Rethinking Fixed Income in Defined Contribution Plans: Ensuring Optimal Diversification

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It’s a core principle of investing: diversify. But when it comes to retirement plans, how diversified are most defined contribution (DC) investment menus? In many cases, plan sponsors and investment committees tend to overemphasize equity investment options in their fund lineups, neglecting to include a healthy mix of fixed income choices. As a result, participants may have fewer choices to be properly diversified. Considering that interest rates are still at historical lows and fixed income products are more varied than ever, it’s time for plan sponsors to rethink fixed income investment options so that participants can better manage risk, generate income, and optimize their level of diversification.

In this briefing, we explore the common pitfalls in DC plan investment menu construction, provide a five-step plan for adding strategic fixed income investments to help counterbalance common diversification issues, and explain why we believe active management may better address participant needs in situations when market conditions are in flux.
Defined Contribution Plans: Bigger than Ever

Despite predictions of declines in DC plan participation in the wake of the 2008 financial crisis, employee engagement continues to prosper. In 2013, 88 million participants took part in 638,390 defined contribution plans.

In addition, asset growth remains robust. A recent Investment Company Institute report shows that 401(k) plans held an estimated $4.4 trillion in assets, representing nearly 18 percent of all U.S. retirement assets, which includes employer-sponsored defined benefit and defined contribution plans, IRAs, and annuities. Just ten years earlier, 401(k) assets were $2.2 trillion – remarkable growth during a decade fraught with financial turmoil and uncertainty.

Long on Equities, Short on Bonds

Fixed income investment options are often underrepresented in defined contribution plans. According to the Plan Sponsor Council of America (PSCA), the average defined contribution plan has 18 investment offerings, but only 2 or 3 fixed income options including capital preservation options such as money market or stable value funds. Offering too few fixed income options may hinder participants’ ability to properly diversify their fixed income exposure. Furthermore, it may have the unintended consequence of encouraging participants to be too aggressive in their overall asset allocations.

Why so few fixed income options? There are several reasons. Historically, many plan sponsors built investment menus using nine equity investment style boxes, ranging from Large, Mid and Small Cap to Value, Blend and Growth. To fulfill the Fixed Income allocation option, however, many simply added a fixed income index fund option benchmarked to the Barclays U.S. Aggregate Bond Index (BAGG) or other such indices. While a fine investment option for some, in our view a single fixed income fund does not provide every participant enough choice to construct a properly diversified portfolio.

Another reason plan sponsors and investment committees tend to curate investment choices is to avoid sub-optimal investment behavior. Several academic studies have concluded that too many investment choices offered within a plan can lead to:

- Confusion and procrastination
- Low levels of engagement and participation
- Naïve and unsound diversification strategies

While both of these trends are very positive, investors appear to be increasingly more cautious and seeking “safer,” more conservative investment vehicles, including options with the potential to generate steady streams of income and reduce downside risk. This is especially true for the large number of workers who are nearing or have entered retirement age, and who are driving the demand for income-producing investments. According to the Employee Benefit Research Institute, 51% of 401(k) participants in their 60s hold no equity funds. 11.6% of account balances for participants in this age group are in bond funds, with another 17.9% in money funds and GICs/stable value funds (combined).

We believe these demographic trends, in addition to evolving investor behavior, strengthen the case for offering more clearly differentiated fixed income options in plan lineups.

401(K) ASSETS

Source: Investment Company Institute, Federal Reserve Board, and Department of Labor, December 17, 2014
When faced with too many choices and information, participants become overwhelmed. As a result they may put off or decide against enrolling in the plan, thereby missing out on valuable compounding time — or the opportunity to save and invest altogether.

Despite these legitimate concerns in support of a concise investment menu, we believe there are compelling reasons to expand the number of fixed income options offered under the plan, particularly if plan participants have access to a managed account program. The advice offered can help make the case for fixed income and guide participants’ allocation decisions that are better matched to their objectives and risk tolerance.

That said, how can sponsors and committees balance the competing needs of offering a sufficient number of fixed income options while not overwhelming participants with too many choices? We address that question next.

**Janus’ Solution: A Framework of Five**

We feel there is a growing, unmet need for more variety in plan menus, specifically in the area of retirement income planning. We believe it is imperative for plan sponsors and investment committees to re-evaluate their current offerings to ensure that the investment menu offers well diversified fixed income options that meet participant needs for downside protection and reliable income generation.

At Janus, we recommend that plan sponsors and investment committees become more knowledgeable about the variety of fixed income instruments available today and how they may complement their existing equity investments. Our retirement strategy group has worked with Janus’ fixed income portfolio management teams to create an optimal fixed income investment menu that we call “The Framework of Five.”

