

THEME THREE

The Investment Landscape

Weathering challenges to keep portfolios on track in both the saving and spending phases



We believe many investors may need to reset their expectations for fixed income, including both the returns they might receive and the amount of fixed income diversification that they will need.

Moving into 2023, working and retired participants both face economic uncertainty and high levels of market volatility. However, we believe that individualized investment advice and professional portfolio management—throughout the journey to and through retirement—potentially can help set participants up for successful outcomes.

Many investors have never experienced the economic dynamics we saw in late 2021 and into 2022, which included the biggest surge in U.S. consumer inflation since the 1980s. We view inflation as the transmission mechanism for all the other risks investors now face. The big question: Could the U.S. Federal Reserve's efforts to tame inflation by raising interest rates and shrinking its balance sheet cause a sharp deceleration in economic and corporate earnings growth or push the U.S. economy into a full-blown recession?

Inflation, rising interest rates, and recession concerns could be front and center issues for investors in 2023 and potentially beyond. In addition to these cyclical risks, we think investors also need to consider the possibility that global markets have 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.

An era of increased economic and market uncertainty could greatly complicate financial decision-making for people in or near retirement, especially for under-savers. Under-savers faced with disappointing returns or outright losses in their portfolios can try to work longer than they had planned, put aside more money, take greater investment risk in pursuit of higher returns, or lower their retirement spending plans. However,

each of these options poses potential challenges for preretirees and retirees.

In a complex and potentially volatile market environment, we believe plan sponsors and retirement savers may want to keep several key issues in mind.

A Critical Need for Diversification

For much of the past decade, a hypothetical do-it-yourself retirement saver who invested their entire portfolio in passive strategies tied to the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index could have done pretty well.¹ A passive portfolio of 60% stocks and 40% fixed income proved tough to beat. But conditions are much more uncertain now. Accordingly, we think it is critically important for retirement investors to build portfolios with well-diversified allocations that have the potential to do well across a range of potential market environments.

For example, real assets equities potentially can be an effective hedge against unexpected inflation. Over the past decade, as inflation remained low, this type of allocation tended to underperform the broader global equity markets. However, as we've seen inflation rates surge recently, real assets have shown their value.

Fixed Income Dynamics

We believe many investors may need to reset their expectations for fixed income, including both the returns they might receive and the amount of fixed income diversification that they will need.

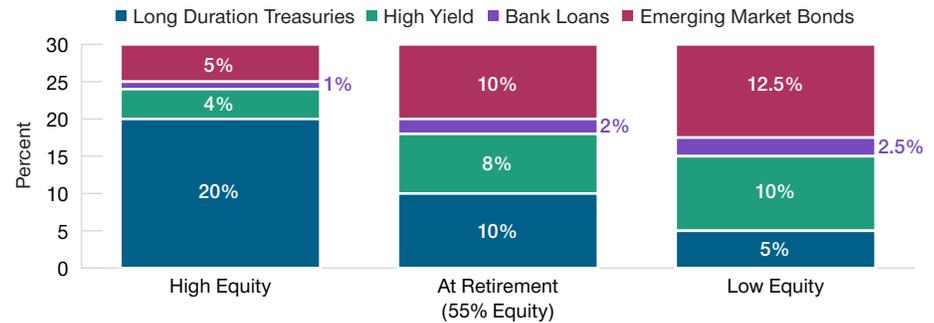
For years, investors could put money into a portfolio that tracked a major U.S. aggregate bond index and have a reasonably good chance of earning positive after-inflation returns while also hedging against equity volatility. However, the Bloomberg U.S. Aggregate Bond Index had a -14.6% return over

¹Based on index data. Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.

See pages 17-18 of the full 2023 U.S. Retirement Market Outlook for T. Rowe Price research sources.

The Role of Fixed Income Can Vary Along the Glide Path

(Fig. 1) Sample dynamic diversification weights at different portfolio equity levels



Source: T. Rowe Price. For illustrative purposes only. Not intended to represent an actual investment or strategy. This is not to be construed as investment advice or a recommendation to take any particular investment action. **Diversification cannot assure a profit or protect against loss in a declining market.** Percentage of total fixed income allocation (core component = 70%).

the 12 months ended September 30, 2022, one of the worst performances on record. And while bond and equity returns historically have tended to be negatively correlated, we saw the reverse in the first half of 2022 as U.S. and global fixed income and equity markets both sold off in tandem.

Such conditions highlight the increased importance of fixed income diversification. U.S. investment-grade bonds still make sense, in our view, as portfolio anchors and can play an important role in adding some potential stability to a multi-asset portfolio. But we think it's important for most retirement investors to have fixed income exposure that goes beyond such "core" bond holdings. We think they also should consider whether it is appropriate for their situation to include international fixed income, high yield bonds, floating rate loans, and more dynamic fixed income strategies in their portfolios.

In our view, enhancing 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. However,

some or all of these sectors may not be included in a retirement plan's core lineup. In our view, this makes fixed income diversification within multi-asset portfolios, such as target date vehicles and personalized portfolio solutions, all the more important for retirement investors as they seek to navigate more complex market environments (Figure 1).

