Optimizing Fixed Income Allocations in Defined Contribution Plans:

A Plan Sponsor Guide to the Changing Fixed Income Landscape

by Chris Karam

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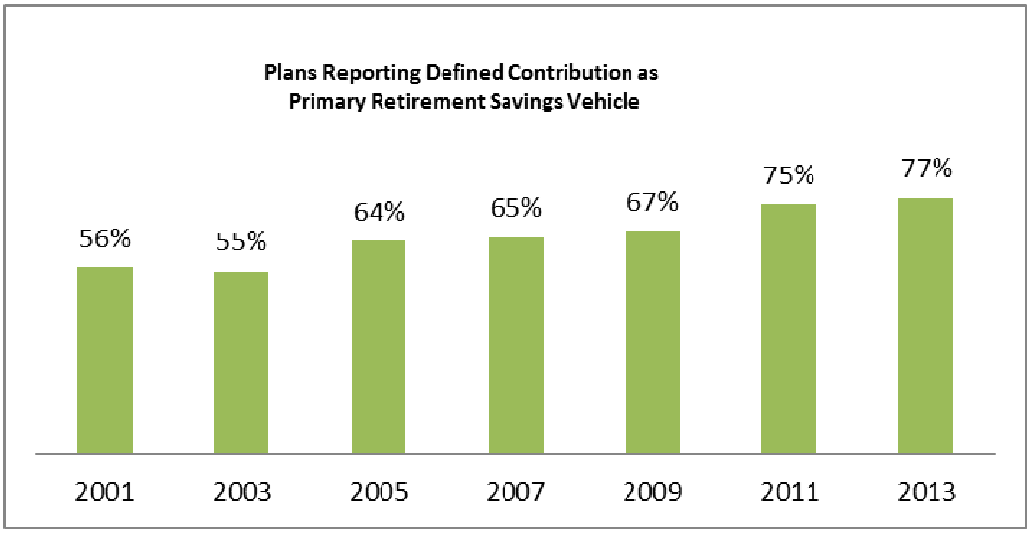
Executive Summary

- *Global fixed income opportunity set has demonstrably shifted towards non-US issues*
- *Retirees and those approaching retirement are seeking income oriented solutions*
- *Industry experts estimate $1 trillion will shift from traditional "core" fixed income into non-core options*
- *Defined contribution plan trends point towards menu consolidation AND demand for greater diversification potential in a low interest rate environment*
- *Plan sponsors should consider a single flexible global fixed income menu option to complement a core bond strategy*

Introduction

While only in its early stages, the retirement of the "baby boomer" generation is having a significant impact on DC plan demographics. In the course of the fiduciary decision making process Plan Sponsors should be mindful of these demographic shifts and how they affect investment options and retirement income provisions they offer participants. Many Plan Sponsors may soon realize their current investment menu does not meet the needs of their evolving personnel. The now common practice of defaulting participants into target date funds and reenrolling the workforce, for example, does not necessarily solve participants' desire for income as they approach or are in retirement. Demographic changes, coupled with the complex interest rate landscape, will likely place a heightened fiduciary responsibility on Plan Sponsors to accommodate these changing investment needs. This white paper offers Plan Sponsors a guide to navigating the global fixed income landscape and structuring an appropriate defined contribution fixed income portfolio.

Defined Contribution ("DC") plan sponsors have undergone significant changes to their plan design, default investment vehicles and the number of investment options since the passing of the Pension Protection of Act of 2006. Plan Sponsors have also seen the importance of DC plans grow as they have increasingly become the primary source of retirement income for US workers. According to Aon Hewitt's 2013 study on Trends & Experience in Defined Contribution Plans, 77% of Plan Sponsors reported their DC plan as their primary retirement savings vehicle. This represents a 40% increase since 2003.



Trends in DC Plans

We noted in a previous white paper entitled, *Improving the Target Date Selection Process,* the rapid growth of target date funds, both in their adoption as a Qualified Default Investment Alternative ("QDIA") and their considerable asset growth. Asset management consulting firm Casey, Quirk & Associates forecasts that target-date funds will represent nearly half of the projected $7.7 trillion in U.S. defined contribution assets by 2020. The retirement industry is also moving towards consolidation of investment options, reversing a 20-year trend towards inflated menu options that resulted in a confusing, overwhelming and discouraging participant experience.

