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Investing for Social and Environmental Impact

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Senior Global Alternative Investment Strategist

Key takeaways

- *Impact Investing offers investors diverse and viable opportunities to advance social and environmental solutions through investments that aim to deliver competitive returns and measurable social results.*
- *We believe that several long-term secular trends are emerging as a growing number of mission-driven entrepreneurs are launching new ventures to solve global challenges.*

What it may mean for investors

- *We believe that private equity offers qualified investors an investment approach with the potential to deliver competitive long-term returns and positive, measurable social and environmental impacts.*

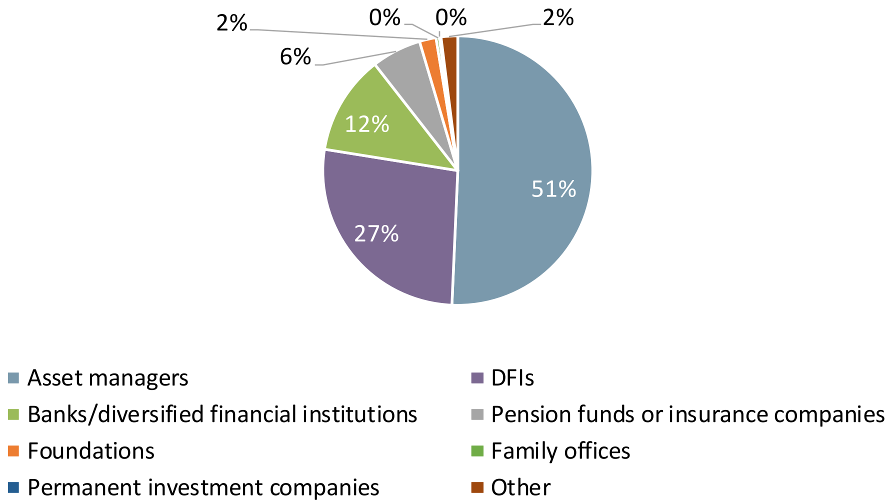
Impact Investing is a subset of Socially Responsible and Sustainable Investing. Impact Investing actively seeks to make a positive impact—as it aims to generate beneficial and measurable social or environmental effects—along with financial gains.

Impact Investing has attracted many investors, with appeal that is widespread and growing. According to Global Impact Investing Network (GIIN) estimates, the size of the institutional segment of the global Impact Investing market was $502 billion at year-end 2018, with more than 1,300 institutional Impact investors globally. Overall, 50% of these Impact Investing assets under management reside with asset managers, reflecting the fact that many investors in this space choose to channel capital through specialized managers. These include managers that invest in venture capital, private equity, private debt, fixed income, real assets, and public equities.

Asset Group Overviews

Investing for Social and Environmental Impact

Chart 1. Impact Investing institutional assets under management (% held by investor type)



Sources: Global Impact Investing Network, Wells Fargo Investment Institute, October 2019. DFI = development finance institution.

Impact Investing with private equity

We believe a good way to implement Impact investments is through private equity. According to GIIN's most recent Annual Impact Investor Survey, private equity is deployed by more than 75% of Impact investors.[1] Private equity investments in the Impact Investing space focus on measurable social and/or environmental impacts, along with performance. The illiquid nature of private equity allows qualified investors to employ a long-term approach that can drive change for their portfolio companies.

As with financial returns, Impact Investing returns can be affected by external factors that may include fluctuating economic growth, new laws, or recently developed technologies. Yet, Impact Investing returns encompass both performance and goals such as increased literacy, healthier infants, and reduced pollution. Each type of Impact Investing social "return" calls for its own metrics to assess whether it is having the intended effect.

The Global Impact Investment Rating System (GIIRS) is one measurement tool that was created to apply sustainability criteria to private investments. GIIRS is a comprehensive system for assessing the social and environmental impact of companies and funds. It uses a ratings and analytics approach comparable to other ratings analytics. It also allows companies to demonstrate their commitment to social and environmental impact to mission-aligned investors.

Impact Investing themes

We see several long-term secular trends emerging as a growing number of mission-driven entrepreneurs are launching new initiatives to help solve global challenges. We believe that these tailwinds are building a robust market for Impact-oriented enterprises and creating an attractive impact-investing climate.

