Cast a wide net:

Generating yield in a yield-starved world

Investing during periods of market stress or extreme market volatility can be quite challenging, as most investors know. The COVID-19-induced dislocation of 2020 is a fresh example of the kinds of difficulties investors might face when markets move quickly and price discovery is complicated. Yet the periods that lead up to market dislocations can be equally challenging. In these environments, bond markets are typically characterized by tight credit spreads and low yields—or, in other words, rich bond valuations. Knowing which risks are worth taking during the "calm before the storm" can be just as important to long-term success as knowing what to do when a storm arrives. Let's consider what things looked like in the period leading up to the outbreak of COVID-19 so we can draw parallels with current market conditions.

Janet Rilling, CFA

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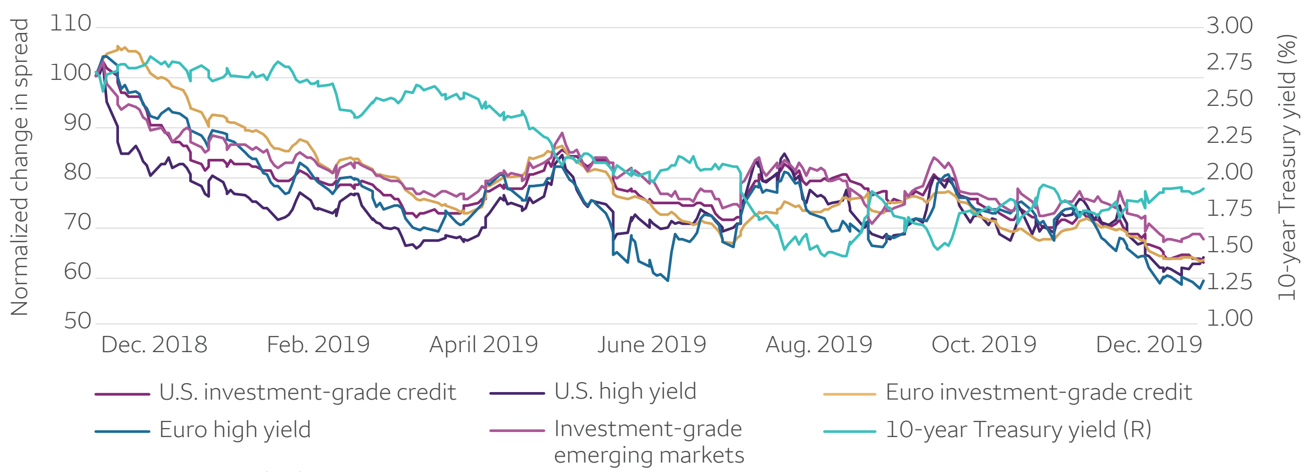
Coming into January 2020—which feels like a lifetime ago—we were faced with a largely low-yield, high-price bond market. It was the tail end of the longest equity bull market on record and, while there were many challenges and risks for investors to consider, including an aging economic cycle, heightened global trade tensions, antagonistic relations with Iran, the beginning of an oil price war, and the start of a presidential election cycle, most securities across fixed-income markets were priced for continued good times. As seen in Figure 1, the credit spreads for high-yield and investment-grade debt in the United States and Europe were nearing their post-financial-crisis tights. Further, Treasury yields had been falling since reaching their late 2018 peak. The Federal Reserve (Fed) had reduced its main policy rate three times in 2019, bringing yields on the front end of the curve back to low levels. It was the type of environment where investors were having to stretch to find yield—meaning they were investing further out the curve or lower in credit quality than they would normally—in order to achieve their income targets.

Figure 1: Investors got paid less for bearing risk throughout 2019

Credit spreads narrowed and rates fell throughout 2019



Source: Bloomberg, as of 12/31/2019

Past performance is no guarantee of future results.

Our approach then, as it has always been, was to cast a wide net to find attractive opportunities. In our experience, we have found that taking a more diversified approach can help us uncover opportunities and more effectively manage risks that often build prior to bouts of volatility. Specifically, we had been reducing our exposure to lower-rated credit sectors throughout 2019 as spreads continued to narrow, with the view that investors were not being adequately compensated for the risks. With the proceeds, we opted to look more broadly for alternatives that presented a better risk/return balance.

