



Dynamic Asset Allocation for Plans with Short-Term Obligations

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Trustees of health and welfare plans face a challenge that traditional pension plans generally do not: their short-term liabilities can shift as quickly as their assets do. A plan's cash flow needs, recommended reserves, and asset values are constantly changing, so a fixed asset allocation set once and left in place may not keep pace with the growth in plan expenses, such as medical inflation, or with swings in claims and contributions. A dynamic asset allocation (DAA) structure addresses this by matching the investment profile of a plan's assets to when its liabilities are expected to come due, moving the plan to a more conservative posture as near-term liabilities grow and to a more aggressive posture as they shrink.

This paper explains how a DAA structure works and how it can be applied. It first describes the mechanics of the model, including the three reserve pools (cash flow, recommended, and surplus) and the asset classes used to build each pool. It then presents three illustrative DAA policy mixes and examines their behavior across historical market downturns and stress scenarios, and it discusses the liquidity considerations that any implementation must address.

Key Takeaways

- › Health and welfare plan liabilities can shift quickly as claims and contributions change, so a fixed asset allocation set once and left in place may not keep pace with a plan's evolving needs. A dynamic asset allocation (DAA) structure addresses this by matching the investment profile of a plan's assets to when its liabilities are expected to come due.
- › The DAA framework divides a plan's assets into three reserve pools: cash flow, recommended, and surplus reserves. Each pool is invested progressively more aggressively as its time horizon lengthens.
- › Trustees can use different DAA policy mixes (e.g., conservative, moderate, and aggressive) to tailor a plan's overall exposure to its risk tolerance. A conservative mix should offer the strongest downside protection and least volatility, while an aggressive mix should offer the highest expected return.
- › Liquidity is essential for the cash flow reserve pool, so it should be limited to highly liquid instruments, such as investment grade bonds and TIPS, that can reliably fund near-term cash needs.

Overview

Trustees of health and welfare plans must balance the need to cover short-term liabilities with the need to invest longer-term assets so they can keep pace with the growth in plan expenses (e.g., medical inflation and claims costs). For this reason, a static allocation may become less aligned with a plan's objectives as funding levels, reserve targets, and liquidity needs evolve. In addition, other types of plans such as VEBAs, OPEB plans, and even some traditional pension plans with shorter-term horizons may benefit from adopting a dynamic asset allocation strategy.¹

A dynamic asset allocation (DAA) structure can improve a plan's ability to meet all benefit obligations, no matter the time frame, by matching the investment profile of the plan's assets with when its liabilities are expected to come due. For example, if a plan's short- or intermediate-term liabilities increase relative to total assets (e.g., through higher claims or reduced employer contributions), DAA moves the plan to a more conservative posture. This helps ensure that the plan's assets are invested less aggressively to match the shorter-term horizon of the plan's liabilities. On the other hand, if a plan's short-term liabilities decrease relative to total assets, DAA moves the plan toward a more aggressive posture.

Dynamic Asset Allocation may be particularly relevant for plans with uncertain or evolving cash flow needs, where liability horizons change over time. In these cases, a static allocation may not adjust quickly enough to reflect shifts in funding requirements. By contrast, plans with stable contributions and longer-duration liabilities may find that a fixed strategic allocation is prudent. As a result, the appropriateness of DAA depends largely on the predictability and timing of a plan's obligations, and how those needs change over time.

Dynamic Asset Allocation Details

A DAA approach creates up to three pools of assets within the plan: cash flow reserves, recommended reserves, and surplus reserves. The pools vary in size and are usually determined with the help of a plan's actuary.² Rebalancing often occurs annually and should be considered when funding needs or reserve levels change materially to ensure the allocation stays aligned with the plan's current obligations. In practice, reallocations are typically guided by predefined policy ranges for each reserve pool. Adjustments are made periodically, or when reserve levels move meaningfully outside those ranges. Effective implementation requires monitoring of reserve levels and coordination between investment and actuarial inputs.

