

## Diversification

A complex market environment sharpens focus on diversification opportunities.



At T. Rowe Price, we strongly believe that diversification is fundamental to helping participants achieve successful retirement outcomes over the long term. During their lifetime of investing, participants will face many risks, and achieving adequate portfolio growth during their retirement journey is critical, as is planning for the bumps that can and will happen along the way.

Outlining the importance of diversification can seem like stating the obvious, but market events in 2022 that resulted in a steep, correlated sell-off in both stocks and bonds prompted valid questions about the role of diversification in helping to mitigate downside risk. In multi-asset portfolios, diversification should not just be about asset allocation between traditional stocks and bonds. While a mix across these asset classes typically influences portfolio growth, diversification across multiple market segments—such as sub-asset classes, regions, and sectors, among others—could boost results during different market regimes or hedge against specific risks and help improve retirement outcomes.

For clients who prioritize the efficiencies and benefits that passive allocations may provide for certain investment sectors, but who are also interested in maximizing growth in order to help improve retirement outcomes, the selective use of active and passive management in managed strategies may add another dimension to diversification. Incorporating distinct components in a portfolio also provides additional levers for making tactical (or short-term) adjustments that could further enhance returns and help mitigate near-term risks.

Data show that target date strategies are the most prevalent default vehicle for retirement investors. While the equity allocation in these strategies is often diversified, many target date providers continue to offer relatively basic fixed income designs that forgo some asset classes altogether. We want to highlight the importance of a well-diversified fixed income allocation, especially in a complex market environment where inflation persists and interest rates are expected to stay higher for longer.

### Time to check under the hood

For over a decade, inflation was not a major concern. Investors had to grapple with the impact of ultralow interest rates on their portfolios and seek additional ways to generate return. In a short period of time, a spike in inflation since 2021 caused the U.S. Federal Reserve and other major central banks to aggressively raise interest rates.

In our view, global markets have likely reached a structural inflection point—an end to the extraordinary era of ample liquidity, low inflation, and low interest rates that followed the 2008–2009 global financial crisis (GFC). For plan sponsors, advisors, and consultants that offer target date vehicles or personalized portfolio solutions, there has never been a more important time to reexamine the fixed income asset allocation structure in these strategies. This is especially true considering that many current allocation policies were influenced by the post-GFC economic environment that was very different from the one we are in today.

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## Interest rate and inflation concerns are top of mind

(Fig. 1) Factors that influence evaluation of strategies with a goal of capital preservation and/or fixed income investment options in plan

	Fixed Income			Capital Preservation		
	2021	2023	Change	2021	2023	Change
Current interest rate environment	89%	81%	-8	89%	94%	+5
Greater focus on diversification opportunities	48	81	+33	33	29	-4
Interest rate expectations	81	77	-4	74	71	-3
Inflation concerns	70	74	+4	48	68	+20
Poor performance	26	52	+26	19	36	+17

Source: T. Rowe Price, 2023 Defined Contribution Consultant Study; 2021 Defined Contribution Consultant Study. Percentages represent the portion of respondents who selected the respective factors listed on the left of the chart.

Notably, our 2023 DC Consultant Study revealed that large retirement plan consultants and advisors have also taken notice, and many reported a heightened focus on diversification opportunities, resulting in part from poor performance in fixed income strategies in 2022 (Figure 1).

### What's next?

For the first time in over 20 years, a higher risk-free rate<sup>1</sup> is providing opportunities that may enhance portfolio returns without increasing exposure to equity risk. Meanwhile, inflation risk lingers, and it remains unclear at what levels interest rates will peak, how long they will remain elevated, when they may decline, or when they could normalize to a neutral rate.<sup>2</sup>

When considering components in a multi-asset portfolio, some asset classes may not contribute equally to short-term outcomes, but their benefits over the long term could help to make the portfolio more durable over a range of market environments. Segments of the fixed income market can behave very differently from each other. Some have historically had higher correlations to equities, others have demonstrated

superior inflation-fighting properties, and others can potentially provide relatively uncorrelated returns.

In 2022, core fixed income assets largely failed to mitigate equity risk when correlations spiked during the market sell-off. This experience highlights the importance of fixed income diversification—especially if core fixed income exposure relies on U.S. investment-grade bond holdings, which can mean a direct exposure to the U.S. yield curve and undiversified interest rate risk. Within fixed income allocations, investors should consider:

