RIVERFRONT INVESTMENT GROUP

Strategic View

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The 21st Century Retirement Plan: *Distribute Phase*

Meeting the Challenges of a Higher Inflation Environment

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SUMMARY

- Higher inflation, low real interest rates and rising life expectancy are three major challenges for financial advisors and their clients, in our opinion.
- In the *Distribute* phase, portfolios will likely need meaningful exposure to 'risk assets' such as stocks and higher yielding bonds to meet return objectives, in our view.
- We believe managing those risks is very important when finding the right balance between current income and growth of principal.

In a world where most people do not enjoy the benefit of a guaranteed pension, retirement becomes a personal responsibility. The goal for many investors is to maintain their standard of living in retirement with the peace of mind that their money will not run out. This is especially challenging in a higher inflation environment. Furthermore, we believe retirees do not want to spend their golden years worrying about the monthly fluctuations in the stock market. This piece is designed to provide information to retirees taking distributions from their portfolio, what we call the *Distribute* investor.

Providing a Stream of Income for Today's Retirees Presents Several Challenges

1. **Life expectancy is increasing.** In the US, life expectancy has increased steadily from 68 in 1950 to 79 today, according to the United Nations, and they forecast it will rise to 84 by 2055. Therefore, the asset pool at retirement must be larger than has historically been the case.

2. **Few guaranteed pensions.** Most private sector employers no longer provide a guaranteed pension. In the 'good ole days' when many companies had guaranteed pensions, retirement income was your employers' problem. Now with defined contribution plans (such as 401k plans), that problem has been shifted to employees who must build up savings and invest it themselves. Investors with insufficient savings are tempted to have excessive exposure to risky assets, trying to achieve unrealistic spending goals.

3. **Higher yields sometimes indicate high risk: research matters.** Owning high dividend-paying stocks can be riskier than you might think. Companies with high dividend yields can be highly indebted and concentrated in certain sectors, often those that have lower earnings potential. Lower quality bonds, especially those rated below investment grade, offer higher yields to compensate investors for higher volatility and greater risk of default. Buying high yielding stocks and bonds without research to identify winners and losers is a risky strategy, in our view.

4. **Lack of investing experience.** Many retirees have little experience with investing, managing risk, and managing emotions. Dealing with the price swings of risky assets involves the following risks, in our opinion:

    - **Emotional Risk:** In our experience, investors plan in 5 and 10-year time horizons, but sometimes succumb to fear and greed by reacting to current headlines. This can cause them to abandon well thought-out plans, made in a calm environment. We believe a critical part of the retirement planning process is to assess and periodically review risk appetite to build a plan that allows the retiree to weather market volatility. This also involves a realistic understanding of the potential longer-term tradeoff between returns and safety.

- **Drawdown Risk:** When 'risk assets' (further explained below) fall significantly in price, a retiree may be forced to choose between selling risk assets at unattractive prices or reducing their spending.

The Challenges of Generating a 3-6% After-inflation Return in Retirement

Good news: Interest rates are higher. Bad news: They are still below the current rate of inflation.

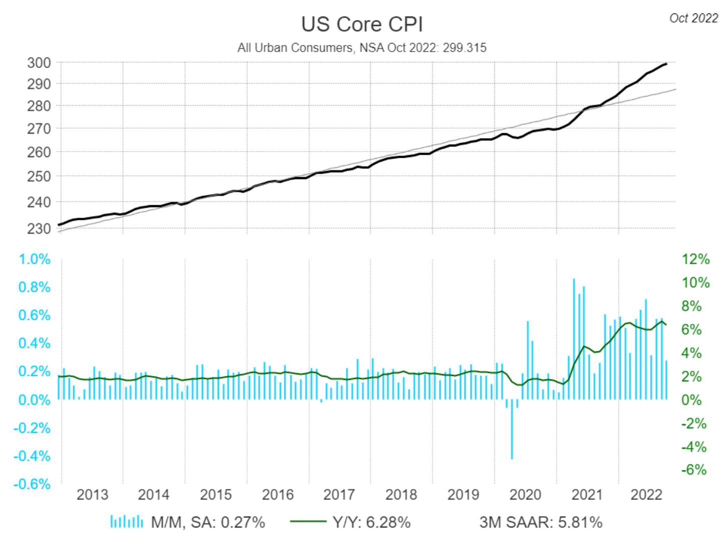
When we last updated this piece in June of 2021, the yield on the 10-year Treasury bond was roughly 1.5%. Since then, the Federal reserve has raised interest rates to around 4% and currently 10-year Treasury yields are roughly two percentage points higher, at around 3.5%. This is good news for retirees as bonds can now provide some cash flow, and yields are above the Fed's long-term inflation target. Investors concerned about inflation can now get a positive yield on the Treasury's Inflation Protected Bonds, known by the acronym TIPS, but they offer only around 1% over inflation and the price of these securities, like other bonds, fall when interest rates rise, and so are not a protection against rising rates.