[1] Global Impact Investing Network, October 2019.

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Table 1. Three distinct impact themes in focus

Health and Wellness	Improve health outcomes by providing high quality, affordable health care for underserved patient communities, providing higher quality and more sustainable food systems, and developing products and services that promote healthy lifestyles.
Education and Workforce Development	Reduce skills and achievement gaps and improve economic mobility by providing training and education, promoting ownership, and catalyzing economic growth in distressed communities.
Sustainability	Reduce environmental impact and greenhouse gas emissions through ecologically beneficial water, energy, agricultural, and other sustainable products, services and business operations.

Source: Wells Fargo Investment Institute, October 30, 2019.

Table 1 shows three distinct Impact Investing themes that we favor. The key drivers for these themes include the following:

Health and Wellness: While health-care spending has risen across the U.S. economy, strong access and quality disparities remain—along with some inequities. New threats also are emerging as drug-overdose deaths increase. There is a strong opportunity for new health-care models that improve the quality/cost equation as well as patient access, especially for underserved populations.

Education and Workforce Development: Workplace dynamics are changing. Expanding wage gaps between rural and urban communities—and within urban communities—may have meaningful societal implications. As companies seek to recruit and retain workforces that allow them to maintain their competitive edge, new technologies and services may help workers to learn new skills, which can—in turn—match workers with new job prospects. As such, we are seeing an emergence of new companies and business models, supported by low-cost infrastructure, that can help to tackle challenges of both under- and unemployment.

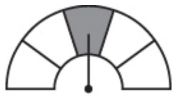
Sustainability: Costs of renewable energy technologies are falling rapidly. In many markets, the cost for renewable energy is now competitive with fossil-fuel energy generation. In agriculture, new technologies that incorporate artificial intelligence and robotics are improving the environmental footprint of food-value chains. In transport, advancements in biotechnology, energy storage, and infrastructure are enabling less carbon-intensive mobility options. Through heightened environmental awareness and new technologies that lower costs, there are more companies building products and services to improve energy and resource efficiency; innovating with new forms of sustainable packaging; and optimizing water usage and management.

Investment implications

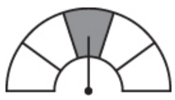
Impact Investing continues the dual focus on societal and environmental issues (along with performance) that has been a key focus for Socially Responsible and Sustainable Investing since its inception. Impact Investing with private equity offers diverse and viable opportunities for qualified investors to potentially receive both competitive returns and measurable social results. Society is demanding that both public and private companies serve a broader social purpose. To prosper over time, companies may very well need to benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. That is why we believe that Impact Investing is here to stay.

EQUITIES

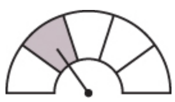
Scott Wren
Senior Global Equity Strategist



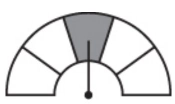
Neutral
U.S. Large Cap Equities



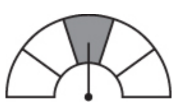
Neutral
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Neutral
Developed Market
Ex-U.S. Equities



Neutral
Emerging Market Equities

Domestically oriented sectors show best third-quarter earnings growth

With about 55% of S&P 500 Index companies reporting third-quarter earnings to date, the sectors that are posting the best year-over-year earnings growth have the bulk of their revenues coming from inside the U.S. (see table). These sectors are the Utilities and Real Estate sectors, with earnings per share (EPS) growth rates of 6.9% and 6.2%, respectively. More than 85% of these sectors' revenues comes from inside the United States. Two of the weakest-earning sectors in this reporting season (so far) are Materials and Information Technology (IT)—more internationally focused sectors.

This divergence shouldn't be all that surprising—as our Macro team has been expecting slower growth overseas than in the U.S. For instance, the IT sector garners only 43.2% of its revenues from here at home. It also generates just over 14% of its revenues from China, the highest Chinese revenue percentage among the 11 sectors (by far). Reported IT third-quarter earnings have declined by 5.2% on a year-over-year basis. We expect that this sector's earnings will decline by approximately 3% when all companies have reported results. The Materials sector, with only 45.6% of revenues being produced domestically, has seen third-quarter reported earnings fall by 23.2%.