Total assets are usually invested more conservatively than a typical pension plan, due to the greater uncertainty of cash flows. The cash flow reserves pool represents those assets required to meet projected net cash outflows in the short term, typically over the next two years, although some plans may need to hold assets for obligations expected over a shorter period. Cash flow reserves are invested very defensively to preserve capital and ensure funds are available to meet near-term cash needs. The recommended reserves pool represents those assets required to meet projected cash outflows in the intermediate term, typically years three through seven. Recommended reserves are allocated slightly less conservatively, often with some exposure to equity and equity-like assets. Investing in riskier assets should increase the expected return of the recommended reserve pool, although it is by no means guaranteed. Finally, the surplus reserves pool represents the remaining assets in excess of the cash flow and recommended reserves. The surplus reserves are invested more aggressively, reflecting the longer investment horizon associated with surplus assets.

The allocation of the plan will therefore change as both asset values and cash flow projections change. For example, if asset values increase while cash flow projections stay constant (i.e., the cash flow and recommended reserves stay constant), then the surplus reserve pool will represent a larger portion of the plan's assets. As a result, the plan will be invested more aggressively with greater capacity to pursue higher long-term returns. If, however, cash flow needs increase while asset prices stay constant, then the cash flow or recommended reserves pool will represent a larger portion of the plan's assets. In that case, the plan will be invested more conservatively.

Under this framework, the plan's overall risk is driven primarily by the relative size of each reserve pool, rather than by tactical shifts within the underlying asset classes. This dynamism helps ensure that the plan's assets are invested appropriately as economic and market environments change.

Pool Components

A plan that uses the Dynamic Asset Allocation model invests in multiple asset classes, primarily including liquid asset classes such as public equities and fixed income. Liquidity provides certainty when assets need to be sold to meet cash flow needs, and it also allows a plan to be rebalanced as its reserve position evolves. While broader opportunity sets exist, the focus here is on assets that can reliably support the liquidity and flexibility required for implementing the DAA structure.

- › High quality (i.e., investment grade) bonds will likely comprise much of the portfolio. Investment grade bonds often (though not always) offer downside protection during equity bear markets while providing regular income. Intermediate-term investment grade bonds (e.g., “core bond” portfolios) tend to offer higher yields while also providing stability to the plan.
- › Short-term investment grade bonds offer the least volatility as they tend not to fluctuate much with changes in interest rates or equity prices. Hence, they are often used to match a plan’s near-term liabilities. Note that their relative attractiveness can vary based on the prevailing interest rate environment (e.g., when short-term rates were near zero, the yield offered by short-term bonds was historically low).
- › TIPS (Treasury Inflation-Protected Securities) offer similar attributes to nominal Treasury bonds, with one key exception: TIPS protect investors from long-term inflation by paying a coupon that adjusts based on the rate of inflation (unlike nominal Treasuries, which pay a fixed coupon). The inflation measure used to adjust TIPS is the consumer price index (CPI), which tracks the prices of a basket of consumer-oriented goods and products. It is worth noting that TIPS performance can vary with changes in interest rates, not just inflation, and that the CPI may not be a perfect match for the inflation experienced by a plan.
- › Short-term TIPS offer more direct inflation protection relative to TIPS, but at reduced duration. This reduced duration creates less interest rate risk than longer duration instruments, all else equal. For plans with near-term horizons, using short-term TIPS to reduce interest rate sensitivity can be effective in matching liability duration, a strategy used to decrease interest rate risk and help the portfolio meet its liability obligations.
- › Emerging market bonds, bank loans, and high yield bonds represent riskier fixed income instruments that may offer a diversification benefit. High yield bonds and bank loans generally offer higher yields, higher expected returns, and greater volatility. Emerging market debt also offers higher yields while providing exposure to a broader set of global interest rate environments. However, it introduces foreign exchange risk when investing in bonds not issued in US dollars.
- › High yield bonds offer higher income than is traditionally available from investment grade bonds. This comes with the trade-off of greater credit risk, as high yield bonds by definition are those rated as below investment grade in terms of credit quality.
- › Bank loans can help reduce sensitivity to short-term interest rates while offering higher yields than cash or investment grade bonds. While they typically have more credit risk than investment grade bonds, they also have seniority in the capital structure. Because bank loans are callable, meaning the issuer can repay the loan before maturity, there is added risk that the loan may not remain in the portfolio for its full expected term.
- › Equities bring a trade-off to the portfolio. While they are the riskiest of the potential components, they also typically offer the highest expected return. While most of the equity allocation is usually composed of US stocks, the inclusion of developed non-US and emerging market stocks may provide additional diversification benefits, as well as risks. Increased equity exposure is most appropriate in reserve pools with longer time horizons, where a plan has greater ability to withstand interim market volatility.

