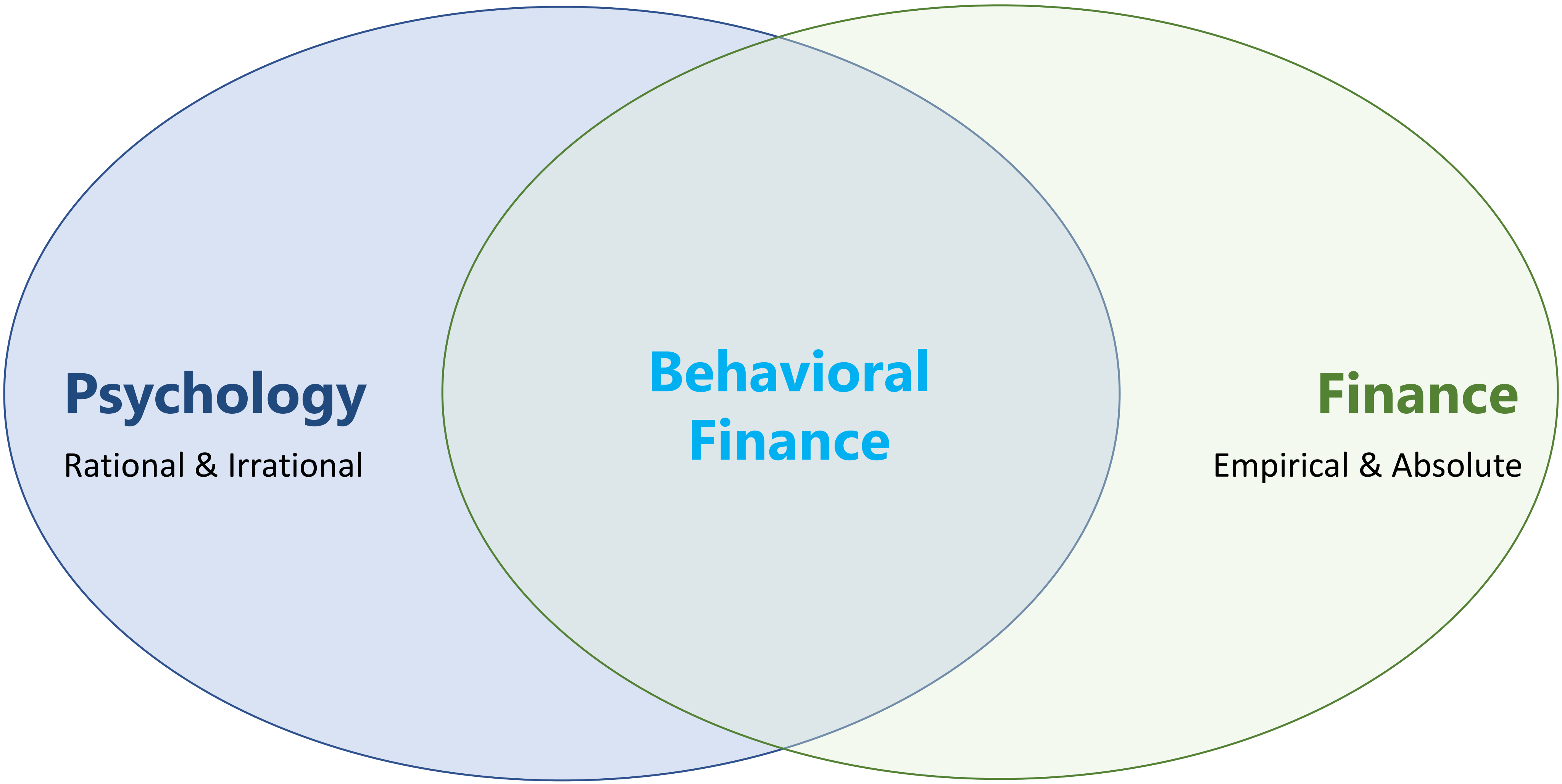
Addressing the Behavior in Finance

Seeking to Smooth Returns & Investor Emotions


Psychology
Rational & Irrational
Behavioral Finance
Finance
Empirical & Absolute

What Investors Hear:

- **Don’t try to time the market.**
- **Diversification & ‘Buy and Hold’ works.**
- **Stick to the goal-based investment plan.**

But Research Suggests…

When market crises arise:

- **Emotions dominate investor decisions**
- **They can’t hold on, sell at wrong time**

In bull markets:

- **Return-chasing behavior surfaces**
- **Mistime the market**

The Investor Side of the Problem: Emotions Drive Behavior

Loss Aversion
Fear of loss leads to pulling out at worst time, leads to "panic selling"

Herding
Copying behavior of others - even in the face of unfavorable outcomes

Anchoring
Focus on past paradigm, not adapting to changes

False Diversification
Believing portfolio is diversified, but assets are actually highly correlated