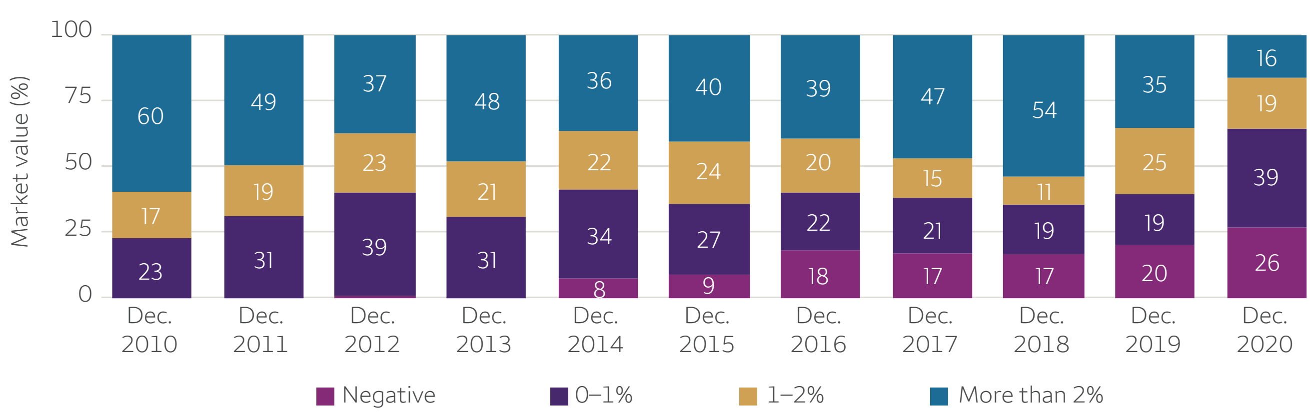
In our judgment, such opportunities existed in investment-grade credit, across a wide swath of securitized sectors, and in global sovereign bonds. These exposures, while not the highest yielding at the time, provided us with liquidity during the volatile sell-off in March 2020, affording us the opportunity to make conviction trades into higher-yielding sectors after spreads had widened.

As we begin 2021, we note that we have experienced nearly a full business cycle over the past four quarters. The economy and markets entered 2020 on strong footing only to sell off tremendously with the onset of the pandemic and its resultant impact on the economy, which produced some of the worst economic readings we've seen in our lifetimes. The market recovery throughout the second and third quarters was profound. Risk assets rallied hard, bringing prices higher and sending yields plummeting. Despite all the risks we find in the marketplace today, we are strangely back in a low-yielding global environment.

To put this rally into proper perspective, consider that the supply of bonds with attractive yields in global fixed-income markets is lower now than it has ever been. At the same time, demand for fixed-income yield is high and, in our view, going higher. These dynamics create real challenges for income-starved investors, and the problem isn't likely going away anytime soon. As Figure 2 shows, nearly two out of every three dollars of investment-grade debt around the world traded with a yield less than 1% by the end of December 2020. Shockingly, there was more debt trading at a negative yield than trading with a yield of more than 2%.

Figure 2: It has been harder for fixed-income investors to find attractive yields

Bloomberg Barclays Global Aggregate Bond Index—market value % by yield



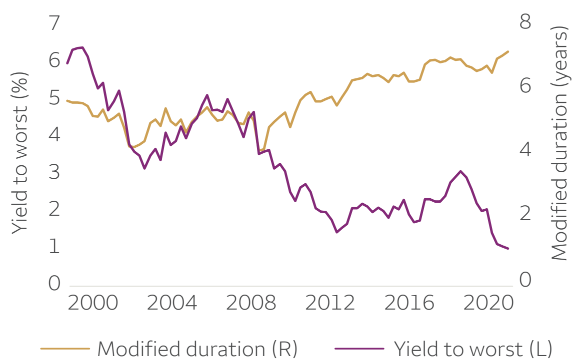
Source: Bloomberg, as of 12/31/2020

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The extremes of the global search for yield have certainly been felt in U.S. bond markets as well. Late in 2020, the Bloomberg Barclays U.S. Aggregate Bond Index reached its all-time low for yield and its all-time high for modified duration.[1] As Figure 3 shows, U.S. investors found themselves getting paid the lowest yield in history for taking on the most interest rate risk.

