Enhancing Fixed Income Menus to Meet Evolving Participant Needs

NEUBERGER BERMAN

Today, over 60% of Americans working in the private industry have access to employer-sponsored defined contribution (DC) retirement plans.[1] DC plans have accumulated $9.6 trillion in assets as of Q3 2023—a 109% increase since 2007[2]—and now represent 28% of all U.S. retirement assets. The growing importance of DC plans to Americans' retirement security has raised new concerns about whether plan menus, particularly their fixed income offerings, are positioned to meet evolving participant objectives.

Participants nearing and in retirement are faced with a growing challenge of generating income while managing investment risks. Plan sponsors are faced with providing a menu to help participants meet this challenge. In our view, many plan menus are in need of adding flexible fixed income options—namely multi-sector fixed income portfolios—that can better address this challenge.

63% of 401(k) plan assets are held by participants in their **50s or 60s.**[3]

As they approach retirement, participants are more likely to engage with their asset allocation.

Participant Profiles Have Evolved—So Should Plan Lineups

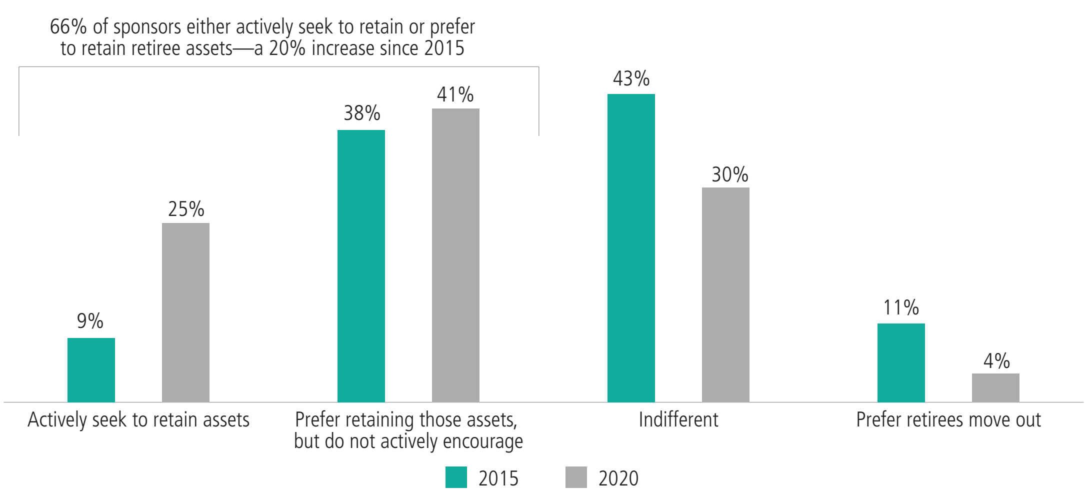
The demographic profile of DC plan participants has changed significantly over the past two decades. Twenty years ago, the bulk of participants were accumulators who needed investment options focused on growth to help them amass greater assets for retirement. Today, however, the majority of 401(k) assets are held by participants at or near retirement age, and their needs are very different.

Surprisingly, despite this meaningful shift in participant composition, plan menus have remained largely unchanged. On average, a typical lineup today consists of roughly 18 total investment options, with the majority of those options being equity funds and only two or three being fixed income and/or cash alternatives (e.g., stable value or money market funds).

Participants nearing retirement are limited in suitable fixed income options within their DC plans. In our view, plan menus with fixed income offerings constrained to only a core bond or stable value fund are unlikely to deliver the capital preservation and income generation that near-retirees are seeking, potentially putting the success of these participants' retirement outcomes at risk.

Additionally, plan sponsors' views on keeping participants in the plan post-retirement have changed over time. In the past, participants were expected to retire and roll their assets out of the plan. Now, more than 60% of employers want to keep retirees in their plan,[4] and sponsors may need to adjust their investment options in order to improve participant retention.