Investor Behavior
Dalbar QAID

Mental Accounting
Isolating results in one area to justify decision in another unrelated area

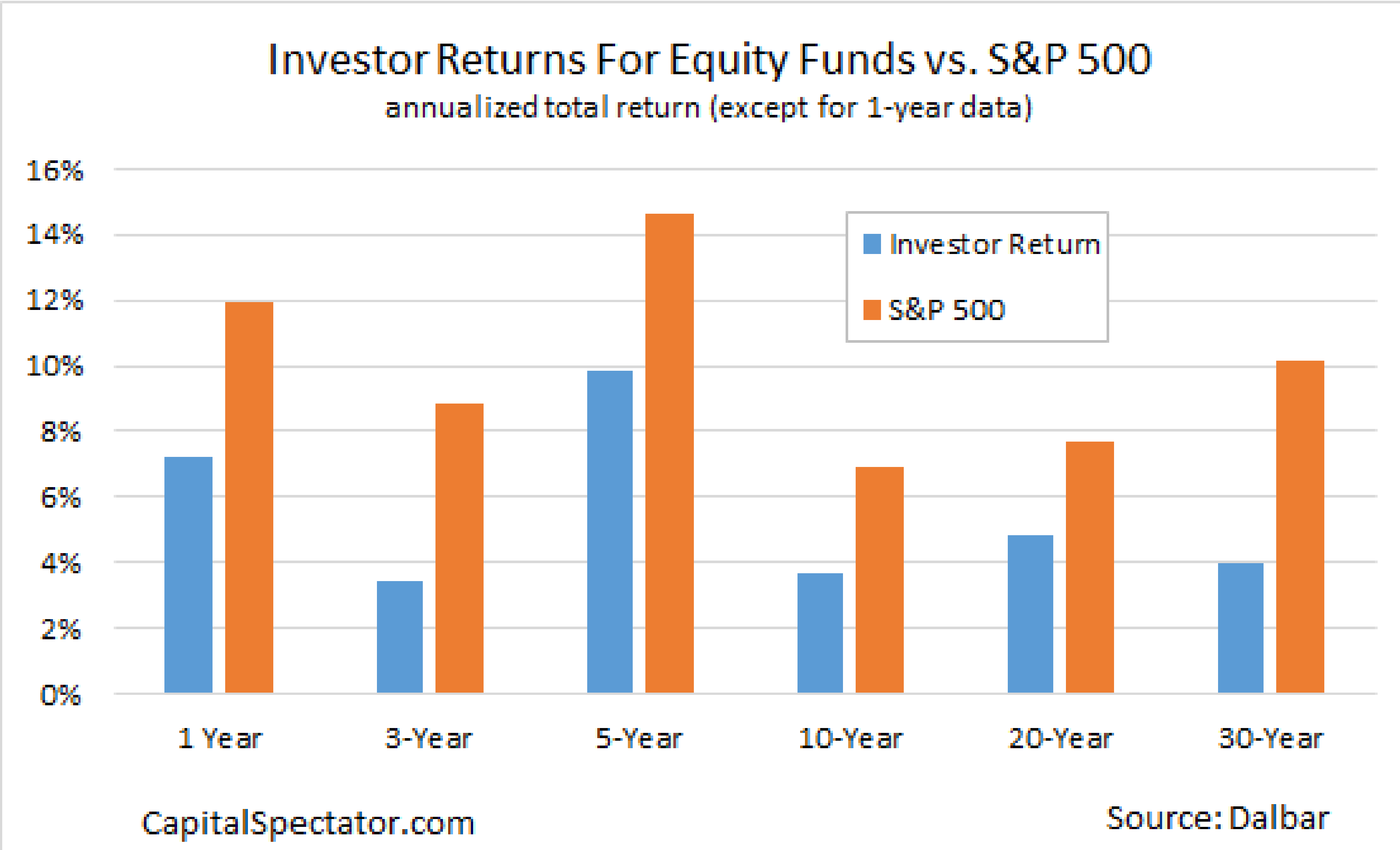
Media Response
Tendency to react to news without reasonable and thorough examination

Optimism
Belief that good things happen to me, and bad things happen to others

Narrow Framing
Changing part of portfolio without considering affects on the total portfolio

Source: QAID, 2017, Dalbar, Inc., Shlomo Benartzi, *Save More Tomorrow* (2012), Richard Thaler, *MisBehaving* (2015)

The Result: Disconnect Between Investor and Market Returns



Source: QAID, 2017, Dalbar, Inc.., Investment Company Institute. * Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investors return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars of the net of the sales, redemptions and exchanges for each period.