Figure 3: U.S. Aggregate investors get paid less for bearing risk

Bloomberg Barclays U.S. Aggregate Bond Index yield to worst and modified duration

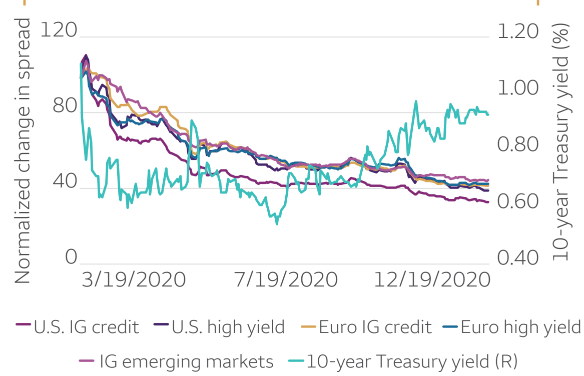


Source: Bloomberg, as of 12/31/2020
Past performance is no guarantee of future results.

While the calendar has flipped to 2021, we can't help but feel déjà vu all over again—we find ourselves in a low-yield environment globally in which credit spreads have narrowed dramatically from their widest levels (see Figure 4). The front end of the yield curve[2] is anchored near zero with the Fed suggesting it could keep rates low for years to come. This is clearly an environment where the "reach-for-yield" mindset will be back in full force. For us, this means a continued focus on our playbook: Cast a wide net, stay more broadly diversified, and take risk exposures where we feel we can be attractively compensated. We think our multi-sector style continues to be an effective way to source yield above what can be achieved from investing in the rate-sensitive U.S. Aggregate benchmark (see Figure 5).

Figure 4: Look familiar?

Spreads and rates are well off their March peaks



Source: Bloomberg, as of 12/31/2020
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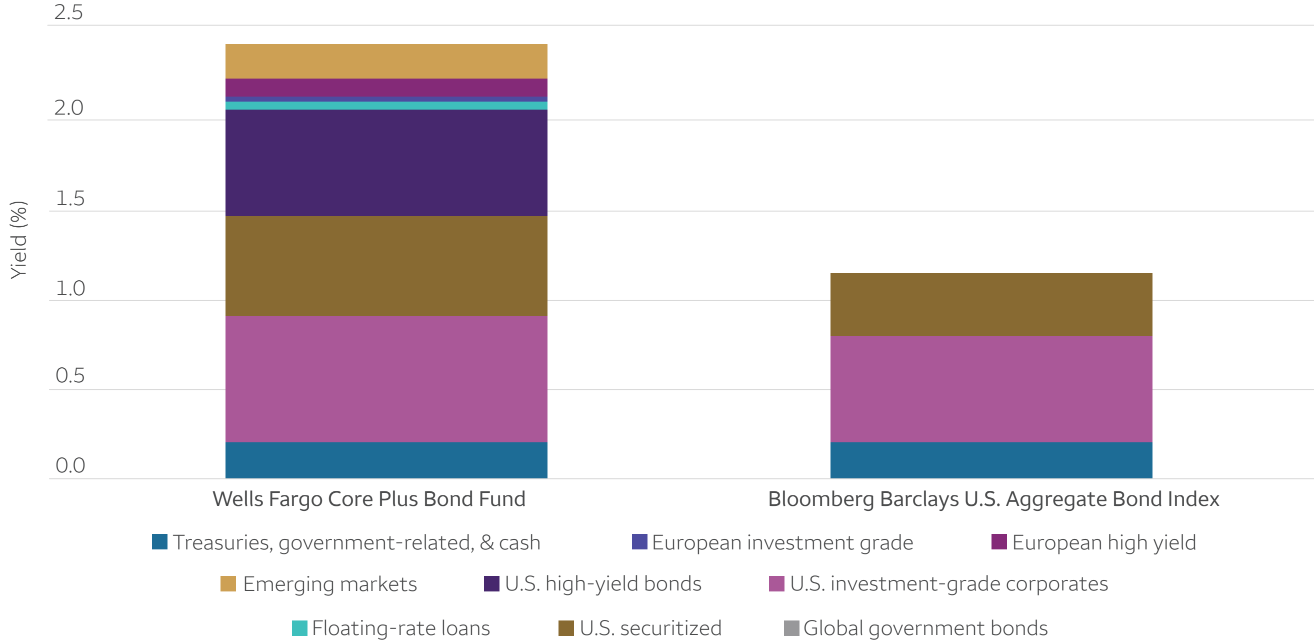
1. Captures the change in the price of a security for a given change in interest rates.

