CONVERSATION GUIDE NO. 2

BEHAVIORAL FRAMEWORK: ADDRESSING INVESTOR MINDSETS

THE GREAT CASH REALLOCATION

Helping Clients Reinvest Cash Now

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INTRODUCTION

Cash allocations have recently ballooned, potentially hampering the future returns of investor portfolios. There are several reasons investors may hold too much cash, including biases that have developed due to prior experience. Financial professionals play an important role in educating clients by countering biases with objective long-term perspectives on asset allocation. Such conversations can be difficult but approaching them through the lens of behavioral finance can help financial professionals gain empathy and a better understanding for how investors feel. This conversation guide will provide ideas on how to:

1. IDENTIFY COMMON BIASES THAT MAY LEAD TO AN OVERALLOCATION IN CASH
2. APPROACH CONVERSATIONS ABOUT NEW OPPORTUNITIES WITH EMPATHY
3. OFFER APPROPRIATE INCREMENTAL CHANGES TO FIXED INCOME ALLOCATIONS

1. IDENTIFY COMMON BIASES THAT MAY LEAD TO AN OVERALLOCATION IN CASH

Every investor is impacted in some way by biases that are shaped by life experiences. These biases can affect decision-making, risk tolerance, and other investing behaviors. Considering behavioral finance biases can help financial professionals empathize and connect with their clients' experiences and attitudes.

While considering an investor's biases, keep in mind each experience is unique. For investors holding too much cash, many of these biases reflect legitimate concerns and may have served them well in recent years. With this perspective, financial professionals can help offer a more objective, long-term view.

Here are some common behavioral biases that can contribute to an elevated cash position:

LOSS AVERSION:

Investors may fear potential losses more than they value potential gains. As a result, they might prefer to hold onto cash rather than risk losses in the market.

What a client may say:

> I prefer keeping a significant amount in cash because I don't want to risk losing money in the market.

> I'm worried about making the wrong investment choices and regretting it later.

RECENCY BIAS:

Investors may be influenced by recent market events and performance. If they have experienced losses in certain asset classes, investors might be more inclined to hold onto cash.

What a client may say:

> The recent market volatility has me concerned, so I'm holding onto cash until things stabilize.

> Over the past couple of years, cash has performed better in my portfolio than stocks or bonds.

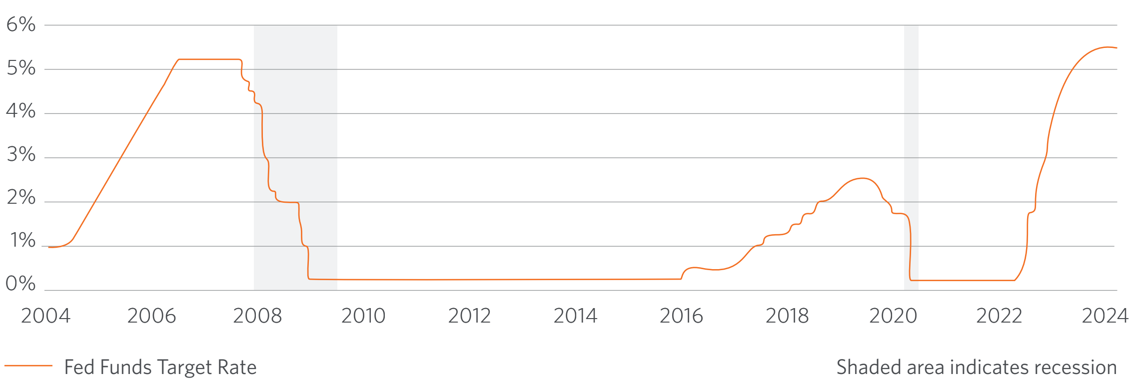
ANCHORING:

Anchoring occurs when investors fixate on a reference point, such as a specific return or yield. If the returns of an asset class fall below this anchor, investors may be reluctant to allocate more resources to that asset class, leading them to hold onto cash instead. Investors may anchor to cash when rates are high or view recent rates as typical.

What a client may say:

> My money market fund is yielding 5%. I'll keep my money in cash until I see something higher.

CYCLES OF THE FEDERAL FUNDS RATE — 2004 TO 2024



As of 1/31/2024. Sources - Fed Funds Rate: Federal Reserve Board of Governors; Recessions: National Bureau of Economic Research

This list is not comprehensive, and several other behavioral biases come into play, such as overconfidence, attribution, and herding. Every investor, even seasoned professional investors, is influenced by a combination of biases, and the specific reasons for holding too much cash can vary from one person to the next.

2. APPROACH CONVERSATIONS ABOUT NEW OPPORTUNITIES WITH EMPATHY

Introducing investment opportunities that align with their goals and risk tolerance may mean presenting the reasons investors should consider reinvesting their cash. Approaching these discussions with empathy helps foster a collaborative environment while acknowledging legitimate concerns and individual risk tolerance. Here are some examples of conversation starters that can open a productive, empathetic dialogue:

"I understand the importance of preserving capital. Some allocation to shorter-duration bonds may add diversification with some downside risk mitigation. This will help keep the investments within your risk tolerance."

"It's natural to be cautious about investments and react to short-term fluctuations. However, by focusing on your long-term goals, we can avoid these more reactive decisions."