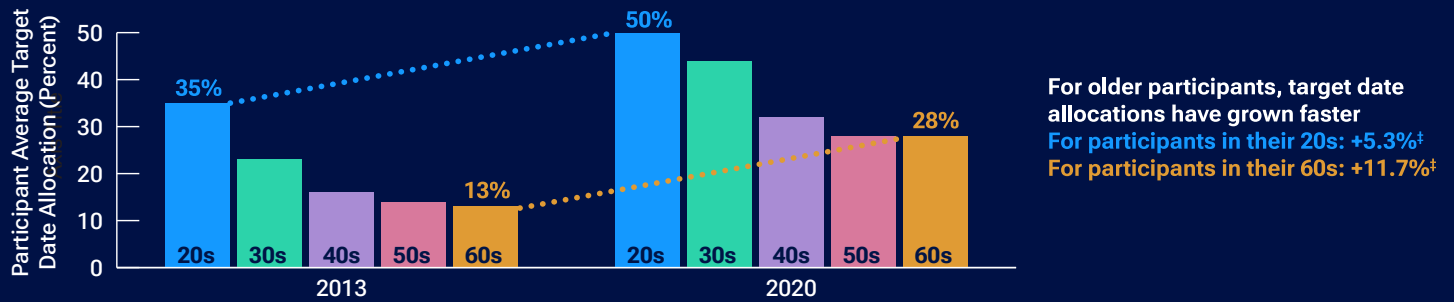
- 1. Looking beyond U.S. investment grade:** Our research suggests that supplementing the core fixed income allocation with international bonds (in particular, currency hedged bonds) allows for additional interest rate diversification and could lower volatility. Additionally, less directional and more flexible bond strategies that seek absolute returns across the full global opportunity set could provide a source of diversification during periods of risk aversion.
- 2. Adding other sources of diversification:** Core fixed income assets now provide positive real (inflation-adjusted) yields

<sup>1</sup> Risk-free rate of return is a theoretical return of an investment with zero risk and the measure is used as a rate against which other returns are measured.

<sup>2</sup> The neutral rate is considered to be the interest rate at which monetary policy is neither stimulating nor restricting economic growth.

## Significant growth in target date assets

(Fig. 2) Average allocation to target date strategies in 401(k) accounts by participant age group, 2013–2020\*†



Source: ICI, 2013–2020. Data analysis by T. Rowe Price.

\*Holden, Sarah, Steven Bass, and Craig Copeland. 2022. “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2020.” ICI Research Perspective 28, no. 11 (November).

†Holden, Sarah, Jack VanDerhei, Luis Alonso, Steven Bass, and AnnMarie Pino. 2014. “401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2013.” ICI Research Perspective 20, no. 10 (December).

‡Compound annual growth rate over 7 years.

The research perspective was released in November 2022, with 2020 data being the most recent available at the time of our analysis.

and can still have a valuable role to play in helping to mitigate downside risk, especially if inflation subsides, allowing policymakers to cut rates in the face of a slowing economy. However, if inflation risk remains persistent, other strategies that could help mitigate risk in market environments like the one seen in 2022 may be beneficial.

Higher-yielding fixed income, including high yield bonds, bank loans, and emerging market debt, could generate attractive returns in the current yield environment. Although non-core bonds can be highly correlated with equities in extreme risk-on and extreme risk-off environments, they offer other meaningful diversification benefits that could make them strong complements to equities as sources of growth.

Fixed income diversification with these “plus” sectors could help investors better

navigate the various risks they will face over their life cycles, as well as the market conditions they may experience as they prepare for and go through retirement. In many cases, all of these sectors may not be included in a retirement plan’s investment lineup. More importantly, they may not be included in many target date allocations. Since data show that average target date allocations continue to grow, with a meaningful increase among participants over age 60, plan sponsors and retirement industry professionals should consider whether these sectors are included within the fixed income allocations of their target date strategies (Figure 2).

### Considerations for plan sponsors, consultants, and advisors

**Take a close look at your fixed income menu:** The growth of the global fixed income markets in recent years has

greatly expanded investment opportunities beyond the U.S. investment-grade sectors. A broader opportunity set can create additional opportunities for diversification and potential excess returns.

**Active management is key for fixed income diversification:** While some passive equity strategies have performed well, using passive fixed income components can be problematic. Within some fixed income sectors, it isn’t practical—or in some cases even possible—to hold all the securities in the most common market indexes, making it difficult to replicate benchmark performance without significant tracking error.<sup>3</sup> In our view, an active management approach is particularly valuable in certain fixed income sectors where credit risk is a primary risk. That’s because firsthand credit research could help mitigate certain default risks.

<sup>3</sup>Tracking error is the divergence between the price behavior of an investment and an index.

T. Rowe Price focuses on delivering investment excellence and retirement services that institutional, intermediary, and individual investors can rely on—now and over the long term.

To learn more, please visit [troweprice.com/retirementUS](https://troweprice.com/retirementUS).

### Investment Risks:

The principal value of **target date strategies** is not guaranteed at any time, including at or after the target date, which is the approximate year an investor plans to retire. These products typically invest in a broad range of underlying mutual funds that include asset classes such as stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. A substantial allocation to equities both prior to and after the target date can result in greater volatility over short term horizons. In addition, the objectives of target date funds typically change over time to become more conservative.

**International investments** can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets.

**Fixed-income securities** are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in **high-yield bonds** involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. Investments in **bank loans** may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.

**Personalized solutions** are subject to risks including possible loss of principal. There is no assurance that any investment objective will be met.

**Active investing** may have higher costs than passive investing and may underperform the broad market or passive peers with similar objectives. **Passive investing** may lag the performance of actively managed peers as holdings are not reallocated based on changes in market conditions or outlooks on specific securities.

**Derivatives** may be used in absolute returns strategies, and they can be riskier or more volatile than other types of investments because they are generally more sensitive to changes in market or economic conditions; risks include currency risk, leverage risk, liquidity risk, index risk, pricing risk, and counterparty risk.

**Diversification** cannot assure a profit or protect against loss in a declining market.

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