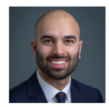
Is Fixed Income Having an Identity Crisis?

Structural changes have implications for DC plan sponsors.

June 2023



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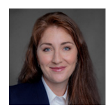

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KEY INSIGHTS

- Structural changes in fixed income markets create an opportunity for defined contribution plan sponsors to rethink the types of fixed income options offered participants.
- Many sponsors are evolving their plans to better address the needs of participants nearing, or in, retirement, who tend to use core menu fixed income options to de-risk their portfolios.
- These developments can be catalysts for sponsors to evaluate how their fixed income options support plan objectives and to reconsider core bond strategies.

The growth and evolution of global fixed income markets and the evolving purpose of defined contribution (DC) plans both suggest it may be time for plan sponsors to rethink participants' fixed income options.

We see two primary catalysts behind this investment perspective: Fixed income markets have structurally changed, suggesting a revised approach is needed, and the purpose of DC plans is evolving as sponsors increasingly seek to support participants nearing or in retirement.

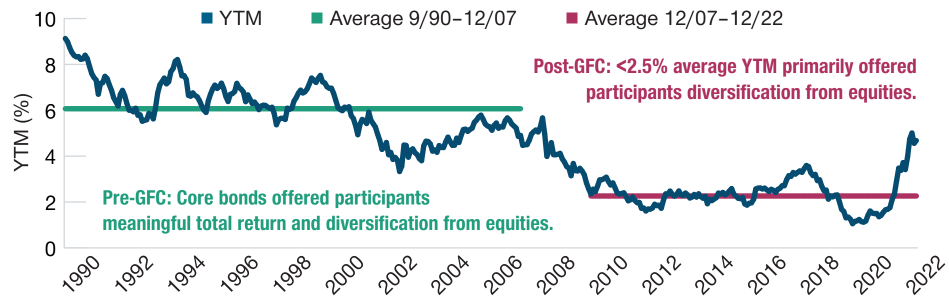
A key input for our perspective is a survey of DC plan sponsors conducted by T. Rowe Price[1]. This research was fielded in October and November 2022, which was a compelling point in time to explore the types of fixed income strategies offered in DC plans and examine sponsor implementation preferences.

As context, at the time of our survey, the Bloomberg U.S. Aggregate Bond Index (U.S. Agg) had suffered a steep year-over-year loss (-14.6% as of September 30, 2022), and the annual U.S. consumer price inflation rate had reached 8.3%—a level not seen since the 1980s. Worse still, the correlation between stock and bond returns had reached an unusually high level, undermining the intended benefits of diversification for many portfolios.

[1] T. Rowe Price Future of Fixed Income in DC Plans 2022 Survey. Survey fielded October 12, 2022, through November 15, 2022. Reflects responses from 158 plan sponsors, of which 70% identified as having 401(k) plans. Among the respondents, 67% reported having more than USD 500 million in plan assets while the remaining 37% had less than USD 500 million. Not all respondents answered every question.

Two Distinct Policy Regimes—What's Next?

(Fig. 1) Yield to maturity (YTM) for the Bloomberg U.S. Aggregate Bond Index



As of December 31, 2022.

Past performance is not a reliable indicator of future results.

Source: Bloomberg Finance, L.P.

Changing Fixed Income Dynamics

Unlike equities, where investors typically are looking for asset growth, fixed income is often tasked with meeting a broader range of potential objectives—such as income, diversification, and downside protection, to name a few. However, because of changing fixed income dynamics, an investor's ability to meet these objectives may be challenged.

