

Defined Contribution

FIXED INCOME IN DC PLANS

A Tool Kit for Striking a Balance





Aging Population Faces Unprecedented Uncertainty

Of the roughly \$4.7 trillion of defined contribution (DC) assets in the U.S., roughly 63% are held by participants age 50 and older.¹ Just as these pre-retirees are increasing the fixed income exposure in their retirement plan portfolios, market factors such as interest rate fluctuations add to the challenge of finding options that can weather unexpected downturns – such as the one we are currently experiencing with the COVID-19 pandemic.

Given this dynamic, it is more important than ever that plan sponsors provide a well-diversified subset of fixed income options to help participants meet their goals. Unfortunately, DC plans often fall short on this front.

Our Survey Findings

To explore the potential implications for plan sponsors and participants, Janus Henderson partnered with the Plan Sponsor Council of America (PSCA) and National Association of Plan Advisors (NAPA) to conduct a survey of roughly 200 retirement plan advisors focused primarily on 401(k)s and nearly 100 plan sponsors.

The survey revealed two key findings:

- ▶ Equity options outnumber fixed income options by approximately 3:1 on respondent plan menus, regardless of plan size.
- ▶ Advisors indicated that they typically recommend only three fixed income options to plan sponsors.

These findings led us to question why there is such a striking lack of diversification in fixed income offerings. We believe the answer may lie in advisors' due diligence process when reviewing and selecting the fixed income portions of their plan menus. To provide advisors more support and guidance through this process – and ultimately elevate the options available to plan participants – we developed this brochure as a reference tool advisors can use in conjunction with their Investment Policy Statement (IPS).

The following pages cover:

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| 1 The Purpose of Retirement Plans | 4 Weighing the Number of Fixed Income Options |
| 2 Aligning Participant Expectations | 5 Quality, Correlation and Risk |
| 3 The Role of Asset Classes | 6 Due Diligence Tips |

¹ "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2016." Employee Benefit Research Institute, September 2018.

The Purpose of Retirement Plans

If we are going to take the time to rationalize certain aspects of DC plans, it is important to first recognize why companies implement them. The most obvious reason is that they provide a more cost-effective retirement savings vehicle for participants than a defined benefit plan. From an employer's perspective, most companies consider it their responsibility to help employees save for the future. A company's ability to offer rich benefits such as matching employee contributions to the plan is also a powerful tool for attracting and retaining talent.

If a retirement plan's ultimate purpose is to fulfill the needs of its participants, one important tool to help achieve that goal is a diversified menu of funds in which to invest. How can advisors determine whether a plan's menu offers adequate diversification? The first step is to gain a clear understanding of participant expectations.

Aligning Participant Expectations

The first question to consider is, what are the plan participants' expectations for retirement? In the face of continued economic and market uncertainty, as well as rising costs in retirement, participants' outlook and goals for their retirement years may have changed.

Second, what are the plan participants' expectations for fixed income? Are participants focused on preserving principal, reducing or dampening volatility during times of market stress, protecting against inflation or generating a modest amount of income to sustain them in retirement?

The answers to these questions form the foundation of the due diligence process and should help inform the steps outlined in the following sections.

The Role of Asset Classes

At a high level, DC plans offer participants access to equities, fixed income and cash. Equities are relatively well defined, and it is generally accepted that a diversified lineup should consist of a mix of capitalization (large cap, mid cap, small cap), style (value, core growth) and geography (U.S., international, global).

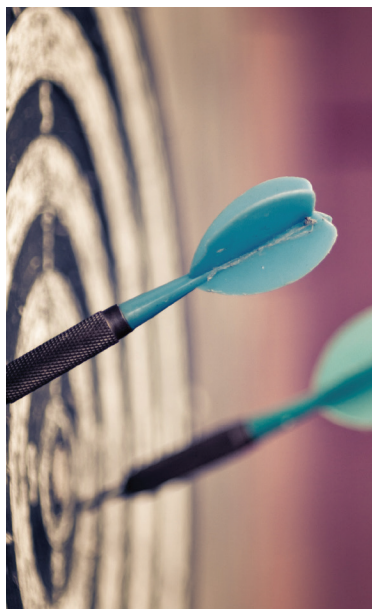
Fixed income is not always as clear cut. The proliferation of new asset classes and approaches complicates matters, as does a complex market that may offer less transparency and readily available analytics compared to equities. This complexity is compounded by the fact that fixed income funds typically own a greater number of securities than equity funds. To confuse matters further, bond funds can vary in duration (short, intermediate, long), quality (investment grade, high yield), sector (government, credit securitized, inflation-protected), capital structure (senior, subordinated) and rate (fixed, floating), and a given fund may contain a mix of all these characteristics.