The Potential Benefits of Active Management

Over the 10 years ended September 30, 2022, the S&P 500 returned an annualized 11.7%—generating similarly strong returns for passive equity strategies tied to the index. With many passive U.S. large-cap strategies performing well, many investors may have thought the costs associated with active management were not worth it. However, in a more subdued long-term environment for equity returns, even 50 basis points of excess return from active management could make a meaningful difference in retirement outcomes, in our view.

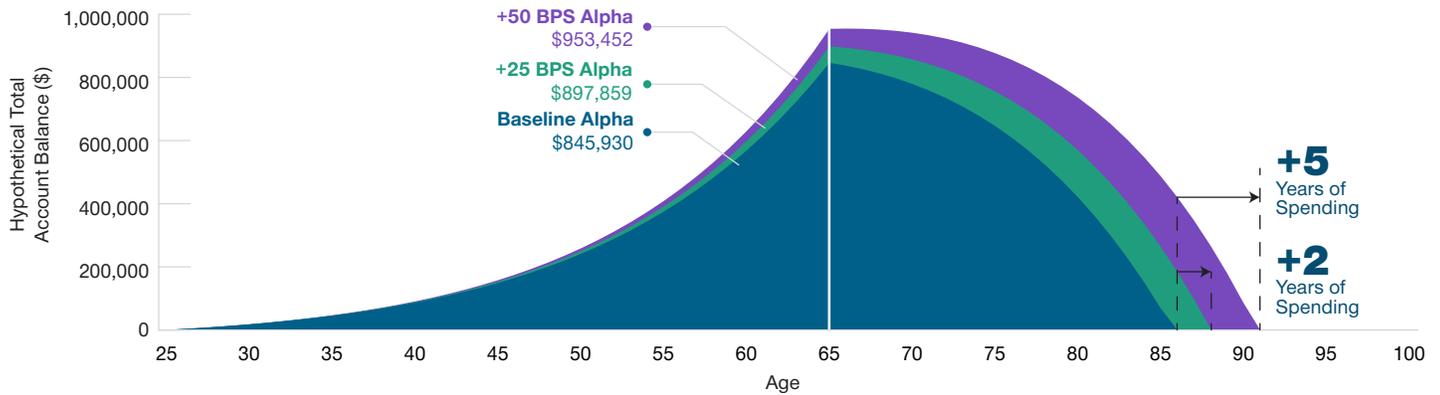
Our analysis, for example, suggests that an additional 50 basis points in excess return over an investor's lifetime could result in additional five years of

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Past performance is not a reliable indicator of future performance. Investors cannot invest directly in an index.

Even Modestly Higher Returns Potentially Can Improve Retirement Outcomes

(Fig. 2) Hypothetical impact of potential active management alpha on portfolio growth



Demographic Assumptions

Starting Balance (\$)	0
Starting Age	25
Starting Salary (\$)	30,000
Annual Salary Growth Rate	3%
Annual Contribution Rate	9%
Retirement Age	65
Ending Salary (\$)	97,861

Scenario Assumptions

	Baseline Alpha	+25 BPS Alpha	+50 BPS Alpha
Returns Before 65	7%	7.25%	7.50%
Returns After 65	5%	5.25%	5.50%
Account Balance at 65 (\$)	845,930	897,859	953,452
Withdrawal (% of Ending Salary)	50%	50%	50%
Annual Withdrawal Amount (\$)	48,931	48,931	48,931
Withdrawal Increase	3%	3%	3%

Source: T. Rowe Price.

For Illustrative Purposes only. Actual investment results will vary, perhaps significantly. Results will vary for other periods, and all investments are subject to market risk. Alpha = excess returns and BPS = basis points. 1 basis point is .01%. The results shown above are hypothetical, do not reflect actual investment results, and are not a guarantee of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Results do not include the impact of fees, expenses, or taxes. Results have been adjusted to reflect the reinvestment of dividend and capital gains. Actual returns may differ significantly from the results shown. The demographic assumptions, returns, and ending balances are shown for illustrative purposes only and are not intended to provide any assurance or promise of actual returns and outcomes.

retirement income for a hypothetical 401(k) plan participant (Figure 2).

We also believe that active management can help fixed income investors achieve the diversification they need. When allocating to sectors such as high yield and emerging market bonds, the primary risk for investors could be the possibility of default. In actively managed strategies, skilled credit analysts and portfolio managers can thoroughly evaluate these risks and seek to avoid troubled credits while also pursuing more attractive return opportunities.

Consideration of ESG factors offers an additional lever that active managers potentially can use to add value. A growing cohort of retirement investors now expect their employers' retirement plans to offer access to strategies that incorporate ESG factors in their investment analysis.

While a values-based approach to incorporating ESG factors initially may be more eye-catching from a participant perspective, we see increasing plan sponsor interest in an ESG integration approach, where material ESG factors are embedded in the investment decision-making process in an effort

See pages 17-18 of the full 2023 U.S. Retirement Market Outlook for T. Rowe Price research sources.

to either contribute to returns or mitigate potential risks. We believe ESG integration aligns with a fiduciary framework and is well positioned to withstand any future objections from a regulatory perspective.

