Reallocation Memo

06 2024

Updated June 2024

Target Risk and Target Income Portfolios

LiveWell Portfolios

Affected Portfolios

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

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 this 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 2023. 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 striving to maximize return expectations given a target risk profile.

Overall Asset Allocation Positioning

- This reallocation slightly reduced exposure to developed international equities. While we still believe that foreign stocks broadly are more attractive than their domestic counterparts, we continued to trim the position across the models. At the same time, we increased exposure to U.S. stocks.

- Within fixed income, we trimmed emerging-market debt, TIPS, high-yield debt, and short-term fixed income, while adding to core fixed income securities.

Key Asset Allocation Changes – Equity

U.S. Equity

- We are recommending a slight decrease in the allocations to U.S. mid-cap stocks, while increasing the exposure to U.S. small-cap stocks and U.S. large-cap growth stocks. We believe that U.S. small-cap equities are relatively cheap from a valuation perspective, while the allocation to U.S. large-cap growth stocks is a recognition of the wide moats and significant free cash flows that are characteristics of many of the stocks in that segment.

Key Asset Allocation Changes – Fixed Income

- We are recommending a decrease in the allocations to emerging-markets debt, TIPS, high-yield debt, and short-term fixed income, as we believe that core fixed income is relatively more attractive from a valuation perspective.

- We are recommending a slight increase in durations across models as we believe that the likelihood of continued interest rate increases has diminished.

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 help 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

Target-Risk Model Fund Additions:

Columbia Dividend Income – Mutual Fund Target Risk Models only

Its philosophy holds that free cash flow is the ideal signal of dividend sustainability, which in turn indicates stable future growth. Specifically, the team targets Russell 1000 constituents in the top two quintiles of free cash flow yield. They analyze companies in this group, emphasizing the balance sheet, which provides financial strength — especially in downturns. The approach produces a portfolio of about 80 holdings that is organically risk-averse thanks to the nature of the stocks rather than because of external guardrails. The portfolio consistently has a higher quality tilt, with key measures such as return on equity and return on invested capital all well above relevant large-value benchmarks and average peers. The team shows a willingness to be overweight, underweight, or neutral weight to a given sector but typically stays within 10 percentage points of the benchmark.

Putnam Large Cap Value

Manager Darren Jaroch applies a multifactor model he developed in the early 2000s to screen an initial universe of roughly 500 stocks that includes the constituents of the Russell 1000 Value Index, foreign-domiciled multinationals, and analyst suggestions. Jaroch routinely updates the model's components seeking to improve factors, add new ones, and remove ineffective ones. Currently, the model has six factors and more than 35 underlying subfactors. Then, Putnam's fundamental analysts perform more due diligence to gain comfort with the management team and the sustainability of current earnings growth. The managers will often gauge the analysts' conviction in a name by looking at the stock’s weighting within analyst-run portfolios. Based on their research and their preference for cash-generative businesses with underappreciated prospects, they make picks with a three- to five-year investment horizon. As a final step, the managers lean heavily on quantitative risk-factor management to decide on allocations and craft a precise portfolio based on where they see relative value.

Unlike many other quant strategies, we believe the team's flexible approach allows it to keep portfolio turnover in check. Over the past five years, annual portfolio turnover has ranged from 12% to 21%, well below the median active large-value category peer's 34% to 41% range.

T. Rowe Price International Value – Mutual Fund Target Risk Models only

Manager Colin McQueen looks for firms that are out of favor owing to short-term geographic, sector, or company-specific issues but that have solid business franchises and the financial strength to recover. He considers only companies that he thinks are significantly undervalued relative to their intrinsic worth. He focuses on firms’ industry structure, capital allocation, franchise strength, balance sheets, and cash flow generation (and what drives that generation) when determining their intrinsic worth.

He’s willing to allow his stock selection to lead to moderate regional, country, and sector over- and underweightings, but he avoids extreme bets. He does invest in Canada and developing countries, though the MSCI EAFE Index, which excludes those markets, is the strategy’s prospectus benchmark. He invests in 100-150 names and moves at a measured pace.

