Reallocation Memo

06 2019

Updated June 2019

Target Risk and Target Income Portfolios

LiveWell Portfolios

Affected Portfolios

- LiveWell Mutual Fund IRA:
  - Conservative
  - Moderate
  - Moderate Growth
  - Growth
  - Aggressive Growth
  - Diversified Income
  - High Income
- LiveWell Variable Annuity:
  - Conservative
  - Moderate
  - Moderate Growth
  - Growth
  - Aggressive Growth
  - Diversified Income
  - High Income

At Morningstar Investment Management LLC, we recently updated the asset allocation target recommendations we provide for the Sammons Retirement Solutions platform's LiveWell portfolios to reflect the results of our most recent financial, economic, and portfolio research. In this memo, we outline the changes in our outlook and the updates we made to our asset allocation target recommendations, including the mutual fund (MF) and variable annuity (VA) portfolio versions.

About Our Methodology

At Morningstar Investment Management, our investment philosophy holds that asset allocation policy is one of the biggest factors in determining a portfolio's risk and return characteristics over time. Further, we are guided globally by seven investment principles which shape our recommendations and outlook:

1. **We put investors first.**
2. **We're independent-minded.**
3. **We invest for the long term.**
4. **We're valuation-driven investors.**
5. **We take a fundamental approach.**
6. **We strive to minimize costs.**
7. **We build portfolios holistically.**

To develop an effective asset allocation for each portfolio, we develop capital market forecasts for every asset class, using a combination of historical return data and current market information. Next, we incorporate these data into our models, testing them under a variety of market conditions to help create a diversified, real-world asset allocation (the mix of asset classes, including stocks, bonds, real estate, alternatives, cash, etc.) for each portfolio.

Earlier this year, we finalized our most recent capital market assumptions, analyzing and incorporating data from 2018. As a result, we made adjustments to our asset allocations, which represent the asset mix we think is appropriate over the long term to achieve a desired risk and return profile. Changes are designed to help keep the portfolios diversified among asset classes while maximizing return expectations given a target risk profile.

Overall Asset Allocation Positioning

- Based on today's peak earnings, U.S. stocks look fully valued. Profit margins set multi-year highs in 2018 and are now coming under pressure as global growth slows. On a cyclically adjusted basis, U.S. stock are particularly expensive, with growth sectors such as technology and consumer discretionary looking especially dear. Within the U.S., our asset allocation model favors value areas of the market and we see less drawdown risk in largecaps, when compared to small and mid-cap stocks. Better relative valuations exist overseas, and our valuation-driven process continues to unearth higher expected returns for both non-US stocks, including emerging markets.

- Our return expectations for U.S. stocks remain low, and we continue to find more value in international developed and emerging markets stocks.
- Among U.S. stocks, we are recommending a reduction in exposure to growth in favor of value stocks across the market-capitalization spectrum, following the strong performance of growth in 2017.
- Within fixed income, we are recommending further reductions to high-yield bonds within the target-risk models. We are recommending increased exposure to short-term bonds, which we feel can offer better relative value amid rising yields and a flatter yield curve.

Key Asset Allocation Changes – Equity

U.S. Equity

- We are recommending increased allocations to value stocks, as growth's valuation and heavy weighting in tech stocks lead us to dislike the reward for risk picture; we expect higher relative returns from value stocks moving forward.

International Equity

- We recommend maintaining an overweight to international and emerging-markets stocks as we continue to find more relative value in equity markets outside the U.S.. Our outlook for Japanese equities has improved, so our recommendations include tilting portfolios slightly toward funds that highlight that country.

Key Asset Allocation Changes – Fixed Income

High Yield & Emerging-Markets Debt

- For the target-risk models, we recommend reduced exposure to credit as valuations continued to become stretched.

Aggregate and Short-Term Bonds

- We recommend increasing allocations to short-term bonds as interest rates increased at the short-end of the yield curve in 2018, offering an attractive potential reward for risk among fixed income assets.
- We also recommend marginally increasing exposure to aggregate bonds, as we favor investment-grade bonds over high yield.

Fund-Specific Changes

- There are many reasons why a portfolio may stray from its stated objective, thus requiring adjustment over time. These reasons include varying market conditions, manager changes, and fund style drift.
- A portfolio's asset allocation should be reviewed regularly to ensure it stays in line with its stated strategy objective, within acceptable risk ranges, and competitive within respective peer universes.