With so many complicating factors, it is important to revisit the role each asset class should play in a plan lineup. Equities should do the bulk of the heavy lifting in terms of growth and long-term return generation. Fixed income should serve to dampen volatility, particularly during times of market stress, while preserving principal, generating a reasonable amount of income and – within strategies explicitly designed to do so – potentially offering protection against inflation.



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Fixed income should serve to dampen volatility, particularly during times of market stress, while preserving principal, generating a reasonable amount of income and potentially providing protection against inflation – all critical functions in a plan lineup.



Assuming a plan lineup consisting of 20 options and a target-date series of five or six funds, a fixed income lineup of five funds may strike a balance for most plans – provided those five fixed income funds have distinct risk/reward characteristics.

But while we believe the level of diversification on the fixed income side is of equal – if not greater – importance, our research shows that very few fixed income lineups offer the level of diversification that is taken for granted on the equity side. As such, we think additional due diligence may be necessary to identify those fixed income options that can offer adequate diversification while helping participants achieve the goals associated with this portion of their portfolio.

Too Many Options, or Too Few? Striking a Balance

While fixed income options are often too limited in retirement plans, too many options can also pose problems by exposing participants to risks they may not be aware of or expect in the fixed income portion of their portfolio.

Investor behavior plays a key role: Several studies have concluded that too many options within a retirement plan can lead to procrastination, low levels of participation and naïve diversification strategies. However, other research has found that larger core menus result in greater plan default adoption and more efficient portfolios from active participants. One study revealed that as plans increased their core menu size from 10 funds to 30, participants nearly doubled the number of funds they included in their portfolios. More importantly, this expanded exposure led to an increase of 3.6 basis points in risk-adjusted return per fund and an estimated 11 basis-point increase in alpha overall.²

In our view, the key to building a well-diversified fixed income menu is offering a set of options that contains distinct risk/reward characteristics to meet a broad range of participant needs. For a plan menu of 20 options that includes a target-date series of five or six funds, the fixed income portion should generally include more than the above-referenced average of three, which we feel is inadequate (especially compared to the much larger quantity of equity options offered in most plans). Within this framework, it may make sense to offer a money market or stable value fund for capital preservation, a short-term/low-duration fund for additional yield with lower risk, a core/core plus fund as an anchor and a multi-sector or world bond fund for diversified exposure and real return to act as an inflation hedge.

In the next section, we outline a review process to provide a starting point for screening fixed income options by assessing quality, correlation and risk.

Assessing Quality, Correlation and Risk

Plan sponsors and advisors alike indicate the importance of quality when selecting fixed income investments – which makes sense, given participants' expectations from fixed income are often preserving principal, reducing or dampening volatility during times of market stress and generating a modest level of income. How can advisors effectively discern the quality of fixed income options and find funds for plan participants? Following are some suggested factors to consider:

- ① **Evaluate correlations.** We believe financial professionals should consider income funds without excessive correlations to the equity funds in the plan's lineup. A good guideline is to seek core funds that are at most "moderately" correlated to equities. Morningstar defines moderately correlated as having a positive correlation of 0.11 to 0.69.³ Advisors should also examine correlations

² Blanchett, D. "Bigger Is Better: Defined-Contribution Menu Choices with Plan Defaults." Morningstar, November 13, 2019.

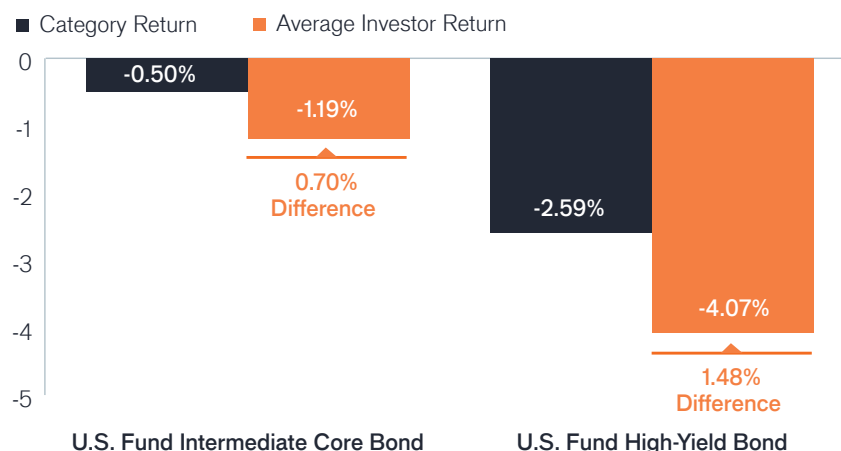
³ "Understanding the Correlation Matrix from Morningstar." Court Investment Services, May 17, 2018.