Fees in DC plans are also on the decline thanks, in part, to government regulations requiring Plan Sponsors to gather plan level fee disclosures and determine their reasonableness. Participants are now required to receive an annual fee disclosure notice detailing fees extracted from plan assets. The fee disclosure regulations have arguably accelerated the movement towards increased allocations to passive investments. According to a survey of 107 executives representing their DC plans, Callan Associates reports the following:

- 24.1% expect to increase the proportion of passive funds in their lineup compared to 12.5% who increased the passive fund portion last year
- Among plans that conducted a fee review, 44.9% reduced fees last year, 42.9% reduced fees in 2012 and 30.3% cut fees in 2011
- The percentage of plans offering
    - Collective trusts rose to 51.9% in 2013 from 48.3% in 2012 and 43.8% in 2011, and
    - Separate accounts was 50.6% last year, up from 42.5% in 2012 and 40% in 2011

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Demographic Shift

Perhaps the most significant change to the DC plan market, however, is the evolving demographics of the participant population. Baby boomers are beginning to retire and they are having a significant impact on our workforce. The Bureau of Labor and Statistics ("BLS") reports the percentage of Americans participating in the workforce has reached a 30-year low, yet the reported unemployment rate has been steadily declining over the last five years.

Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S.
Data are as of 3/31/14.

A natural conclusion from this data is that workers reaching retirement age are retiring and leaving the workforce. This conclusion is supported by data collected by MetLife since 2007, evaluating the trends of the oldest baby boomers (those born in 1946). The most recent MetLife study, published in May 2013, found the following:

- More than half (52%) of oldest Boomers (and their spouses) have fully retired and are not working, up from 19% in 2007 and 45% in 2011.
- More than half (54%) of retired, oldest Boomers did so earlier than planned, citing health issues and job-loss as the two top reasons for doing so.
- The vast majority (86%) of the oldest Boomers are currently collecting Social Security. Of these, 43% started collecting benefits earlier than expected.

- Nearly six in 10 (58%) retired, oldest Boomers say their retirement income is less than pre-retirement. Just 20% reported a decreased standard of living and 18% said they have experienced an increased standard of living.

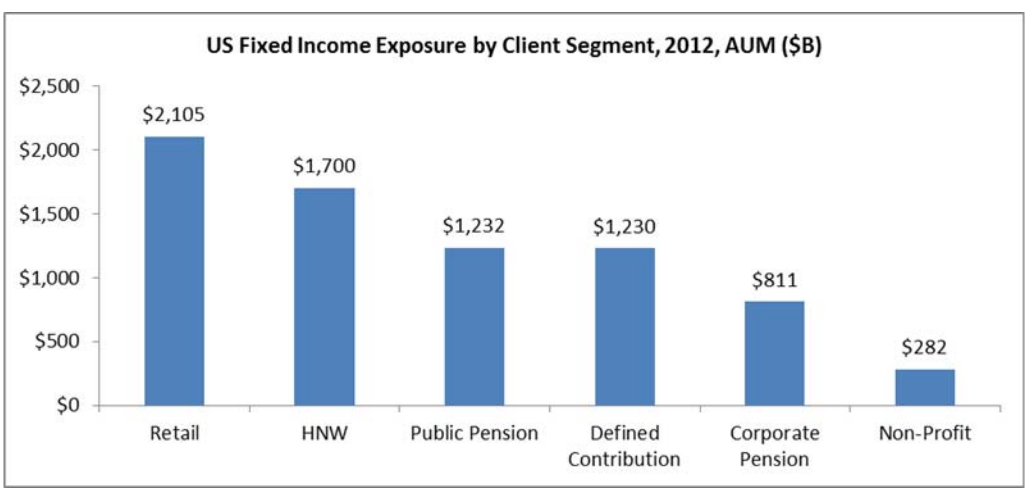
- Long-term care costs are a top retirement concern for oldest Boomers, and close to 70% of all oldest Boomers say they believe long-term care should be covered under the national Medicare umbrella. Only a quarter currently have private long-term care insurance.