The Role of Tactical Allocation

Since saving for retirement is a long-term goal, most investors need to look decades into the future when considering their asset allocations. However, we don't believe that investment managers should just take a "set it and forget it" static approach to their portfolios. Tactical allocation changes that seek to take advantage of dislocations in market valuations over shorter time periods potentially can enhance returns and reduce risks.

Helping Meet Retirees' Needs

The investment climate is, without doubt, uncertain. For that reason, as well as others, we believe plan sponsors will continue to collaborate with plan consultants and other financial professionals to provide plan participants with the tools they need to stay on track toward their retirement objectives. In the process, many plan

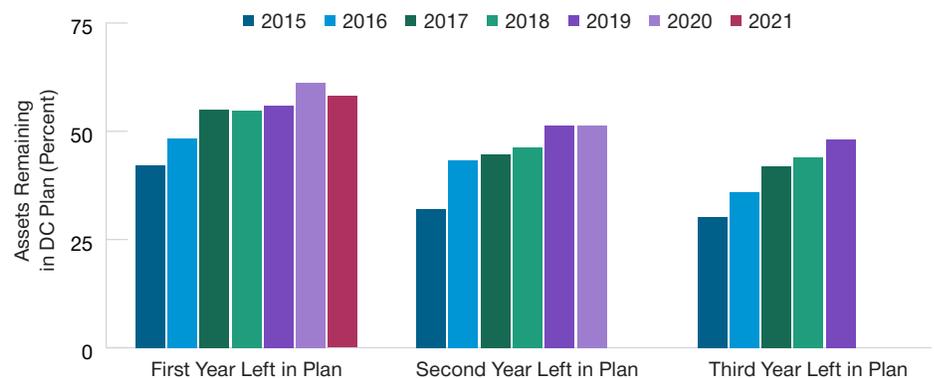
sponsors also are redefining their relationships with their employees and, increasingly, with retirees. Most notable in this regard is how many sponsors are seeking to help plan participants navigate the transition from saving to managing and drawing down their wealth in retirement.

We have discussed at length the demand for financial wellness advice and how this can extend to the use of retirement portfolios customized to personal needs, preferences, and circumstances. What we have not discussed yet is how plan sponsors are stepping in and seeking to meet the specific needs of retirees.

Historically, many retirees rolled their assets over into IRAs at retirement to access more personalized guidance and advice from financial professionals. However, recent analysis of the plans in T. Rowe Price's recordkeeping database points to more retirees keeping their assets in their former employers' plans and keeping those assets there for longer periods of time (Figure 3). In our view, this creates both an opportunity and a challenge for plan sponsors as they form

Meeting the Needs of Retirees Is Both a Challenge and an Opportunity for Plan Sponsors

(Fig. 3) Share of retiree assets kept in DC plans*



Source: T. Rowe Price Retirement Plan Services.

*Percent of account value retained by DC plan participants age 65 or older after one, two, or three calendar years following separation from service.

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Retiree needs are not limited to generating adequate and sustainable income.

views on how the purpose of their plan aligns with offering services to retirees.

When asked about the potential benefits to retirees of keeping their assets in a former employer's plan, plan consultants and financial professionals cited ongoing fiduciary oversight and lower costs for comparable investments versus rollover IRAs. Plan sponsors, too, increasingly are identifying benefits for their plans when retirees choose to keep their assets in them through retirement. Still, it is up to plan sponsors to decide what relationship with retirees is right for them. Factors such as plan demographics and workforce characteristics are critical considerations.

In general, we see sponsors who want their plans to retain retiree assets falling into three camps: those who feel an obligation to help former employees draw down their wealth in retirement, those who want to preserve plan pricing economies of scale that can benefit all participants, and those who are concerned about both objectives.

For plan sponsors who decide to help retirees manage and draw down their wealth in retirement, we believe that these efforts will require more than simply adding a solitary product or service. In contrast to individuals in the accumulation phase of the retirement investing journey, those approaching

or in retirement have diverse needs, making it less likely that a single investment such as a managed payout fund or an annuity will suffice.

Consistent with the demand for holistic, personalized solutions that can help savers accumulate wealth, we believe plan sponsors may want to consider creating ecosystems for their retirees that encompass an array of investment solutions, complemented by services that potentially can assist retirees who are drawing down their savings. Retiree needs are not limited to generating adequate and sustainable income. Our understanding of the behavior of retirement investors suggests that their increasingly diverse needs can best be met in a comprehensive retirement ecosystem that includes investments, guided tools, and access to advice.

The process of constructing a solutions ecosystem for retirees is likely to be iterative and build on common retirement plan characteristics we already know are effective, such as plan design features, target date strategies, and advice. Finally, while many plan sponsors may choose to pursue this path, we continue to believe in the value of financial professionals and think that many retirees may be equally well served by continuing to seek help outside their retirement plans.

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