Certain other asset classes and strategies (e.g., closed-end private market partnerships) do not generally provide sufficient liquidity to conform to the frequent rebalancing likely required by the DAA model or satisfy the cash flow needs of a plan with a short-term time horizon. For this reason, they are generally excluded from the core DAA framework.

Dynamic Asset Allocation Policy Options

As with any asset allocation decision, there is no single asset mix that is appropriate for all investors. Some Trustees seek a relatively conservative allocation for each of the cash flow, recommended, and surplus reserve pools, while others prefer more aggressive allocations. This section outlines three possible DAA policy mixes, labeled conservative, moderate, and aggressive, that are designed to meet the risk preferences of most Boards of Trustees.

It is worth noting that the more conservative the DAA policy is, the less sensitive the plan is likely to be to asset value fluctuations. This is important because cash flow projections and asset values are often negatively correlated: when the economy is in recession, contributions usually decrease, interest rates typically decline (thereby raising liabilities), and demand for payments may increase. Thus, when assets go down, cash outflow projections are

likely to go up, and vice versa. Therefore, the swings in a plan's risk posture are likely to be more severe with a more aggressive DAA policy.

“Conservative” DAA Policy

In a conservative DAA structure, bonds account for the entirety of the cash flow reserve pool, reflecting the need to preserve capital and maintain liquidity for near-term obligations, with an emphasis on short-term and high-quality instruments that can be readily converted to cash (see Figure 1). Equity exposure is introduced through the recommended and surplus reserve pools. Even within the surplus reserves, equities are capped at 30% of assets and are largely allocated within US markets (see Figure 2). Because surplus reserves typically represent a smaller portion of total plan assets, the overall equity allocation at the plan level remains limited, generally falling in the range of 5% to 25% (see Figure 3). This structure is designed to preserve liquidity while allowing for modest growth.

Figure 1
Conservative DAA Policy Pools

	Cash Flow Reserves	Recommended Reserves	Surplus Reserves
Fixed Income	100%	85%	70%
Equities	0%	15%	30%
Total	100%	100%	100%
Expected 10-Year Return ³	4.10%	4.56%	4.98%
Expected 10-Year Volatility	3.54%	4.81%	6.66%

Allocations shown represent the asset mix within each reserve pool. The related illustrative conservative portfolio analysis assumes a cash flow-negative plan profile with 35% cash flow reserves, 55% recommended reserves, and 10% surplus reserves.

Figure 2
Conservative DAA Policy Asset Mixes

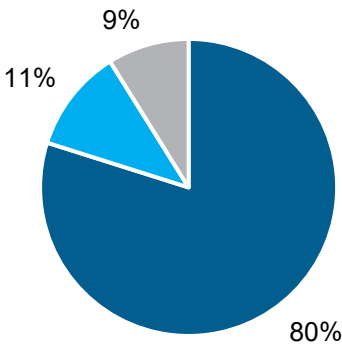
Asset Mix of the Fixed Income Portfolio		Asset Mix of the Equity Portfolio	
Short-Term Bonds	25%	US	80%
Investment Grade Bonds	30	EAFE	15
Short-Term TIPS	15-35	Emerging Markets	5
TIPS	0-20	Total	100
High Yield Bonds	5		
Bank Loans	5		
Total	100		

Allocations shown represent the asset mix within each reserve pool. The related illustrative conservative portfolio analysis assumes a cash flow-negative plan profile with 35% cash flow reserves, 55% recommended reserves, and 10% surplus reserves.