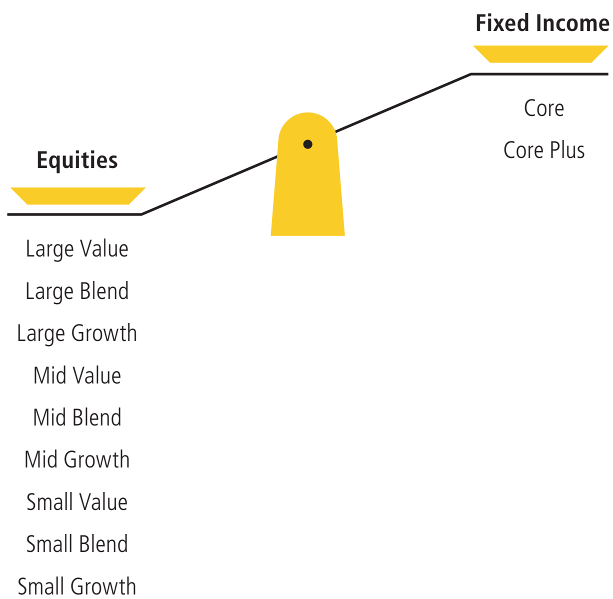
Plan sponsors are increasingly focused on retaining assets in-plan



Source: PIMCO Defined Contribution Consulting Support and Trends Survey April 2015, June 2020.

Fixed Income Markets Have Evolved, Yet There Are Too Few Fixed Income Options in Plans

In today's investment landscape, defined contribution plans often provide a wide array of domestic equity style boxes, typically offering nine distinct options that cater to various market capitalizations and investment styles (value, blend and growth), and typically offer additional foreign equity options as well. However, when it comes to fixed income options, these plans often fall short, usually limiting choices to just core and core plus bond funds. This lack of diversification across the credit spectrum is a significant oversight, especially given the current investment environment where investment-grade yields are well positioned to meet retirement income requirements. Expanding the range of fixed income choices would not only align with the diversified approach seen in equity offerings, but also offer participants the necessary tools to construct well-rounded, income-generating portfolios. More fixed income options are needed to ensure adequate diversification and to address the varying risk tolerances and income needs of plan participants.



Core and Core Plus Strategies: Are They Enough for Participants' Retirement Goals?

While core and core plus bond funds serve as foundational elements in many defined contribution plans, they often miss the mark in providing the necessary diversification and yield potential to meet the complex needs of participants striving for a secure retirement. These funds typically focus on high-quality, investment-grade bonds and may include a limited allocation to higher-yielding sectors in the case of core plus funds. However, this narrow focus can constrain returns and limit opportunities for enhanced income, especially in a low-interest-rate environment. To truly optimize retirement outcomes, participants need access to a broader array of fixed income options that can offer higher yields, better diversification across credit qualities and more effective interest rate management.

Fixed Income Investing Is Complex, but a Retirement Tier Could Help

To address the shifting needs and concerns of the retiring workforce, an increasing number of plan sponsors are evaluating the importance of keeping participants invested in their DC plans through retirement.

The term Retirement Tier is used to describe a platform of investment products, tools and services designed specifically for plan participants nearing and in retirement who are interested in remaining invested in their employer-sponsored DC plan. The product solutions and educational resources within the tier are tailored to take into account the specific goals and needs of participants who are transitioning to and in the spending phase.

Separate from the traditional tiers commonly referred to by DC industry professionals (see tiers 1 – 3 in the below display), the Retirement Tier is intended to be a complementary feature and refers to a range of retirement-oriented services and investment options rather than a single retirement income solution.

When adding a Retirement Tier, a DC plan menu may consist of the three traditional tiers with an additional collection of core menu options selected specifically for nearing and current retirees.

Potential Retirement Tier Options

The Retirement Tier could be as simple as directing participants to the options in the existing plan menu that may be appropriate for those near or in retirement, such as Target Retirement Income fund (the final portfolio in the target date series). However, since most plans have built those menus for accumulators chances are some additional options may be needed to sway participants to remain in the plan. Options to consider could include additional fixed income choices, income producing equity solutions, target payout funds and guaranteed options. Some of these will require the plan sponsor to take time to understand the features, benefits and complexities that come with these newly designed strategies. Others will be easier to evaluate and add. Regardless, most can agree that along with any of these strategies, there will be a need for more education and advice to help plan participants improve their retirement outcome.

