2020 FORESIGHT

GETTING A "FIX" ON FIXED INCOME

LOOKING AHEAD
TO THE FUTURE OF FIXED INCOME IN
RETIREMENT SAVINGS PLANS.

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In the wake of near-record volatility in equity markets during the first six months of 2020, retirement savings plan investment fiduciaries and the financial professionals that advise them are bound to be hyper-focused on how each Core investment performed. Both parties will also likely re-evaluate the adequacy of their Core investment structure. Increased due diligence is indeed warranted as the traditional roles of key asset classes continue to evolve to meet the shifting demographics of plan participants. Our inaugural 2020 Plan Investment Trends survey[i] provides supporting evidence for these trends and reveals new insights about the role of fixed income in retirement savings plan investment menus.

Plan participant needs encompass a wide variety of risk, return and retirement needs. Retirement savings plan menus are generally designed to provide an array of investment options that enable participants to construct a suitable, well-diversified portfolio.

Fiduciaries have long understood the need for a diversified menu of investment options. However, regardless of plan size, plan provisions or diverse participant populations, the typical 401(k) plan has three to four times as many equity options as fixed income choices. Data from the Plan Sponsor Council of America's *Annual Survey of 401(k) and Profit-Sharing Plans* confirms that while the number of options has expanded over time, that ratio has remained unchanged through many market cycles[ii]:

ASSET "CLASS"

Among the fixed income options regularly incorporated in a Core investment structure, survey data show that advisors most frequently recommended stable value (84.3 percent), intermediate/core (74 percent) and multi-sector (55.9 percent). Stable value (67.4 percent) and bond index (61.1 percent) funds dominate actual plan investments.[iii] While core bonds remain an integral component in most plan menus, they may no longer be a "one-size-fits-all" solution given the historically low government yields around the globe and the new opportunities presented by wider credit spreads.

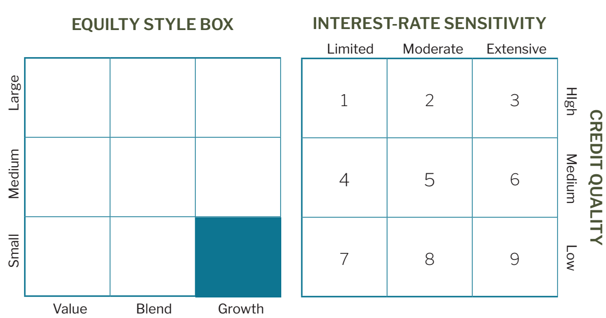
Our research also confirmed that advisor approaches differ in constructing the Core lineup and in selection of equity versus fixed income investments. Almost three fourths of investment professionals know and use a nine-quadrant style box to encourage diversification among equity investments. However, only forty percent of those investment professionals used a comparable style-box approach in presenting fixed income investments (see sidebar). This difference in approach may explain why there are fewer fixed income options and thus less diversification in the typical Core investment lineup. Limiting the number of fixed income options may hinder participants' ability to properly diversify their risk exposure in line with their return expectations and retirement goals.

Traditionally, fixed income investments have been used to reduce a portfolio's overall volatility to an acceptable level without significantly reducing returns. Not surprisingly, the vast majority of financial professional respondents said that they considered diversification in their recommendations. However, fewer than two-thirds of investment professionals(63.4 percent) confirmed that "correlation with equities" was an "essential" or a "preferred" criterion in recommending fixed income options.

Box "Set"

While nearly three-quarters (72 percent) of surveyed advisors confirm that they regularly incorporate a nine-quadrant style box' when making recommendations for Core domestic equity investments, only 40 percent of advisors use the comparable style box when making recommendations for Core fixed income investments[2].

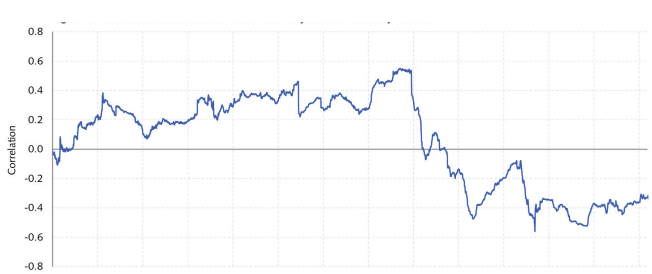
Equity boxes are determined using three organization size categories or capitalization bands (small, mid-side and large) as well as three investment styles (value, blend and growth).