Average Fund Investor Returns vs. Benchmarks

Investment Period	Average Equity Fund Investor	Average Fixed Income Fund Investor	Average Asset Allocation Fund Investor	Inflation	S&P 500 Index	Bloomberg Barclays Aggregate Bond Index
20 Year	5.29%	0.44%	2.58%	2.15%	7.20%	4.60%
10 Year	4.88%	0.48%	2.52%	1.64%	8.50%	3.31%
5 Year	10.93%	-0.40%	5.41%	1.48%	15.79%	1.29%
3 Year	8.12%	-0.05%	3.85%	1.71%	11.41%	1.40%
12 Month	20.64%	1.52%	10.08%	2.11%	21.83%	2.31%

All returns above through 12/31/17. S&P Index performance based on price returns, not total return.

Source: Quantitative Analysis of Investor Behavior (QAID), 2018, page 6, DALBAR, Inc., www.dalbar.com

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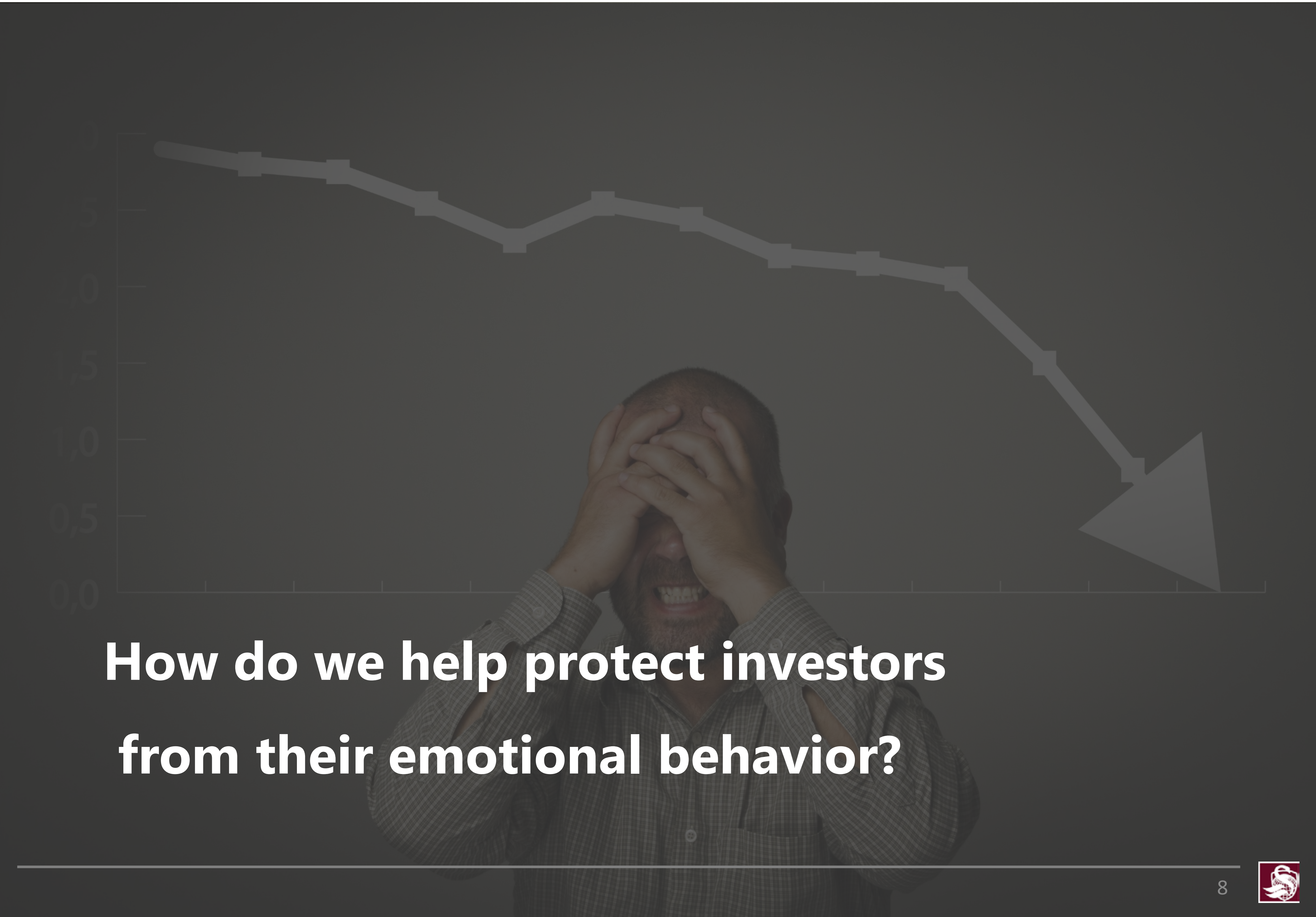


How do we help protect investors from their emotional behavior?

