T. Rowe Price

#Dontbebasic: Three reasons to reevaluate your target date solution

From the Field
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Key Insights

- The main goal of effective diversification is to build a portfolio that is durable and able to weather multiple market environments.
- In an uncertain market, with lingering inflation and interest rate risk, investors need thoughtful diversification across growth and risk mitigation opportunities.
- A long-term view on active management is key as data show that even the most efficient asset classes can offer opportunities for robust alpha in given years.

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In a world that increasingly relies on hashtags to communicate, we offer the following on diversification: #Dontbebasic. A "basic" or simplified approach to asset allocation can be a crucial mistake when it comes to constructing target date solutions, which are intended to support investors over long time horizons that will include a range of market environments.

While target date solutions are inherently diversified, given their multi-asset exposures and dynamic glide path, the level of diversification and its purpose can vary meaningfully across providers. By "diversification," we mean using a mix of investments that either enhance returns or mitigate risk to drive outcomes in a portfolio.[1] Without the right level of diversification, retirement savers may be missing out on opportunities or taking on too much risk over the course of their retirement journeys. **Here are three reasons why it's important to go beyond "basic" when evaluating target date solutions.**

#Dontbebasic reason no. 1: Things have changed

We are no longer in a "basic" market environment, so retirement savers cannot afford a basic approach to asset allocation. For most of the past decade, investors were well served with beta exposure. There were some notable exceptions (here's looking at you, calendar year 2022!), and we believe financial markets will be more discriminating in the future. Furthermore, for the past decade, inflation was not a concern, but this is no longer the case (Figure 1). Inflation surged to 9% in mid-2023, and while these elevated levels have since abated, inflation risk lingers as spillover effects from geopolitical tensions are causing renewed supply chain disruptions, which are once again having impacts on goods and transportation prices.

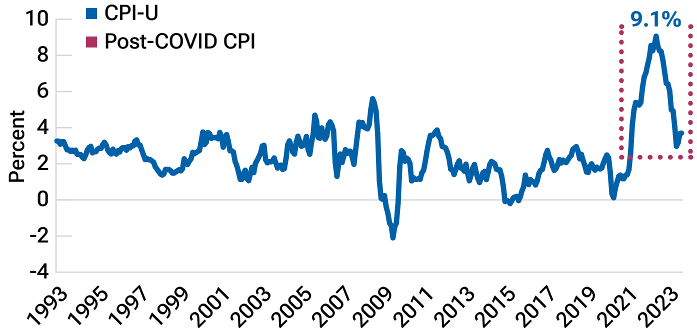
Concerns around inflation and its potential to erode purchasing power remains high for retirees. Our research shows that **75% of retirees are worried about the impact of inflation** on their

[1] Diversification cannot assure a profit or protect against loss in declining markets.

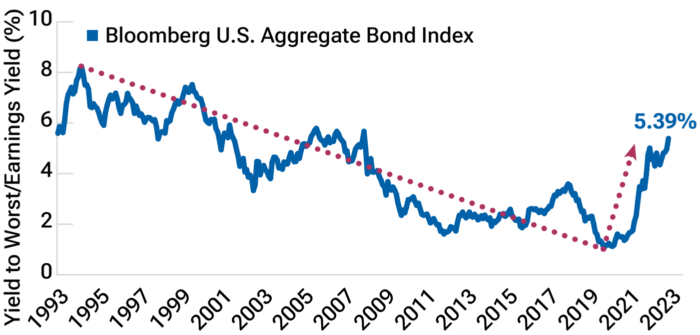
The inflation and interest rate environment has shifted

(Fig. 1) Inflation and interest rate data over the past 30 years

Inflation Data Past 30 Years[1]



Interest Rates Past 30 Years[2]



[1] Source: Bureau of Labor Statistics.
[2] Source: Bloomberg Finance L.P.
Past performance is not a reliable indicator of future performance.

retirement—significantly outpacing other concerns, such as "running out of money" (45%) and "not knowing life expectancy" (44%)[2]. Given the steady stream of inflation-related headlines inundating retirement savers, it's not surprising to see inflation at the top of their list of concerns. From a diversification perspective, asset classes and strategies with inflation-hedging characteristics should be considered in a portfolio to help address these concerns. For example, allocations to real assets and short duration Treasury inflation protected securities as participants approach expected retirement age could help to preserve retirees' purchasing power.