Fixed income boxes are determined using static or dynamic evaluations of interest-rate sensitivity based on the bond fund's effective duration (limited, moderate, and extensive) as well as three levels of credit quality (high, medium, low).

Typically, stocks and bonds have a negative correlation – when stock prices rise, bond values fall, and vice versa. Indeed that is what financial professionals and participants expect - they buy fixed income to diversify their equity exposure. But the artificially low yields that followed the financial crisis of 2007-08 resulted in a proliferation of new products that take on more equity-like risk in their pursuit of higher returns – offerings that may not perform as expected. That's why it's important to look past the labels to know exactly what you're buying, and to understand how it conforms to the intent of the portfolio.

Figure 1: Correlation Between S&P 500® and 10-year U.S. Treasury Returns



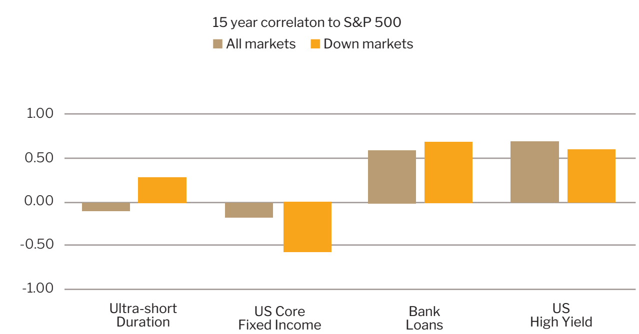
Correlations based on daily returns using exponential weighting with a 2-year half-life. Source: Bloomberg.

Indeed, for most investors, a negative stock–bond correlation is helpful because it enhances portfolio diversification. However, even when correlations are negative, the degree of correlation varies significantly among different forms of fixed income investments. In fact, despite its importance as a selection factor, "diversification" is the primary focus in only one of the four typical fixed income strategies; Core.

Typical Fixed Income Strategies

- **Core** – capital preservation during a market downturn,
- **Diversify** – low correlation to other fixed income investments,
- **Risk-Adjusted Income** – equity-like fixed income, and
- **Multi-sector fixed income investing**.

CORE FIXED INCOME HAS HISTORICALLY
ACTED AS A DIVERSIFIER ESPECIALLY WHEN NEEDED



CLOSING THE GAPS

Most participants are aware that stock returns outpace bond returns. However, while this has historically been the case, the difference may not be as great as some may think. Using more than 60 staggered 35-year intervals from 1900 to 1996, one study showed that stock returns, adjusted for inflation, were 5.5 percent a year. Comparatively, bonds had real returns of roughly 3 percent.[iv] The differences are even less once adjusted for risk – and, considering the buffering role fixed income typically plays in portfolio construction, the value received, certainly relative to the risk undertaken merits attention. Intuitively, the more volatile the investment option, the more likely a participant may be to react, and to respond by selling low and buying high.

Actively managed funds, whether comprised of equities or bonds, tend to have higher fees due to greater trading costs and portfolio management expenses. Indeed, it has become something of a mantra, particularly in excessive fee litigation, to suggest that actively managed funds are imprudent where passively managed alternatives exist. While stock index funds are often touted as outperforming their actively managed counterparts, certainly in rising markets, the opposite is true when it comes to fixed income. Actively managed bond funds have done better than bond index funds during the one-, three-, five-, ten-, and twenty-year periods ending December 31, 2019. This applies regardless of the type of fixed income investment, intermediate-term, high-yield, or short-term.[v] These indices tend to be overweighted in low-yielding government securities, in contrast to equity index offerings are typically weighted by market-cap, and thus dominated by the inclusion of stronger, better performing companies. Bond index funds are very narrowly defined and generally include only a small portion of the investable universe, while active managers have a broader toolkit from which to add value. These considerations are, unfortunately, often glossed over in configuring a participant-directed plan menu in favor of the perceived simplicity and efficiency of indexed offerings. In sum, all index funds are not created equal, and thus care should be taken to make sure that you understand what's "inside", and how it complements the remainder of the menu.