Baby boomers retiring or approaching retirement age will likely need to begin the portfolio transition process from growth to income producing assets. Absent a defined benefit pension income stream, a participant's DC asset allocation will likely need to be similarly altered to reflect these realities. In addition to shifting baby boomer portfolios to income producing assets, the nature of the assets generating this income is also undergoing a transformation. Casey Quirk & Associates estimates U.S. investors will shift **$1 trillion of assets** — almost 15% of their current fixed income allocation — from traditional fixed income products (core, core-plus, government and benchmark-oriented strategies) to next generation debt strategies, including global and emerging market bonds, high-yield and loan portfolios, alternative fixed income products, and vehicles designed to defend investors from inflation and rising rates.

The IRS issued proposed regulations on 401(k) plans in 1981, and the first 401(k) plans went live in January, 1982, giving birth to the modern day DC plan system. Interest rates have generally declined since that point in time, as best illustrated below using the history of the 10 -year Treasury Yield since 1958 as a proxy. Traditional 401(k) menu design has historically consisted of a variety of equity funds, both domestic and international, asset allocation funds, such as a balanced account or target date strategy, a fixed interest or stable value option, and one core bond offering. This core bond offering is generally represented by a domestic intermediate-term bond strategy with the Barclays US Bond Index as the appropriate de facto benchmark. Core bond investors in DC plans have been able to take advantage of the declining interest rate environment and allow their portfolio to experience exemplary returns for 30 years.

Source: Federal Reserve, BLS, J.P. Morgan Asset Management. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for March 2014, where real yields are calculated by subtracting out February 2014 year-over-year core inflation. All returns above reflect annualized total returns, which include reinvestment of dividends. Corporate bond returns are based on a composite index of investment grade bond performance. Guide to the Markets – U.S. Data are as of 3/31/14.

These exemplary returns have naturally coincided with lower yields. As of March 31, 2014, the yield on the 10-year Treasury settled at 2.72%. These lower yields have naturally resulted in minimal yield on short-term instruments such as Money Market accounts and Stable Value pools. For baby boomers seeking income this creates a serious problem, especially if the main or only fixed income option in their DC plan is benchmarked against the Barclays US Aggregate Bond Index. Across numerous retirement client segments, individual and defined contribution investors are most exposed as Casey Quirk & Associates estimates they hold $5 trillion in fixed income assets, and are not prepared for the potential losses in this part of their portfolio (see chart below).

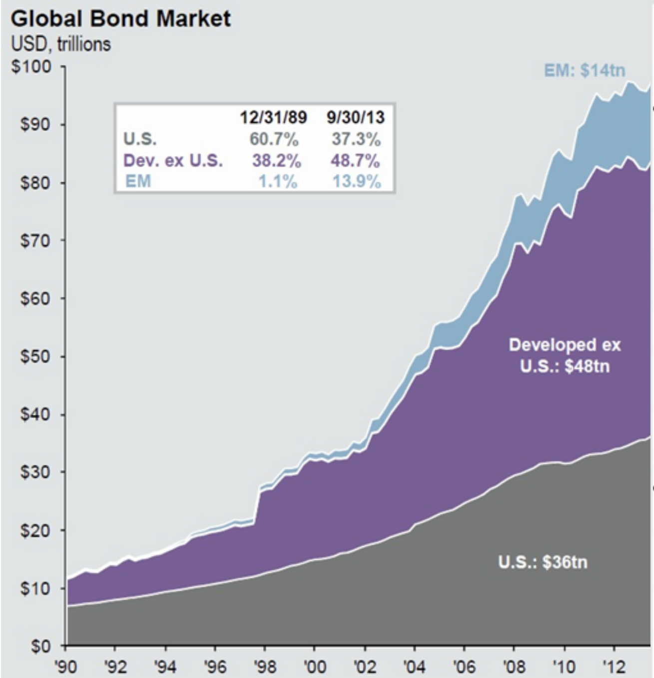


The Fixed Income Opportunity Set

The fundamental mismatch of participant income needs and fixed income offerings could be addressed by offering a series of income oriented asset classes such as Bank Loans, Inflation-Protected Bonds, High Yield Bonds or Emerging Market Debt. Another approach would be to offer one or two fixed income options with significantly different characteristics than the core intermediate-term solution likely already available. Accomplishing this task requires a delicate fiduciary balance of adapting to the evolving participant demographics with the behavioral finance challenges and educational hurdles of introducing a new investment option.