On the other hand, the Utilities sector gets 97% of its revenue from U.S. customers—and its third-quarter earnings have risen by 6.9% so far (although we expect that growth to drop to 6% after all companies have reported).

The bottom line is that slower growth overseas is resulting in better-than-average EPS performance from several domestically oriented sectors.

Key takeaways

» Slower growth overseas is resulting in better-than-average third quarter earnings performance from several of the more domestically oriented sectors.

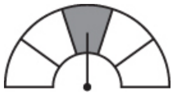
» More stable growth globally and a lessening of trade tensions likely would help to broaden sector earnings performance.

Third quarter EPS growth and domestic revenues by S&P 500 Index sector

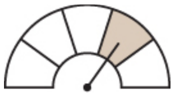
Sector	U.S. revenues as a percent of total revenues	Third-quarter reported EPS growth to date
Utilities	97.1%	6.9%
Real Estate	85.1%	6.2%
Financials	78.4%	-5.0%
Consumer Discretionary	68.7%	-1.2%
Communication Services	64.2%	-2.3%
Industrials	63.6%	1.8%
Health Care	61.8%	5.3%
Energy	58.4%	-22.5%
Consumer Staples	55.3%	3.5%
Materials	45.6%	-23.2%
Information Technology	43.2%	-5.2%

Sources: FactSet, Wells Fargo Investment Institute, October 30, 2019. Table shows third-quarter earnings per share growth of S&P 500 Index companies reporting to date (as of October 30, 2019). **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment.

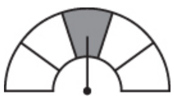
Brian Rehling, CFA,
Co-Head of Global Fixed Income Strategy



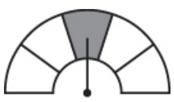
Neutral
U.S. Taxable Investment Grade Fixed Income



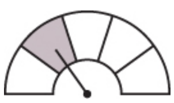
Favorable
U.S. Short-Term Taxable Fixed Income



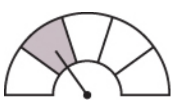
Neutral
U.S. Intermediate Term Taxable Fixed Income



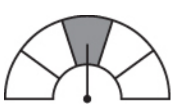
Neutral
U.S. Long-Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



Unfavorable
Developed Market Ex.-U.S. Fixed Income



Neutral
Emerging Market Fixed Income

Why own bonds?

Despite an exceptionally low yield environment, our expectation is that high quality fixed-income investments will offer investors positive low-single-digit returns in the years ahead. For investors that may be asking why they should own the fixed income asset group when we expect it to produce lower long-term returns than equities overall, we urge them to consider the bigger picture.

Diversification. The future is often uncertain. While we may have a strong feeling of what tomorrow will bring, unforeseeable events often alter reality. Taking too large a bet on any one particular outcome can increase risk significantly. Investment strategies based on concentrated allocations are usually higher-risk.

Reduced volatility. One of the primary reasons to continue to own fixed-income investments is the lower volatility these investments typically offer when compared to stocks. Bonds, when used properly as part of a diversified investment strategy, may help smooth out a portfolio's overall performance over the long term.

Liquidity. Most bonds have a maturity date at which principal is returned to the investor if the issuer has not defaulted. For investors that are able to anticipate future cash needs, purchasing high-quality credit instruments with maturities near those occasions can be an effective way to remain invested in the markets while maintaining some assurance that funds will be available when they are needed.

Income. Income and cash flow are important needs for many investors. If a bond is held to maturity and the issuer does not default, the investor will receive the expected cash flow, regardless of whether interest rates increase or decrease.

Key takeaways

» We believe that investors should ensure that their bond portfolio is well diversified across maturities and credits. Tactically, we remain neutral on duration.[2]

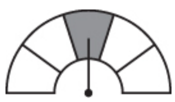
» We expect U.S. interest rates to decline modestly from current levels, and we believe that investors should maintain bond allocations at their strategic levels (in alignment with their goals and risk profile).

» For a more in-depth discussion on the benefits of bonds, please ask your investment professional for the full "Why Own Bonds" report.[3]

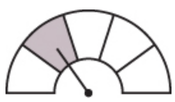
[2] Duration is a measure of interest-rate risk.
[3] "Why Own Bonds", Wells Fargo Investment Institute, June 2018.

