WELLS FARGO
Investment Institute

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Monthly Investment Outlook: Capital Market Assumptions

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Title graphic: Capital Market Assumptions

Capital market assumptions, or CMAs, provide our expectations for asset-class performance and risk. CMAs reflect what we believe investors may experience through at least one full market cycle, including periods when financial markets rise and fall.

Title graphic: Developing our 2021-2022 CMAs

Our CMAs incorporate trends we expect over at least the next 10 years. We utilize a building-block approach starting with our long-term expectations for inflation and cash returns.

Graphic: Conceptual view of building-block risk premia

Using the building-block approach, we assume that investors demand compensation for taking additional risks, including term risk, credit risk, equity risk, and illiquidity.

While we believe inflation will exceed 2% in 2021 and 2022, we expect it to return to a 2% average for the remainder of the strategic time frame. We anticipate a cash discount to inflation, similar to the discount over the past 10 years.

Overall, our CMA return assumptions for fixed income are lower this year due to the reduction in cash return expectations, while returns for other asset groups reflect a positive environment for risk assets and are similar to last year's expectations.

Title graphic: Investor implications

We use CMAs to develop strategic asset allocation recommendations that reflect an investor's goals and risk tolerance.

This year, changes to our strategic allocations include reductions in cash and fixed income in favor of equity, commodities, and alternative investments for qualified investors. We adjusted some allocations within the equity asset group, although we continue to favor U.S. and emerging markets over international developed markets, and small caps over large caps.

We believe a well-diversified portfolio will help manage volatility over a strategic time horizon. Comparing the risk-and-return characteristics of various asset allocations may help investors choose the portfolio mix that best suits their needs.

Risk considerations

Different investments offer different levels of potential return and market risk. 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. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. **Foreign** investing has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. The prices of **small-cap** 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. **Bonds** are subject to interest rate, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. 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.

Alternative investments carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Other risks may apply as well, depending on the specific investment product.

Private equity investments are less transparent than public investments and private equity investors are afforded less regulatory protection than investors in registered public securities. Private equity funds are sold in private placements and may be offered only to individuals who are both "qualified purchasers" (as defined in U.S. Investment Company Act of 1940, as amended) and "accredited investors" (as defined in the Securities Act) and for whom the investment is otherwise appropriate.

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