Planet DC™

IT'S A NEW WORLD IN RETIREMENT

The many faces of risk.

It's time to reframe the DC plan's fixed income lineup.

Fixed income can be an essential component of a Defined Contribution plan's lineup. It may help lower volatility, provide diversification to equities and potentially enhance the risk/return profile in participants' portfolios. But fixed income investing, like all investing, comes with a multitude of risks that must be carefully managed.

Traditionally, many DC plans have relied primarily on strategies benchmarked to the Bloomberg Barclays U.S. Aggregate Bond Index as their primary fixed income offering. However, a limited fixed income offering, coupled with a challenging — and changing — fixed income landscape (notably the potential for rising interest rates coupled with a low yield environment within traditionally offered fixed income benchmarked solutions), is driving the need to rethink a DC plan's approach to fixed income solutions. With bond investments comprising 11% of 401(k) plan balances, the potential impact on participant investment outcomes may be significant.[1]

Participants face many risks in a retirement plan from simply outliving their savings, to losing assets in a market downturn, to experiencing the eroding effects of inflation. For fixed income portfolios in DC plans, three risks in particular affect participants: participant user risk, interest rate risk and market risk.

How can you be sure that you are implementing the right fixed income approach in a DC plan? By addressing these risks with the appropriate international or global fixed income investment options, and continually re-evaluating the lineup.

[1] 2016 ICI Factbook (2015 Data).

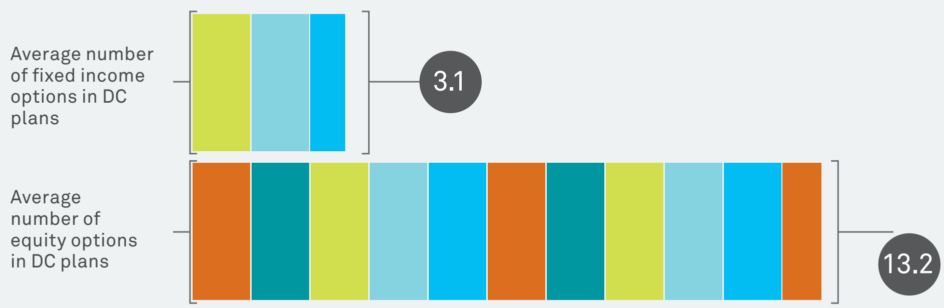
PARTICIPANT USER RISK

Not enough choice, not enough knowledge.

Participant user risk is characterized by limited investment knowledge. Many participants do not understand the role of fixed income within a portfolio, the implications of interest rate fluctuations or how fixed income risk differs from equity risk. In addition, fixed income is typically under-represented in the DC plan compared to equities. This results in portfolios that may be under-diversified and not aligned with their risk preferences and tolerances.

CONSIDER THIS: In the absence of offering more fixed income solutions, provide the right mix of fixed income options to help participants diversify across countries, sectors and durations. Expand education efforts to help participants better understand the role of fixed income in their portfolio.

MANY PLAN SPONSORS DO NOT OFFER ENOUGH FIXED INCOME CHOICES



Source: ICI/Brightscope, December 2015.

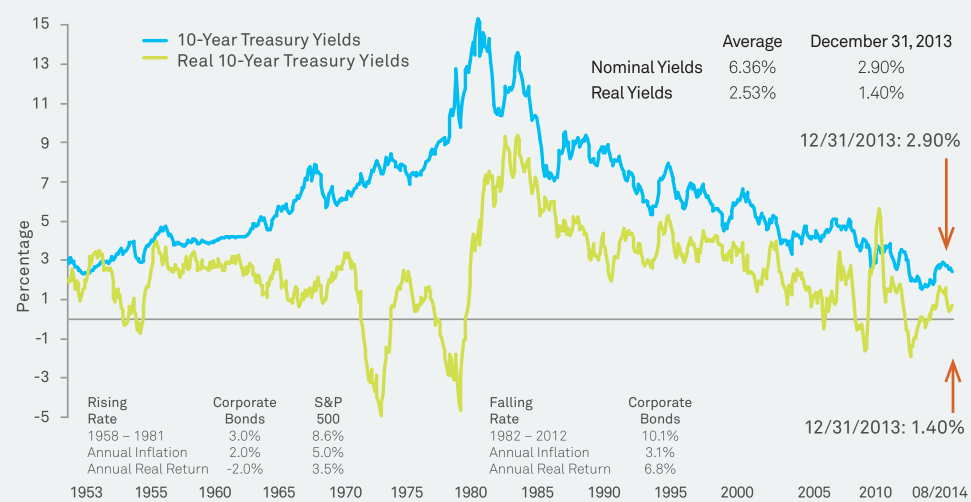
INTEREST RATE RISK

What's on the horizon?

As the economic landscape continues to shift, the risk of rising interest rates looms as a challenge investors will inevitably face. Real yields on Treasury bonds may lag behind nominal yields (the actual fixed interest rate of the bond) depending on the prevailing interest rates. Interest rates and bond prices are inversely related: as interest rates rise on newly issued bonds, the market value of already issued bonds will fall. As a result, participants with large fixed income allocations may be exposed to interest rate risk and declining asset values.

CONSIDER THIS: If offering an array of fixed income solutions, including an international option, educate participants on the need to diversify within their fixed income holdings and to rebalance their broader portfolio yearly, or in response to changing conditions.