2. A graphical representation of fixed-income security yields (usually U.S. Treasuries) at their respective maturities, starting with the shortest time to maturity and sequentially plotting in a line chart to the longest maturity. The yield curve is based on historical performance and does not represent future results.

Figure 5: A more diversified approach to sourcing income



Sources: Bloomberg and WFAM, as of 12/31/2020

Wells Fargo Core Plus Bond Fund total returns (%) as of 12/31/2020

Total returns (%)	YTD*	1 year	3 year	5 year	10 year
Wells Fargo Core Plus Bond Fund – Inst (WIPIX)	11.63	11.63	6.84	6.43	5.16
Bloomberg Barclays U.S. Aggregate Bond Index	7.51	7.51	5.34	4.44	3.84

*Returns for periods of less than one year are not annualized.

Figures quoted represent past performance, which is no guarantee of future results, and do not reflect taxes that a shareholder may pay on an investment in a fund. *Investment return, principal value, and yields 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 shares are sold without a front-end sales charge or contingent deferred sales charge.

The manager has contractually committed, through December 31, 2021, to waive fees and/or reimburse expenses to the extent necessary to cap the fund's total annual fund operating expenses after fee waiver at 0.40% for Institutional Class. The fund's gross expense ratio is 0.56%. The fund's net expense ratio is 0.42%. Brokerage commissions, stamp duty fees, interest, taxes, acquired fund fees and expenses (if any), and extraordinary expenses are excluded from the expense cap. Without these reductions, the fund's returns would have been lower. Prior to or after the commitment expiration date, the cap may be increased or the commitment to maintain the cap may be terminated only with the approval of the Board of Trustees. The expense ratio paid by an investor is the net expense ratio (the total annual fund operating expenses after fee waivers) as stated in the prospectus.

Source: WFAM, as of 12/31/2020

We seek to cast a wide net, stay more broadly diversified, and take risk exposures where we feel we can be attractively compensated.

As we look forward, we would be remiss not to mention the many favorable elements we see on the horizon. With each passing day we move closer to the administration of a vaccine and more effective therapeutics. As life gradually returns to normal, economic recovery is expected to follow—a typically good time for risk assets and credit repair. Further, the strong appetite for yield in a low-yield world is not likely to abate. And while the supply of new debt may meet some of this demand, the record levels of investment-grade corporate issuance witnessed in 2020 are not likely to be repeated.

This means the “reach-for-yield” mindset should be expected to continue and, perhaps, be self-reinforcing. But, as in prior “calm-before-the-storm” periods, remaining mindful of valuations and casting a wide net may again prove to be a rewarding approach.

Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable. Loans are subject to risks similar to those associated with other below-investment-grade bond investments, such as risk of greater volatility in value, credit risk (for example, risk of issuer default), and risk that the loan may become illiquid or difficult to price. The use of derivatives may reduce returns and/or increase volatility. Certain investment strategies tend to increase the total risk of an investment (relative to the broader market). This fund is exposed to foreign investment risk, high-yield securities risk, and mortgage- and asset-backed securities risk. High-yield securities have a greater risk of default and tend to be more volatile than higher-rated debt securities. Consult the fund’s prospectus for additional information on these and other risks.

Index definitions:

Bloomberg Barclays U.S. Aggregate Bond Index
The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

Bloomberg Barclays Global Aggregate Bond Index
The Bloomberg Barclays Global Aggregate Bond Index is a measure of global investment-grade debt performance. This multicurrency benchmark includes Treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging market issuers. You cannot invest directly in an index.

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at WFAMInstitutional@wellsfargo.com.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at 1-888-877-9275.
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Retirement at Wells Fargo Asset Management, at nathaniel.s.miles@wellsfargo.com.
- To discuss sustainable investing solutions, contact Hannah Skeates or Christopher McKnett, co-heads of Sustainable Investing at Wells Fargo Asset Management, at hannah.skeates@wellsfargo.com or christopher.mcknett@wellsfargo.com.

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