Meanwhile, bond yields have finally rebounded as shown by the yield on the Bloomberg U.S. Aggregate Bond Index (Figure 1). After many years of modest yields, during which fixed income primarily offered ballast relative to equities, current yield can now contribute to total return. Although yield levels may drift lower—given the Federal Reserve's recent pivot on monetary policy—they are unlikely to return to the anemic levels of the 2010s as long as inflation remains a threat. **In terms of diversification, it's, therefore, time to rethink the role of fixed income in a portfolio.**

Notably, our 2023 defined contribution (DC) consultant study revealed that our view is not unique, and professionals in the retirement industry have also taken notice. Data showed that **81% of consultants and advisors—up from 48% in 2021—are focused on identifying opportunities for diversification within fixed income**, including along the credit spectrum and/or across the global yield curve. In today's uncertain market environment, the more levers asset allocators have at their disposal, the better equipped they are to deliver a more consistent and less volatile return experience, which is particularly relevant for DC plan participants.

#Dontbebasic reason no. 2: Diversification 3.0 is here

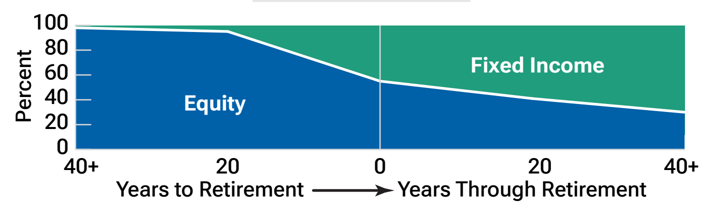
At the most basic level, diversification is a simple split between stocks and bonds. For illustrative purposes, we consider a 60/40 portfolio as Diversification 1.0. With the advent of target date solutions nearly three decades ago, we moved past a simple static allocation to offer allocations that shift along a glide path over time to reflect the investor's evolving risk and return needs, i.e., Diversification 2.0.

Is your fixed income allocation diversified?

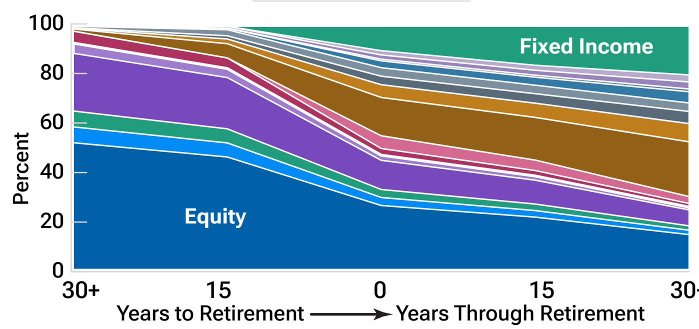
(Fig. 2) The evolution of diversification

Diversification 1.0

Diversification 2.0



Diversification 3.0

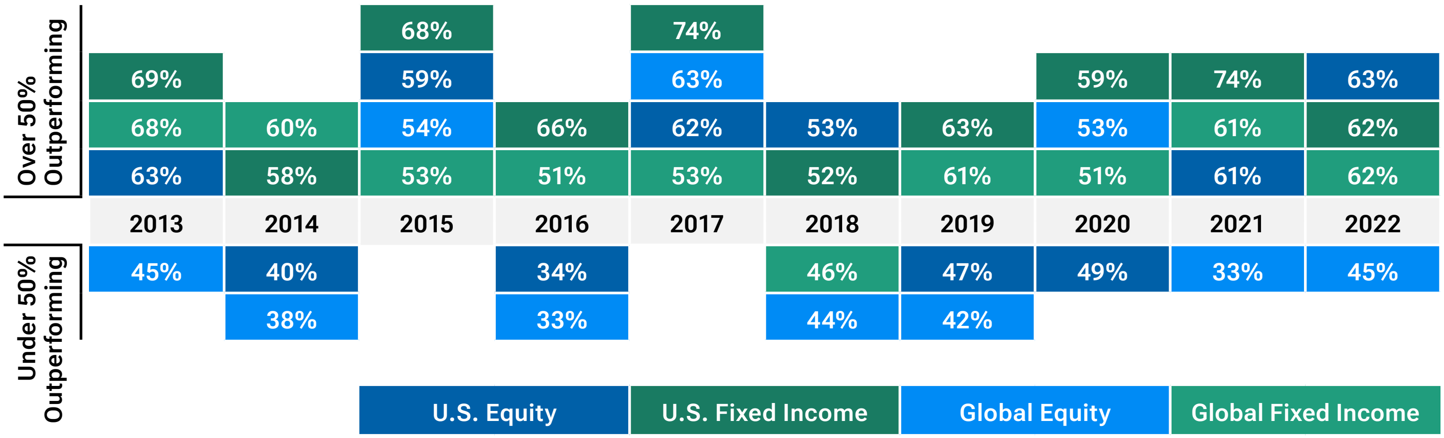


For illustrative purposes only. Not representative of an actual investment or T. Rowe Price product.

