More Than a Number:
Using Portfolio Construction to Lower Downside Risk

U.S. large-capitalization stock funds make up roughly 20% of total 401(k) plan assets—more than any other single asset class. It's crucial that plan sponsors select the right fund options for this asset class.[1]

Funds that blend skillful stock selection with advanced portfolio construction can help shield participants from unforeseen downside risks and help them achieve their retirement goals.

Allspring's Special Global Equity (SGE) team believes enhanced risk control methods for portfolio construction allow for proper diversification of risk without the need to own a large number of names, which can unintentionally dilute exposure to a manager's best ideas.

Many active large-cap managers increase the number of holdings in their portfolio, hoping to diversify away risk that is not otherwise being properly measured and managed. However, evidence doesn't support this practice. Figure 1 shows down-market capture for large-cap value strategies categorized by their number of portfolio holdings. (Down-market capture measures a strategy's performance relative to its benchmark in down markets—the lower the number, the better the performance.) If increasing the number of portfolio holdings was actually associated with lower risk, we would expect to see more favorable down-market capture data (on average and over time) as the number of holdings increased. On the contrary, some of the smaller tiers had more favorable down-side market capture rates than the higher tiers.

Large-cap value strategies' down-market capture rates show mixed results across the number of holdings.

FIGURE 1: LARGE-CAP VALUE STRATEGIES' DMC RATES SHOW MIXED RESULTS ACROSS THE NUMBER OF HOLDINGS

	3 YEARS		5 YEARS		10 YEARS	
NUMBER OF HOLDINGS	NUMBER OF STRATEGIES	AVERAGE DMC	NUMBER OF STRATEGIES	AVERAGE DMC	NUMBER OF STRATEGIES	AVERAGE DMC
0–30	45	97.8	43	95.9	40	94.4
31–40	52	95.7	50	97.6	45	96.8
41–50	64	93.3	62	95.7	52	94.6
51–60	38	97.7	38	99.6	38	99.1
61–70	39	96.1	39	99.1	37	98.5
71–80	25	95.0	25	96.9	25	95.5
81–100	29	92.8	29	96.0	25	94.8
100+	55	95.1	53	97.2	46	96.5
UNIVERSE AVERAGE		**95.4**		**97.2**		**96.3**

Source: eVestment. Number of holdings range based on reported holdings as of 30-Jun-23.

1. Source: Cerulli: U.S. Defined Contribution Distribution, 2022, Callan DC Index Allocations, P&I. Target date funds, which make up nearly 34% of 401(k) assets, represent multiple asset classes.

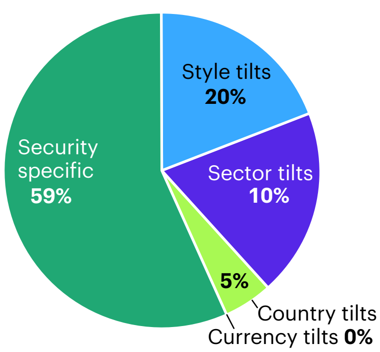
A better approach

The Allspring SGE team combines a unique approach to stock selection with a meticulous portfolio construction process, aiming to neutralize undesirable risks while allowing security selection to drive portfolio returns.

Defined contribution (DC) plan sponsors have relied on the team's small- and mid-cap value strategies to help participants grow their retirement savings for nearly 20 years—in more than 22,300 plans and representing over $8.3 billion in assets. The Allspring Special U.S. Large Cap Value Equity portfolio is built on the same philosophy of delivering a consistent, style-pure portfolio that protects capital during market drawdowns and performs as expected throughout the market cycle.

The team's portfolio construction process uses Allspring's proprietary ex-ante (forecast) and ex-post (historical) risk tools to create a portfolio with not only a suitable amount of active risk but also suitable types of active risk (Figure 2). The team monitors the impact on active risk of sector, style, country, and currency exposures plus correlations across stocks.

FIGURE 2: SECURITY SELECTION HAS DRIVEN ACTIVE RISK FOR THE SPECIAL U.S. LARGE CAP VALUE



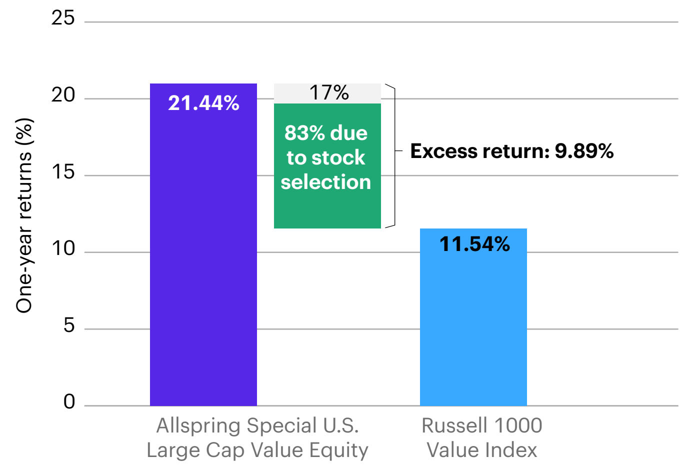
Source: Allspring, as of 30-Jun-23.