Figure 3
Illustrative Combined Asset Mix for Conservative Portfolio

Credit reflects the combined allocation to high yield bonds and bank loans shown in the Fixed Income Portfolio asset mix in Figure 2.

■ Rate Sensitive ■ Equities ■ Credit



“Moderate” DAA Policy

In a moderate policy structure, bonds continue to account for the entirety of the cash flow reserve pool, reflecting the need to maintain liquidity for near-term obligations (see Figure 4). At the same time, the allocation to shorter-term and high-quality fixed income is reduced relative to the conservative mix, and emerging market bonds are introduced for higher yield and return potential (see Figure 5). Equity exposure is increased in the recommended and surplus reserve pools, with the latter now capped at 40%. As a result, a larger share of total plan assets is allocated to growth-oriented investments, leading to an overall equity allocation that is likely to fall in the range of 15% to 35% (see Figure 6). This positioning seeks to balance a higher return potential with greater short-term volatility.

Figure 5

Moderate DAA Policy Asset Mixes

Asset Mix of the Fixed Income Portfolio		Asset Mix of the Equity Portfolio	
Short-Term Bonds	20%	US	70%
Investment Grade Bonds	25	EAFE	20
Short-Term TIPS	15-25	Emerging Markets	10
TIPS	10-20	Total	100
Emerging Market Bonds	5		
High Yield Bonds	10		
Bank Loans	5		
Total	100		

Allocations shown represent the asset mix within each reserve pool. The related illustrative moderate portfolio analysis assumes a cash flow-neutral plan profile with 20% cash flow reserves, 50% recommended reserves, and 30% surplus reserves.

“Aggressive” DAA Policy

In the aggressive policy, bonds continue to represent most of the cash flow reserve pool, although a modest allocation to equities is introduced to allow for limited growth exposure within short-term reserves (see Figure 7). Equity exposure is further increased in the recommended and surplus reserve pools, with equities now capped at 50% of the surplus reserves. As a result, a significantly larger share of total plan assets is allocated to growth-oriented investments, leading to an overall equity allocation that may range from 30% to 50% (see Figure 9). The goal of this policy is to pursue higher long-term return potential through greater participation in sustained market growth, while accepting greater sensitivity to market movements and increased short-term variability.

Figure 4

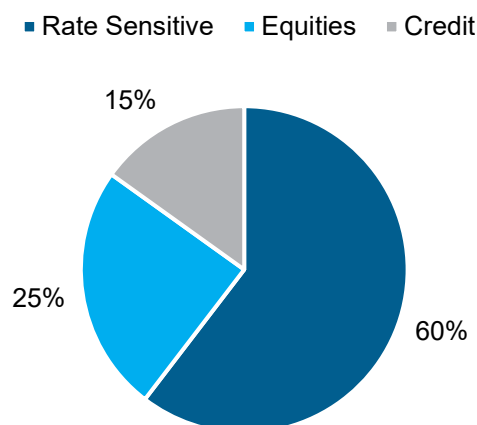
Moderate DAA Policy Pools

	Cash Flow Reserves	Recommended Reserves	Surplus Reserves
Fixed Income	100%	75%	60%
Equities	0%	25%	40%
Total	100%	100%	100%
Expected 10-Year Return⁴	4.29%	4.98%	5.33%
Expected 10-Year Volatility	4.32%	6.70%	8.56%

Allocations shown represent the asset mix within each reserve pool. The related illustrative moderate portfolio analysis assumes a cash flow-neutral plan profile with 20% cash flow reserves, 50% recommended reserves, and 30% surplus reserves.

Figure 6

Illustrative Combined Asset Mix for Moderate Portfolio



Credit reflects the combined allocation to emerging market bonds, high yield bonds, and bank loans shown in the Fixed Income Portfolio asset mix in Figure 5.