"No matter what the state of the mutual fund industry, boom or bust, investment results are more dependent on investor behavior than on fund performance.

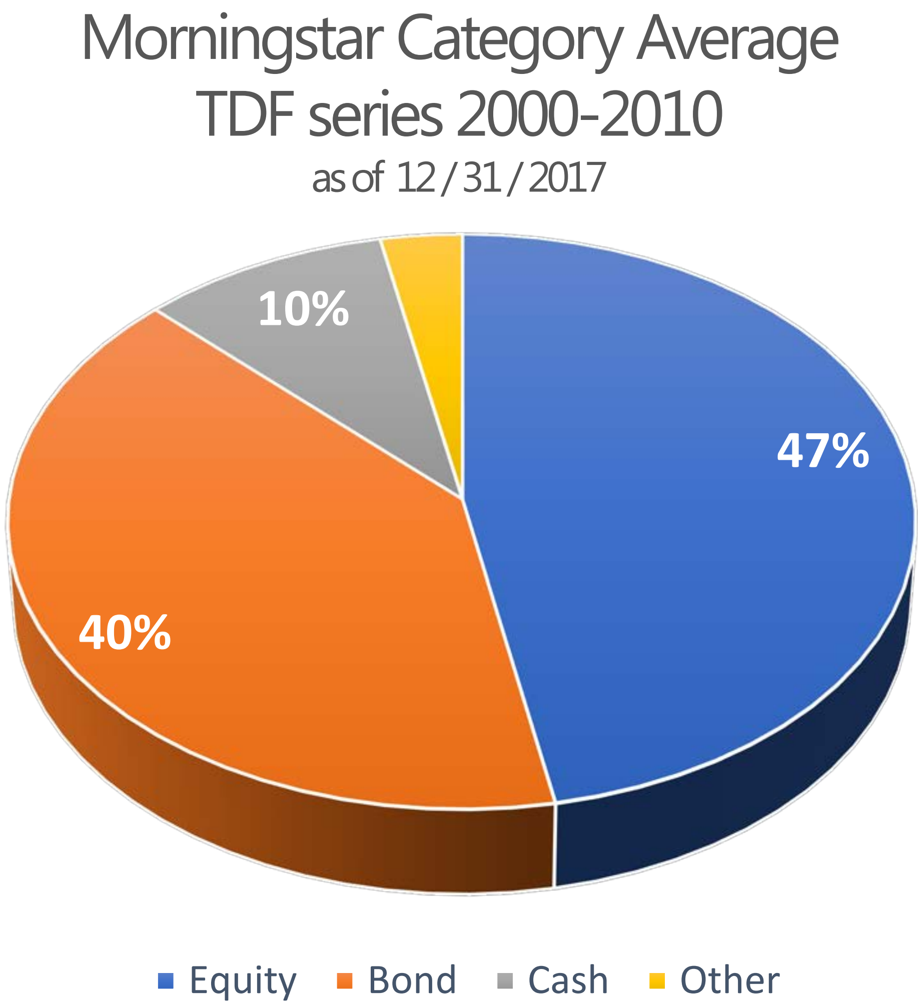
Mutual fund investors who hold on to their investments have been more successful than those who try to time the market."

