T. Rowe Price

How dynamic credit can mitigate downside risk

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Key Insights

- We believe a more diversified fixed income profile can enhance outcomes for target date investors by helping to manage downside risk.
- Low correlation to other asset classes can help limit drawdowns when markets decline and preserve capital to participate more fully when markets advance.
- We believe the addition of Dynamic Credit will help provide a smoother ride through credit cycles, especially for investors approaching and in retirement.

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Preparing for retirement can be a decades-long process for investors, spanning a full range of market environments, interest rate regimes, and ebbs and flows of volatility. For these investors, the need for growth of principal is considered alongside the desire for lower balance variability and lifetime income, especially as the duration of retirement continues to grow for many populations. As leaders in the U.S. target date marketplace, we have devoted significant resources to understanding how to deliver diversification that can help keep retirement investors on the path to achieve their goals.

Purposeful diversification

While many target date providers continue to offer comparatively basic allocations to fixed income that rely heavily on investment-grade bonds, our research has led us to a different conviction. We believe a more diversified fixed income profile can enhance outcomes for target date investors by helping to manage downside risk as well as providing exposure to securities with lower correlations to equities and U.S. interest rates. From this research, we arrived at a compelling case to include a Dynamic Credit strategy in our own target date solutions.

We think about our allocation to fixed income as the ballast in our glide paths, which are intended to mitigate different risks faced along the life cycle. Our fixed income profile includes allocations to yield-seeking sectors like high yield and emerging markets bonds, inflation focused allocations like inflation focused bonds, and exposures intended to preserve capital, like long duration bonds. Dynamic Credit is a new and differentiated allocation within our glide path that can make our risk management capabilities more robust and diversify performance drivers across a variety of markets.

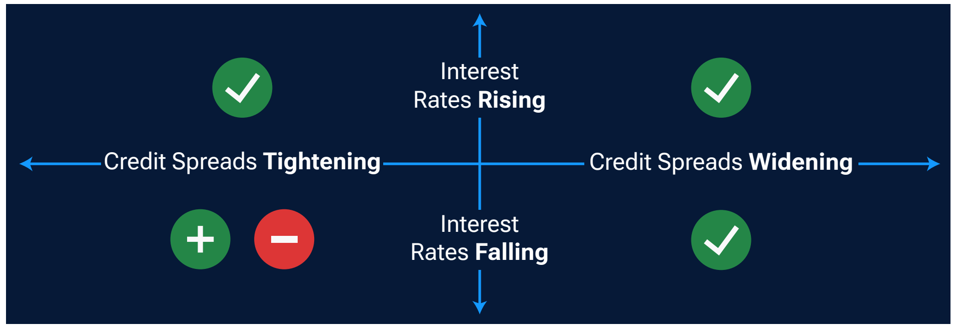
Dynamic Credit

Dynamic Credit employs a flexible, cross-sector approach to source opportunities from our global research platform. Rather than narrowly focusing on a specific asset class, such as investment-grade debt or emerging markets bonds, this strategy can invest across all credit instruments to take advantage of pricing dislocations and compelling yield opportunities wherever they manifest.

The strategy seeks to generate excess returns primarily through a combination of high-conviction security selection and sector rotation. This rigorous approach to credit selection is reflected in the strategy's long positions, which, at a typical range of 100 to 200 names, is fairly concentrated among fixed income portfolios. These holdings include assets that our target date glide paths do not otherwise have dedicated allocations, including securitized credit, convertible securities, and municipal bonds. The strategy also employs active credit shorting and duration management to both generate attractive returns and dampen volatility.

Diversifying performance drivers across market environments

(Fig. 1) Strategy seeks more flexible, alpha-oriented outcomes



Source: T. Rowe Price.
Green icons represent expected outperformance versus credit beta; red icon represents expected underperformance. For illustrative purposes only.
The expected performance for Dynamic Credit is relative to alternative credit indices, such as investment-grade corporates, high yield corporates, or emerging market bonds. Market environments and expected performance are based on the general strategy structure but are not based on actual performance nor intended as forward-looking performance projections. As with any investment, performance may vary and is subject to potential loss. Actual performance may differ significantly.

The value of low correlation

Dynamic Credit's alpha-seeking but risk-aware approach is well suited for a range of market conditions, and it may be even more valuable in the current unsettled credit environment. We believe that our fundamental credit analysis process that generates forward-looking insights from a global research platform with broad sector expertise can help us identify and capitalize on inefficiencies ahead of the market.

The strategy targets lower correlations with equities and traditional credit asset classes. Correlation measures the relationship between two asset classes. For example, two assets could be positively correlated, so that they move in the same direction, or negatively correlated, meaning they tend to move in opposite directions.

The tangible benefit of diversification through an allocation with lower correlation to other asset classes, such as Dynamic Credit, is that an unfavorable environment for other assets would not necessarily have a comparable effect on the strategy. This creates the potential to limit losses when markets decline and to preserve capital that can help investors participate more fully when markets advance.

Purpose in the glide path

Our research demonstrated how incorporating hedging strategies during the time when investors are most sensitive to market volatility can help improve risk-adjusted returns through reduced drawdowns from significant market events—which, ultimately, can lead to improved retirement outcomes. For retirement investors, we believe the addition of Dynamic Credit will help provide a smoother ride through credit cycles and differentiated sources of return, especially for investors approaching and in retirement.

As investors in our glide path portfolios approach retirement, their investment mix shifts away from equities and toward fixed income. As fixed income becomes a larger allocation within our glide paths, we layer in exposure to return-seeking fixed income, such as high yield bonds and emerging market debt. As part of this allocation, we also include exposure to Dynamic Credit. This exposure is phased in during the 10 years leading up to retirement, increasing to 20% of the return-seeking fixed income allocation at retirement. The Dynamic Credit allocation serves the purpose of providing exposure to the credit markets but doing so in a risk-aware way that can smooth returns around retirement and, importantly, can reduce the impact of significant market declines.

The addition of Dynamic Credit is part of the natural evolution of our target date solutions and a reflection of our research-based approach and long history of helping retirement investors navigate market volatility. This enhancement reflects our sharp focus on delivering consistent outcomes over a lifetime of investing.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

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