Figure 7

Aggressive DAA Policy Pools

	Cash Flow Reserves	Recommended Reserves	Surplus Reserves
Fixed Income	90%	65%	50%
Equities	10%	35%	50%
Total	100%	100%	100%
Expected 10-Year Return⁵	4.70%	5.30%	5.61%
Expected 10-Year Volatility	5.54%	8.22%	10.10%

Allocations shown represent the asset mix within each reserve pool. The related illustrative aggressive portfolio analysis assumes a cash flow-positive plan profile with 10% cash flow reserves, 40% recommended reserves, and 50% surplus reserves.

Figure 8**Aggressive DAA Policy Asset Mixes**

Asset Mix of the Fixed Income Portfolio		Asset Mix of the Equity Portfolio	
Short-Term Bonds	10%	US	65%
Investment Grade Bonds	30	EAFE	25
Short-Term TIPS	10-20	Emerging Markets	10
TIPS	15-25	Total	100
Emerging Market Bonds	5		
High Yield Bonds	10		
Bank Loans	5		
Total	100		

Allocations shown represent the asset mix within each reserve pool. The related illustrative aggressive portfolio analysis assumes a cash flow-positive plan profile with 10% cash flow reserves, 40% recommended reserves, and 50% surplus reserves.

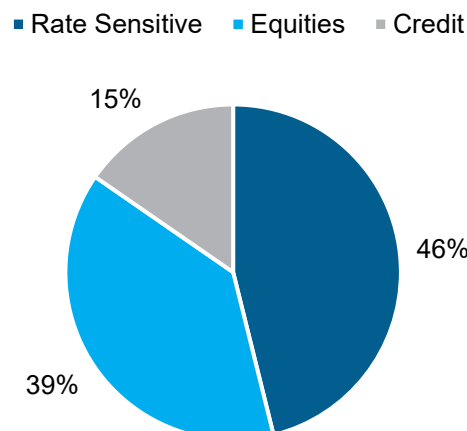
Portfolio Risk Comparison

This section compares the conservative, moderate, and aggressive DAA portfolios across various stress tests and historical scenarios. This kind of testing is intended to illustrate the likely impact of periods of stressed or even extreme conditions. The results help assess whether each portfolio is appropriately structured to weather these environments and which policy would best match a

Figure 10**Historical Scenario Analysis (Cumulative Return)**

Scenario	Conservative	Moderate	Aggressive
Post-COVID Rate Hikes (1Q22 thru 4Q23)	-7.40%	-8.77%	-10.03%
COVID-19 Market Shock (1Q20)	-6.27%	-11.67%	-16.86%
Global Financial Crisis (4Q07 thru 1Q09)	-1.13%	-9.93%	-18.70%
Popping of the dot-com Bubble (2Q00 thru 3Q02)	17.98%	7.15%	-3.58%
Crash of 1987 (September thru November 1987)	-1.66%	-5.73%	-9.73%
Stagflation (1Q73 thru 3Q74)	-1.77%	-9.11%	-15.82%

Based on Meketa Investment Group's Asset Allocation Tool using our 2026 capital markets expectations. These are hypothetical results and do not represent the actual performance of any plan or account.

Figure 9**Illustrative Combined Asset Mix for Aggressive Portfolio**

Credit reflects the combined allocation to emerging market bonds, high yield bonds, and bank loans shown in the Fixed Income Portfolio asset mix in Figure 8.

Board's risk posture. As expected, an analysis of historical scenarios shows that the conservative model would have provided the best hedge against the major market downturns of the past fifty years (see Figure 10).⁶

