Global Investment Strategy

Managing Investments in an Uncertain World

A New Way of Thinking About Your Long-Term Financial Goals

Key Takeaways

» When planning for the future, investors generally face three primary uncertainties: longevity, inflation, and market risk.

» Investors should make planning decisions based on considerations that encompass a broad range of outcomes.

» A suitable strategy for dealing with uncertainty can help investors stay focused over the long term.
Choices We Make Today Help Determine our Tomorrows

The world is full of uncertainty; however, we believe you can make decisions today to help put the odds in your favor of meeting your long-term financial goals and help create greater peace of mind about your financial future.

When planning for the future, investors generally face three primary uncertainties:

- **Longevity**: how long we expect to live
- **Inflation**: how much we expect our purchasing power to decrease over time
- **Market performance**: how we expect our investments to perform over the designated time horizon

These considerations are interrelated and may become increasingly difficult to predict the longer the time horizon.

Fortunately, there are ways to address uncertainty that can help increase the likelihood of meeting your long-term goals and succeeding financially. You don’t know for sure how long you will live, how much the cost of goods and services will rise in the future, or what return your investment portfolios will provide from year to year. Therefore, we recommend setting investment and spending projections based on considerations that encompass a broad range of outcomes, not just the average. After all, an investment plan based on the combination of an average life expectancy, normal rate of inflation, and typical rate of return on investments generally would imply a probability of achieving success only about half the time.
Understanding Uncertainty—Today, Tomorrow, and Beyond

When considering strategies to deal with longevity, inflation, and market uncertainty risks, it is important to understand how financial conditions can change from today to tomorrow and beyond. Uncertainty, of course, increases the further you look into the future. You can observe first-hand what is happening today. You can often anticipate what is likely to happen in the near term. However, we believe you should consider a broader range of potential outcomes when trying to evaluate likely prospects over the longer term, particularly in the distant future.

Longevity: How Long Might You Live?

Most of us would rather not spend a lot of time thinking about our own mortality. However, your quality of life may be improved markedly by planning for what could happen in the future rather than confronting it unprepared.

Experience shows you should save and invest today to fund future expenditures, especially for a time when it is no longer possible to work and receive a regular paycheck. But how much should you save for your retirement? That depends, of course, on things like how much you plan to spend, your lifestyle, and how long you expect to live.

To prepare for the future, we believe you should consider a broad range of possible life expectancies and not just assume the average life expectancy. Mathematical statistics can be used to predict the average life expectancy for a large group of individuals of the same age. However, statistically speaking, 50 percent of the population will live longer than the average life expectancy while the other half will live less than the average.
So, how long of a life expectancy should you prepare for, especially if you do not want to deplete your savings in retirement? The answer is there are many possibilities. If you assume your life span will be shorter than average, you could be making a big mistake. You may not have enough assets to cover all your expenses if you end up living longer than average. To be safe, you could go to the other extreme and assume you will live longer than everyone else in your age group. This would help ensure you will not exhaust your savings in your golden years. But in doing so, you’re likely to sacrifice too much during your lifetime to prepare for something that’s unlikely to occur.

So what should you assume about life expectancy? To reduce the risk of being underfunded, it may be best to assume a life expectancy greater than the average but less than the maximum. Thus, you may have a greater chance of meeting your future spending needs by preparing for a life expectancy that covers a greater than average period. You may want to extend your assumption to the age that you may have a 20 percent chance of reaching. This type of strategy takes uncertainty into consideration and, at the same time, helps improve the odds of succeeding financially.
Inflation: How Much Purchasing Power Might You Lose?

Historically, the cost of goods and services has increased over time as the demand for resources increased alongside a growing global economy. Unfortunately, even a trivial amount of inflation can add up over time, substantially eroding savings’ purchasing power. For example, if prices rise two percent each year, the cost of goods and services would double in approximately 36 years, causing the purchasing power of a dollar saved today to drop by 50 percent over that period. If prices increased three percent per year (the historical average rate of U.S. inflation going back to 1926), prices would double in only about 24 years.

