A Case for Core Plus Fixed Income Strategies in Defined Contribution Plans

By the Loomis Sayles Defined Contribution Services

KEY TAKEAWAYS

- Core plus fixed income strategies can offer DC plan sponsors and investors broad market sector exposure in a single product.
- By emphasizing income and capital appreciation, core plus can add to the overall return potential of a participant's portfolio at different life stages.
- Tactical investing across multiple bond sectors entails risk and is a complex discipline. Careful investment manager selection is critical in this category.

Plan sponsors may be able to add meaningful single-portfolio diversification to their defined contribution (DC) plans by looking beyond traditional DC investment options and learning more about the advantages of core plus fixed income strategies.

The Role of Core Plus

Providing access to investments that offer a prudent level of diversification potential is one of the primary responsibilities of plan sponsors in their role as fiduciary. By delivering broad fixed income sector exposure in one professionally managed portfolio, core plus strategies can increase the asset class options available to plan participants and may help them maximize asset allocation potential. And for participants who might otherwise seek separate investments in corporate, government, high yield and non-US-dollar bonds, core plus can be a cost-effective fixed income solution that keeps the investment option menu simple. Finally, core plus strategies offer the potential for total return as well as yield advantage, and they can play an effective role within a custom target-date fund structure.

A Greater Focus on DC Plans

DC plans are becoming the primary corporate retirement vehicle. Given this trend, DC participants may benefit from maintaining a significant allocation to fixed income investments, similar to defined benefit (DB) plans. A typical corporate DB plan, for example, holds roughly 40% of its assets in fixed income in an effort to improve risk-adjusted returns and match assets to liabilities.[1] Looking ahead, many DC plan participants who are forced to take a greater role in their own retirement planning will likely rely on fixed income securities for similar reasons. In pre-retirement years, fixed income investments can help dampen the volatility of equity returns and reduce the potential for significant portfolio loss as principal preservation becomes more important. In retirement, the income generation potential of bond funds can help provide a smoother stream of distributions.

Core Plus Portfolios For Accumulation and Income

Core plus strategies in a DC plan can provide exposure to a range of fixed income securities. They have the flexibility to pursue opportunity in various sectors, including those outside of the domestic US-dollar investment grade markets. This can enable core plus strategies to add to the overall return potential of a participant's portfolio at different life stages.

Most investors approaching retirement need better risk-adjusted returns than equities alone can provide. Core plus strategies emphasize income and capital appreciation, which may make them an attractive choice for plan participants seeking to expand their sources of appreciation potential beyond equities. Investors in the distribution phase can also benefit from a total return objective, particularly in a low or rising rate environment. As income assumes an increasingly important role, "plus sectors," such as high yield, non-US dollar and emerging markets, can provide a yield advantage. They also allow the potential for capital appreciation through active sector allocation and issuer selection. However, investors should be cognizant of the potential risks associated with investing in these sectors, including credit, currency and market risk.

Growing Fiduciary Responsibility

Diversification has always been a key component of the fiduciary responsibility provisions within ERISA, but the definition of fiduciary responsibility has evolved. In the legislation first enacted over 30 years ago, investment diversification was intended to minimize the risk of large investment losses to the plan. In recent years, however, retirement investing has become increasingly complex.

As sponsors begin to incorporate more fixed income strategies into their plans, they will need to provide choices that can help participants navigate the vagaries of the bond market, especially as interest rates rise from historical lows and economic conditions fluctuate. Core plus strategies are one practical solution to some of the fixed income challenges facing today's plan sponsors.

[1] *Towers Watson, "Accounting for Pensions and Other Postretirement Benefits, 2014."*

Defining Core Plus Strategies

Core plus strategies typically divide assets among US government bonds, foreign government bonds, foreign corporate bonds, domestic corporate bonds (including high yield issues) and securitized credit. Figure 1 shows the annual returns of various bond categories over the past ten years.

FIGURE 1: EXPOSURE TO MULTIPLE BOND SECTORS MAY ENHANCE DIVERSIFICATION & INCOME (%)

Source: *JP Morgan, Barclays, Standard & Poor's, BofA Merrill Lynch. Annual data from January 2005 to December 2014. Results displayed in US dollars and sorted in descending order.*

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
10.73	11.85	11.30	12.39	58.21	15.12	9.02	18.53	7.44	7.46
5.08	9.88	8.66	11.40	51.62	12.04	8.46	15.81	5.29	5.53
2.96	6.85	6.28	-4.94	28.18	11.78	8.15	9.82	0.62	4.92
2.74	6.77	4.56	-10.91	18.68	10.13	5.91	9.66	-1.53	3.09
2.65	5.33	2.02	-20.74	18.50	9.00	4.98	6.38	-2.60	2.45
1.68	4.30	1.87	-26.16	3.94	6.78	4.08	2.02	-5.08	1.60
-9.24	3.48	-0.88	-29.10	-2.20	5.52	1.52	0.85	-6.58	-2.53

