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DC Plan Sponsors: Now's the Time to Get More From Bonds

It's perhaps the most important decision that affects Americans' retirement readiness: what investments to include in defined contribution (DC) plans such as 401(k)s. Companies sponsoring DC plans typically aim to promote diversification by offering choices that span asset classes and investment strategies. Yet behavioral research confirms that many DC participants simply spread their assets evenly across the core lineup. Since investment menus tend to be long on equities and light on bonds, diversification suffers – even more so since risks in common benchmarks themselves have grown more concentrated. Indeed, in a DC lineup where seven in 10 choices invest in equities an individual allocating their assets evenly could have a portfolio with 98% of the volatility driven by equity risk, according to PIMCO's analysis.

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We believe it's time for DC plan sponsors to review their core lineups given equity levels at historical highs and interest rates at record lows. To better manage risks and generate returns, it's critical that plan members' investments have appropriate diversification and flexibility. While paring equity offerings may be one step, we believe reviewing fixed income lineups is another consequential move. The inclusion of active strategies with global exposure or additional income opportunities could help participants achieve successful retirement outcomes. Inflation-hedging assets also are fundamental for retirement savers and deserve their own place in DC core lineups. (See "Designing Outcome-Focused Defined Contribution Plans: Building Sustainable Income for Retirees").

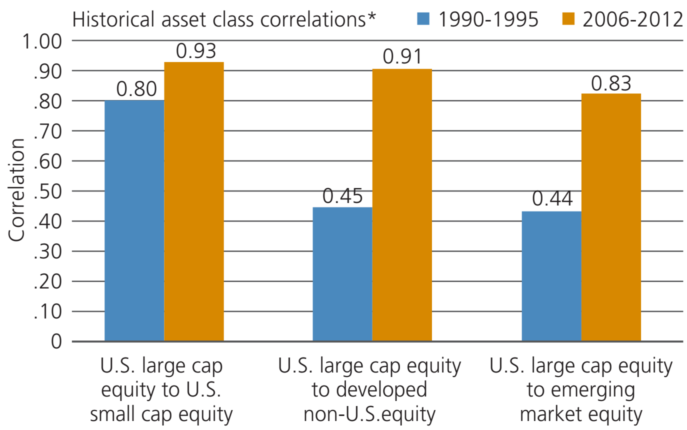
Boxed in

The relative dearth of fixed income options in plan lineups is a legacy of style-box investing. Many plan sponsors have packed their menus with strategies matching each of the nine equity style boxes (large, medium and small cap vs. value, blend and growth). According to the latest survey by the Plan Sponsor Council of America (PSCA), the typical DC plan offers 19 investment choices – but often only one in the bond category. Although

This article focuses on DC plans in the U.S.

style-box approaches aim to promote diversification across equity investments, their ability to do so has fallen as correlations among equity styles have grown in recent decades (see Figure 1).

FIGURE 1: EQUITY CORRELATIONS ON THE RISE



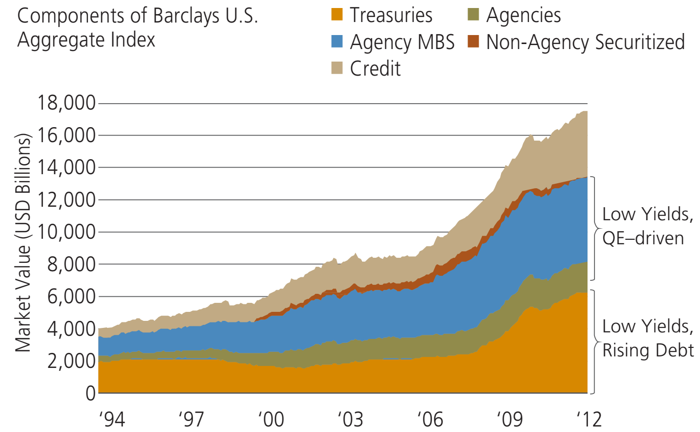
Source: PIMCO as of 31 December 2012
*U.S. Large Cap Equity: S&P 500 Index; U.S. Small Cap Equity: Russell 2000 Index; Developed Non-US Equity: MSCI ACWI ex US Index; Emerging Market Equity: MSCI EM Index.