"STAYING" POWER

So, what do investment professionals consider when recommending fixed income options? Survey responses indicate risk tolerance (56.3 percent), retirement age (40.8 percent), and average age (38.3 percent). Incredibly, particularly in view of the diversity of participant investment practices, as well as participants' diverse needs and uses of plan assets, fewer than 25 percent of investment professionals also consider average tenure, salary, education level, presence of other benefits (such as a defined benefit pension plan), gender, average account balance, and/or ethnicity/race.

In the past, investment recommendations may have been more focused on achieving minimum compliance and checking the fixed income box rather than anticipating participant investment needs at every stage of accumulation and decumulation. A participant's investment needs will vary during the accumulation stage, as a "term vested" participant, and during periods of decumulation as a "retiree". Needs may also change when a surviving spouse steps into the participant's shoes and continues participation. Many plans also permit a non-spouse beneficiary to continue the account for a specified period.

Given this fluid nature of participant needs, fiduciaries and investment professionals may want to examine participant demographics prior to the next review of investment performance and evaluate whether the Core investment structure continues to match participant needs. Today, an ever-increasing number of plan sponsors encourage participants to retain assets in the plan after separation.[vi] Other trends suggest a change in participant preferences such as an increase in asset retention post separation, deferred commencement until the age 72 required beginning date, and an increase in the use of installment payouts as a source of periodic income in retirement.

As the prevalence and amount of guaranteed retirement income from other sources declines (e.g., defined benefit pension plans, etc.), and as more participants age into retirement, a more diverse set of fixed income options may be needed for income generation.

SECURE "ACTS"

As plans are amended to incorporate changes permitted by the Setting Every Community Up for Retirement (SECURE) Act[vii], most industry experts expect an even greater focus on retirement income, particularly the decumulation phase and outcomes. To meet these evolving trends, we expect to see more fiduciaries and investment professionals incorporate liability driven investment considerations, especially given the interest rate risks highlighted by monetary and fiscal responses to COVID-19. We expect some fiduciaries will begin to use processes more frequently applied to defined benefit pensions to ensure their fixed income investments match participants' liability duration. For example, , some plans may now choose to accommodate participant needs for longer-duration and/or inflation-protected fixed income investments.

TDF "Targets"

Due to record volatility in equity markets, many industry experts expect litigation to increase later in 2020 focused on fiduciary monitoring of Target Date Fund (TDF) investment performance. As in the wake of the 2007-09 financial crisis, participants most likely to be surprised may be those who were defaulted to a 2020 TDF (or its equivalent) and who expected to retire and/or commence payout at this time. Many 2020 TDFs – which increasingly target a "through" rather than "to" retirement date focus - had 50+ percent equity allocations.

While beyond the scope of this paper, as qualified default investment alternatives (QDIAs), and specifically target-date funds approach $1 Trillion in plan assets, plan fiduciaries will want to be particularly attentive, both to the asset allocation compositions and underlying glidepaths that support the portfolio transitions of retirement savers, and likely with a growing sensitivity to the balance and utilization of fixed income alternatives.

POST-PANDEMIC ASSESSMENTS

Diversification as a form of risk management should be on the minds of all plan sponsors. A highly diversified portfolio will—on average—help participants achieve higher returns over periods of long-term investing.

Recently, fixed income investments have experienced several changes, including:

- Global central banks, including the Federal Reserve Bank, have pegged front-end rates at zero, which, combined with accommodative monetary and fiscal policy, have incentivized risk-taking.
- Long bonds (with a duration of more than 10 years) have given up their historically higher yields compared to shorter duration bonds, creating an almost flat yield curve, resulting in less incentive to own long bonds.
- Differences in risk have resulted in high-yield bond performance which more closely resembles that of an equity investment, as we often see in risk-off environments.
- Relatively low rates of inflation have depressed the demand for Treasury Inflation Protection Securities (TIPS).
- Miniscule returns on money funds, with nearly half of U.S. money funds generating zero- or 1-basis-point yields as of May 29, 2020, according to Crane Data.