MONITOR FIXED INCOME OFFERINGS — PREPARE FOR RISING RATES



Past performance is no guarantee of future results.

Source: © Copyright 2014 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All rights reserved. This chart is for illustrative purposes only. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core inflation for that month except for December 2013, where real yields are calculated by subtracting out November 2013 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. Yields fluctuate.

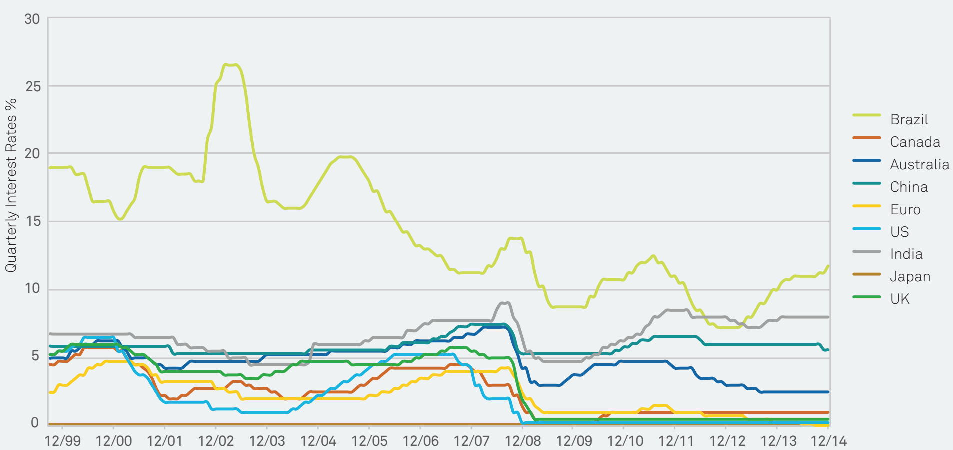
MARKET RISK

Preparing for all kinds of weather.

Market risk is the risk that the value of an investment will decrease over a given time period because of economic changes or other events that have an impact on the market. Asset allocation and diversification can help protect against market risk since different portions of the market tend to perform or underperform at different times. As mentioned, risk can be exacerbated in DC plans that rely primarily on fixed income strategies benchmarked against the Bloomberg Barclays U.S. Aggregate Index. As such, participant user risk is compounded by the limited choice of fixed income solutions that are primarily U.S.-benchmarked. Without access to broader fixed income markets, a participant's portfolio may experience higher levels of volatility.

CONSIDER THIS: Offer solutions across country, sector, quality and duration to help participants properly diversify to potentially gain better fixed income returns. Taking a more global approach to providing fixed income solutions within the DC lineup can help reduce market risks and volatility by providing access to diverse interest rate and yield environments. Diversification across bond types is also important because over-reliance on single-sector bond portfolios may lead to excessive volatility. With better asset allocation and the right investment solutions to properly diversify, participants may experience less volatility and overall enhanced returns.

PROVIDE GLOBALLY DIVERSE INVESTMENT OPTIONS



Source: Bloomberg Data as of December 31, 2014.

BALANCING THE DC PLAN'S FIXED INCOME LINEUP

Depending on the goals of the plan, every plan sponsor and investment committee member will have a unique philosophy and approach to providing fixed income solutions within their DC lineup. It's important to avoid overlap and redundancy when expanding the opportunity set. It's critical to consider how participants will react to more choice, how effectively they will be able to allocate and diversify within this expanded menu, and the capacity of the plan to add more investments. The approaches outlined here may be helpful in determining and implementing the right course.

A PLAN WITH ONLY ONE FIXED INCOME OFFERING

Consider utilizing a globally diversified, professionally allocated fixed income solution. This ensures participants are provided with optimal exposure and global diversification to potentially mitigate risk.

A PLAN WITH A LIMITED FIXED INCOME LINEUP

Consider pairing a U.S. intermediate term bond fund with an international bond fund to offer an enhanced opportunity set that may potentially result in better risk-adjusted returns. This combination helps to ensure global diversification through a mix of domestic and international strategies and potentially reduces country-based risk, investment-grade risk and interest rate risk.

A PLAN SEEKING TO DIVERSIFY RISK AND FIND A YIELD ADVANTAGE

Consider a more flexible approach by including a global opportunistic fixed income solution, which pursues a globally diversified total return fixed income solution with access to traditional and alternative investments. It offers the potential to capture more yield while positioning for greater duration flexibility. And it provides broad investment opportunities in multiple rate and credit environments around the globe.

CONSIDER THIS: Start re-evaluating the DC plan now to determine if it provides a globally diversified portfolio and the right number of fixed income options for participants. The benefits of doing so include reducing risk, simplifying choice, and helping participants achieve the secure futures they deserve.

Begin your fixed income transformation now.

1. **Review the plan's investment menu.** How many fixed income options are in the lineup? Do they provide proper diversification for addressing risk?
2. **Run a benchmarking report.** Retirement plan advisors can run benchmarking reports for plan sponsors. Compare the plan's fixed income options with plans of similar sizes and industries.
3. **Implement a two-pronged educational campaign.** Target all participants to help convey a general understanding of the basics of fixed income. Specifically target employees nearing retirement.

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Risks

Asset allocation and diversification cannot assure a profit or protect against loss. **All investments** involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. **Bonds** are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

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