- The recommendations we made to Sammons Retirement Solutions® Inc. below are designed to help maximize the portfolio's return potential while seeking to maintain an effective target asset allocation. Given annual changes to the asset allocation targets detailed above, we recommended the following fund reallocations. In addition to the following recommendations, we suggested small individual fund allocation adjustments to account for fund style drifts and new asset allocation targets, to help realign portfolios to a long-term asset allocation target. The main goal of fund selection is to hit our targets. Sammons Retirement Solutions® Inc. has final decision-making authority over whether to implement any of Morningstar Investment Management's recommendations.

Recommendations

We recommend one fund removal/addition this year. We also recommend reallocating among existing funds to tilt portfolios toward areas of the market we feel have more favorable reward for risk.

We recommend the replacement of First Investors Opportunity A with ClearBridge Mid Cap R.

Due to the pending liquidation of First Investors funds following its parent's acquisition, we recommend removing First Investors Opportunity A from the Target Risk Portfolios.

To replace First Investors Opportunity A, we are recommending ClearBridge Mid Cap R. The fund has the advantage of a stable, seasoned, and strong management team. Comanagers Derek Deutsch and Brian Angerame have been at the helm of this mid-blend Morningstar Category fund for more than 13 years now; they are longtime veterans of the ClearBridge complex and have 19 and 24 years of investment experience, respectively. Deutsch and Angerame have three dedicated small/mid-cap analysts who are pretty seasoned themselves and who have focused on this fund for roughly three to 11 years each. The team also has ClearBridge's solid set of sector specialists to draw on for support. Deutsch and Angerame have employed the same sound, quality-oriented, and risk-conscious strategy throughout their tenure. In particular, they look for companies with strong fundamentals, capital discipline, and attractive valuations using both a quantitative model (which evaluates free cash flow yield, returns on equity, and other factors) and fundamental analysis (which focuses on industry dynamics, business models, and other variables). They pay ample attention to company, sector, and other risks; maintain a high active share versus the Russell Midcap Index; and move at a measured paced while doing so.

Thanks to the various risk-control measures in this process, as well as the Deutsch and Angerame's execution, this fund has done a solid job of avoiding excessive volatility.

Increase the weighting in American Century Value, as we continue to favor large-cap value over growth.

Michael Liss has comanaged this fund since 2004 and served as its lead manager since September 2008, and he works in a collaborative fashion with 13 other managers and analysts. This fund's investment process begins much as it does at the team's other charges. It screens a universe of 6,000 stocks for criteria such as solid returns on capital, low leverage, strong franchises, and industries with high barriers to entry. The resulting group of 500 stocks serves as the team's selection pool. From there, the team assesses risk/reward ratios. Although this is not a deep-value offering, the team stays true to the fund's moniker and selects from the least expensive third of the 500 potential holdings based on at least two of five valuation measures, including price/earnings and price/free cash flow. The fund has a nominal all-cap mandate, but large-cap stocks dominate the portfolio, and it lands in the large-value corner of the Morningstar Style Box™ year after year.

Increase the allocation to Invesco Oppenheimer International Growth, as that strategy continues to find opportunities in Japan, where our expected returns for stocks have increased over the past year.

Portfolio manager George Evans favor companies with sustainable competitive advantages and good management, operating in growing industries. Often these stocks fit into one of four themes: mass affluence, new technology, restructuring, and aging. As a result, the portfolio has historically had large concentrations in consumer discretionary and technology names, even relative to its foreign large-growth category peers. The portfolio's three-year average annual turnover is about 13%, well below the 51% norm for foreign large-growth offerings. The managers believe that quality companies tend to sustain their competitive advantages and deliver good returns for many years. This is very much a stock-pickers' fund. The managers do not make top-down, macro-driven decisions.

Increase the weighting in PIMCO Low Duration, as the yield curve continues to flatten.

This strategy's robust, well-supported process looks similar to the one in place at flagship PIMCO Total Return but with a focus on the short end of the yield curve. The fund invests in traditional core sectors--government debt, mortgages, and investment-grade corporates--but also takes modest positions in high-yield, developed- and emerging-markets debt, and currencies (the fund's benchmark is the narrowly focused Bank of America Merrill Lynch 1-3 Year Treasury Index). The managers start with the firm's macroeconomic forecasting (determined by PIMCO's Investment Committee) and bottom-up analysis to determine interest-rate, yield-curve, currency, country, sector, and security-level decisions. Themes prominent in PIMCO Total Return's portfolio tend to surface here, too.

NOTE:

For the VA Target Risk Models (Moderate and Conservative), we recommended increasing the allocation to PIMCO VIT Short-Term. We also recommended increasing the weighting in mid-cap strategies Janus Henderson VIT Enterprise and American Century VP Mid Cap Value for the VA Target Risk Models (Moderate Growth, Growth, and Aggressive Growth). Those increased weightings come at the expense of Ivy VIP Small Cap, whose prospects we favor less.