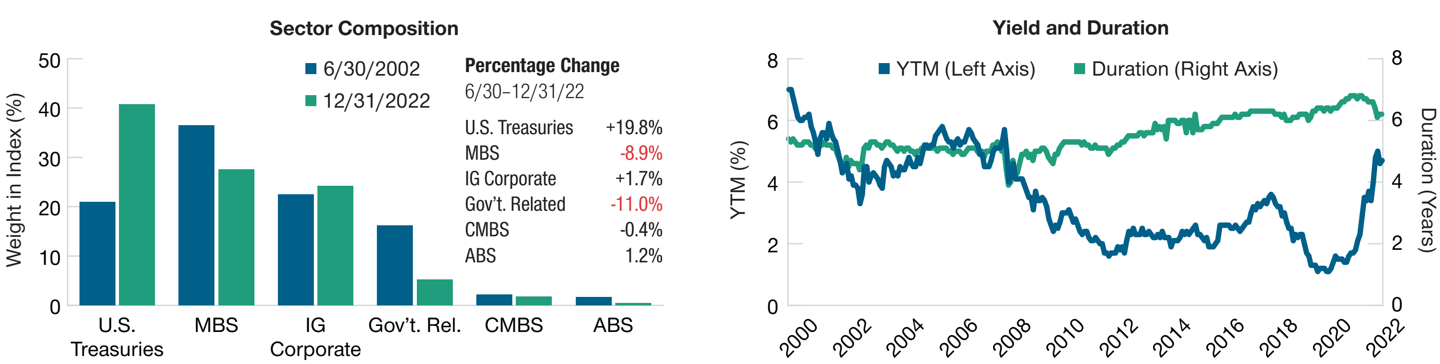
We believe the evolving characteristics of fixed income markets, in particular the U.S. core bond sector, are tantamount to a "fixed income identity crisis," one that is prompting some plan sponsors to rethink and potentially expand the types of fixed income exposures their participants may need to seek optimal long-term outcomes.

In our view, the 2008–2009 global financial crisis (GFC) marked a turning point—a longer-term shift in monetary and macroeconomic conditions that fundamentally changed the environment for fixed income investing (Figure 1).

Prior to the GFC, yields to maturity averaging in the 6% range for core investment-grade (IG) assets offered participants meaningful total return potential and significant diversification for equity risk. In the years following the

Times Change. So Do Fixed Income Benchmarks

(Fig. 2) Characteristics of the Bloomberg U.S. Aggregate Bond Index



As of December 31, 2022.

Past performance is not a reliable indicator of future results.

MBS = mortgage-backed securities. CMBS = commercial mortgage-backed securities. ABS = asset-backed securities.

Source: Bloomberg Finance, L.P.

Why reevaluate fixed income options?

Reasons cited by plan sponsors:

19%: Increased weight of U.S. Treasuries and government-backed bonds in the Bloomberg U.S. Aggregate Bond Index.

24%: Decrease in yield to maturity of the Bloomberg U.S. Aggregate Bond Index.

24%: Increased duration of the Bloomberg U.S. Aggregate Bond Index.

Source: T. Rowe Price Future of Fixed Income in DC Plans Survey, March 2023.

GFC, sharply lower core yields did not offer attractive return opportunities, but the asset class still tended to provide diversification against equity risk.

Looking to the future we must ask, "What can plan sponsors and their participants reasonably expect from their fixed income allocations?" In our view, the shift to a higher-inflation, tighter monetary policy environment marks another fixed income regime change, one that potentially has major implications for return and diversification potential.

At the same time, the composition of major core fixed income benchmarks, such as the U.S. Agg, has changed significantly over the past several decades, making core bond allocations more susceptible to changes in U.S. Treasury yields (Figure 2).

Is It Time to Reevaluate Fixed Income in DC Plans?

Our Future of Fixed Income in DC Plans survey found that a number of sponsors see the changing composition of the U.S. Agg as a reason to reevaluate their plan's fixed income investment options.