A Retirement Tier Complements the Traditional Tiers

TIER 1

Do it for me:
QDIA

- Target Dates Series
- Managed Accounts

TIER 2

Do it with me:
Core Menu

- Domestic Equity
- International Equity
- Fixed Income
- Capital Preservation

Retirement Tier Menu

- Decumulation Investment Solution
- Growth Investment Solution
- Conservative Withdrawal
- Moderate Withdrawal

TIER 3

Do it myself:
Brokerage Window

- Self-directed
  (Not used by all plans)

Educational Tools and Resources

Why Not Just Use Target Date Retirement Income Funds?

They May Have Too Much Equity Exposure for Some Participants

Most target date fund series roll into some version of a target date retirement income fund when the fund reaches its target dated year. These funds usually maintain an allocation to equities of 35% to 65% depending on the target date fund manager. This level of equity exposure may be acceptable for recent retirees, but those who are further into retirement may want to reduce equity exposure while still investing in a diversified fixed income portfolio where the allocation to fixed income sectors is managed by a portfolio manager.

Retirement income vintages are so overweight equities and risk assets currently and historically because they had to be when rates were so low. However, the yield environment has changed to a point where investors are not forced into holding excess risk capital as they may have been during the last decade.

Multi-Sector Fixed Income as a Non-Equity Option Retirement Tier Option for the "Do-It-For-Me" Participant

Offering a multi-sector bond portfolio can be a good way to expand the choice of asset allocation portfolios for retirees that you are looking to keep in the plan post-retirement. The addition of a multi-sector fixed income fund is a way to offer participants' an additional option beyond money market and core bond that may serve them more effectively than the final target date portfolio.

In our view, providing a multi-sector fixed income fund is an important component of a Retirement Tier. It takes away the high levels of equity exposure found in the final target date fund that can run counter to the needs of income- and capital preservation-oriented investors while retaining all the benefits of a portfolio manager actively adjusting the asset allocation of the fund—including the ability to shift allocations across bond sectors, credit levels and duration—that participants like about using target date funds.

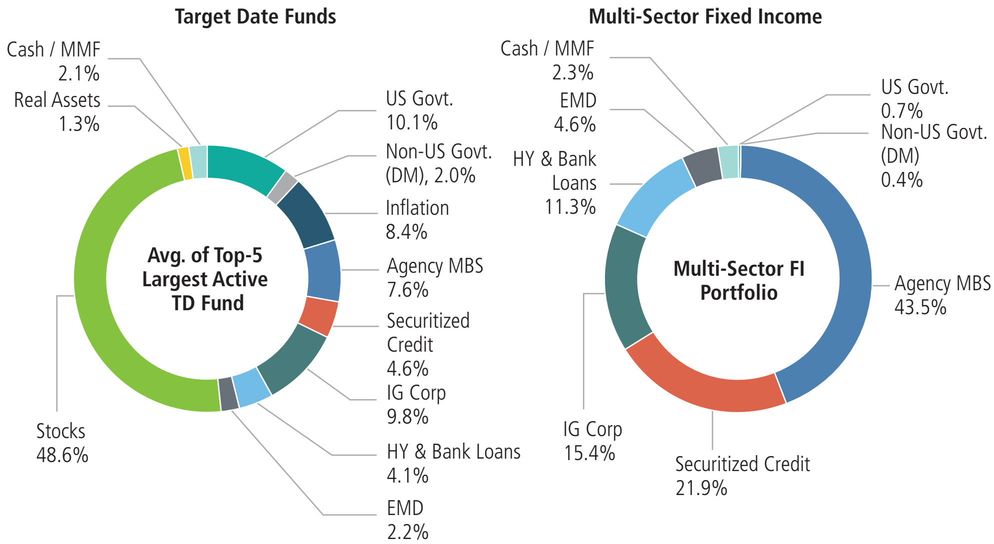
Even if a plan offers a variety of standalone fixed income strategies, it may be unrealistic to expect participants to allocate to them within portfolios and adjust their portfolios in light of market changes and individual needs—reinforcing the value of a professional manager within the multi-asset option.