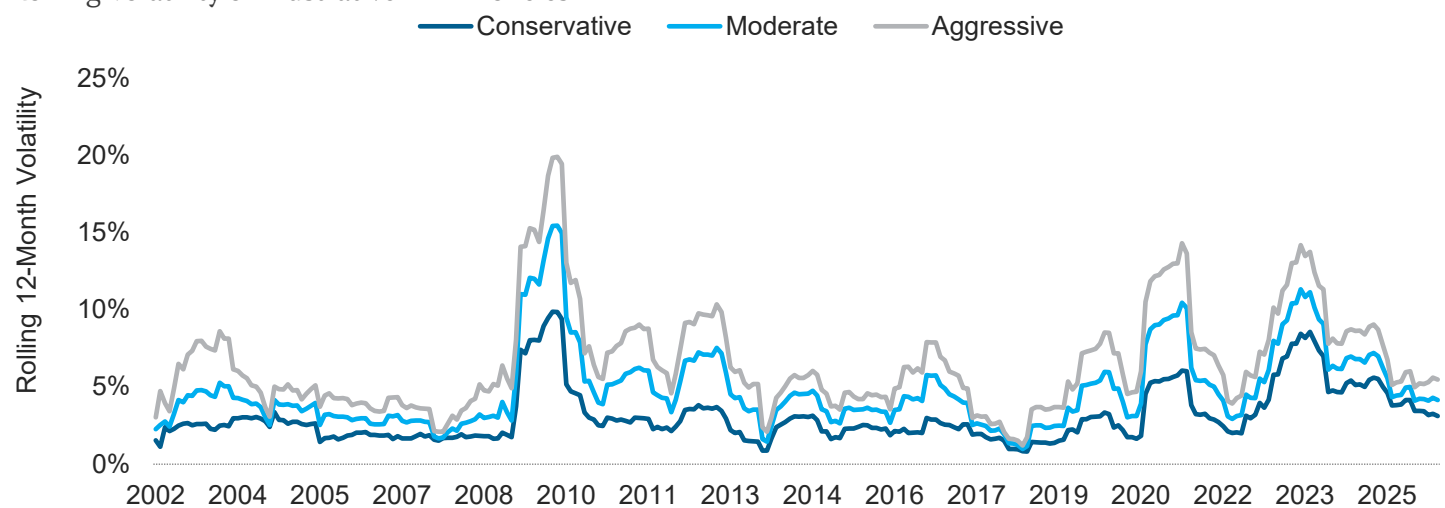
Similarly, a stress test analysis shows that the conservative model is also structured to provide the most protection against the most extreme capital market risks (see Figure 11).

The results help assess whether each portfolio is appropriately structured to weather these environments and which policy would best match a Board's risk posture.

Figure 11**Stress Testing: Impact of Market Movements (Expected Return Under Stressed Conditions)**

What happens if (over a 12-month period):	Conservative (%)	Moderate (%)	Aggressive (%)
10-Year T-Bond rates rise 100 bp	-1.29%	0.27%	1.72%
10-Year T-Bond rates rise 200 bp	-4.90%	-4.46%	-3.94%
10-Year T-Bond rates rise 300 bp	-6.67%	-5.47%	-4.71%
Baa Spreads widen by 50 bps, High Yield by 200 bps	1.81%	1.18%	0.74%
Baa Spreads widen by 300 bps, High Yield by 1000 bps	-6.76%	-12.26%	-17.43%
Trade-weighted US\$ gains 10%	-1.34%	-2.52%	-3.62%
Trade-weighted US\$ gains 20%	0.81%	-0.13%	-0.60%
Equities decline 10%	-0.40%	-2.24%	-3.87%
Equities decline 25%	-4.38%	-8.55%	-12.24%
Equities decline 40%	-8.30%	-14.63%	-20.55%

Based on Meketa Investment Group's Asset Allocation Tool using our 2026 capital markets assumptions. The assumptions underlying the model, and hence the output of the stress tests, will vary as market conditions (e.g., the level of interest rates) change. These are hypothetical results and do not represent the actual performance of any plan or account.