Almost a quarter of respondents (24%) pointed to the decreased yield to maturity and increased duration of the U.S. Agg as reasons to rethink their plan's fixed income offerings. This is important because two of the primary objectives of a participant's fixed income allocation are contribution to total return and, for participants nearing or in retirement, income generation. Furthermore, as participants age and their fixed income allocations grow, managing duration risk becomes increasingly important. Finally, nearly 1 in 5 respondents (19%) identified the increased allocation to U.S. Treasuries in the U.S. Agg as a reason for reevaluating the plan's fixed income investments, which speaks to the narrower exposure traditional core bond strategies now provide.

The Purpose of DC Plans Is Evolving

In addition to shifting market dynamics influencing plan sponsors to rethink fixed income options, we believe there is a DC-specific catalyst as well. We observe that many DC plan sponsors are evolving the purpose of their plans to better address the needs of participants nearing, or in, retirement. Two specific data points from our survey help explain why this has become a priority for many sponsors:

- 54% of plan respondents described their participant demographics as older compared with a decade ago.
- 33% cited an aging participant population as a catalyst for reevaluating their fixed income investment options.

Furthermore, approximately two-thirds (66%) of survey respondents said they would like more participants to keep

The Purpose of DC Plans Is Evolving

Among plan sponsors:

54% say their participants are older now compared with 10 years ago.

33% cite aging as a catalyst for reevaluating fixed income options.

66% want more participants to keep their balances in the plan after retirement.

59% say they already see more participants doing so.

Source: T. Rowe Price Future of Fixed Income in DC Plans Survey, March 2023.

Fixed Income in DC Plans: The “Where” Leads to the “Why”

(Fig. 3) Sponsor rating on a scale of 1–10 (least important to most important)

*Q: What **fixed income objectives** are most important to meet the **range of needs for your participants**?*

Plan Sponsor Objective	Rating
1. Preserve capital	7.8
2. Diversify portfolio	7.6
3. Generate income	6.8
4. Provide total return	6.7
5. Provide inflationary hedge	5.9

Source: T. Rowe Price Future of Fixed Income in DC Plans Survey, March 2023.

> “...we believe this is the right time for sponsors to revisit how their fixed income investments align with their participant demographics and plan demographics.

their balances in plan after retirement. This is a significant shift in sentiment given that for many years participants often were forced out of their DC plans upon retirement.

Even more noteworthy is the finding that 59% of plans already observe more participants keeping their balances in plan after retirement. This aligns with a trend we see on T. Rowe Price’s recordkeeping platform, where more retired participants are keeping at least a portion of their postretirement investment balances in their plans.

With many plans facing an aging participant population and increasingly seeking to retain retiree assets, we believe the time is right for sponsors to revisit how their fixed income investments align with participant demographics and plan objectives.

The Where, What, and Why of Fixed Income on the Core Menu

To have a meaningful, practical, and implementation-oriented conversation about fixed income in DC plans, it is important to first identify the “where” and the “why” of the fixed income investment being considered.

There are two primary applications for fixed income investments within a DC plan investment lineup:

- The core menu, where participants can access off-the-shelf fixed income funds or white-label solutions that allow the plan fiduciary to package multiple fixed income strategies into a single core option.
- Multi-asset solutions, the most common of which is a target date strategy, that can be offered via an off-the-shelf vehicle or a white-label solution. We also include managed accounts in this category as they are of increasing interest to many plan sponsors.

For the purposes of this paper, the “where” is defined as the core menu. The “why” represents the sponsor’s fixed income objectives. To identify these objectives, we posed the following question in our sponsor survey: “What fixed income objectives are most important to meet the range of needs for your participants?” We provided five objectives and asked sponsors to rate the relative importance of each objective on a scale of one (least important) to 10 (most important) for both older and younger participants.

The results (Figure 3) tell us that plan sponsors’ primary objectives for their core menu fixed income offerings are, first, to seek to preserve capital and second, to offer diversification from the equity portion of participants’ total portfolios. However, it is worth noting that there wasn't significant variation in the ratings given to objectives one through four. This tells us that sponsors are asking the plan's fixed income strategies to achieve multiple objectives.