Templeton Developing Markets – Mutual Fund Target Risk Models only

The bottom-up investment approach focuses on companies with sustainable earnings power and trading at a discount to its intrinsic value. Stock ideas are generated by utilizing the team’s local expertise in identifying long-term investment trends. Analysts then dive into prospective holdings by assessing a company’s competitive positioning, management foresight, and financial strength before conducting valuation analysis. There have been a few changes on the portfolio construction side over the years, which warrants some caution. After taking a more diversified approach between 2016 and 2019 to mitigate concentration risks, the duo reverted to a higher portfolio concentration by lowering the targeted number of holdings from the previous 70-100 level to 60-80 in 2020, a range which they have since adhered to. The portfolio then took a hit from some stock misfires and its overweighting in Russia in 2021 and 2022. To better control portfolio risks, the duo has since decided to limit the maximum active weight of their country exposures and individual holdings to 8% and 4.5% against the MSCI Emerging Markets Index, respectively. These are tighter from the respective 10% and 6% formal risk guidelines. While these risk-management practices are prudent, we would like to see more evidence of the duo’s commitment to the current portfolio construction guidelines and the effectiveness of such enhancements.

PIMCO Total Return

Manager Mohit Mittal follows Pimco’s time-tested multisector approach, but he aims to opportunistically incorporate more of the firm's higher-conviction views against its benchmark than his predecessor. In theory, this will give the strategy a better shot at accomplishing its goal of 100-150 basis points of outperformance per year (before fees) over the Aggregate Index, which has proved elusive in recent years. It isn’t yet clear, however, we believe this will affect the fund’s typically strong downside protection during credit selloffs.

Still, most aspects of this process that we like are not changing. This strategy still combines the Pimco investment committee’s macro forecasting with bottom-up analysis to determine interest-rate, yield-curve, currency, country, sector, and security-level decisions. The firm uses a system of secular and cyclical forums to help inform and debate its views on the economy. Its resources informing broad macro calls all the way down to individual security decisions are topnotch.

This strategy has typically favored securitized fare over investment-grade corporate credit exposure owing to the latter's higher sensitivity to equity markets. This has helped the fund excel when equity and credit markets sell off but can cause it to lag when they are strong.

Lord Abbett Short Duration Income - VA Target Risk Models only

While bottom-up research is key to the process, so is the implementation of top-down views, which set the overarching themes of investing and establish the parameters within which security selections are to be carried out. Managers on this strategy have the flexibility to rotate in and out of sectors, and they can dial up and down exposures to various asset classes depending on relative value considerations, or dip into lower credit quality and hold up to 35% in below-investment-grade debt.

That flexibility could be difficult to execute efficiently in more capacity-constrained markets, and while derivatives give the team room to maneuver and act quickly, they can also create leverage and exacerbate gains and losses. That said, their usage in this strategy is mostly tactical and marginal, and overall a mix of asset types including investment and high-yield corporates, securitized, and US Treasuries helps to improve the fund's liquidity profile. Finally, duration is managed close to that of the ICE BofA 1-3 Year US Corporate Index.

While the bulk of portfolio assets has been in investment-grade fare, allocations to below-investment-grade debt have exceeded 20%, often more than what's held by category peers. Exposures to U.S. Treasuries and agency mortgage-backed securities have remained consistently lower than the category norm. Bank loans, commercial MBS, and collateralized loan obligations have also made appearances in this portfolio, reflecting the multisector nature of the strategy.

Target-Risk Model Fund Increases:

BlackRock Equity Dividend - VA Target Risk Models only

This process seeks healthy dividend-paying and -growing companies at affordable prices, with an aim to outperform, in part by protecting on the downside. The team uses quant screens and bottom-up research to find new ideas. The monthly screens, which the quant researchers have continued to refine since DeSpirito introduced them in 2014, not only help turn up ideas the managers and analysts may have missed, they can also confirm or challenge the managers' theses on stocks they know. Next, analysts perform deep dives into stocks' fundamentals, management, and industry competition. The managers consider whether a stock can grow its dividend faster than the overall market, based on its competitive dynamics, balance-sheet strength, and how easily it can maintain its dividend payments.

While valuation takes a bit of a back seat to a company's ability to grow in the screens, DeSpirito is price-conscious and has kept the fund in the large-value corner of the Morningstar Style Box for several years. This process usually leads to a portfolio of stocks with competitive advantages that enable them to earn consistent returns on invested capital in all environments. The strategy's price sensitivity, however, has led it into more cyclical and lower-quality fare at times, and quality portfolio metrics such as returns on equity and invested capital have slipped in recent years.

Attention to valuation can lead this portfolio into high cash stakes and stocks outside the United States, subject to the fund's 25% prospectus limit. The stake differentiates the fund but also courts risk.

Janus Henderson Small Cap Value - Mutual Fund Target Risk Models only

The strategy benefits from an experienced team. It had been run by longtime subadvisor Perkins Investment Management, which was a wholly owned subsidiary of Janus Henderson that was fully integrated within the larger firm in May 2021.