Austin Pickle, CFA
Investment Strategy Analyst

"Forgiveness is a virtue of the brave."
—*Indira Gandhi*



Neutral
Commodities



Unfavorable
Private Real Estate

Fracking in 2020

Announcements from progressive 2020 Democratic presidential candidates have ranged from a pledge to ban fracking to criminally prosecuting oil and natural gas executives. While we see an all-out national ban on fracking as unlikely, regardless of who becomes president, we have been asked—what would happen in the Real Assets space if fracking was banned? Let's take a look.

The U.S. is the world's largest oil producer, with daily output of 12.6 million barrels per day (Mb/d). Most of this is from shale by fracking—9 Mb/d to be precise (see chart). To put that into perspective, total Saudi Arabian oil production averaged about 9.8 Mb/d in August. Would the world be able to replace lost U.S. oil if fracking was banned? Not a chance, in our view. OPEC (Organization of the Petroleum Exporting Countries) would be the world's best hope, but its spare capacity is only about 4.5 Mb/d.[4] This oil supply shortfall would mean that oil prices could spike significantly higher, potentially challenging all-time, triple-digit highs.

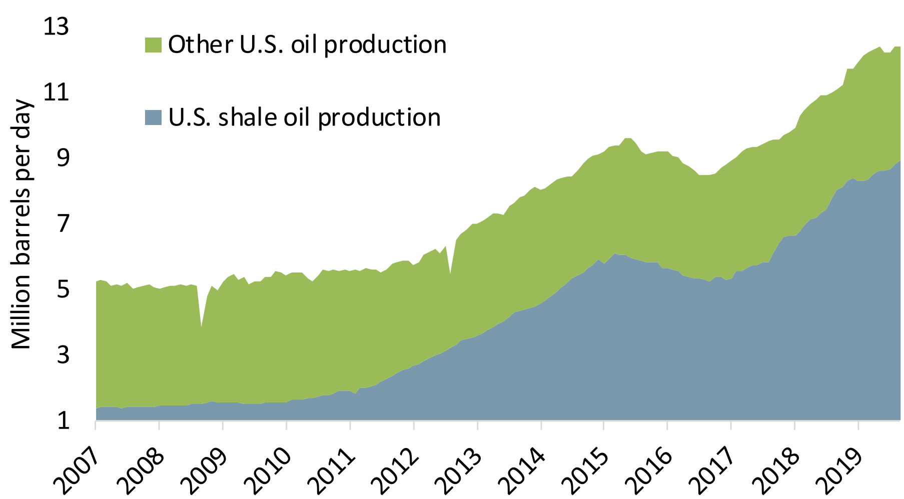
In the Real Assets space, that could mean higher commodity prices overall. Oil is a key input cost to mining, harvesting, processing, and transporting other commodities. There also would likely be significantly higher natural-gas prices as it is largely produced by fracking. Further, Midstream would suffer as oil-production volumes would crash lower and many of their customers would go bankrupt.

Key takeaways

» We believe that an all-out national ban on fracking is highly unlikely, regardless of who becomes president.

» In the event of a fracking ban, we would expect oil, natural gas, and commodity prices to rise and Midstream to suffer.

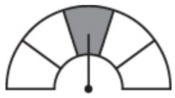
U.S. shale oil production versus total production



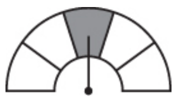
Sources: Bloomberg, Energy Information Administration, Rystad, Wells Fargo Investment Institute. Monthly data: January 31, 2007 – September 30, 2019.

[4] Spare capacity is the difference between the amount of oil actually being produced and the maximum amount of oil possibly able to be produced if the floodgates were opened.