To better address income needs both an understanding of the global fixed income opportunity set and the comparative performance of these investments against the Barclays US Aggregate Bond Index is necessary. In evaluating global fixed income, even at a very high level, several key distinctions quickly emerge:

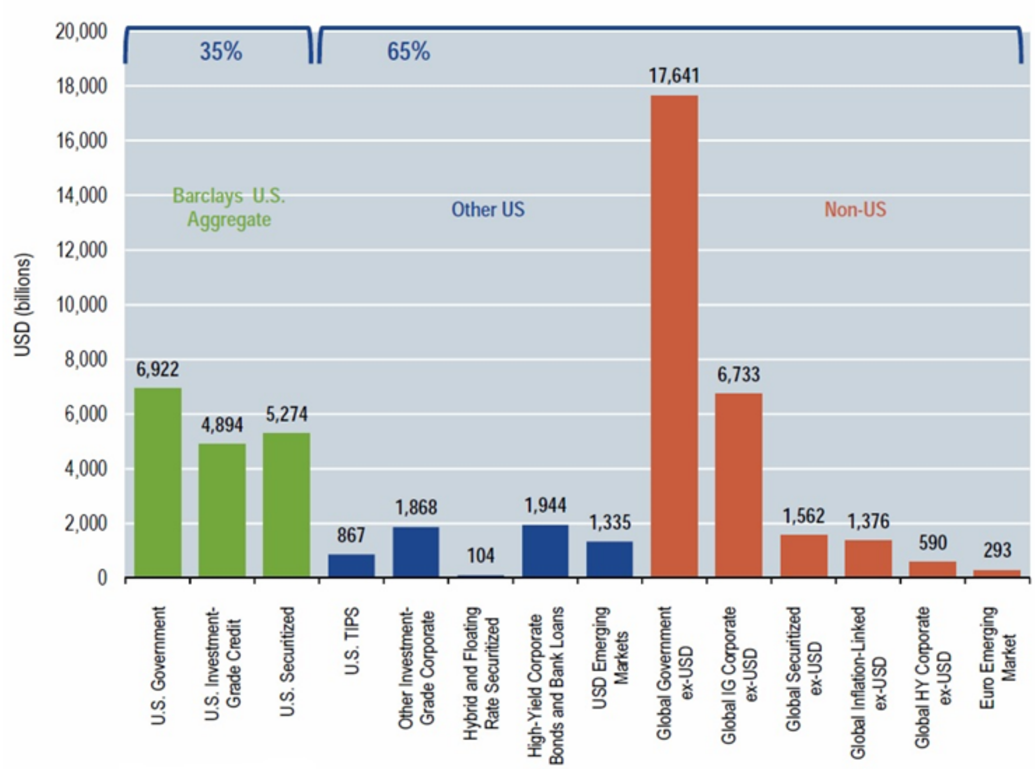
- The US fixed income opportunity set represents only 37.3% of the global fixed income landscape
- Emerging market yields are generally higher than equivalent US issues
- Global credit opportunities may offer portfolio diversification benefits, via lower correlation to the U.S. 10-year Treasury.



			Yield	Return	
Aggregates	Correl to 10-year	Duration	Current	1Q14	2013
U.S.	0.83	5.7 Yrs	2.37%	1.84%	-2.02%
Gbl. ex. U.S.	0.39	6.7	1.74%	2.72%	-3.03%
Japan	0.54	8.0	0.57%	2.82%	-15.87%
Germany	0.26	5.7	1.13%	2.16%	2.59%
U.K.	0.18	8.6	2.56%	2.74%	-0.58%
Italy	0.08	6.2	2.37%	5.03%	11.56%
Spain	0.11	5.4	2.07%	5.16%	15.52%
Sector					
EMD ($)	0.19	7.1	5.86%	3.48%	-6.58%
EMD (LCL)	0.05	4.6	6.88%	1.90%	-8.98%
Euro Corp.	0.10	4.5	1.77%	2.36%	2.37%
Euro HY.	-0.41	3.9	4.62%	3.28%	9.90%

Source: Barclays Capital, BIS, FactSet, J.P. Morgan Asset Management. Fixed income sectors shown above are provided by Barclays Capital and are represented by the global aggregate for each country except where noted. EMD sectors are represented by the J.P. Morgan EMBIG Index (USD) and the J.P. Morgan GBI EM Global Diversified Index (LCL). European Corporates are represented by the Barclays Euro Aggregate Credit – Corporate Index and the Barclays Pan-European High Yield index. Sector yields reflect yield to worst. Duration is modified duration. Correlations are based on 7-years of monthly returns for the all sectors. Past performance is not indicative of future results. Current data are as of 3/31/2014 unless otherwise noted. Guide to the Markets – U.S. Data are as of 3/31/14.