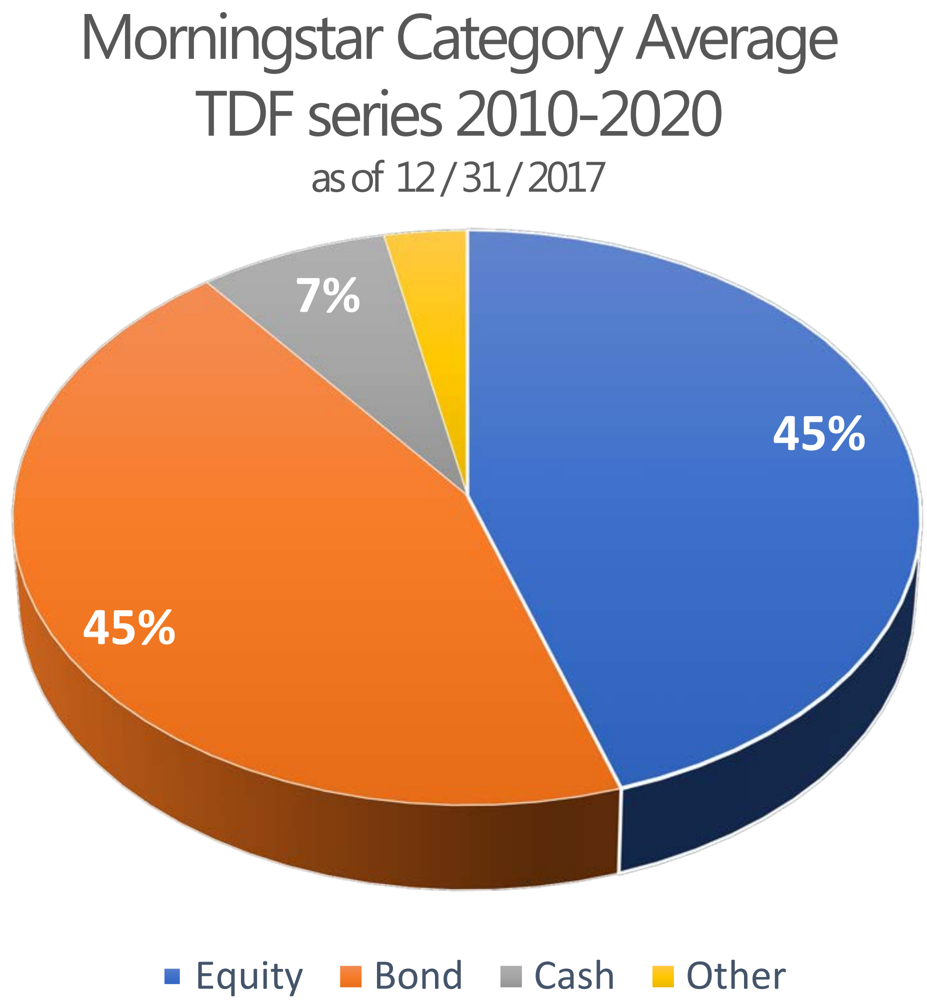
- Dalbar 23rd Annual Quantitative Analysis on Investor Behavior

What Investors are Sold:

- **Products designed to 'fit' a trend or style box**
- **Index funds, TDFs, and ETFs designed to track, or even beat the market.**
- **Returns and Performance**
- **Lower Fees, Lower Costs**

What is the Industry Doing Differently?





Source: Zephyr StyleADVISOR, Morningstar Target Date series 2000-2010 and series 2010-2020 category averages

What Do Many 'Products' Actually Deliver:

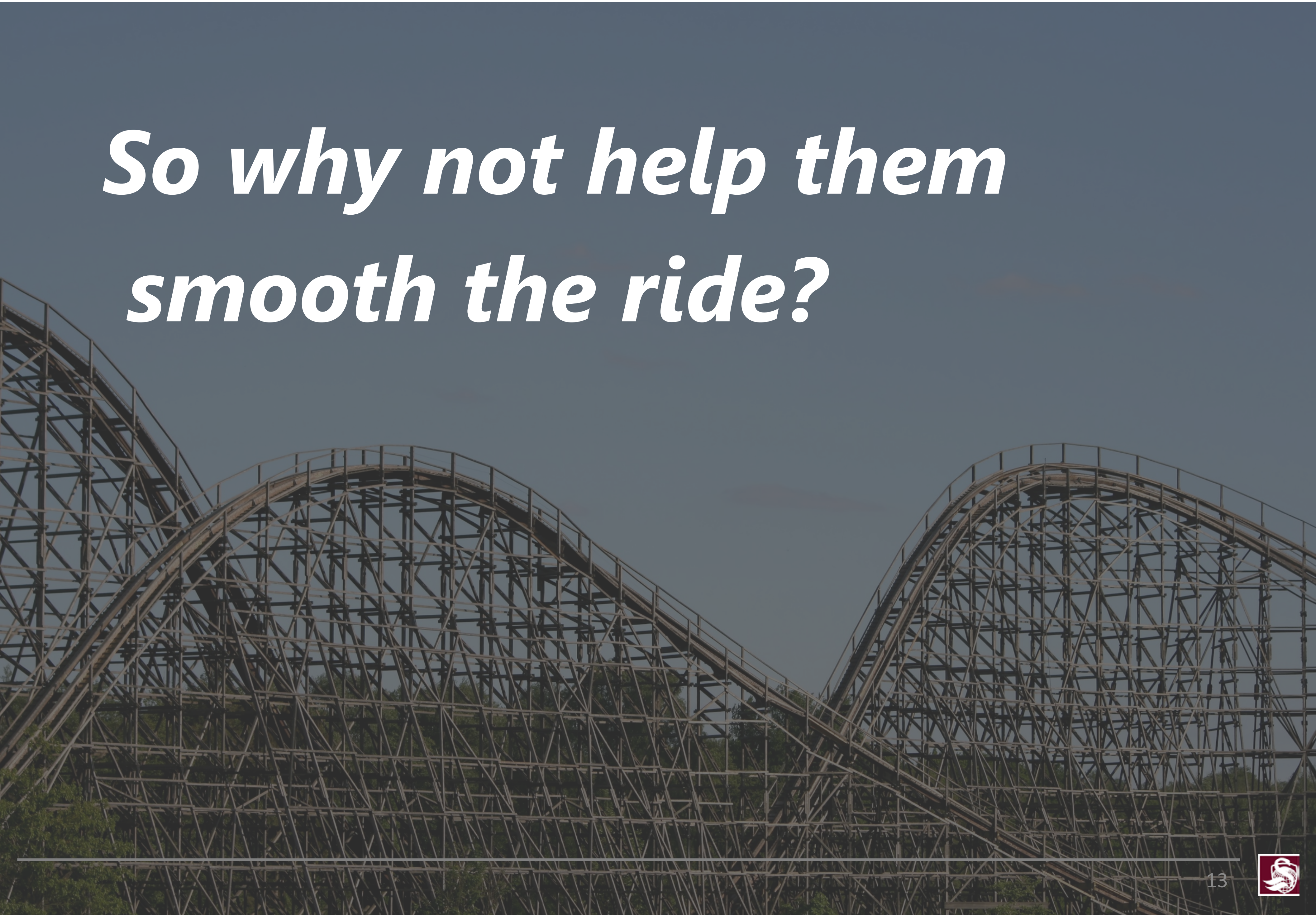
- A "lower cost" roller coaster ride
- More emphasis on 'beating the market'
- More Herding, Anchoring, Optimism
- More False Diversification