We know that the most prevalent fixed income strategies offered on DC plan menus today are a core bond or a core plus approach. Considering 2022's stunning experience for fixed income investors, we have to ask: How did those strategies do in terms of meeting the objectives of capital preservation and portfolio diversification?

The answer is "not well." For 2022, the U.S. Agg posted a -13.01% return. Its correlation with the S&P 500 Index, meanwhile, jumped to 0.67, sharply higher than its -0.02 average over the 10 years ended in 2021. Given that most core and core plus options track the U.S. Agg relatively closely, they didn't achieve the objectives of preserving capital or diversifying equity risk.

Who Is Using Core Fixed Income Options?

As plan sponsors consider reevaluating their core menu fixed income offerings, it is important to review how these investment options are being used.

Beginning on the left in Figure 4, we see that participants approaching retirement age—those in their 50s and 60s—represent 39% of total 401(k) participants. However, those two age groups combined hold 63% of total 401(k) assets. This makes sense—older participants have larger account balances that hopefully represent a career's worth of retirement savings.

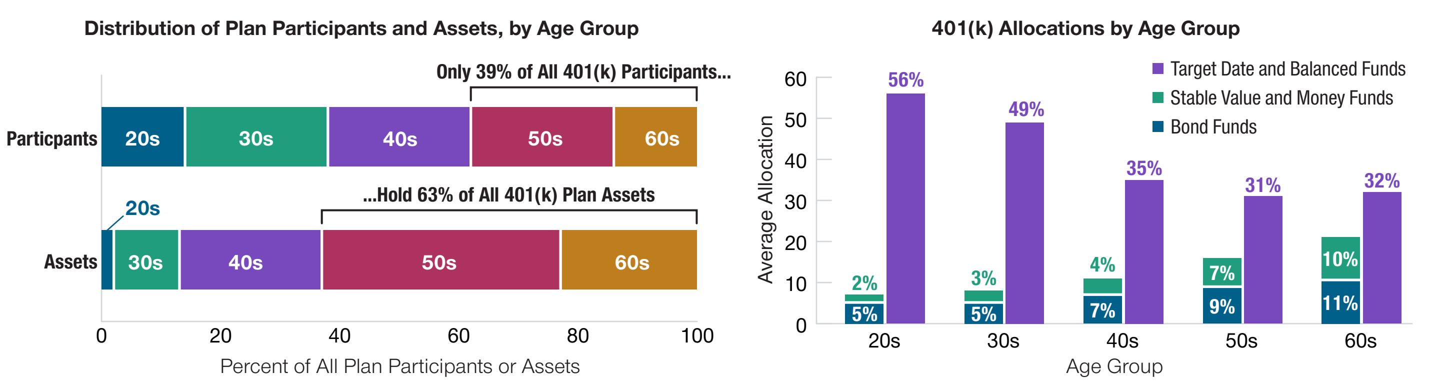
On the right in Figure 4 are average 401(k) allocations, also broken out by age cohort. It's evident that participants approaching retirement are less likely to be target date investors. Instead, these participants tend to be core menu users and are increasing their allocations to core fixed income and capital preservation options as they approach retirement age. In view of this data, an important question for plan sponsors' consideration is, "What investment options are available for these participants to de-risk into?"

Let's Talk About the "How"

We have identified core menu fixed income as the "where," and defined the "why" (the key sponsor objectives) as being primarily to preserve capital and diversify the total portfolio. Now we need to address the "how." In other words, what fixed income strategies are being used to achieve these objectives?

Who Is Using Core Menu Fixed Income Options?