Knowing that the team's strength lies in a differentiated security selection process, portfolio managers intentionally neutralize the impact from any one style factor, sector weight, or macro event—rather than try to predict macro events or winning style exposures. This process has allowed them to isolate the bulk of the strategy's active risk and excess return drivers to security selection, as evidenced by the historical attribution (Figure 3). The result of this process is a more repeatable return pattern with a lower standard deviation and tracking error than peers.

Comprehensive risk assessment

DC plan architects have long recognized that downside protection is one of the most important ingredients to long-term wealth creation—preserving wealth is key to building wealth. It is especially important to evaluate how a manager protects against down-market moves. Is past performance a result of hiding in defensive sectors and effective timing decisions that

FIGURE 3: SPECIAL U.S. LARGE CAP VALUE EQUITY EXCESS RETURNS WERE PRIMARILY DUE TO STOCK SELECTION



Sources: Allspring and FactSet. FactSet. One-year returns ending 30-Jun-23. This is based on a representative account. **Past performance is no indication of future results.** For further information, please see the GIPS Composite Report at the end of this report.

may prove difficult to repeat? Or was it due to a consistent stock selection process that has natural defensive characteristics and is not dependent on timing cycles?

One of the differentiated hallmarks of the SGE team's investment philosophy is an appreciation that companies control their destiny by how they use the balance sheet. The team's unique process in assessing and measuring the financial flexibility of a company's balance sheet provides insight on the company's ability to provide both defensive and offensive characteristics. This time-tested process, which has added value in the U.S. small-cap and mid-cap sectors, is now applied to the U.S. large-cap value universe.

The SGE team believes that stocks only fall as far as the balance sheet will allow them to fall. In other words, a properly built balance sheet will put an effective floor in a stock price. This analysis goes beyond the simplistic measurement of the amount of debt issued to gauge the underlying character of the balance sheet. For example, the team focuses on the maturity profile of outstanding debt, the volatility of the cash flow stream that supports the debt service payments, the required capital intensity to maintain the asset base that creates the free cash flow, and the margin of safety relative to the company's debt covenants. Each element plays a critical role in defining the risk embedded in the balance sheet as well as the options available to the management team.

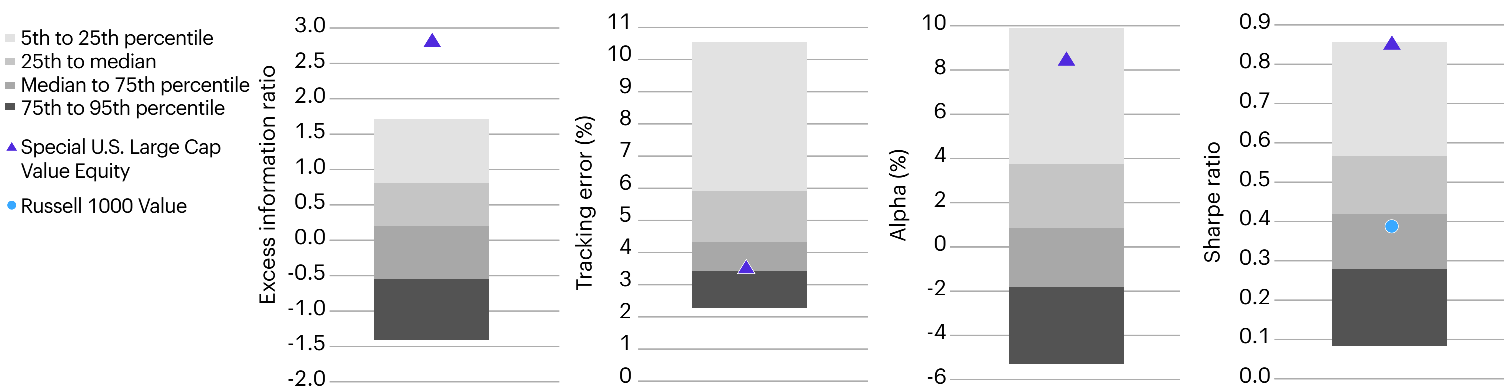
Each company in the SGE portfolios is assessed through this enhanced analytical lens. If the balance sheet is built correctly with all of these characteristics in place, the company will likely be able to buy back their stock at lower prices, acquire competitors when they are weak, maintain research and development, and make capital expenditures when others pull back. These decisions have the potential to halt the drop in stock prices, as the market appreciates the future benefits of these decisions against the backdrop of fear that is driving other stock prices lower.