Don't address Loss Aversion: Most Powerful Emotion

They need a better way to hold on… through ups/downs

The Bumpy Market (Emotional) Ride is the Problem

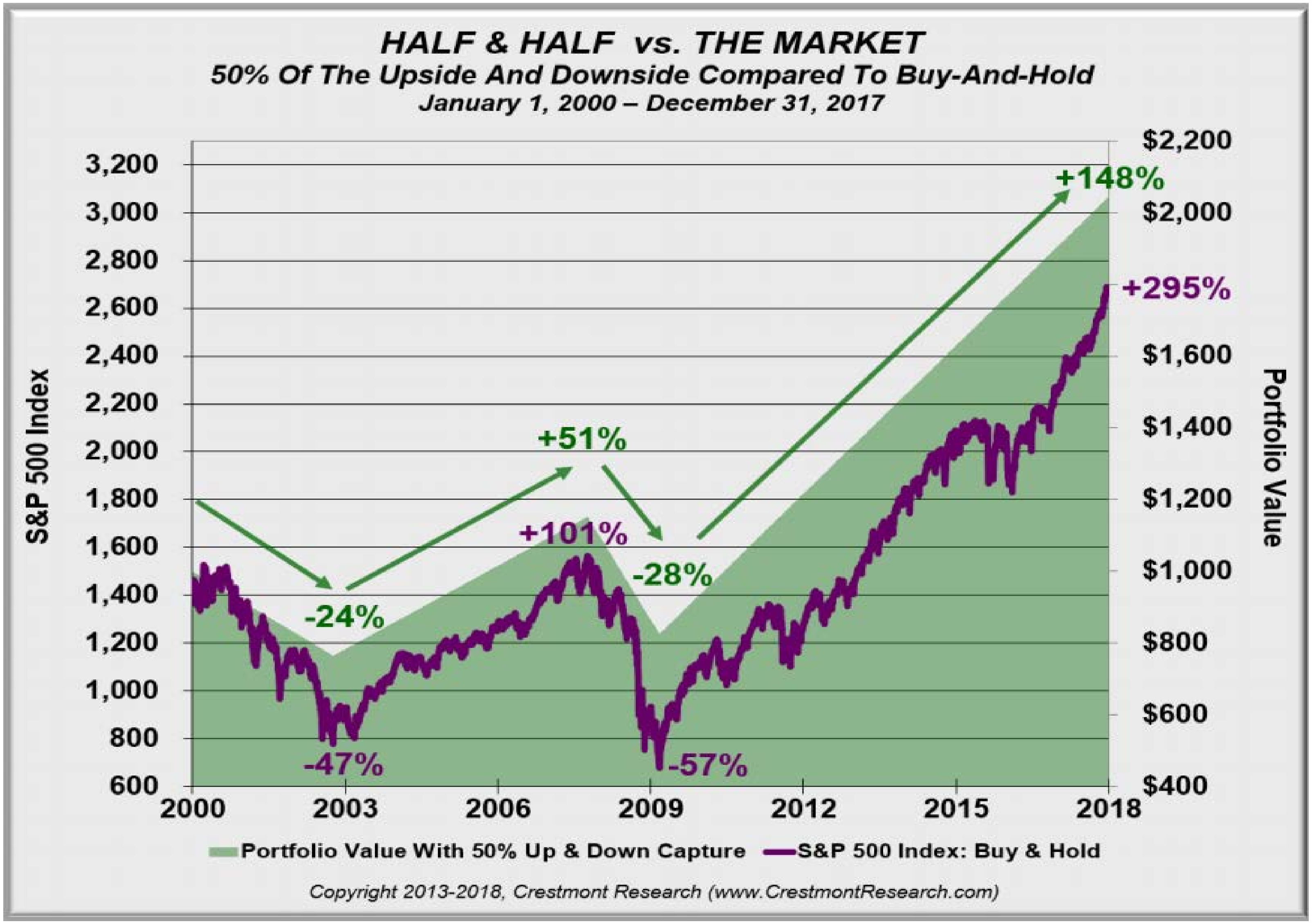
So why not help them smooth the ride?