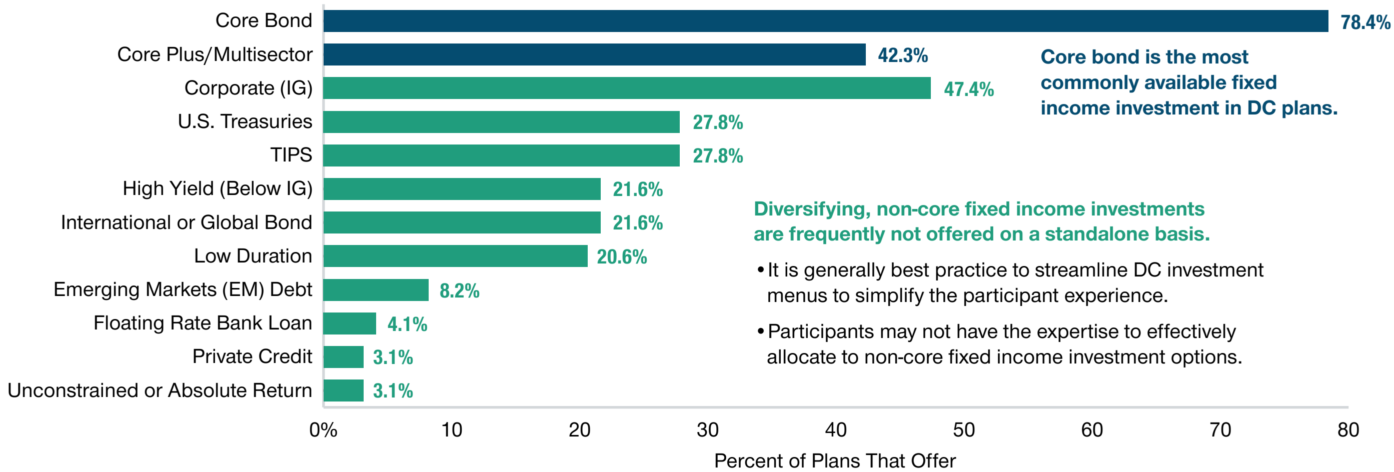
(Fig. 4) 401(k) plan participants, assets, and allocations by age group



As of December 31, 2020.
Source: Holden, Sarah, Steven Bass, and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2020," EBRI Issue Brief, no. 576, and ICI Research Perspective, vol. 28, no. 11 (November 2022).
On the web at: https://www.ebri.org/docs/default-source/ebri-issue-brief/ebri_ib_576_k-xsec-29nov22.pdf?sfvrsn=bdb382f_4

Let’s Talk About the “How”

(Fig. 5) Fixed income investments offered as standalone investment options on the core menu



TIPS = Treasury Inflation Protected Securities
Source: T. Rowe Price Future of Fixed Income in DC Plans Survey, March 2023.

Reasons to Consider a White-Label Approach

Among plan sponsors:

79%: It is important to offer participants a range of fixed income options based on their risk, return, and retirement income preferences.

43%: “It is more challenging to educate participants about fixed income.”

30%: Expect traditional fixed income to perform differently in the future.

26%: Currently use a white-label fixed income option.

Source: T. Rowe Price Future of Fixed Income in DC Plans Survey, March 2023

Figure 5 shows the percent of sponsors in our 2022 survey who offered each of the identified fixed income strategies as standalone investment options. It’s immediately apparent that core bond and core plus offerings continue to dominate core menu fixed income offerings. For the most part, DC plan core menus are not taking advantage of the diverse global fixed income universe—even though fixed income sectors generally show much more heterogeneity than equity sectors.

On average, the sponsors we surveyed said they offered three standalone fixed income options—typically a core or core plus strategy, a capital preservation option (which was more likely to be a stable value strategy than a money market fund), and one of the fixed income diversifiers shown in Figure 5. However, as sponsors have sought to streamline plan menus over the past decade, many of these diversifying, non-core fixed income strategies have been cut from the menu. We also know that most plan participants don’t have the expertise to effectively allocate across non-core fixed income strategies.

We are not suggesting that plan sponsors add fixed income diversifiers as standalone strategies in their core menu fixed income offerings. However, we believe there is a compelling investment case for providing participants exposure to many of these sectors. The question for plan sponsors then becomes, “Which sectors should be included and how should they be they offered?”