So when planning for the long term, how can you help mitigate inflation’s detrimental effects? Prices do not increase in a constant trajectory—they may rise slowly in some years and more rapidly in others. However, building a long-term investment plan that assumes policymakers will keep inflation low may be a risky strategy. The Federal Reserve (Fed) currently has a two-percent long-term inflation target. You may be able to put the odds of achieving your financial goals in your favor by assuming the Fed will allow inflation to be above that target more often than it would allow inflation to be below it. After all, the Fed’s two-percent target is below the long-term historical average rate.

Other investment-related strategies can deal with the uncertainty of inflation. For example, you can choose a well-diversified portfolio that includes assets that have historically provided rates of return above the inflation rate. However, higher-return investments traditionally come with more market uncertainty risk. Therefore, we believe you should choose a level of market risk that is consistent with your risk tolerance and overall investment objective.
Market Performance: What Range of Returns Might You See?

Investment returns typically fluctuate within a range, much like life expectancies. In good times, many investments perform well and provide above-average returns. In bad times, however, these same investments may perform poorly and suffer below-average returns. We do not think that you should expect your portfolio returns will always be high or that they will always be low. We believe you should expect returns to fluctuate across the wide range of possible returns from high to low and then follow a long-term strategy that considers this variability of outcomes.

Some Asset Classes Have Provided Better Returns Than Others

The value of a dollar invested, 1926-2014

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Compound Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small stocks</td>
<td>12.2%</td>
</tr>
<tr>
<td>Large stocks</td>
<td>10.1%</td>
</tr>
<tr>
<td>Government bonds</td>
<td>5.7%</td>
</tr>
<tr>
<td>Treasury bills</td>
<td>3.5%</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

Source: Ibbotson® Stocks, Bonds, Bills, and Inflation (SBBI®)

This information is hypothetical and for illustrative purposes only. It is not intended to represent any specific return, yield, or investment, nor does it represent the experience of any individual investor. It assumes the value of $1 invested at the beginning of 1926, the reinvestment of income and no transaction cost or taxes. Past and hypothetical performance is no guarantee of future results. Small stocks are represented by the Ibbotson® Small Company Stock Index. Large stocks are represented by the Ibbotson® Large Company Stock Index. Government bonds are represented by the 20-year U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index. An index is unmanaged, and not available for direct investment. Different investments offer different levels of potential return and market risk. Please see the end of this report for asset class risk descriptions. ©2015 Morningstar. All rights reserved.

Our assumptions about the projected returns of most asset classes are unlikely to change much as long as current macroeconomic trends continue. Even when the Fed finally begins to raise interest rates, we expect it will do so at a slow and measured pace. As a result, in our opinion, our asset class return assumptions and strategic allocations are unlikely to deviate significantly from recent market trends. However, looking beyond what we expect tomorrow to what we expect over a longer period of time for the performance of each asset class opens the door to a much wider range of possibilities.
Economic growth rates can fluctuate significantly over long periods of time. A look back reveals the U.S. economy has experienced prolonged periods of boom and bust. Consequently, it would be reasonable to assume these types of conditions could occur again in the later years of a long-term plan. History also shows the economy goes through long cycles of innovation and growth. This innovation creates new and different investment possibilities. At some point, the U.S. economy is likely to once again experience such a period of innovation, rapid economic growth, and above-average asset-class returns. Unfortunately, it is impossible to know when this turn of events might happen.

Past performance is no guarantee of future results, so going forward, assumptions about future returns must be carefully considered. If you incorrectly assume investment returns will be higher than they actually turn out to be and consequently do not save much today, you face the risk of depleting your assets in the future. Alternatively, if you incorrectly assume investment returns will be low and, therefore, save a lot, you might end up making unnecessary sacrifices today by saving too much for tomorrow.
Helping Put the Odds in Your Favor

So what is the right amount to save and what are the appropriate asset-class return assumptions to use?

As previously indicated, we believe you should make savings, spending, and investment decisions in a manner that gives a greater probability of success than the 50/50 chance the averages represent.