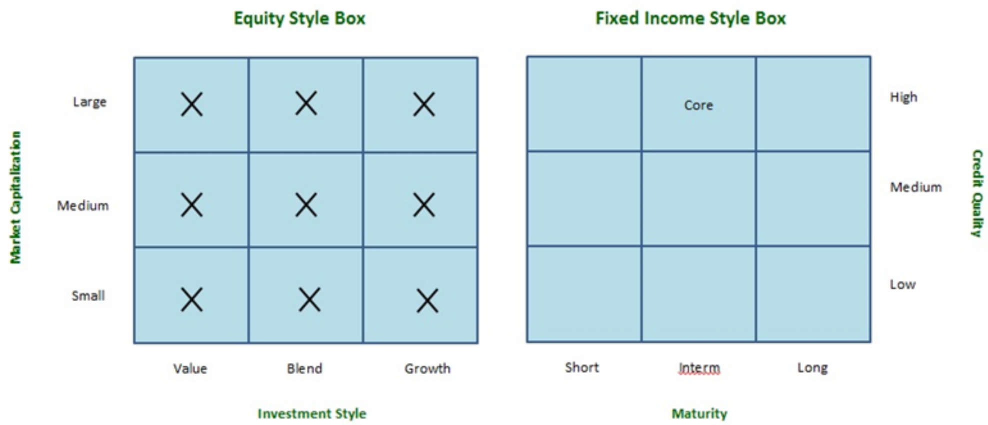
Furthermore, comparing the composition of the Barclays US Aggregate Bond Index with a globally representative sample index of the global fixed income opportunity set underscores the significance of non-US government bonds, non-US corporate bonds, high yield and emerging market debt, amongst other sectors.



Money managers are introducing new products to the market to help plan sponsors and investment consultants fulfill their fixed income objectives but the requisite income and diversification benefits could be met by introducing as few as one new option to achieve an optimal fixed income allocation.

DC Fixed Income Allocation

Fixed income investments represent an essential component to DC plan menu design, yet historically, plan sponsors have not dedicated nearly the number of options to fixed income investments when compared to equity. DC plans typically offer equity choices that cover the nine “style boxes” for domestic equities that span both market capitalization and investment styles (value-to-growth spectrum). These domestic options are usually complemented by international, global and/or emerging market equity funds. Fixed income, however, has been represented by one or two core strategies that are benchmarked against the Barclays US Aggregate Bond Index.



The next generation of DC investment menus should offer a mix of fixed income funds that better represent the global fixed income landscape and offer various diversifying yield and sector exposures complementing existing core strategies. Giving DC participants access to fixed income investment options that provide geographic, credit and duration diversification is a plan sponsor best practice. Dynamically changing participant demographics, the thirst for non-traditional sources of income and the fiduciary responsibility to provide fixed income diversification are forces that should encourage plan sponsors to explore these options. Participants will appreciate a combination of high income, global diversification, flexible duration and prudent risk management.

Summary

Changes in participant demographics are encouraging Plan Sponsors to revisit their DC fixed income offerings. The intersection of income needs and diversification potential are critical to helping participants in retirement or nearing retirement age achieve their desired income needs. Adding a complementary fixed income option to sit alongside a "core" bond offering may optimize the plan menu in this new DC paradigm.

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About Sheridan Road Advisors

Sheridan Road Advisors, LLC ("Sheridan Road", the "Company", or the "Firm") is an independent, objective, and holistic institutional investment consulting firm that provides Retirement Plan Consulting Services, Executive Benefits and Wealth Management Services. We oversee approximately $10.5 billion in assets and serve more than 260,000 participants in our retirement plans. Sheridan Road focuses on both corporate and tax-exempt defined contribution and defined benefit retirement plan consulting with approximately 80% of the total assets under management coming from these services.

Sheridan Road currently works with approximately 230 retirement plan clients across more than 20 states representing virtually every market segment and industry group. Our clients' retirement plans range in size from the middle-market (< $50 million) to the institutional plan market (> $1 billion). The Company has offices in Chicago, Indianapolis, Milwaukee, Minneapolis, Nashville, New York, and Tampa to better service our client base.

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