One of the most powerful ways for a company to put a floor in their stock price is to play offense while the rest of the world is playing defense. A properly built balance sheet makes this possible. For example, the Special U.S. Large Cap Value Equity portfolio holds D.R. Horton Inc. (DHI). The company is America's largest homebuilder and primarily serves entry-level homebuyers. From January through October 2022, as interest rates began to rise and home affordability became increasingly challenged, the U.S. Home Construction ETF (ITB) fell approximately 32%. D.R. Horton's share price fell approximately 28%, and as the stock fell, management acted offensively and repurchased $1.1 billion in stock during 2022. In addition, they more than tripled their investment in single-family and multi-family rental properties when other firms were pulling back to conserve their balance sheet capacity. Not only did D.R. Horton's stock outperform as the peer group fell, it has since appreciated 64% off the October lows while the ITB ETF is up only approximately 58%. The unique ability to use its balance sheet to reduce share count while accelerating capital investment in their rental franchise for the benefit of future free cash flow minimized the downside and enhanced the upside. This is a type of smart balance sheet management the team seeks to identify and capture in holdings within the Special U.S. Large Cap Value Equity portfolio. It's the holdings and portfolio construction that matter, not simply the total number of holdings.

Delivering what clients expect

The SGE team assumed responsibility for the Allspring Special U.S. Large Cap Value Equity portfolio in January 2021, setting out to better align the portfolio with the team's small- and mid-cap portfolios, which are widely used across the retirement community. In part, this work prioritized moving the portfolio back into the value style box and incorporating the risk controls that the team has become known for. Figure 4 highlights results of this effort—a lower tracking error relative to peers and top-decile risk-adjusted returns as measured by the information ratio and Sharpe ratio over the past year.

FIGURE 4: SPECIAL U.S. LARGE CAP VALUE EQUITY HAD STRONG ONE-YEAR PERFORMANCE (AS OF 30-JUN-2023)



	INFORMATION RATIO (IR)	IR RANK	TRACKING ERROR (TE)	TE RANK	ALPHA	ALPHA RANK	SHARPE RATIO	SHARPE RANK
Special U.S. Large Cap Value Equity	2.83	1	3.45	73	8.51	6	0.85	6
Russell 1000 Value Index	NA	NA	NA	NA	NA	NA	0.38	57
Number of observations	418		418		418		418	
Universe (5%)	1.73		10.52		9.86		0.85	
Universe (25%)	0.80		5.89		3.67		0.57	
Universe (median)	0.19		4.35		0.89		0.42	
Universe (75%)	-0.56		3.36		-1.81		0.28	
Universe (95%)	-1.39		2.21		-5.31		0.08	

Source: eVestment Alliance Database via MPI. Performance is gross and does not include fees and expenses, which will reduce returns. The GIPS Composite Report, including information on net returns, can be found at the end of this report. **Past performance is not a reliable indicator of future results.**

Despite the fact that the timing of this process coincided with a very volatile, macro-driven market, the portfolio has achieved the results SGE clients have come to expect—namely, low tracking error with strong excess returns. The SGE team continues to apply a disciplined approach, targeting active risk through stock selection and downside protection through advanced portfolio construction for consistent returns over the long term.

GIPS® composite report

Special U.S. Large Cap Value Equity

PERIOD	GROSS ANNUAL RETURN (%)	NET ANNUAL RETURN (%)	PRIMARY INDEX RETURN (%)	SECONDARY INDEX RETURN (%)	COMPOSITE 3 YR STD DEV (%)	PRIMARY INDEX 3 YR STD DEV (%)	SECONDARY INDEX 3 YR STD DEV (%)	INTERNAL DISPERSION (5)	NUMBER OF ACCOUNTS	COMPOSITE ASSETS ($-MM)	TOTAL FIRM ASSETS ($-MM)
2022	-5.48	-6.10	-7.54	-18.11	21.00	21.25	20.87	0.38	9	905.3	374,321
2021	24.70	23.91	25.16	28.71	18.11	19.06	17.17	0.55	12	1,106.7	483,747
2020	3.61	2.93	2.80	18.40	19.06	19.62	18.53	1.17	17	1,237.5	508,914
2019	31.91	31.08	26.54	31.49	12.10	11.85	11.93	0.04	19	1,340.5	419,579
2018	-3.54	-4.17	-8.27	-4.38	11.01	10.82	10.80	0.78	17	1,719.4	371,582
2017	16.22	15.47	13.66	21.83	10.22	10.20	9.92	0.51	23	2,116.9	385,111
2016	8.90	8.20	17.34	11.96	10.83	10.77	10.59	0.70	37	3,078.7	330,718
2015	0.27	-0.38	-3.83	1.38	10.76	10.68	10.47	0.24	93	3,367.8	349,342
2014	11.68	10.96	13.45	13.69	9.31	9.20	8.97	0.14	91	3,518.5	351,065
2013	30.95	30.12	32.53	32.39	12.83	12.70	11.94	0.62	106	4,115.7	357,113