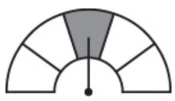
Nicholas Sprague, CFA
Global Alternative Investment Strategist



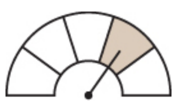
Neutral
Private Equity



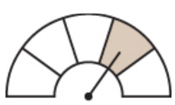
Neutral
Hedge Funds-Macro



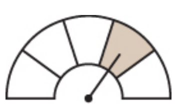
Neutral
Hedge Funds-Event Driven



Favorable
Private Debt



Favorable
Hedge Funds-Equity Hedge



Favorable
Hedge Funds-Relative Value

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

Private equity secondary funds—a compelling risk and return story

As private markets continue to mature, the secondary market has expanded rapidly. Total first-half 2019 secondary deal volume was $42 billion—a 55% increase over the same 2018 period. Despite this growth, the market remains well-balanced, with the average high secondary bid for all funds at 89% of net asset value (NAV).[5]

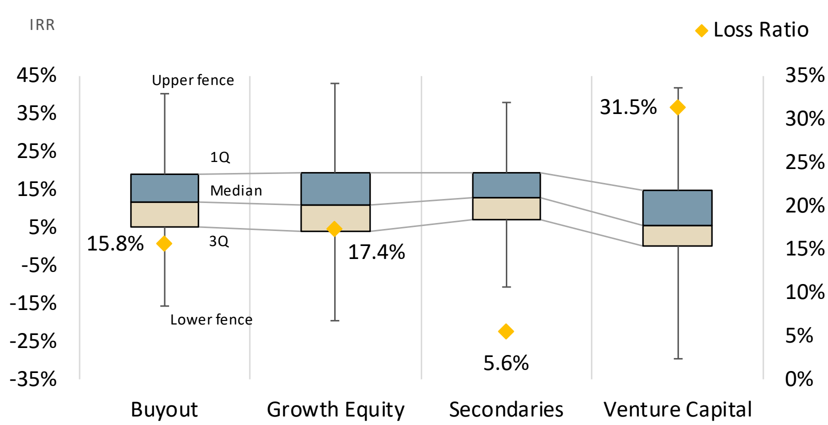
Limited and general partners leverage secondary markets for liquidity to proactively manage portfolios and funds. The seller often can lock in gains and opportunistically redeploy capital. Secondary fund managers can purchase these portfolios of mature assets—frequently with good visibility to future cash flows and at a discount to underlying NAV. Furthermore, secondary fund managers can diversify portfolios across vintage, stage, industry, and geography. We believe that these secondary portfolio characteristics have enabled an attractive risk/return profile (see chart). The median net internal rate of return (IRR) per annum for secondary funds exceeds that of other major primary private equity strategies at lower loss ratios. The median net IRR for secondary funds raised between 1998 and 2018 is 13.0%, compared to 11.9%, 11.0%, and 5.8% for buyout, growth equity, and venture capital funds, respectively. Further, loss ratios for these strategies over this period were roughly 3 to 6 times greater than the 5.6% loss ratio for secondary funds.[6] While the tighter secondary fund return dispersion limits "home-run" potential, it also can help on the downside. As the business cycle ages, the latter could become increasingly important.

Key takeaways

» Growth in the private equity secondary markets has been rapid but balanced.

» We believe the unique characteristics of secondary funds can provide for an attractive risk/return profile.

Secondary funds—historically strong returns with potential to help limit downside participation



Sources: Cobalt LP; Data as of June 30, 2019. Chart shows the upper fence, first quartile ("1Q"), Median, third quartile ("3Q"), and lower fence IRR performance (LHS) and loss ratios (RHS) by fund strategy for vintage years 1998-2018. Upper (lower) fence is defined as the 1Q (3Q) lower boundary plus (minus) 1.5 times the interquartile range. Loss ratio is equal to the invested capital in deals realized below cost, net of any realized proceeds, divided by total invested capital.

[5] Greenhill Global Secondary Market Trends and Outlook, July 2019.
[6] Cobalt LP, data as of June 30, 2019.

Risk Considerations

Sustainable investing focuses on companies that demonstrate adherence to environmental, social and corporate governance principles, among other values. There is no assurance that social impact investing can be an effective strategy under all market conditions. Different investment styles tend to shift in and out of favor. In addition, a [strategy's] [fund's] social policy could cause it to forgo opportunities to gain exposure to certain industries, companies, sectors or regions of the economy which could cause it to underperform similar portfolios that do not have a social policy.

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. **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. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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 suitable 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.

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