Smoothing the Ride Works

Starting Value

$1,500



Ending Values

$2,051

$1,809

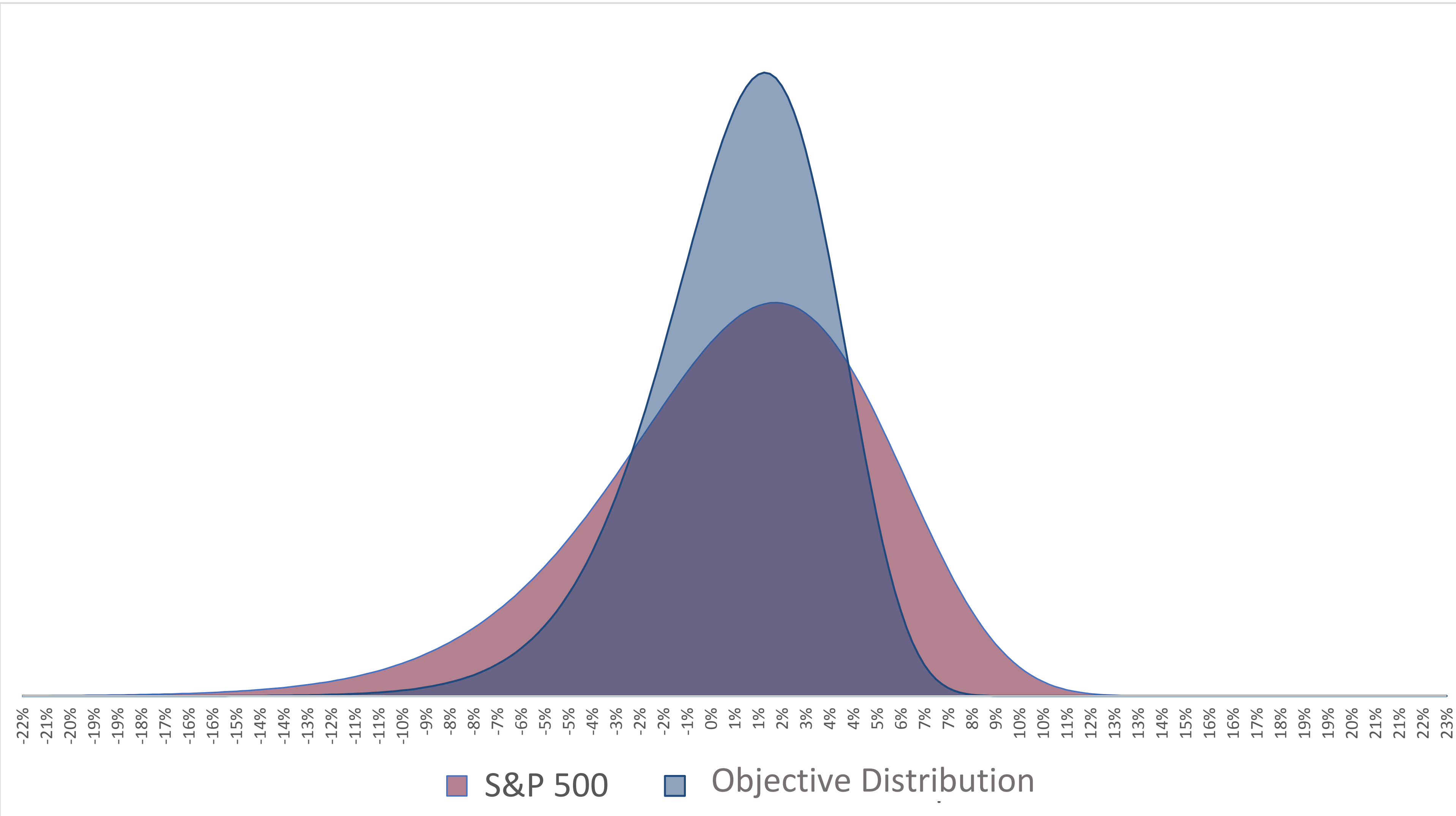
Return Comparison

↑ 13.37%

NOTE – Returns based on S&P 500 Price Index, not the Total Return index.