"By diversifying your portfolio and maintaining a long-term perspective, we can increase the odds you'll reach your goals and **reduce the likelihood of shortfall risk."**

"It's understandable to consider leaving money in your money market fund* due to its yield today, but market conditions change. Let's determine the best course of action to maintain some yield throughout different market conditions."

Diversification does not guarantee a profit or protect against a loss.

3. OFFER APPROPRIATE INCREMENTAL CHANGES TO FIXED INCOME ALLOCATIONS

Once you've communicated empathy and understanding, the next step is to provide tangible suggestions for reallocating cash. Here are some suggestions on offering appropriate incremental changes to fixed income allocations:

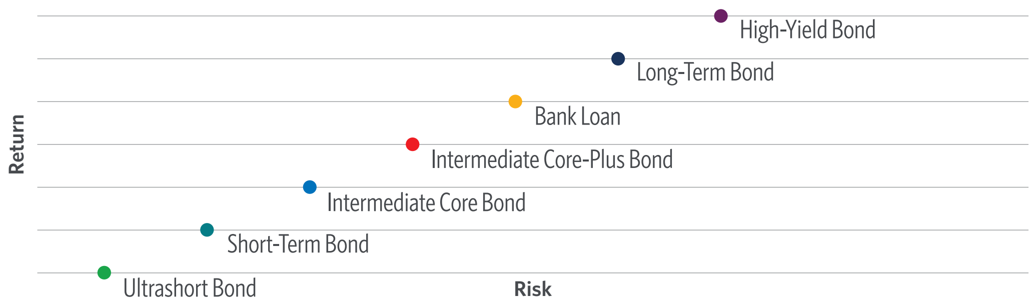
START A PHASED APPROACH:

Clients don't have to move cash all at once, or all into long-duration bonds. Some more risk-averse investors may want to incrementally move cash to short- to intermediate-duration options. This may involve gradually reallocating a portion of cash over several months to short-duration fixed income, which can help maintain flexibility while reducing the opportunity cost if cash rates fall.

INTRODUCE CREDIT AND DURATION DIVERSIFICATION BASED ON RISK TOLERANCE:

Propose diversification strategies that align with the client's risk tolerance and financial goals. Discuss how remaining in cash does not provide comprehensive diversification, and that spreading investments across durations and credit can help reduce risk while increasing upside potential.

FINDING THE RIGHT ENTRY POINT ON THE RISK LADDER



As of 12/31/2023 Source: Morningstar Direct

EDUCATE CLIENTS ON POTENTIAL FIXED INCOME RETURNS:

Provide clear information on the potential returns of alternative fixed income investments compared to holding cash. Illustrate how a balanced portfolio can offer growth while managing risk.

Financial professionals play a crucial role in guiding clients through conversations about biases such as loss aversion, recency bias, and anchoring, which may contribute to an overallocation of cash. Recognizing the legitimacy of their concerns, financial professionals can then approach discussions constructively, presenting fixed income opportunities that are better aligned with the client's long-term goals and risk tolerance.

*You could lose money by investing in money market funds. Although money market funds seek to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

KEY TAKEAWAYS

An overallocation to cash may be due to behavioral biases that underscore legitimate concerns.

While educating investors about allocations, **financial professionals should address investor concerns with empathy.**

Moving cash in a phased approach can reduce opportunity cost risks while adhering to a client's risk tolerance.

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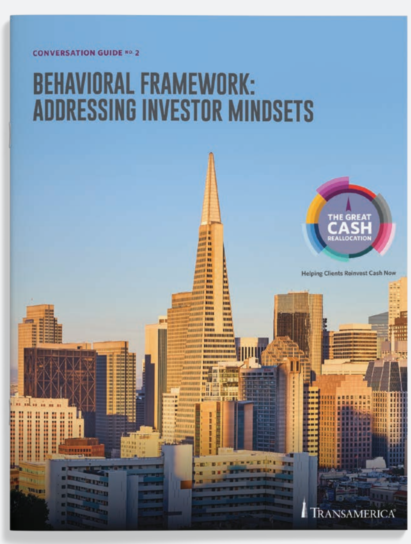
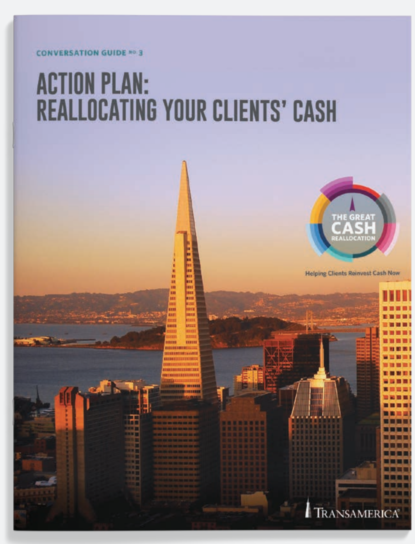
Setting the Stage:
Educating Clients on the Opportunity



Behavioral Framework:
Addressing Investor Mindsets



Action Plan:
Reallocating Your Clients' Cash

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NOTES

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IMPORTANT INFORMATION

Fixed income securities are subject to risks including credit risk, interest rate risk, counterparty risk, prepayment risk, extension risk, valuation risk, and liquidity risk. The value of fixed income securities generally goes down when interest rates rise, and therefore the value of your investment in the fund may also go down. Changes in interest rates, the market's perception of the issuers and the creditworthiness of the issuers may significantly affect the value of the fund.

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