Fiduciaries and investment professionalswill want to consider these trends in their reviews and may also want to incorporate an "attribution analysis" to identify why an actively managed bond fund's performance differs from that of its passive benchmark (see sidebar – Attribution Analysis). As plan sponsors and investment professionalsprepare for their 2nd Quarter 2020 investment reviews, a renewed focus on diversification may prompt changes in investment managers as well as the structure of the Core menu. Fixed income investments like the Bloomberg Barclays U.S. Aggregate Bond Index typically post top decile returns during periods of extreme market volatility. However, the same index has historically been outperformed by actively managed fixed income funds – falling to the bottom decile in past recessions.

LOOKING AHEAD – DEMOGRAPHICS ARE DESTINY

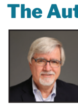
The 401(k) marketplace appears to be maturing concurrent with the retirements of the Baby Boom generation[viii]. Many Core investment structures have not kept pace with changes within participant populations, notably the reality that many workplaces now encompass five separate generational cohorts[ix]. Not only are participants increasing their fixed income exposure as they age, but the sustainability of their retirement assets depends on this rationalization.

Indeed, the retirement marketplace evolution, changing participant demographics, increased litigation, and a greater focus on retirement income and outcomes are all likely to prompt even greater, more lasting changes to the Core investment lineup.

What's more, these changes will necessitate thoughtful consideration of plan menus to ensure they not only support adequate portfolio diversification, but also contemplate a wide range of participant needs and circumstances.

In the months ahead, we expect to see more fiduciaries and investment professionals move towards an institutional approach to investment selection – a greater focus on outcome-oriented investments (target date funds, stable value, retirement income solutions, managed accounts), broader asset class diversification, and a thoughtful mix of active and passive investment choices. ■

The Authors



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Footnotes

[i] Plan Sponsor Council of America (PSCA), National Association of Plan Administrators (NAPA), Janus Henderson Investors (JHI) 2020 Plan Investment Trends Survey, June 2020

[ii] PSCA Annual Surveys, 43rd (12/31/99), 51st (12/31/07) and 62nd (12/31/18).

[iii] PSCA, NAPA, JHI Note ii, supra.

[iv] Journal of American Finance, "Long-Term Bonds vs. Stocks", 2004. See also: Historical Bond Versus Stock Performance From 1999 – 2019. "… Since the turn of the century, sometimes bonds have outperformed stocks. The 20-year total return of the Vanguard Long-Term Bond Index Fund (VBLTX) was 272%, compared to the return on the S&P 500 Index ETF (SPY) of 210%. Selecting different investments will yield different results. …" Accessed 6/29/20 at: https://www.financialsamurai.com/historical-bond-versus-stock-performance/

[v] D. Weil, Active Funds Are Winning (in Bonds, That is), Active managers have more flexibility to seek higher yields in high-yield and emerging markets, Wall Street Journal, 2/3/19, Accessed 6/29/20 at: https://www.wsj.com/articles/active-funds-are-winning-in-bonds-that-is-11549249561

[vi] PSCA, NAPA, JHI, Note ii, supra. 38.2 percent of surveyed investment professionals encourage plan sponsors to encourage participants to retain assets in the plan after separation.

[vii] Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, Pub. L. 116–94, Section 401, part of the Further Consolidated Appropriations Act, 2020, 12/20/19.

[viii] J. VanDerhei, EBRI. Among the 64 MM participants in the EBRI data base, 27MM have an identified age – among that group, over one third are age 50 or older, and just over 1 million (~4%) are over age 65.

[ix] Many plans now include participants from five generations - Silent or Traditionalist (1925–1946), Baby Boomer (1946–1964), Generation X (1964–1981), Millennial or Generation Y (1982–1995), and Generation Z (born after 1995).