More challenging is the current rate of inflation. Throughout 2022, inflation has been considerably higher than the yields on bonds or cash and so although interest rates are higher, investors have lost purchasing power. We think inflation will remain above investment grade bond yields for at least the first half of 2023.

The outlook for Inflation: Peaking, but likely to remain above the Fed's 2% target throughout 2023

The Federal Reserve is now fully committed to bringing inflation down as their number one priority, something that has been repeated by Fed Chairman Powell at every opportunity for many months. We believe the Fed will ultimately succeed, and we have seen leading indicators of inflation are already declining. However, it may take a recession to bring inflation down to the Fed's target. By their own admission, the Fed was slow to realize that inflation was not a 'transitory' problem as they thought in 2021. In early 2022, the Fed started to realize that inflation was sticky and that it was spreading from manufactured goods prices to services and rents, as reflected in 'core' CPI which excludes food and energy (see chart 1, right). Then came the war in Ukraine – a major wheat producer for the world – the sanctions on Russian oil, and COVID-19 lockdowns in China. By May, the Fed realized they had made a mistake and started raising rates aggressively.

Chart 1: Core Inflation will take time to come down



Source: Refinitiv Datastream, RiverFront. Data monthly as of October 15, 2022. Shown for illustrative purposes only. Past Performance is no guarantee of future results.

Chart 1 shows annual and monthly data for core inflation (excluding food and energy). The inflation data is expressed by the line in the top panel. You can see how it took off in 2021 and is still rising at a year-on-year pace of 6.3% (the line in the bottom panel) as of the October data – well above the Fed's 2% target. To get a sense of recent trends, we also like to look at the monthly data (shown in the panel on the bottom). The bars represent month-on-month changes. Here the October data gives some hope for optimism that inflation is no longer accelerating and may be peaking in our view, but it is in its early days.

The longer-term outlook for inflation is more encouraging

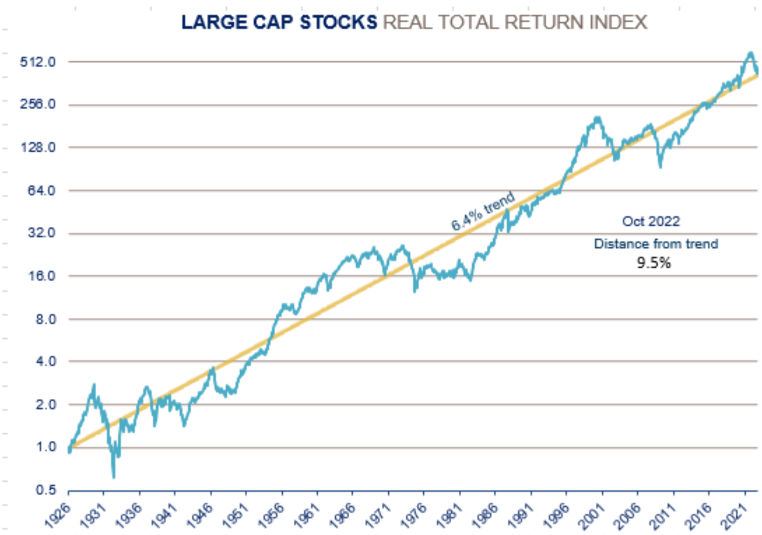
It seems logical that longer-term investors should be more concerned about longer-term inflation trends. One of our rules at RiverFront is "Don't Fight the Fed" and so with the Fed now committed to getting inflation down to more normal levels, we believe they will achieve this this on a 3-5-year view. The important question to us is whether they will be resolute about 2% or will be satisfied with a somewhat higher average. Market participants seem to be confident that inflation can average 2.5-3% over the next 7-10 years and we broadly agree. Since inflation is a critical ingredient for financial planning, *Distribute* investors should think about what level to put in their plan.