A White-Label Approach for Fixed Income

Considering that there is a broad universe of fixed income strategies that usually are not available to DC plan participants today, we encourage sponsors to consider a white-label approach for their core menu fixed income offerings.

More than three-quarters (79%) of plan sponsors in our survey said they believe it is important to offer a range of fixed income options based on their participants’ risk, return, and retirement income preferences. However, when we look at the availability of non-core fixed income strategies on the core menu, we can see that many plans are not executing on that belief.

This is where we believe a white-label structure can be particularly effective. While sponsors may not necessarily want to offer additional fixed income options on a standalone basis, including exposure to some of these diversifying sectors in a white-label structure can enhance their ability to meet their stated objectives for the plan's core menu fixed income offerings.

Three-quarters of plan sponsors also agree that it is more challenging to educate participants about fixed income. In our view, a white-label structure can help address this concern because it eliminates the need to provide specific, dedicated educational materials on the individual underlying strategies within the offering.

Bringing It All Together in an Improved Core

Traditional core and core plus strategies do have some advantages. They are familiar to most sponsors, with more than three-quarters of the plans in our survey reporting that they currently offer a core bond option. However, traditional core bond offerings also have some key disadvantages.

We believe it is possible to design core bond allocations that can better support sponsor objectives such as

Comparable Returns but With Less Volatility

(Fig. 6) Performance of Bloomberg U.S. Aggregate Bond Index versus hypothetical improved core

	Bloomberg U.S. Aggregate Bond Index	Improved Core* (Hypothetical)
Annualized Returns		
1-Year	-13.02%	-9.98%
3-Year	-2.72	-1.64
5-Year	0.02	0.55
10-Year	1.06	1.47
Annualized Volatility		
1-Year	8.33%	5.72%
3-Year	5.85	4.26
5-Year	5.09	3.75
10-Year	4.11	3.12
Sharpe Ratios		
1-Year	-1.66	-1.88
3-Year	-0.56	-0.51
5-Year	-0.22	-0.15
10-Year	0.10	0.26

Improved Core Outperformed Index

As of December 31, 2022.
Past and modeled performance are not reliable indicators of future performance. This page contains hypothetical data and is for illustrative purposes only. See the Important Information at the end of this paper regarding hypothetical data.
*See footnote to Fig. 7 for definition of the improved core portfolio.
Sources: Bloomberg Financial L.P., T. Rowe Price. All data analysis by T. Rowe Price.

We believe an improved core bond strategy can offer diversification potential beyond the exposures typically found in the major aggregate indexes and can better align with a sponsor's primary objectives for its core menu fixed income.

diversification, capital preservation, and total return. In our view, an improved core bond strategy should seek to:

- diversify U.S. rate exposure by including an allocation to U.S. dollar hedged non-U.S. bonds;
- smooth participants' return experience by allocating to a defensive, nontraditional bond strategy with the flexibility to dynamically manage across markets that historically have had relatively low correlation to traditional assets.

We believe an improved core bond strategy can offer diversification potential beyond the exposures typically found in the major aggregate indexes and can better align with a sponsor's primary objectives for its core menu fixed income.

We have deployed this approach in T. Rowe Price's target date strategies, and our analysis indicated that, historically, an improved core bond approach could have provided returns comparable to the U.S. Agg but with less volatility (see sidebar). Hypothetical performance metrics (Figure 6) and an analysis of hypothetical returns in various financial and macroeconomic scenarios (Figure 7) both demonstrate this potential.