No one knows what the future will hold. However, it is possible to simulate a broad range of potential scenarios using a random selection from the full range of returns projected by Wells Fargo Investment Institute. We believe you should probably strive for a savings, spending, and investment plan that would be successful in about 75 percent to 90 percent of those simulations. However, your specific percentage target may vary.

To realistically expect to be successful in meeting long-term goals more than 50 percent of the time, your analysis should include simulations in which asset-class return assumptions are both below average and above average. This is why it is important for the scenario analysis to include longer-term investment return expectations that reflect the full range of historical possibilities, not just the near-term outlook.

How Should You Think About Uncertainty?

So how can you deal with the uncertainty of the financial markets over a long time period? We see three fundamental strategies for you to consider:

**Know yourself:** A starting point is to stay grounded in your tolerance for risk and investment objectives. Self-knowledge can help you allocate investments across asset classes toward a desired return level while remaining within a comfortable risk level. Once an allocation is set, events occasionally may offer an opportunity to rebalance. Creating such a plan and sticking to it may help you sleep better, particularly during times of market uncertainty.

**See the long term:** The economy is often resilient to surprises. Even events with far-reaching consequences typically have presented new challenges that businesses and households have managed to overcome. Trying to time when to move in and out of the market has proven to be an unsuccessful strategy for many investors.

**Use an appropriate asset allocation strategy:** Unpredictable events make it difficult to anticipate the best asset class performers, but allocating across asset classes may help you take advantage of the long-term tendencies across markets. Correlations between asset classes, such as stocks and bonds, historically have been more stable than asset prices over time. For example, a combination of stocks and bonds may create a portfolio that has less volatility than stocks alone and one that offers the opportunity for a better return over the long term than bonds alone.* Of course, your asset allocation strategy should reflect your tolerance for risk and long-term return objectives.

* Keep in mind, correlation measures the degree to which asset classes move in sync; it does not measure the magnitude of that movement. There is also no guarantee that historically low or non-correlation will continue in the future.
Summary

Increased market uncertainty during the past decade has raised investor concerns about the risks of meeting long-term objectives. As a result, planning for the future has evolved over time to address volatility and various other types of risk. We believe you should base your long-term investment plans on assumptions about longevity risk, inflation risk, and market performance risk.

In developing a strategy for dealing with these risks, we believe it is essential to refine expectations for investment returns and include a wider range of longer-term possibilities that are consistent with historical experience. We encourage you to speak with an investment professional about any questions or concerns regarding your long-term plan.
About the Authors

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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.

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During his undergraduate and graduate studies he studied at Nankai University in Tianjin and Cheung Kong Graduate School of Business in Shanghai.
**Asset Class Risk Descriptions:**

All investing involves some degree of risk, whether it is associated with market volatility, purchasing power or a specific security. **Stocks** are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. The prices of **small-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, price and credit risks. Prices tend to be inversely affected by changes in interest rates. **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.

**Index Definitions**

**Consumer Price Index (CPI)** from the U.S. Bureau of Labor Statistics tracks changes in the prices paid by urban consumers for a representative basket of goods and services.

**Ibbotson Large Company Stock Index** represents the S&P 90 Index from 1926–1956 and the S&P 500 Index thereafter.

**Ibbotson Small Company Stock Index** measures the performance of the smallest 20% of publicly traded stocks.

**S&P 90** In 1928 Standard & Poor’s realized the need to disseminate its market indicator information more frequently. Instead of trying to calculate the 233 Composite on an hourly or even a daily basis, which would have been difficult to do in an era before sophisticated calculators or computers were available, Standard & Poor’s created a more manageable subset of stocks. This new index was the first daily, and then the first hourly index published by Standard & Poor’s. Comprised of 50 Industrial, 20 Railroad, and 20 Utility stocks, it became known as the S&P 90 Stock Composite Index.

**S&P 500** comprises 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value-weighted index; each stock’s weight in the index is proportionate to its market value. It is one of the most widely used benchmarks of U.S. equity performance.