The role of stocks: Capital appreciation and a growing dividend stream

We believe a retiree seeking to generate a 3-6% return after inflation with consistent monthly income, will need to invest a sizable portion of their assets in more volatile investments to get the higher returns they seek. Let's call these "risk assets", which can include stocks, investment grade bonds, higher yield "junk" bonds, real estate, and other investments.

US stocks, with dividends reinvested, have a return history relative to inflation going back to 1926 (see chart 2, below). The trend rate of return is 6.4% over the rate of inflation (see trend line rising at 6.4% per annum). Stock's ability to outpace inflation comes, in part, due to companies' ability to adapt to changing conditions. This is tremendous news for all investors, but particularly for the *Accumulate* investor, especially if they are adding to their portfolio on a regular basis. Prolonged bear markets such as those seen in the 1930s, 1970s and the first decade of the 2000s provide an opportunity for the *Accumulate* investor to add stocks at below-trend prices. We define the *Accumulate* investor as one focused on long-term growth of capital and a time horizon of 10-years or more.

Chart 2: The very long-term trend is up, but prolonged bear markets can occur



Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2022 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through October 2022. Past performance is no guarantee of future results. It is not possible to invest directly in an index. RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Blue line represents the Large Cap Real Return Index. Yellow line represents the Annualized Real Trend Line of Large Cap Real Total Return Index according to Price Matters®. Shown for illustrative purposes only, not indicative of RiverFront portfolio performance. Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. The chart above uses a logarithmic scale. Line movements will be dampened/subdued based on the exponential y-axis.

However, these prolonged bear markets present challenges for the *Distribute* investor such as:

1. **No longer reinvesting dividends.** Dividend reinvestment allows the power of compounding to increase the rate of returns, making a meaningful difference to total returns over time. A Distribute investor who is often using dividends to fund spending cannot take advantage of this. However, they can still benefit from the growth of dividends.

2. **No longer making contributions.** An investor in the distribution phase of retirement is usually taking money out of the market, not putting it in. Therefore, bear markets are no longer an opportunity, but a risk. Investors typically want to avoid taking money out of the market after a significant decline, but this may not be possible. Prolonged bear markets are why an all-stock portfolio is likely not appropriate for the majority of Distribute investors who benefit from a more balanced portfolio with bonds and cash providing stability, in our view.

3. **Managing emotions.** A whole body of academic work has been devoted to the 'behavioral science' of investing, understanding fear and greed, where fear is the dominant emotion. In our experience, emotions rarely improve investment performance and can sometimes be very detrimental. Warren Buffett, one of the world's most successful investors, says that "we simply attempt to be fearful when others are greedy, and greedy only when others are fearful." (Letter to Berkshire Hathaway shareholders 1986). Since we think fear tends to dominate human emotions,

we risk being the 'fearful' investors from which he is buying. Watching your nest egg fall while you are withdrawing from it and knowing you have no more to add to it is 'fear inducing', and even if you want to be 'greedy', you can't. At that point, the investor is often questioning their whole retirement strategy and whether it will work. In such moments, we believe the key is confidence in your financial plan and by extension, the planner. If you believe the plan is designed to weather these environments, it is easier to move past fear.

The Building Blocks of a 21st Century Retirement Plan

Risk Assets: When constructing a retirement plan, we believe investors should use enough 'risk assets' to provide the required returns while taking emotional tolerance into consideration. We have discussed stocks at length and note that riskier assets require more careful selection and closer scrutiny. With stocks and other assets such as high-yield bonds, we think it is important to understand their specific risks, which may not be obvious upon cursory review. We believe higher yielding bonds can play an important role in boosting cash flow, but we also believe this is a decision, like stocks that should be actively managed and monitored.