Sources: Allspring Global Investments; Primary Index: Russell 1000 Value Index; Secondary Index: S&P 500 Index

Allspring Global Investments (Allspring) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Allspring has been independently verified for the periods January 1, 1997 through December 31, 2022. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The Special U.S. Large Cap Value Equity Composite has had a performance examination for the periods January 1, 2021 through December 31, 2022. The verification and performance examination reports are available upon request.

For the purpose of complying with GIPS, the GIPS firm is defined as Allspring. Since the GIPS firm's creation in 1996, the firm has acquired a number of investment teams and/or assets through mergers or acquisitions which include assets and/or investment teams from Wells Capital Management, EverKey Global Partners, Wells Fargo Asset Management (International) Limited, Analytic Investors, LLC, Golden Capital Management, LLC, Wells Fargo Asset Management Luxembourg S.A. and Wells Fargo Funds Management, LLC (WFFM).

The Special U.S. Large Cap Value Equity Composite consists of all actual, fully discretionary Large Cap accounts. The strategy typically consists of approximately 40 securities with market capitalizations in excess of $2 billion at initial investment and managed with a view toward capital appreciation. Investment results are measured versus the Russell 1000® Value Index and the S&P 500 Index. The Composite creation date is April 1, 2021. The composite inception date is January 1, 2010. Prior to November 1, 2022 the inception date was January 1, 1992. The change was made to comply with the new SEC advertising rule.

Composite returns are net of transaction costs and non-reclaimable withholding taxes, if any, are expressed in U.S. dollars, and reflect the reinvestment of dividends and other earnings. Gross Composite returns do not reflect the deduction of investment advisory fees. As of January 1, 2013, net Composite returns are calculated using a model investment advisory fee, which is the maximum annual advisory fee based upon the fee schedule in effect during each respective performance period. Any changes to the fee schedule are reflected in the calculation of the net Composite returns beginning with the period in which the fee schedule is revised. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Prior to January 1, 2013, net Composite returns were calculated using actual investment advisory fees. The Composite may contain accounts with performance-based fees. Prior to January 1, 2013, net returns are net of any performance-based fees. Allspring's fee schedules are available upon request and may also be found in Part 2 of Form ADV. The published fee schedule for this strategy is 0.65% for the first $25mm, 0.50% for the next $25mm, 0.45% for the next $50mm, and 0.40% over $100mm. The strategy is available via one or more pooled funds, which may have alternate fee schedules. The limited distribution pooled fund is Allspring Special Large Cap Value CIT, which has a total all-in fee of 0.50%. Prior to January 1, 2021, the Composite had a Significant Cash Flow ("SCF") policy to temporarily remove accounts from the Composite. A SCF is defined as a single client initiated net cash flow of either cash and/or securities within a seven business day window that exceeds 25% of the account's previous day's total market value. Prior to October 1, 2018, the seven business day window requirement was not in effect, but the remainder of the SCF definition was the same. Additional information regarding Allspring's policies for valuing investments, calculating performance and preparing GIPS Composite Reports is available upon request. A list of composite descriptions, a list of limited distribution pooled fund descriptions, and a list of broad distribution pooled funds are available upon request.

Effective January 1, 2013, internal dispersion is the equal-weighted standard deviation of the annual gross returns of all accounts included in the Composite for the entire year. Prior to January 1, 2013, internal dispersion was calculated using the asset-weighted standard deviation of all accounts included in the Composite for the entire year. For years where there are 5 or fewer accounts in the Composite for the entire year, dispersion is not presented as it is not a meaningful statistical calculation. The 3-year annualized standard deviation measures the variability of the gross Composite returns and the index returns over the preceding 36-month time period.

Actual performance results may differ from Composite returns, depending on the size of the account, investment guidelines and/or restrictions, inception date and other factors. Performance for some accounts in this Composite may be calculated by third-parties that use different security pricing and performance methodologies. Past performance is not indicative of future results. As with any investment vehicle, there is always the potential for gains as well as the possibility of losses. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.

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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.

Contact details

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- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **1-866-701-2575**.
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- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **1-800-368-1370**.

FOR SUSTAINABLE INVESTING

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