[2] T. Rowe Price Retirement Savings and Spending Study, 2023. All respondents are retired, and the percent reflects those who describe themselves as very or somewhat worried.

Active management can add meaningful alpha even in efficient asset classes

(Fig. 3) Asset class "success rates" for active managers over the past decade



As of December 31, 2022.

Past performance is not a reliable indicator of future performance.

Source: T. Rowe Price analysis using data from Nasdaq's eVestment Alliance, LLC.

Benchmarks are selected at the more granular strategy level and then aggregated into regional and asset class groupings. Based on managers' self-reported returns, gross of fees. See the Appendix for more information on the methodology for this exhibit.

From there, we envisioned Diversification 3.0 for target date solutions—the most prevalent investment option offered in employer-sponsored DC plans—as taking a deeper dive beyond a mix across traditional asset classes like stocks and bonds to also consider introducing exposure across sub-asset classes, regions, and sectors (Figure 2). For example, as represented by the different colors in the graphic, target date glide paths could be diversified within the fixed income allocation to include several approaches ranging from U.S. investment-grade to emerging markets to high yield bonds, each introduced at a specific point in the glide path to fulfill a specific objective.

We encourage DC plan sponsors and their consultants and advisors to take another look under the hood of their target date solution and ask the question, "Does our plan's provider take a 'basic' approach to fixed income?" For instance, the fixed income allocation in some passive target date solutions may only include U.S. investment-grade bonds, which can result in direct exposure to the U.S. yield curve and undiversified interest rate risk.

Our target date solutions now include nine underlying fixed income building blocks, which are introduced at specific points along the glide path to address participants' evolving objectives. Some historically have had lower correlations to equities, others demonstrated stronger inflation-fighting properties, and still others potentially can provide relatively uncorrelated returns. We believe that including these different types of fixed income assets and being strategic about our allocations to them, allows us to more effectively mitigate risk to help investors meet their retirement objectives.

#Dontbebasic reason no. 3: Passive can be basic

Some investors argue that efficient asset classes do not need active management. However, a look at actual results over the past 10 years paints an interesting picture (Figure 3). Data show that for every calendar year since 2013, more than half of active U.S. fixed income strategies outperformed their benchmark, offering a consistent opportunity for active alpha over the past decade. In addition, more than half of U.S. equity strategies—often considered the most efficient asset class—outperformed their benchmark in six of the last 10 years.

Our analysis shows that there are asset classes that may provide more frequent opportunity for active alpha, but the pattern of outperformance varies significantly by period. Therefore, even the most efficient asset classes can provide robust alpha opportunity in given years. To align with retirement investors' time horizons, we encourage plan sponsors and their consultants to take a long-term view on active management. Also, as highlighted in #Dontbebasic reason no. 1, we anticipate that alpha generation will be even more important as financial markets likely shift away from an environment where investors have generally been rewarded for beta exposure.

Final thoughts

It's important to note that, while not every strategy or building block within a total portfolio will add value in every market environment, the main goal of effective diversification is to build a portfolio that is durable and able to weather multiple market environments. **Investors saving for retirement need thoughtful diversification, and we believe active management can help realize their savings goals.**

T. Rowe Price sources

2023 Defined Contribution Consultant Study:

This study included 45 questions and was conducted from February 14 through March 31, 2023. Responses are from 32 consulting and advisory firms with over 171,000 plan sponsor clients and more than USD 637 trillion assets under administration.

2021 Defined Contribution Consultant Study:

This study included 51 questions and was conducted from September 20 through November 8, 2021. Responses are from 32 consulting and advisory firms with over 33,000 plan sponsor clients and more than USD 7.2 trillion assets under administration.

2023 Retirement Savings and Spending Study:

The Retirement Savings and Spending Study is a nationally representative online survey of 401(k) plan participants and retirees. The survey has been fielded annually since 2014. The 2023 survey was conducted between July 24 and August 13, 2023. It included 3,041 401(k) participants, full-time or part-time workers who never retired, currently age 18 or older, and either contributing to a 401(k) plan or eligible to contribute and have a balance of USD 1,000 or more. The survey also included 1,176 retirees who have retired with a Rollover IRA or left-in-plan 401(k) balance.