An Improved Core Could Help Investors Weather Multiple Markets

(Fig. 7) Historical scenario analysis*

	Scenario Performance	
	Bloomberg U.S. Aggregate Bond Index	Improved Core† (Hypothetical)
When U.S. fixed income was down	-2.03%	-1.18%
During a rising rate environment	-0.16	0.24
When inflation expectations were increasing	1.05	1.34
During a credit sell-off	1.81	1.87
When U.S. equities were down	2.83	2.61

Improved Core Outperformed Index

March 31, 1995, to December 31, 2022.
Past and modeled performance are not reliable indicators of future performance. This page contains hypothetical data and is for illustrative purposes only. See the Important Information at the end of this paper regarding hypothetical data.

*Periods selected for scenario analysis are 6-month time periods between 3/31/1995 and 12/31/2022. "When U.S. fixed income was down" = periods when the performance of the Bloomberg U.S. Aggregate Bond TR USD Index was negative. "During a rising rate environment" = periods when the YTM of a constant maturity, on-the-run 10-year U.S. Treasury note increased. "When inflation expectations were increasing" = periods when the U.S. 10-year breakeven (defined as the difference between the YTM of a constant maturity, on-the-run 10-year U.S. Treasury note and the YTM of a constant maturity, on-the-run 10-year U.S. TIPS note) increased. "During a credit sell-off" = periods when the performance of the Bloomberg U.S. High Yield TR USD Index was negative. "When U.S. equities were down" = periods when the performance of the S&P 500 TR USD Index was negative.

† Improved core portfolio = a blend of the Bloomberg U.S. Aggregate Bond TR USD Index (64.3%), the Bloomberg Global Aggregate Bond ex USD Hedged USD Index (21.4%), and a "nontraditional bond" allocation (14.3%) represented from 2/1/2015 through 12/31/2022 by the Dynamic Global Bond (USD Hedged) Composite and from 2/1/1995 to 1/31/2015 by the 3-month Treasury bill plus 1.37% annually (equivalent to the composite historical excess return over cash from 2/1/2015 to 12/31/2022). Composite performance was net of fees and reflected the deduction of the highest applicable management fee that would be charged, without the benefit of breakpoints. Composite performance also reflected reinvestment of dividends and was net of all non-reclaimable withholding taxes on dividends, interest income, and capital gains. For purposes of the hypothetical performance data shown, Improved Core portfolio allocations are rebalanced monthly.

Sources: T. Rowe Price, Bloomberg Finance L.P, Standard & Poor's (see Additional Disclosures). All data analysis by T. Rowe Price.

The improved core bond design suggested in this paper was incorporated into T. Rowe Price's target date strategies in 2018. The core component in their fixed income allocation includes:

- a predominately U.S. investment-grade strategy benchmarked to the U.S. Agg;
- a U.S. dollar-hedged international bond strategy;
- a nontraditional global bond strategy that seeks to deliver consistent risk-adjusted total returns while limiting downside risk.

This core is supplemented with diversifying allocations to return-seeking sectors such as high yield bonds, floating rate loans, and EM debt.

Concluding Thoughts

Given the incongruity between plan sponsor objectives and core bond index construction, plan sponsors may want to reevaluate their core menu fixed income options to increase their ability to meet their stated objectives—whether that is to preserve capital, provide diversification, or contribute to total return.

For sponsors who identify retaining retiree assets in their plans as a key priority, it could be a helpful exercise to understand how their core menu is being used by participants nearing retirement—those currently in their 50s or 60s—to identify potential gaps in their fixed income offerings.

Furthermore, we believe some sponsors may want to explore the potential for white-label vehicles to further align and tailor their fixed income investment options with their plan objectives.

Finally, regarding the question our title poses—is fixed income having an identity crisis?—we believe the answer is yes, in the sense that the role fixed income has played in participants' portfolios over the last decade is unlikely to be the role it plays in the future.

More specifically, to meet the varying objectives plan sponsors ask of participants' fixed income allocations, we believe there is opportunity to embrace an improved core bond structure. In particular, a white-label approach could allow sponsors to broaden the types of fixed income exposure offered to participants without growing their core menus or asking participants to navigate the complex trade-offs involved in allocating across fixed income sectors.

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Hypothetical Data

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