The safety-first approach has been consistent. The managers don't buy stocks just because they look cheap. Rather, they consider the whole business and only invest when they believe potential gains significantly outweigh potential losses. The approach produces a portfolio of strong, competitively advantaged businesses.

Portfolio candidates must have strong balance sheets with low debt ratios, financial flexibility, solid recurring cash flows, durable competitive advantages, and committed management teams with significant insider ownership. The managers then use conservative relative and absolute valuations to determine upside and downside 12-month price targets. On the downside, they assume top-line contraction and margin compression and compare valuations to previous trough or recession levels. On the upside, they normalize margins and earnings, compare stock valuations to previous normalized (not peak) levels, and emphasize mean reversion. In both cases, they focus on building in a margin of safety in case their estimates are wrong. Positions in which they believe they have the lowest risk/reward ratios receive the largest weights in the portfolio, and holdings are sold when the ratio declines.

NOTE:

Fund Removals:

For the Mutual Fund Target Risk Model (Income & Growth, Moderate Growth, Growth and Aggressive Growth), we recommend the removal of abrdn Emerging Markets.

For the Mutual Fund Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth and Aggressive Growth), we recommend the removal of American Century Value.

For the Mutual Fund Target Risk Models (Moderate Growth, Growth and Aggressive Growth), we recommend the removal of ClearBridge Mid Cap.

For the Mutual Fund Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth, and Aggressive Growth), we recommend the removal of Templeton Foreign.

For the Mutual Fund Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth, and Aggressive Growth), we recommend the removal of Western Asset Core Plus Bond.

For the VA Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth, and Aggressive Growth), we recommend the removal of American Century VP Value II.

For the VA Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth, and Aggressive Growth), we recommend the removal of Templeton Foreign VIP 2.

For the VA Target Risk Models (Conservative, Income-and-Growth, Moderate Growth, Growth, and Aggressive Growth), we recommend the removal of Western Asset Core Plus VIT II.

For the VA Target Risk Models (Conservative, Income-and-Growth, and Moderate Growth), we recommend the removal of PIMCO VIT Short-Term Adv.

For SRS professionals use only

Investment research and ratings are produced and issued by Morningstar, Inc. or subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with and governed by the U.S. Securities and Exchange Commission. Analyst Ratings are subjective in nature and should not be used as the sole basis for investment decisions. Analyst Ratings are based on Morningstar's Manager Research Group's current expectations about future events and therefore involve unknown risks and uncertainties that may cause such expectations not to occur or to differ significantly from what was expected. Analyst Ratings are not guarantees nor should they be viewed as an assessment of a fund's or the fund's underlying securities' creditworthiness.

Morningstar Investment Management LLC is a registered investment adviser and subsidiary of Morningstar, Inc. Morningstar Investment Management provides nondiscretionary consulting services to Sammons Retirement Solutions® Inc. (SRS) but is not acting in the capacity of adviser to individual investors. Morningstar Investment Management provides recommendations to SRS regarding asset allocation targets for certain LiveWell® products/programs which are subject to change without notice. Morningstar Investment Management establishes the allocations using its proprietary asset classifications. If alternative classification methods are used, the allocations may not meet the asset allocation targets. The Morningstar name and logo are registered marks of Morningstar, Inc. Morningstar Investment Management is not affiliated with SRS.

Morningstar Investment Management does not guarantee that the results of their advice, recommendations, or the objectives of a portfolio will be achieved. There is no guarantee that negative returns can or will be avoided in a portfolio. An investment made in a security may differ substantially from its historical performance and as a result, you may incur a loss. Past performance is not a guarantee of future results.

Opinions expressed are as of the current date and are subject to change without notice. Morningstar Investment Management LLC shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses or opinions or their use. This commentary is for informational purposes only. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this piece should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell that specific investment. Performance data represents past performance, which does not guarantee future results.

The commentary contains certain forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially and/or substantially from any future results, performance, or achievements expressed or implied by those projected in the forward-looking statements for any reason.

Investments in securities (e.g., mutual funds, exchange-traded funds, common stocks) are subject to investment risk, including possible loss of principal, and will not always be profitable. Prices of securities may fluctuate from time to time and may even become valueless. Securities in this report are not FDIC-insured, may lose value, and are not guaranteed by a bank or other financial institution. There can be no assurance any financial strategy will be successful. They do not ensure a profit or protect against a loss.