2022 Retirement Savings and Spending Study:

The Retirement Savings and Spending Study is a nationally representative online survey of 401(k) plan participants and retirees. The survey has been fielded annually since 2014. The 2022 survey was conducted between June 24 and July 22. It included 3,895 401(k) participants, full-time or part-time workers who never retired, currently age 18 or older, and either contributing to a 401(k) plan or eligible to contribute and have a balance of USD 1,000 or more. The survey also included 1,136 retirees who have retired with a Rollover IRA or left-in-plan 401(k) balance.

Appendix

Figure 3 Methodology

- The "success rates," or percentage of managers in a given roll-up universe outperforming the selected benchmark over the specified year, on the preceding page are determined by roll-up groupings of products (U.S. equity, U.S. fixed income, etc.) in eVestment compared with benchmarks selected for a more granular selected grouping. Details on those benchmarks can be seen below.

- The universes for each section were chosen based on third-quarter 2021 total assets under management reported as of January 31, 2023. The top 10 are shown in the exhibit below. Cash management, passive, and enhanced index universes were excluded.

- The roll-up universe chart consists of an aggregated view for select asset class and geographic cross-sections. Products' performance comparisons are made at the primary universe level, with benchmarks chosen for the primary universes as shown below then aggregated to the roll-up universe level (e.g., U.S. large-cap core products are compared against the S&P 500 Index, U.S. small-cap value products are compared against the Russell 2000 Value Index within the U.S. equity roll-up). Although not listed below, primary universes outside the top 10 are included in these roll-up universe calculations.

- To be included in each year's calculations, products must have reported gross-of-fees returns for the full year. All comparisons between products and benchmarks are made gross of fees, dividends, and distributions and on a USD basis. All performance calculations are based on data reported as of January 31, 2023.

Roll-up groupings and primary universes with benchmarks selected for analysis

U.S. Equity

Primary Universe	Selected Benchmark
U.S. All-Cap Core	Russell 3000
U.S. All-Cap Growth	Russell 3000 Growth
U.S. All-Cap Value	Russell 3000 Value
U.S. Large-Cap Core	S&P 500
U.S. Large-Cap Growth	Russell 1000 Growth
U.S. Large-Cap Value	Russell 1000 Value
U.S. Mid-Cap Growth	Russell Midcap Growth
U.S. Mid-Cap Value	Russell Midcap Value
U.S. Small-Cap Growth	Russell 2000 Growth
U.S. Small-Cap Value	Russell 2000 Value

Global Equity

Primary Universe	Selected Benchmark
Global All-Cap Core	MSCI World
Global All-Cap Growth	MSCI World Growth
Global All-Cap Value	MSCI World Value
Global Large-Cap Core	MSCI World
Global Large-Cap Growth	MSCI World Growth
Global Large-Cap Value	MSCI World Value
Global Small-Cap Growth	MSCI World Small-Cap
Global REIT	FTSE EPRA/NAREIT Developed
Global SMID-Cap	MSCI ACWI SMID-Cap
Global Extended	MSCI World

U.S. Fixed Income

Primary Universe	Selected Benchmark
U.S. Bank Loan	Credit Suisse Leveraged Loan
U.S. High Yield	Bloomberg U.S. Corporate High Yield
U.S. Corporate	Bloomberg U.S. Credit
U.S. Long Duration Credit	Bloomberg U.S. Long Credit
U.S. Core Plus	Bloomberg U.S. Aggregate
U.S. Core	Bloomberg U.S. Aggregate
U.S. Short Duration Gov/Cred	Bloomberg U.S. Govt/Credit 1–5 Year
U.S. Interm. Duration Gov/Cred	Bloomberg U.S. Interm. Govt/Credit
U.S. Long Duration Gov/Cred	Bloomberg U.S. Long Govt/Corporate
U.S. Interm. Duration Muni	Bloomberg U.S. Municipal 1–10 Year

Global Fixed Income

Primary Universe	Selected Benchmark
Global Bank Loan	Credit Suisse Leveraged Loan
Global High Yield	ICE BofA Global High Yield
Global Credit	Bloomberg U.S. Credit
Global Core Plus	Bloomberg Global Aggregate
Global Government	FTSE WGBI
Global Aggregate	Bloomberg Global Aggregate
Global Inflation Indexed	Bloomberg Global Inflation Linked
Global Multi-Sector	Bloomberg Multiverse
Multi-Asset Credit	50% CS Lev. Loan/50% ICE BofA GHY
Global Unconstrained	Bloomberg Multiverse

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