A Balanced Structure: We believe investors should ensure the portfolio has not only a stream of fixed income payments, but also a mixture of stocks that produce a combination of growing dividends and earnings. We tend to prefer companies with the greatest potential to grow dividends, rather than those with the highest starting yield, as we believe growth of income is important in the Distribute phase. Also, companies in faster-growing sectors often reinvest their excess cash flow to expand and do not necessarily pay dividends. We do not want to exclude these stocks as we think they can play an important role in growing the retirees' asset base.

How RiverFront Can Help

Retirement is the beginning of a potentially long Distribute phase as life expectancy continues to increase. With the help of a financial advisor, a professionally crafted retirement plan can be tailored to investors' needs and risk tolerances. **We think our focus on portfolio construction, risk management, transparency, and consistent communication are critical elements in giving financial advisors and their clients the peace of mind to stick with the agreed plan.**

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

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The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the *interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Bloomberg US Aggregate Bond Index measures the performance of the US investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than one year.

Chart 2: U.S Market Cap index information calculated based on data from CRSP 1925 US Indices Database ©2022 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Used as a source for cap-based portfolio research appearing in publications, and by practitioners for benchmarking, the CRSP Cap-Based Portfolio Indices Product data tracks micro, small, mid- and large-cap stocks on monthly and quarterly frequencies. This product is used to track and analyze performance differentials between size relative portfolios. CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization. The series of 10 indices are identified as CRSP 1 through CRSP 10, where CRSP 10 has the largest population and smallest market-capitalization. CRSP portfolios 1-2 represent large cap stocks, portfolios 3-5 represent mid-caps and portfolios 6-10 represent small caps.

The Real Return is the annual percentage return realized on an investment adjusted for inflation. Trend, according to Price Matters® is the slope of an exponential growth function that closely tracks a real (inflation-adjusted) long term Index for that Asset Class. Distance from Trend is the distance of the trend line relative to the current index level expressed as a percentage.

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the US government. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money. As inflation rises, TIPS adjust in price to maintain its real value.

A real estate investment trust (REIT) is a company that owns, operates, or finances income-generating real estate. Modeled after mutual funds, REITs pool the capital of numerous investors. This makes it possible for individual investors to earn dividends from real estate investments—without having to buy, manage, or finance any properties themselves. There are special risks associated with an investment in real estate and Real Estate Investment Trusts (REITs), including credit risk, interest rate fluctuations and the impact of varied economic conditions.

Definitions:
For each outcome category (accumulate, sustain and distribute) RiverFront's portfolio management team has assigned one or more RiverFront product(s) based on their assessment of the product's investment objective as it relates to a typical client's return and risk objectives when seeking investment outcomes of accumulating wealth, sustaining wealth and distributing wealth. The team has also designated RiverFront product alternatives for those clients looking to take more or less risk with the outcome category. The 'more aggressive' (or more risk) alternatives will generally have greater equity and international exposure as well as longer time horizon targets, while those designated as 'more conservative' (or less risk) will have fewer equities, a lower exposure to international and shorter time horizon targets. Since the risk assessments are dependent on the outcome category selected, RiverFront products may fall in multiple categories. All investments carry a risk of loss and there is no guarantee that an investment product or strategy will meet its stated objectives.

Don't Fight the Fed – 'Supportive' means the Fed's monetary policy regarding inflation and employment is in what we believe based on our analysis to be the investors' best interest; 'Against' means the Fed's monetary policy, in our view, is going against the investors' best interest; 'Neutral' means the Fed's monetary policy is neither supportive nor against the investors' best interest in our view. Don't Fight the Trend – Terms correlate to the 200-day moving average as it relates to the equity indexes: 'Positive' means that the trend is rising, 'Flat' means the trend is flat, 'Negative' means the trend is falling. Beware the Crowd at Extremes – Terms correlate to the NDR Crowd Sentiment Poll and its measurement of Extreme Optimism (Bearish), Neutral, or Extreme Pessimism (Bullish).

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

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