Bonds unleashed

A similar concentration risk may exist in fixed income core lineups where the sole bond option is an index fund benchmarked against the Barclays U.S. Aggregate Bond Index (BAGG). In these cases, adding, rather than paring, investment choices may offer the best solution. Because the BAGG is a market capitalization-weighted index comprising U.S. investment grade bonds, the share of U.S. Treasuries in the index hit a 10-year high of 36% at the end of 2012 as the U.S. government has continued to finance its deficits through debt issuance. Notwithstanding increasing levels of U.S. debt and the downgrade of the U.S. government's credit rating in 2011, yields have fallen to historical lows. The driver, of course, has been the U.S. Federal Reserve, which has sought to anchor short-term interest rates near zero while driving interest rates lower on longer-term government and mortgage-backed securities (which compose more than 70% of the index) through its quantitative easing programs (see Figure 2). In short, the growing weight of government-related securities in the BAGG coupled with low interest rates for a large portion of the index suggests limited scope for capital appreciation and may increase the risk of losses when rates rise. Plan sponsors should consider bond options that have the ability to actively manage risks, invest globally and enhance yield relative to the index.

PIMCO expects that low policy rates will prevail for some time, perhaps until the economy reaches the Fed's unemployment and inflation targets. By then, of course, it will be too late: Markets move quickly and DC plan participants need to be prepared before the economy shows signs of sustained improvement.

FIGURE 2: THE BARCLAYS U.S. AGGREGATE HAS GROWN MORE CONCENTRATED IN GOVERNMENT-RELATED DEBT



Source: PIMCO as of 4 February 2013

Go active

We believe the goal of diversification and superior outcomes could be better achieved if core DC bond offerings included active options that are not passively tied to the BAGG. If a lineup has only a single bond option, an actively managed strategy that can tap into global markets may be best. Consider that during the past 25 years the active bond strategies with the most assets in 401(k) plans collectively outpaced the BAGG, including during periods of rising rates (see Figure 3). Unlike strategies that attempt to replicate the risks of the index, active bond managers can modify interest-rate and other risks by adjusting a portfolio's duration, fine-tuning yield-curve positioning, increasing allocations to international bonds, including those in developing markets, and using inflation-linked bonds – which, surprisingly, are not part of the BAGG.

Indeed, $100,000 invested in these active managers in May 1987 would have grown, on average, to $650,722. If it had been invested in the BAGG, however, it would have grown to only $596,000. The best-performing active strategies, of course returned significantly more.

Go global

Investing globally in fixed income can help plan members reach common retirement goals through the potential for higher returns, greater diversification of risks and inflation hedging. As capital markets have deepened around the world, the U.S. share of the global fixed income market shrank to only 37% at the end of September 2012, according to Bank for International Settlements data. Just as U.S. companies have focused overseas to capture broader, global sources of growth, so too should DC plan participants.

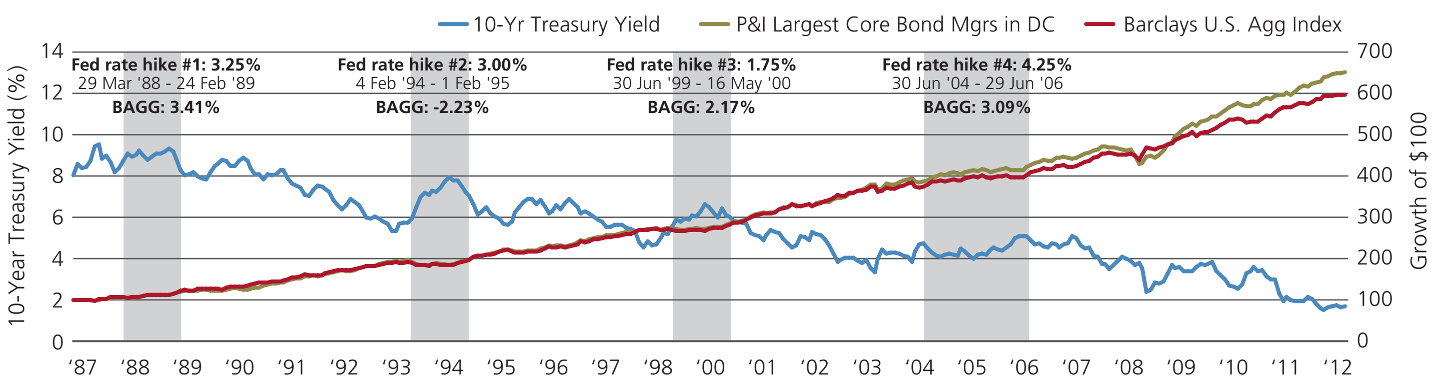
For plan sponsors open to additional fixed income options, active global bond strategies can help avoid the pitfalls of benchmark-tracking approaches. Like the BAGG, the JPMorgan Government Bond Index Global, the most widely used global government bond benchmark, suffers from concentration risk. Given that the eurozone crisis is far from resolved, it's a concern that eight of the 13 governments in the index are European. Moreover, low-yielding bonds of just four developed economies – the U.S., Japan, Germany and the U.K. – compose more than 75% of the index. In an era of monetary policy coordination in developed markets, this concentration works against the goals of diversification, higher yields and downside risk mitigation.