Narrowing the Distribution of Returns

Parametric Monthly Return Distribution Since July 1997

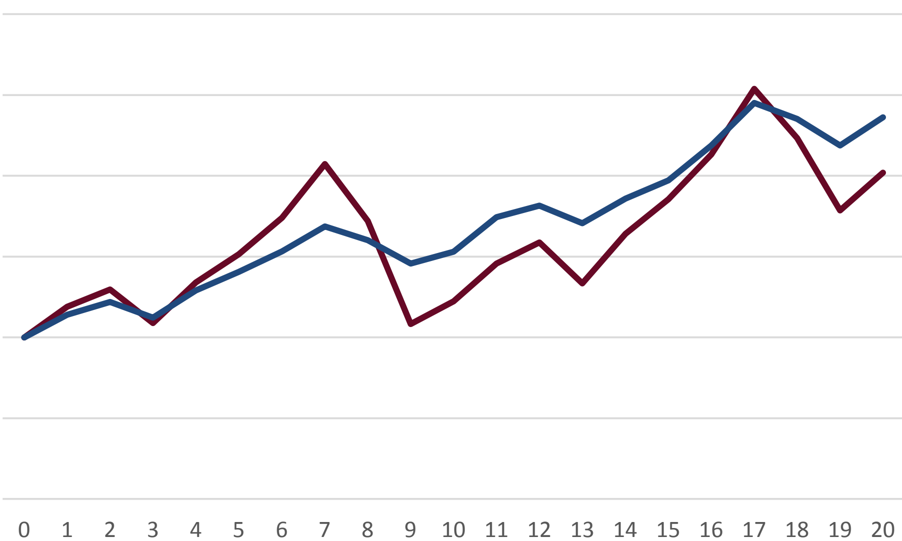


Source: Morningstar and Swan Global Investments

Limiting the Bumps, Smoothing the Ride

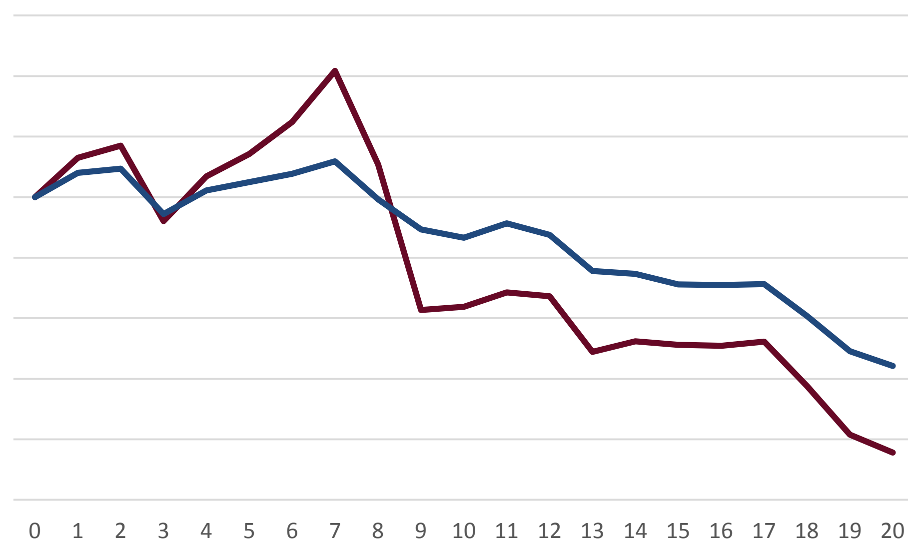
Benefits Investors Before *and* After Retirement

Accumulation Phase: primary goal is to invest and grow wealth for retirement (goal).



Smoothing returns may help participants remain invested and on track towards their goal.

Distribution Phase: primary goal shifts to sustaining income throughout lifetime.



Avoiding big losses is critical when withdrawing from the account. Can't run out of money.

The Defined Risk Strategy

Equity markets tend to go up over time, so we remain **Always Invested**.

- Low-cost ETFs for exposure to market

Large losses derail investors from their goals, so we remain **Always Hedged**.

- Long-term put options to seek protection

The Defined Risk Strategy

1 Establish Equities

- Purchase exposure to asset class, such as
  - **S&P 500**
  - **Russell 2000**
  - **EAFE**
  - **EM**
- No stock selection, No market timing
- Invested at all times

2 Create Hedge

- Buy puts on the underlying equity
- At or Near-the-Money
- Long-term – generally one to two years, initially

3 Harvest Option Premium

- Seek to sell shorter-term options
- Market-neutral, non-directional trading strategies

The Process is

Transparent	Disciplined	Repeatable

"By actively seeking to not lose big, we believe that investors will be better off in the long run."

- Randy Swan, CEO and Lead Portfolio Manager

Disclosures

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Disclosures

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