.67
Electric	2.48	0.00	2.62	2.91
Energy	4.32	-1.55	5.63	3.95
Technology	6.24	-0.02	7.02	7.55
Transportation	5.7	-0.95	6.41	7.01

Sources: Bloomberg and Wells Fargo Investment Institute. As of April 28, 2025. Interest coverage: earnings before interest and taxes divided by interest expense.
Past performance is no guarantee of future results.

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Real Assets

John Sheehan, CFA
Equity Sector Analyst

The importance of positioning in the Real Estate sector

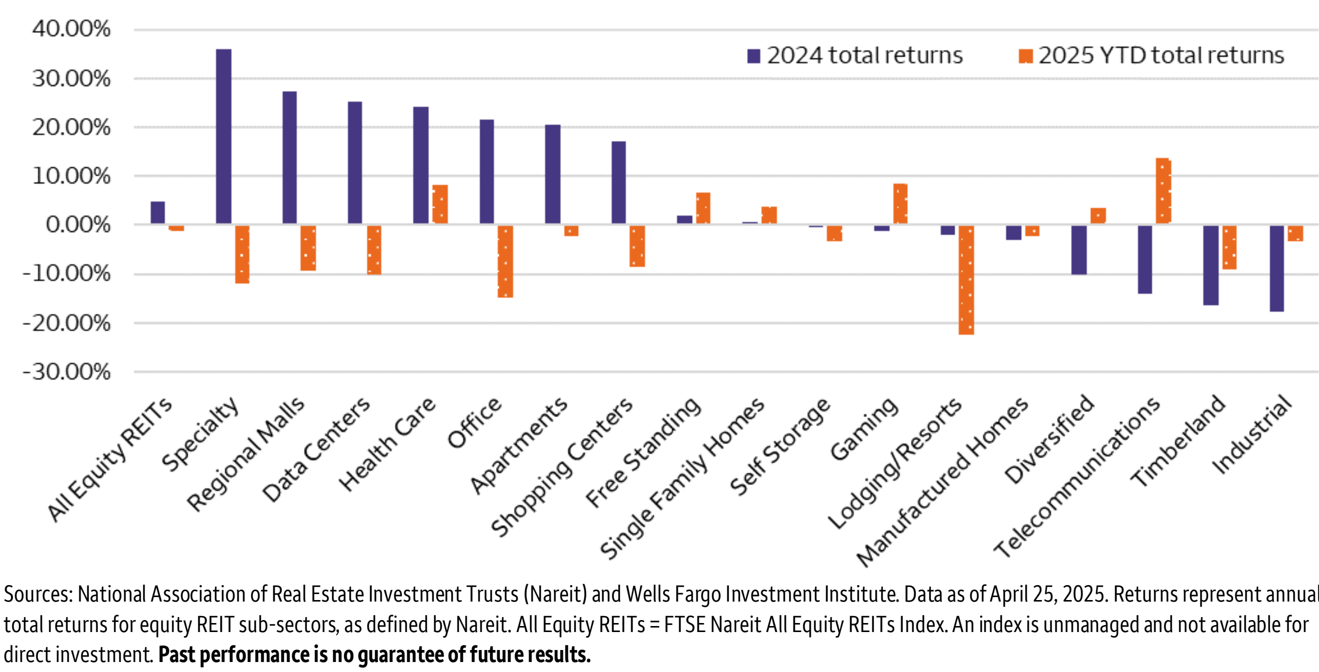
We have noted in the past that REIT performance often varies significantly from one sub-sector to another, and 2024 was no exception. Total returns across the 17 REIT sub-sectors again demonstrated variability, ranging from 35.9% (Specialty REITs) to -17.8% (Industrial REITs).

As the chart shows, Data Center REITs were among the top-performing sub-sectors in 2024. We believe this reflected investor optimism regarding the impact of artificial intelligence on customer demand for data centers. We attribute the stronger relative returns for Regional Mall REITs to reasonable U.S. economic growth along with a low unemployment rate, factors that have given consumers the confidence to continue spending on discretionary goods. Finally, Health Care REITs appeared to have benefited from continued solid resident demand for modern senior living properties in many major cities, which we feel is a function of the aging of the Baby Boomer generation.

In terms of REIT sub-sectors with weaker performance, we think higher interest rates and concerns about wireless carrier spending negatively impacted Telecommunications REIT returns. After generating strong total returns in 2023, we believe Industrial REITs were impacted by higher levels of new industrial warehouse development, which we believe pressured rental rate growth in larger industrial markets.

Although equity REIT total returns were positive in 2024, overall index returns did trail 2023 equity REIT performance. As of April 25, 2025, equity REIT year-to-date total returns were modestly negative (-1.3%). We remain neutral on the Real Estate sector. Further, we would highlight the significant variability in returns by sub-sector. We recommend investors considering REITs focus on Data Center and Industrial REITs given positive long-term demand drivers. Looking ahead, we believe Telecommunication REITs could be a beneficiary of potential interest-rate reductions in 2025 along with continued growth in mobile data consumption and the rollout of fifth generation (5G) wireless technology.

2025 REIT total returns are trailing 2024 performance and remain highly variable across sub-sectors



Sources: National Association of Real Estate Investment Trusts (Nareit) and Wells Fargo Investment Institute. Data as of April 25, 2025. Returns represent annual total returns for equity REIT sub-sectors, as defined by Nareit. All Equity REITs = FTSE Nareit All Equity REITs Index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

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Tactical guidance*

Cash Alternatives and Fixed Income

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	U.S. Long Term Taxable Fixed Income U.S. Short Term Taxable Fixed Income	Cash Alternatives Developed Market Ex-U.S. Fixed Income Emerging Market Fixed Income High Yield Taxable Fixed Income U.S. Intermediate Term Taxable Fixed Income		

Equities

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
	Emerging Market Equities	Developed Market Ex-U.S. Equities U.S. Small Cap Equities	U.S. Large Cap Equities U.S. Mid Cap Equities	

Real Assets

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Private Real Estate	Commodities	

Alternative Investments**

Most Unfavorable	Unfavorable	Neutral	Favorable	Most Favorable
		Hedge Funds—Equity Hedge Hedge Funds—Relative Value Private Equity Private Debt	Hedge Funds—Event Driven Hedge Funds—Macro	

Source: Wells Fargo Investment Institute, May 5, 2025.

*Tactical horizon is 6-18 months

**Alternative investments are not appropriate for all investors. They are speculative and involve a high degree of risk that is appropriate 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. Please see end of report for important definitions and disclosures.

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Risk considerations

Forecasts, estimates, and projections are not guaranteed and are based on certain assumptions and views of market and economic conditions which are subject to change.

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. **Dividends** are not guaranteed and are subject to change or elimination. **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.

There are special risks associated with an investment in real estate, including the possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Other risks associated with investing in listed REITs include the use of leverage, unexpected reductions in common dividends, increases in property taxes, and the impact to listed REITs from new property development.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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 appropriate 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

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

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S&P 500 Diversified Banks Index is a sub-industry index that comprises stocks in the S&P Total Market Index classified inv the GICS Asset Management & Custody Banks, Diversified Banks, Regional Banks, Diversified Financial Services, and Commercial & Residential Mortgage Finance sub-industries.

S&P 500 Regional Banks Index comprises stocks in the S&P Total Market Index that are classified in the GICS Regional Banks sub-industry.

An index is unmanaged and not available for direct investment.

Investment Grade bonds - A rating that indicates that a municipal or corporate bond has a relatively low risk of default. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A'

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