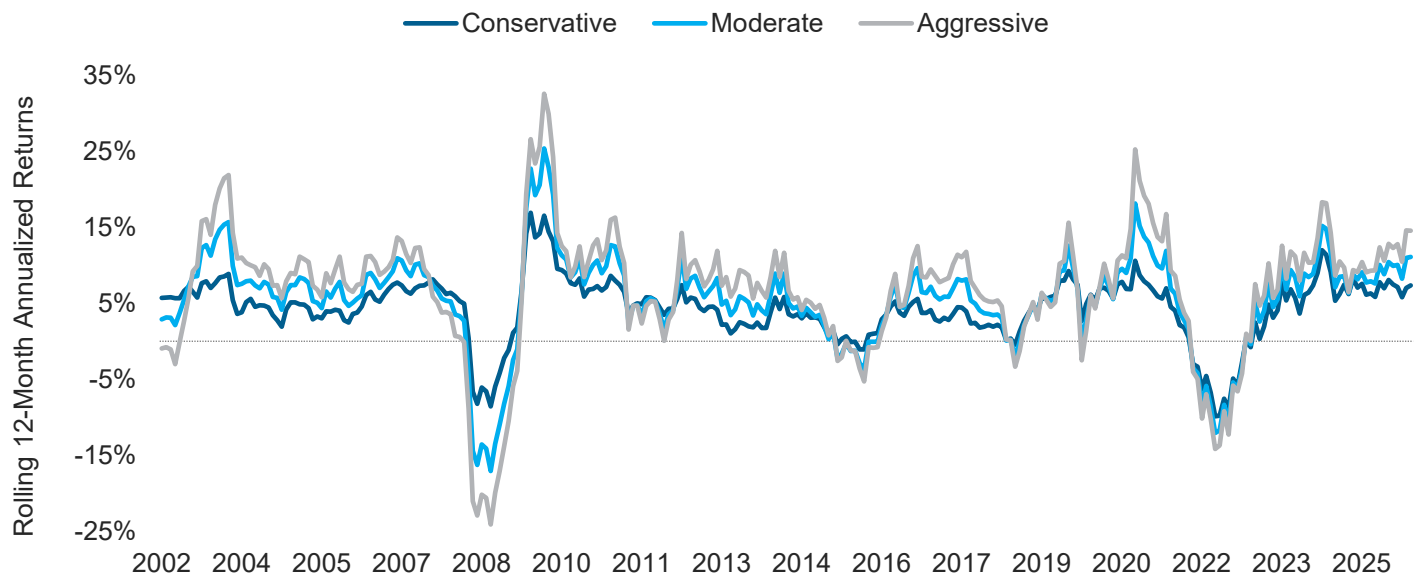
Figure 12**Rolling Volatility of Illustrative DAA Policies**

The asset classes analyzed were proxied by the Bloomberg US Aggregate, Bloomberg US TIPS, JPM GBI-EM, Bloomberg US TIPS 1-5 Year, S&P UBS Leveraged Loan, Bloomberg High Yield, Bloomberg US Government/Credit 1-3 Year, Russell 3000, MSCI EAFE, and MSCI Emerging Markets indices, respectively. The resulting figure is hypothetical and does not represent the performance of an actual portfolio.

While historical scenarios and stress tests show how the portfolios may perform in specific market environments, volatility provides another view of portfolio risk. The volatility of any portfolio is typically not stable over time. It changes with evolving market conditions, including periods of market stress and shifts in interest rates. For example, over the past few decades, the rolling 12-month volatility of the conservative example has varied from less than 1% to more than 12% (see Figure 12). Meanwhile,

the rolling volatility of the aggressive example peaked at more than 20% during the GFC.

Likewise, the rolling 12-month return of the aggressive portfolio was down more than 23% during the GFC, while the nadir for the conservative portfolio during this period was roughly half as low (see Figure 13). This provides context for how policy choice influences risk and return outcomes over time.

Figure 13**Rolling Returns of Illustrative DAA Policies**

The asset classes analyzed were proxied by the Bloomberg US Aggregate, Bloomberg US TIPS, JPM GBI-EM, Bloomberg US TIPS 1-5 Year, S&P UBS Leveraged Loan, Bloomberg High Yield, Bloomberg US Government/Credit 1-3 Year, Russell 3000, MSCI EAFE, and MSCI Emerging Markets indices, respectively. The resulting figures are hypothetical and do not represent the performance of an actual portfolio.