among fixed income options: For example, average correlation between the core and core plus categories is 1.0, which means filling two spots with these fund categories may not provide true diversification. We have seen this theme play out in recent fiduciary court cases such as *Fleming v. Rollins*, in which the plan sponsor was sued due to the plan's equity funds being too highly correlated and the fixed income options too limited.⁴

- ② **Seek funds that have performed well in risk-off environments.** While past performance is no guarantee of future results, it may be helpful to understand how funds have performed in past environments. Review specific periods of equity market volatility, as these are the discrete time periods during which participants would have wanted their fixed income to perform like fixed income. Periods such as the calendar years 2015 and 2018 help illustrate how much high-yield- and equity-related risk was in a portfolio. While inflation hasn't been top of mind in recent years, it is still a meaningful risk, particularly for older participants. Depending on the demographics of the plan, you may want to review your lineup to determine whether it includes an option expressly designed to protect against inflation.
- ③ **Compare risk statistics such as standard deviation and maximum drawdown.** Understanding standard deviation can help show the type of experience a participant can expect by investing in a particular fund. Has the fund being evaluated produced a consistent return stream with small deviations in returns from month to month, or have swings been more pronounced with higher highs and lower lows? Maximum drawdown highlights the worst loss in a fund. This is important to understand, as participants may be inclined to make changes to their fund allocations if they experience a larger drawdown than anticipated, effectively locking in those losses and missing any upswing that may follow.

Individual investors have consistently underperformed category averages, largely due to the impact of emotional investing (selling low and buying high). This behavior is exacerbated in riskier asset classes, with investors performing even worse than those in more conservative asset classes. This highlights the critical need for due diligence, giving plan participants less-volatile options to better set them up for success.

2018 investor return vs category average



Source: Morningstar
Morningstar® Investor Return™ (also known as dollar-weighted return) measures how the average investor fared in a fund over a period of time.

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⁴ N.D. Ga., No. 1:19-cv-05732, complaint filed December 23, 2019.

“ Unquestionably, fiduciaries need not choose the cheapest fees available to the exclusion of other considerations ...”

Patterson v. The Capital Group Companies, Inc. (2018)

- 4 Understand the level of risk in non-benchmark sectors. Drawdowns should be in line with goals for that specific asset class, with an acceptable level of non-benchmark risk in sectors like high yield or non-U.S. Fund managers employ a wide range of techniques in seeking to generate alpha and managing risk exposure, so financial professionals should inquire about the level of currency exposure and use of leverage and derivatives, as well as exposure to non-benchmark sectors such as below-investment-grade or floating-rate securities.
- 5 Keep fees reasonable. Because they tend to be wide ranging in the fixed income category, fees are an important component to evaluate. Remember that ERISA is clear in noting that fees need not be the lowest, but rather they should be reasonable in light of the level and quality of services provided. Over the years, the Department of Labor and the courts have reaffirmed this idea. With that said, it is important for plan sponsors to not only compare investment expenses to similar products or options but also consider how the inclusion of a fund – even if its fees are relatively high – will fit with the above items and help participants create portfolios that are more closely aligned with their long-term goals.

Assessing Participant Demographics

As shown below, demographics such as education level, gender and ethnicity/race – which, in our view, can be important considerations – are rarely taken into account by either sponsors or advisors when selecting fixed income options. In fact, even seemingly vital factors such as average age and retirement age were cited as “always” considered by advisors only around 40% of the time.

As participants age, their needs and risk tolerance may shift, which could necessitate more income options.

Demographic	Plan Sponsor Always	Advisor Always	Plan Sponsor Never	Advisor Never
Risk Tolerance	44.3%	56.3%	21.5%	14.6%
Average Age	25.3%	38.3%	31.6%	20.9%
Retirement Age	34.6%	40.8%	32.1%	21.4%
Account Balances	12.3%	20.4%	46.6%	29.6%
Education Level	11.4%	22.2%	48.6%	30.8%
Gender	2.9%	3.0%	87.1%	72.1%
Ethnicity/Race	2.9%	0.5%	88.6%	89.8%

In addition to assessing expectations, following are some guidelines on how various (often overlooked) demographic factors should inform plan designs:

- **Gender.** It’s important to understand that women tend to be more conservative than men when it comes to investing. In addition, they may have less saved due to time away from the workforce and lower pay. As such, it is imperative that they lose less because they simply have less to lose, making it critical to include a fixed income fund that is unlikely to give participants any negative downside surprises.
- **Age.** As participants age, their needs and risk tolerance may shift, which could necessitate more income options. Older participants are more likely to be self-

directed, for example. It is vital to periodically assess how the participant base has changed over time and evaluate whether a plan should include both a conservative fixed income option as well as one with a higher return or income goal to meet the needs of a varied age range. Maintaining purchasing power becomes more important as participants age. Depending on participants' needs and goals as they approach retirement, additional travel and leisure expenditures, as well as increased spending on health care, may require the need to protect against and keep up with inflation.