In contrast, active global strategies benchmarked against alternative indexes not tied to traditional weightings such as outstanding debt can align investors with global growth trends and potentially reduce exposure to highly indebted countries. PIMCO's Global Advantage Strategy, for instance, invests across global markets using a patented GDP-weighted approach. It seeks to help bond investors gain greater exposure to areas of global growth and higher yields because its GDP-weighted index is more inclusive of emerging market countries with stronger underlying fundamentals and is less exposed to highly indebted developed countries. It's a more forward-looking approach harnessed to evolving growth opportunities.

Increase income

Finally, because many participants are seeking higher returns or income, plan sponsors open to multiple bond options may consider strategies focused on yield to help participants maximize and preserve wealth. A single strategy that commingles high yield, investment grade corporate bonds and emerging market debt – or a combination of these and other asset classes – could minimize the potential volatility of individual strategies, provide professional asset allocation across market segments and simplify participant communication.

FIGURE 3: THE LARGEST ACTIVELY MANAGED STRATEGIES HAVE BEATEN THE BARCLAYS AGGREGATE OVER THE PAST 25 YEARS



Source: PIMCO as of 4 February 2013

The "*Pensions & Investments* largest core bond managers in DC" composite performance was calculated as follows: PIMCO took the list of the 50 largest domestic fixed income strategies held within U.S. DC plans, as identified by *P&I*, and identified the 16 strategies that represent active core managers as defined by Morningstar. Then, using publicly available data for the commingled vehicle run by each manager, we averaged monthly returns for each of the 16 strategies over a 25-year period. Commingled vehicles with a track record shorter than 25 years were added to the composite based on their inception date.

PIMCO's Diversified Income Strategy, for example, may serve as a risk-managed, income-oriented and global multi-sector complement to traditional core bond holdings. It pursues a global opportunity set, focusing on bonds that provide higher yield than government securities. Key areas include investment grade corporate, high yield and emerging market bonds, as well as other sectors offering attractive relative value opportunities. In addition, the Diversified Income Strategy is designed to offer stable recurring coupon payments and relatively low correlation with developed market government bonds.

Broader options, broader benefits

As the global economy heads toward an inflection point, we believe now is the time for DC plan sponsors to re-evaluate their investment lineups. Today's equity-heavy DC plan lineups coupled with the tendency of participants to naively allocate their investments evenly across strategies –"the 1/N Rule" in industry argot – may expose them to extreme market risks.

Plan sponsors could potentially improve retirement outcomes by trimming choices for stocks and considering additional options for bonds. Depending on the desired core lineup structure, sponsors may retain or add a single diversified bond strategy such as PIMCO Total Return. Others may prefer a broader menu that includes a global bond option followed by a diversified income strategy.

John Miller, Julie Salsbery and Loren Sageser also contributed to this article.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the **bond market** is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in **foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. **High-yield, lower-rated, securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. The correlation of various indices or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility.

Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. JPMorgan GBI Global (Unhedged) is an unmanaged market index representative of the total return performance in U.S. dollars on an unhedged basis of major world bond markets. It is not possible to invest directly in an unmanaged index.

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