- Barclays US Corporate High Yield Index
- Barclays US Corporate Investment Grade Index
- Barclays US Government Index
- S&P/LSTA Leveraged Loan Index
- JPM EMBI Global Index
- JPM GBI ex-US Unhedged Index
- BofA ML US ABS & CMBS Index

The performance shown represents index performance and does not represent any Loomis Sayles investment product. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

A typical single core plus bond strategy can include these sectors:

- *Investment Grade Corporate Bonds.* High-quality investments with a Standard & Poor's credit rating of BBB or higher or a Moody's credit rating of Baa or higher.
- *High Yield Corporate Bonds.* Issued by companies considered to be a higher credit risk, rated BB or lower. These bonds typically pay a higher yield than higher-quality fixed income securities.
- *Securitized Credit.* Securities backed by a collection of cash flows from assets such as credit card or auto loan receivables, or commercial or residential mortgage payments.
- *US Government.* US government obligations including Treasurys and agency bonds that are highest in quality and generally imply little to no credit risk.
- *Emerging Market Debt.* Includes bonds issued by developing countries.
- *Non-US Dollar.* Issues denominated in a currency other than the US dollar can benefit from a currency's appreciation versus the US dollar. Non-dollar positions may provide access to yields that exceed what the US markets offer and lessen exposure to US interest rates.
- *Bank Loans.* Investments in senior, secured floating-rate debt of corporate borrowers.

Sectors like high yield and non-US dollar allow core plus managers to scour a broader opportunity set when constructing a portfolio. The challenge lies in determining where to deploy capital at any given time. A thorough top-down assessment of the global macroeconomic environment and capital market drivers combined with security-specific research insight and an experienced portfolio management team can help identify the best ideas for each unique market environment. For participants who want their fixed income sector allocations to evolve along with changing market conditions, a tactical, research-based core plus strategy may be an appropriate solution. Of course, diversification does not ensure a profit or guarantee against a loss. Please see important risk disclosures at the end of this paper.

Multiple Sectors, One Recordkeeping Slot—Keeping it Simple

Another benefit to covering multiple asset classes with one investment choice is simplicity for plan participants. Research has shown that simpler plans tend to have higher participation rates because they are less overwhelming and easier to understand. Since a core plus strategy takes only one investment slot, it leaves room for other investments that can also add potential diversification and total return to a participant's portfolio.

It is equally important that the individual investment options be understandable, and some core plus products offer more transparency than others. Strategies that invest using all cash bonds and reserve derivative exposure for duration management tend to be more transparent.

Seeking to Hedge Against Rising Interest Rates

As Figure 2 shows, interest rates have been trending downward for the better part of three decades. Many sponsors may not have experienced an extended period of rising rates and the adverse effects such an environment can have on their plans' fixed income investments. One important advantage of tactical, diversified core plus strategies is that their performance is not typically closely tied to interest rates. When rates rise, managers have the flexibility to seek returns from sectors or foreign markets that may not be affected.

FIGURE 2: US 10-YEAR TREASURY RATES FROM JANUARY 1971 TO DECEMBER 2014

Source: *Federal Reserve, history through December 2014.*

The Importance of Careful Manager Selection

Investing across multiple bond sectors is a complex investment discipline. In our view, portfolio performance depends more on the investment manager's ability to effectively execute a strategy than on the overall performance of the bond market.

A core plus portfolio manager who understands the dynamics of bond duration, yield curves, currencies, and sector behaviors can pursue high risk-adjusted returns through portfolios that have the flexibility to take advantage of changing market conditions. Careful investment manager selection is critical to evaluating strategies in this category. A fixed income manager who has experienced a range of market cycles may be prepared to make difficult calls, understanding which sectors to invest in and when.

Adding a well-managed core plus bond strategy to DC plan options may be one way to improve overall plan diversification and provide added choice for participants as they seek to build more resilient long-term portfolios.

This report was originally published in February 2014. We have updated the content as necessary and otherwise believe the information is current and relevant.

About Risk

Strategies that invest in bonds can lose their value. When interest rates rise, bond prices usually fall and vice versa. Credit risk (the risk that the issuer or borrower will fail to make timely payments of interest and/or principal) is heightened for lower rated or higher yielding fixed-income securities and lower rated borrowers. In addition, lower-rated debt securities may be subject to greater price volatility. Below investment grade (also known as high yield) securities are subject to a high degree of market and credit risk. In addition, the secondary market for these securities may lack liquidity, which in turn may adversely affect the value of these securities and that of a strategy. Foreign investments involve special risks including greater economic, political and currency fluctuation risks, which may be even greater in emerging markets. Securities issued by US government-sponsored agencies are not insured, and may not be guaranteed by the US government. Portfolios investing in these strategies are subject to currency risk (the risk of fluctuations in exchange rates between the US dollar and foreign currencies), which could cause the value of the portfolio's investments to decline.

Disclosure