- **Average age employees separate from service.** Does the plan sponsor encourage participants to leave assets in the plan after separating from service? Or are there participants who may stay in the plan through retirement? The answers to these questions can help determine whether more options may be needed (or fewer, in the case of plans with high turnover and participants who skew younger). Participants in retirement may look to fixed income options that offer relatively consistent income distributions.
- **Ethnicity.** Consider gathering participation and allocation data based on race and ethnicity to understand where gaps or educational opportunities may exist. For example, studies have shown different percentages of equity exposure among white, Hispanic, Asian and African American participants, as well as lower overall levels of participation and savings rates for African American and Hispanic participants.⁵

Enhancing Your Due Diligence Process

Based on the information above, following are some additional suggested steps that may help to enhance your due diligence process.

- 1 **Update your IPS** to incorporate the considerations we have outlined here. For example, if your current IPS focuses primarily on performance and fees, it may be prudent to delve deeper with your due diligence process by including metrics regarding correlations, standard deviation and/or maximum drawdown.

The samples below are meant to further enhance your ongoing due diligence process and provide additional options to consider. The figures and ranges referenced are not hard-and-fast rules, as each plan is different.⁶

- **Correlation Sample:** Include a preferred correlation average or range. For example, equity funds within the plan's core menu should maintain an average overall moderate correlation or less on a five-year basis.
- **Standard Deviation Sample:** Provide a standard deviation ranking for the core menu. For example, funds within the core menu should have a standard deviation ranking within the top 50% (the lower, the better) for the three-year period. A lower standard deviation would lead to less volatility. Those funds with lower standard deviations will rank higher among peers.
- **Maximum Drawdown Sample:** Identify a maximum drawdown for fixed income options in the plan, because maximum drawdowns have the potential to become realized losses. For example, aim for a maximum drawdown within the top 50%.

Given the complexity of fixed income, increased educational efforts may be warranted to ensure investors understand the role the asset class plays in a diversified portfolio.

⁵ "401(k) Plans in Living Color." Ariel/Aon Hewitt Study, 2012.

⁶ Plan specifics, investment options and other factors may dictate the inclusion of or changes to some of these items

- **Down Capture Sample:** Because down capture ratios show how a fund has outperformed in down markets, it may make sense to include a preferred average in your IPS. For example, an average three-year down capture ratio should be no greater than 100%.
 - **Fixed Income Credit Quality Sample:** Consider including the average credit quality of the bonds in the fixed income portion of the plan. For example, the fixed income portion should be rated BBB or higher, meaning the assets are considered investment grade.⁷
 - **Alternatives Exposure Sample:** Exposure to alternative assets within the plan's investments could add additional risk. Include a statement in your IPS that these types of investments should be considered on a fund-by-fund basis and be based on the long-term best interests of participants.
- 2 **Include qualitative metrics** in your process to help determine whether the plan lineup offers an appropriate level of diversification for the participant base. For example, use income replacement tools to ensure participants are on track and to assess their ability to retire "on time." Also consider how participants' exposures and allocations may change as they transition through their career cycle. For example, does the core menu offer options that meet the needs of individuals as they age? And does it meet the needs of participants in different age ranges?
 - 3 **Review educational offerings** and utilize financial wellness programs to educate participants. Given the complexity of fixed income, increased educational efforts may be warranted to ensure investors understand the role the asset class plays in a diversified portfolio. Be sure to consider factors such as ethnicity, gender, job function and communication preferences when evaluating which methods of education might be best suited for different audiences.
 - 4 **Revisit your fixed income lineup regularly** to ensure it includes an adequate number of options based on the demographics of the plan. As the recent research revealed, most DC plans offer three times as many equity options as fixed income options. It may be prudent to expand your plan's fixed income lineup to provide additional options that can help meet the changing needs of participants. As participants age and their account balances grow, for example, they may benefit from options that offer inflation protection and the potential for additional income.

⁷ Securities rated below BBB are considered below investment grade and are associated with higher credit risk and higher default risk, which may not be appropriate for all participants.

Janus Henderson's Defined Contribution Resources

Janus Henderson offers a variety of scalable services and solutions designed to enhance your retirement capabilities, including guidance on plan design, fiduciary training, retirement consulting, participant education, and portfolio construction and strategy. Our team of experts also provides timely insights on the DC marketplace in our quarterly "Top DC Trends and Developments" report and through regular updates on the Janus Henderson blog. To learn more about our resources, contact your Janus Henderson sales director.

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