Within the High-Income Portfolio, we lower exposure to equities and increase the weighting to fixed income, including Lord Abbett Floating Rate.

Lord Abbett's team has shown an ability to pinpoint both macro trends and individual issuers with strong upside potential. Jeff Lapin and the managers on Lord Abbett's corporate-focused taxable-bond team have been more in sync during the past few years. It shows in the application of the group's broad macro views, which it develops using economic forecasting and analysis of credit conditions to help decide which sectors to downplay or overweight. For instance, Lapin increased the fund's position in gaming and leisure names in 2017 based on the team's view that consumers were shifting traditional retail dollars to experiences. The team moved in concert again as Lapin doubled the portfolio's position in the traditionally defensive healthcare industry to 12% of portfolio assets from 6%, as credit-market volatility increased during 2018.

The managers are assisted by 21 credit analysts and four associate analysts who focus on fundamentals and target asset-rich firms with strong balance-sheet positioning, good cash flow coverage ratios, and experienced management teams. Then the analysts look for loans with advantageous covenants and attractive valuations. Lapin does not lean toward a specific credit-quality profile and has been more inclined than his predecessors to freely move up and down the quality spectrum as valuations change.

Within the High-Income Portfolio, lower exposure to equities and increase the weighting to fixed income, including Lord Abbett High Yield.

The Lord Abbett team has capably used this strategy's flexibility. The management team, led by Steve Rocco, starts by using economic forecasting and analysis of credit conditions to help decide which sectors to downplay or overweight before looking for the most attractive individual high-yield issues with the help of its analyst team. This fund must hold at least 80% in junk bonds and has the freedom to invest up to 20% in other securities such as equities, convertibles, bank loans, commercial mortgage-backed securities, and investment-grade corporate bonds, giving the fund a slightly different look from many of its high-yield competitors. Rocco prefers bonds that are likely to be upgraded soon, and analysts tend to favor bonds issued by asset-rich firms with steady and predictable cash flows. The team closely monitors securities in the fund, selling bonds that show signs of credit deterioration.

Within the Diversified-Income Portfolio, lower exposure to equities and increase the weighting to fixed income, including PIMCO Income.

Dan Ivascyn has called the shots since the fund's 2007 inception and heads PIMCO's mortgage credit effort. His profile soared in 2014, first named a deputy CIO following Mohamed El-Erian's departure in January, and then group CIO (effectively PIMCO's top investor) when Bill Gross resigned in September 2014. Moreover, Alfred Murata has been a comanager on this fund since March 2013. The duo was named Morningstar Fixed-Income Fund Manager of 2013. They were joined in July 2018 by Joshua Anderson, a specialist in structured product, real estate, and specialty finance securitizations who has worked at PIMCO since 2003.

Like all of PIMCO's strategies, this one relies on numerous top-down and bottom-up calls. Thanks to its income focus, the fund has weightings in higher-income areas, such as high-yield corporates and non-U.S. bonds, and has for years had a strong taste for nonagency mortgages relative to the multisector-bond category. This also means that while the fund will reflect PIMCO's macro themes when implementing its strategy, the portfolio will diverge meaningfully from siblings such as PIMCO Total Return. The fund also typically employs some leverage, mostly via derivatives.

Within the Diversified-Income Portfolio, lower exposure to equities and increase theweighting to fixed income, including Western Asset Core Plus Bond.

The Western Asset Core Plus Bond fund earns a Positive Process Pillar rating for its team-based combination of top-down and bottom-up approaches. Like a typical core-plus offering, this fund benchmarks itself against the Aggregate Index, but it can and does go out-of-index. High yield, bank loans, foreign developed- and emerging-markets, currencies, and nonagency mortgages have all at one point or another been part of this portfolio. Top-down decisions are made by the firm's U.S. broad market strategy committee, which is chaired by Western Asset CIO Ken Leech and which includes most of the firm's senior investment and risk professionals. The committee determines duration, yield-curve positioning, and sector weightings. Once the committee has determined allocations for the latter, sector teams step in to take care of bond selection. Guided by relative-value considerations, they seek to fill their sector sleeves with bonds that are attractive on their own and that can also contribute toward achieving the fund's desired risk profile.

NOTE:

For the VA High Income Portfolio, lower exposure to equities and increase the weighting to fixed income, including Eaton Vance VT Floating Rate Inc and Lord Abbett Series Bond-Debenture. For the VA Diversified Income Portfolio, lowere the exposure to equities and increase the weighting to fixed-income, including PIMCO Income Advisor and Western Asset Core Plus VIT.

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