Simple and straightforward, the Framework provides plan sponsors with recommendations and a step-by-step process for offering broad diversification across all major fixed income asset classes. We believe that offering five fixed income options along with a qualified default investment alternative (QDIA) and a reasonable number of equity options results in a diversified, rational 401(k) investment menu.

| STEP ONE: CHOOSE A CAPITAL PRESERVATION OPTION |
| Nearly all plan sponsors and participants need an investment option that seeks to preserve capital, especially in volatile markets. With minimal risk, a U.S. money market or stable value fund option serves a need within a plan’s fixed income lineup for those participants who have low risk tolerance or a shorter horizon to their retirement date. |

| STEP TWO: ADD A U.S. SHORT-TERM INVESTMENT GRADE FUND OPTION |
| Funds that invest in short-duration bonds such as a U.S. short-term investment-grade bond fund may provide slightly higher current yield than a pure capital preservation vehicle. Short-duration funds seek to mitigate the risk of rising interest rates while preserving principal. |

| STEP THREE: SELECT A CORE-PLUS VEHICLE |
| Typically serving as an investment “anchor” within a fixed income lineup, a core-plus investment offers broad exposure to the U.S. treasury, mortgage-backed, corporate, and high-yield sectors. With an average duration typically ranging between five to seven years, a core-plus option can provide more attractive levels of yield relative to shorter-duration funds. This type of fund option should be considered as a strategic addition to the lineup, offering participants potentially higher levels of current income, along with moderately higher levels of risk. |

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Making the Case for Active Management

Janus is an active investment manager whose investment professionals follow a rigorous and disciplined investment approach. This is in stark contrast to passively managed approaches which track the Barclays U.S. Aggregate Bond Index Portfolio which plans often utilize in an attempt to lower costs. Why is active management an important factor in a fixed income option and how can an active approach add value in a retirement plan?

Our answer is this: Despite their advantages, indexed strategies can have a hidden drawback — an inability to adapt to changing interest-rate regimes or other market conditions. For example, consider the long-anticipated demise of the 30-year bull market in fixed income securities, which could have important implications for investors if (or when) interest rates rise. If this happens, current bondholders could potentially face significant deterioration in the values of their current holdings. This bear market, in contrast, may actually create opportunities for active managers who have the flexibility to move around the yield curve and reinvest maturing bonds into higher-coupon options, offsetting the decline in price.

Second, we have seen the duration profile of the Barclays U.S. Aggregate Bond Index extend above five in the past two years, potentially adding more volatility risk to funds that track the Index. That’s because longer-duration bonds are more sensitive to interest-rate changes than short-duration bonds, increasing the potential for volatile returns. In the current low yield environment, interest rate sensitivity has become more pronounced, resulting in heightened volatility in Index-tracking strategies.

Yield Duration of the Barclays U.S. Aggregate Bond Index

Source: Bloomberg, Barclays (as of 12/31/2013)
In our view, an investment manager should be able to review and adapt a portfolio in accordance with changing markets. This may mean selectively moving in or out of an industry, asset class, or geography when risks change to find new opportunities that can be properly managed. With actively managed fixed income funds, portfolio managers can manage volatility within markets by being more defensive, shortening duration, seeking new opportunities, and making real-time adjustments in response to market fluctuations. For example, a portfolio manager may identify a company prime for a ratings upgrade, which can result in price appreciation regardless of the interest rate environment.

As illustrated in the chart below, despite a 27-year period of rising rates, the annual return of the Intermediate-Term Government Bond Index was a healthy 4.5%. This was achieved by reinvesting older, maturing bonds into higher yielding, newer bonds. An active manager has the ability to shorten duration in a secular bear market to help offset declining bond prices.

Passively managed funds approach risk differently than actively managed funds, and both types of funds will appeal to different types of investors. Therefore, we believe that both types of investments deserve consideration in most plan lineups. Regardless of the strategy preferences of the advisor and plan sponsor, it is critical when formulating the lineup to understand participants’ risk-return expectations, to construct an appropriate framework to meet those expectations, and to ensure that the plan’s investment managers are in full alignment with the framework.
1. **CONSTRUCT AN EMPLOYEE NEEDS PROFILE**
DC plan sponsors are well advised to work with an investment professional to evaluate their employee demographics, income level, education level, age, risk tolerance, and investment expectations. This is the most important step a plan sponsor can take to assess the long-term viability of its plan investment menu.

2. **MAKE SURE THE INVESTMENT COMMITTEE UNDERSTANDS THE DYNAMICS OF FIXED INCOME INVESTING**
Against the backdrop of a 30-year bull market in fixed income, the committee should be conversant in the topic areas of interest-rate risk, duration risk, and rising correlation levels between fixed income and equities during periods of market dislocation.

3. **CONSIDER THE ADVANTAGES OF ADOPTING THE “FRAMEWORK OF FIVE”**
Particularly if your plan's fixed income options are highly concentrated in money market, stable value and/or passively managed vehicles, working through the framework may be a useful way to diversify the options you make available to plan participants, in a way that complements your QDIA and equity options.

4. **MAKE CHANGES TO YOUR PLAN THAT ENHANCE YOUR OVERALL EMPLOYEE BENEFITS PROGRAM**
Each qualified plan is different. Plan sponsors who make value-added adjustments to the plan that better meet the needs of their participants ultimately may benefit from greater participation levels and employee engagement in the plan.

5. **FOCUS MORE ATTENTION ON FIXED INCOME DUE DILIGENCE**
Not all bond funds are created equal. We believe DC plan sponsors should employ the same level of due diligence and scrutiny on their fixed income managers as they do on their equity managers. Fixed income portfolios often contain hidden or obscured risks in the types of investments they hold and the strategies used to manage duration and interest-rate risk.

**Conclusion**
We believe DC plan sponsors must take greater responsibility for scrutinizing their core lineups to ensure that participants in their plans are not limited to passive investment approaches that on the surface may provide broad diversification at low cost, but do so at the expense of downside risk mitigation. By paring down redundant equity choices and including an optimal number of actively managed fixed income options that offer potential for attractive, risk-conscious income replacement opportunities, participants at different life stages can build portfolios that offer a more appropriate mix of risk and reward.
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