Liquidity

Liquidity is a primary concern for plans with a short-term horizon. The dynamic asset allocation model seeks to structure the investments that comprise the cash flow reserve pool such that they best match anticipated near-term liabilities. In a DAA structure, the cash flow reserve pool is typically limited to highly liquid instruments such as investment grade bonds and TIPS, as these are the assets most likely to be called on to fund cash outflows in a pinch. Commingled vehicles or mutual funds with daily liquidity are commonly used for this purpose.

Conclusion

The case for a dynamic asset allocation structure rests on a single observation: for health and welfare plans, liabilities move on their own schedule, driven by claims and contributions instead of a fixed formula. Rather than requiring the Board to react each time that schedule shifts, a DAA framework separates a plan's assets into cash flow, recommended, and surplus reserves and lets the balance between them do the adjusting, automatically moving the portfolio to a more conservative posture as near-term liabilities grow and a more aggressive one as they shrink.

Because no single risk posture fits every plan, the conservative, moderate, and aggressive policy mixes

give Trustees a spectrum to choose from, and the choice ultimately comes down to how much short-term variability the Board is willing to accept in exchange for higher expected returns. The scenario and stress testing in this paper make that trade-off concrete: the conservative mix has weathered major downturns far better than the aggressive one, while the latter has captured more of the upside in strong markets. Across all three mixes, however, the cash flow reserve pool should hold only the most liquid instruments, such as investment grade bonds and TIPS, so that near-term obligations can be met even when markets are under stress.

Taken together, these elements give Trustees a repeatable framework, not a one-time decision, for keeping a plan's assets aligned with its liabilities as both evolve.

Appendix: Additional Asset Classes

The DAA approach does not preclude other assets from being included in the portfolio. Among those asset classes we see occasionally included are cash and core real estate.

Core open-end real estate may be used by plans that are willing and able to tolerate some small amount of illiquidity. “Core” means that the properties are generally of high quality, low leverage, and high occupancy. Core real estate may include offices, apartments, industrial and retail properties. An allocation to real estate may offer several benefits including a potential long-term hedge against inflation (as landlords pass their costs along to tenants) and a diversification benefit relative to stocks and bonds. The primary disadvantage is less liquidity than stocks and bonds, especially during stressed market environments.

Cash and cash equivalents offer substantial liquidity to a portfolio, which can be helpful for plans with stringent liability constraints (i.e., substantial near-term liabilities). Cash is also a good hedge against rising short-term interest rates.

End Notes

- ¹ VEBAs are tax-exempt trusts used to fund employee benefits. OPEB plans provide post-employment benefits other than pensions, including retiree healthcare. Some traditional pension plans may also face short time horizons depending on plan-specific circumstances such as their funding and cash flow situation.
- ² Actuaries typically estimate each pool using projected claims, expected contributions, reserve targets, and other plan-specific assumptions.
- ³ Expected return and volatility are provided for illustrative purposes to offer context on the relative risk and return characteristics of each policy. Estimates are based on Meketa’s 2026 10-year capital markets assumptions.
- ⁴ Expected return and volatility are provided for illustrative purposes to offer context on the relative risk and return characteristics of each policy. Estimates are based on Meketa’s 2026 10-year capital markets assumptions.
- ⁵ Expected return and volatility are provided for illustrative purposes to offer context on the relative risk and return characteristics of each policy. Estimates are based on Meketa’s 2026 10-year capital markets assumptions.
- ⁶ For purposes of this analysis, each DAA policy is paired with a representative plan profile that reflects the type of reserve structure most likely to support that policy choice. The conservative example assumes a cash flow-negative plan consisting of 35% cash flow reserves, 55% recommended reserves, and 10% surplus reserves, reflecting the greater need to preserve liquidity for near-term obligations. The moderate example assumes a cash flow-neutral plan consisting of 20% cash flow reserves, 50% recommended reserves, and 30% surplus reserves, reflecting a more balanced reserve profile. The aggressive example assumes a cash flow-positive plan consisting of 10% cash flow reserves, 40% recommended reserves, and 50% surplus reserves, reflecting a larger surplus reserve pool available to support longer-term growth. The results shown in Figures 10 and 11 are hypothetical, do not reflect the performance of any actual plan or account, and are not necessarily indicative of future results.

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