At the end of the day, the right Retirement Tier solution comes down to what you think offers the participants a diverse enough set of options to remain in the plan post-retirement. It's our belief that complementing a core offering with a multi-sector product can enhance a participant's fixed income toolkit and return/income potential amidst a rapidly changing market environment.

Multi-Sector: An All-in-One Solution Without the Equity Risk of the Final Target Date Fund

Diversifying credit exposures within multi-sector can help solve for a part of the ongoing demand for risky assets in retirement vintages. Focus on downside mitigation when you need principal preservation.

Asset Allocation Comparison



Source: Morningstar. Target date fund allocation is the average of the top five TDFs by assets as of June 30, 2024. The multi-sector allocation is hypothetical, based on the views of our fixed income team.

Multi-Sector Fixed Income Offers an Attractive Risk-Return Profile

A key argument in favor of TDFs and their maintenance of equity weightings is that those recent retirees may need that exposure to help offset the impacts of inflation and longevity. However, multi-asset fixed income portfolios can hold high yield, emerging markets debt and other assets that, while somewhat more volatile than traditional fixed income, can provide additional total return potential without the level of risk associated with stocks—both in terms of overall volatility and historical drawdowns (see display).

Attractive Returns with Lower Drawdown Risk

Performance and Risk
Last 20 Years Through June 30, 2024

	Total Return	Std Deviation	Avg Drawdown	Max Drawdown
U.S. HIGH YIELD	6.53%	9.08	-5.68%	-33.23%
EMERGING MARKETS DEBT	5.89%	8.95	-6.25%	-25.85%
S&P 500	10.29%	14.96	-10.17%	-50.95%

Source: Morningstar. High Yield represented by the Bloomberg High Yield Corporate Index and Emerging Markets Debt by the JPM EMBI Global Diversified Index. Returns are annualized. Data as of June 30, 2024.

DC plan sponsors could consider revising their plan menus to offer more fixed income options that better align with their participants' desire for income and capital preservation, while also helping to protect against risks like interest rate volatility and inflation that participants face in retirement.

Like a Target Date Fund, Multi-Sector Fixed Income Solutions Quickly Adjust for Changing Market Conditions

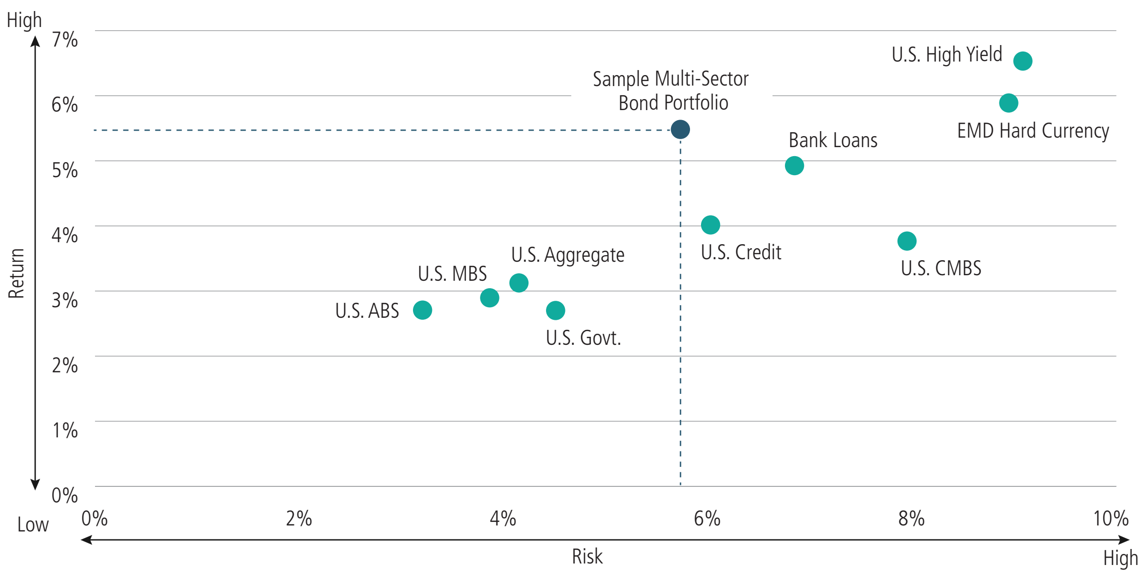
Fixed income markets can change quickly. Given how quickly the market moves, it would be difficult for even the most knowledgeable and engaged participant to reallocate their portfolio to avoid risks and take advantage of opportunities.

