



How dynamic credit can mitigate downside risk

From the Field
December 2023

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.

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,



Wyatt Lee, CFA
Portfolio Manager and Head of Target Date Strategies



Saurabh Sud, CFA
Portfolio Manager, Dynamic Credit

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.

The value of low correlation

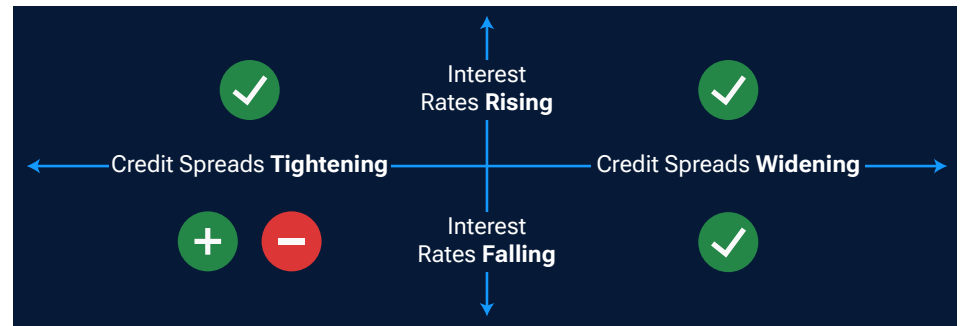
Dynamic Credit's alpha-seeking but risk-aware approach is well suited for a range of market conditions, and it may be even more valuable in the current unsettled credit environment. We believe that our fundamental credit analysis process that generates forward-looking insights from a global research 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

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.

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.

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.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2023 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.