To help alleviate this difficulty, plan sponsors looking to upgrade their fixed income offerings, but wary of expanding and complicating their menu options, may want to consider adding a flexible multi-sector fixed income fund.

The portfolio managers of an active multi-sector strategy can look across markets for what they believe are attractive investment opportunities and add value through asset allocation, security selection, duration/yield curve positioning and currency management. As the chart below illustrates, we believe the ability to employ a greater variety of approaches through an active strategy may lessen participants' vulnerability to interest rate volatility and allow adjustments for changing market conditions, resulting in a potentially better risk/reward profile for participants.

Multi-Sector Portfolios Have the Potential to Offer an Attractive Risk-Return Profile[5]

20-Year Risk/Return Profile



Source: Neuberger Berman, Bloomberg Barclays, ICE BofAML, JPMorgan and S&P/LSTA, as of June 30, 2024. **Past performance is no guarantee of future results.**

Not All Multi-Sector Fixed Income Strategies Are the Same

That being said, it's important to note that the multi-sector universe is a diverse peer group and not all multi-sector managers take the same approach. Some managers take a more diversified approach, while others tend to be less diversified, reflecting a persistent bias to a few select sectors. Some less-diversified managers may take large sector positions in high yield or securitized loans while others may add equities to the portfolio, making it important to understand the strategy and process being implemented when selecting a multi-sector manager.

We Believe That the Addition of a Multi-Sector Fixed Income Product in a Retirement Tier Helps to:

1. Provide participants with an all-in-one professionally managed fixed income option similar to the target date fund
2. Complement "traditional" core fixed income funds while providing equity diversification in an effort to best suit the needs of participants throughout their full investment lifecycles (in retirement; not just accumulation phase)
3. Keep participants invested in the plan post-retirement

[1] U.S. Bureau of Labor Statistics, March 2023.

[2] Board of Governors of the Federal Reserve System, Financial Accounts of the United States - Z.1, L.118.c Private Pension Funds Defined Contribution Plans (1) December 2023.

[3] EBRI/ICI. 401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2018, March 2021.

[4] Alight Solutions, "2019 Top Topics in Retirement and Financial Wellbeing: Building on the Past, Working Toward the Future," 2019.

[5] Indices shown: Bloomberg U.S. Aggregate Bond Index (U.S. Aggregate), Bloomberg U.S. Mortgage Backed Index (U.S. MBS), Bloomberg Investment Grade Credit Index (U.S. Credit), Bloomberg Asset-Backed Securities Index (U.S. ABS), Bloomberg Commercial Mortgage-Backed Securities Index (U.S. CMBS), JP Morgan EMBI Global Diversified (EMD Hard Currency), S&P/LSTA Leveraged Loan Index (Bank Loans), Bloomberg U.S. Government Index (U.S. Govt.) and ICE BofA Merrill Lynch U.S. High Yield Master II Constrained Index (U.S. High Yield). It is not possible to invest directly in an unmanaged index.

INDICES DESCRIPTION

Bloomberg U.S. Aggregate Bond Index: The index measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable bond market and includes Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) (agency fixed-rate and hybrid adjustable rate mortgage (ARM) pass-throughs), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) (agency and nonagency). This index is not subject to a fee.

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