Charles Schwab Investment Management

Are there hidden fixed income risks in your TDF

Three reasons to re-examine your fund's fixed income exposure in today's market climate

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Executive summary

Most defined contribution plan sponsors and their advisors would agree that the primary goal of the fixed income allocation of a target date fund (TDF) is to help protect assets against market volatility, particularly as investors near retirement, when exposure to fixed income is at its greatest.

Yet some of these TDF fixed income allocations, especially in funds that exclusively rely upon active management, may be exposing investors to increased downside risk. After years of historically low interest rates, many active fixed income managers are seeking to compensate by increasing their allocations to riskier securities.

Key takeaways

- Today's extended low-rate climate can lead to excessive risk-taking in fixed income.
- Extra risk-taking can cause fixed income exposures to behave more like equities.
- Elevated fixed income risks can jeopardize investors' accumulations when they are most vulnerable.
- A blended approach to fixed income within a TDF may deliver better results than exclusively employing an active or a passive strategy.

More exposure to non-government securities

Active fixed income strategies may warrant a closer review given that they frequently seek higher-yielding credit strategies, often at the risk of increasing drawdown risk should markets turn volatile. This generally elevated risk exposure is displayed in Exhibit 1, which highlights the significantly greater non-U.S. government security exposure the average active fixed income fund holds compared with the Bloomberg Barclays U.S. Aggregate Bond Index. These non-government securities generally represent riskier credit- and mortgage-related sectors.

Although active strategies can shift allocations and attempt to outperform based on deviations from index exposures, this approach comes with a potential cost. Riskier assets can result in permanent losses and significant downside exposure—the opposite of what a TDF investor desires approaching and into retirement. It's therefore critical for plan sponsors and their advisors to be mindful of the type and amount of "risk" assets held within an active fixed income strategy in a TDF.

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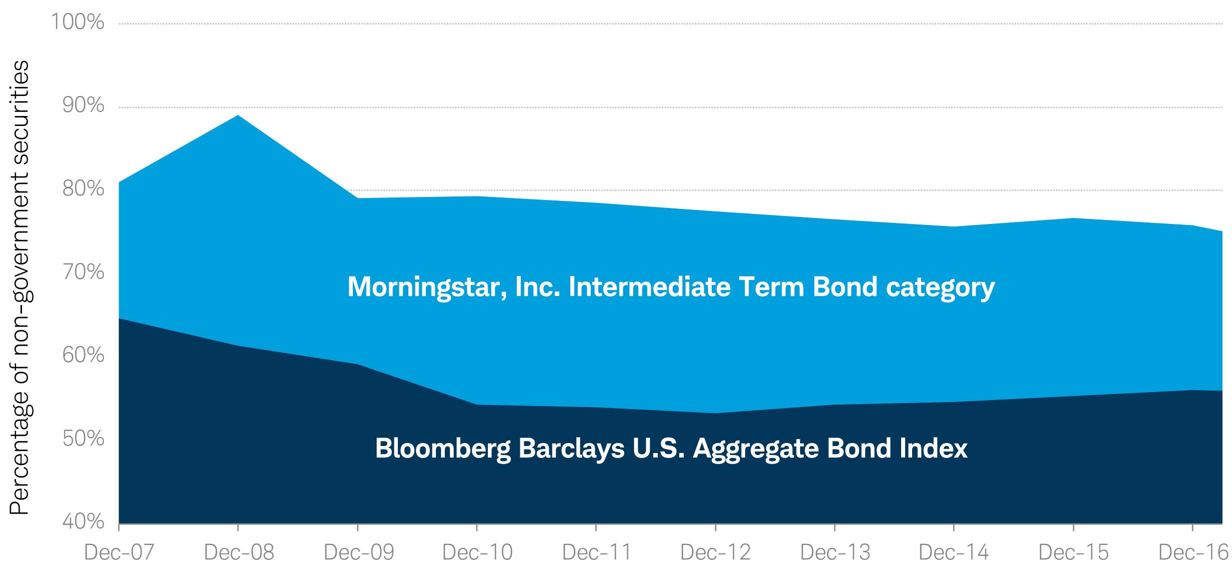
Exhibit 1: More exposure to non-government securities

From December 31, 2007, through December 16, 2016, the average active fixed income fund held at least 15% more non-government securities than the index tracked by many passive strategies.[1]



Sources: Morningstar, Inc.; Bloomberg; Charles Schwab Investment Management, Inc.

Conversely, passive strategies, such as those following the Bloomberg Barclays U.S. Aggregate Bond Index, have higher exposure to "quality" assets, such as U.S. Treasury and government agency securities. These fixed income securities often outperform other fixed income sectors during times of stress, and represent very little credit risk. Moreover, although government-related securities may not offer the higher yields sought by many active managers, these highly rated instruments have historically experienced far less downside risk and, therefore, are generally more appropriate investments for TDF investors.

A balanced approach that utilizes both active and passive fixed income strategies may offer a more prudent path to help investors protect retirement assets.

For TDFs approaching the target date, we believe the primary objective should be to protect investors' accumulated nest eggs. A fixed income allocation that incorporates lower-risk passive strategies and/or conservative active strategies helps to fulfill this goal. Therefore, a balanced approach that utilizes both active and passive fixed income strategies may offer a more prudent path to help investors protect retirement assets and capture stronger risk/reward characteristics across full bond market cycles.

Three reasons to re-examine your TDF's fixed income allocation

Following, we offer three reasons plan sponsors and their advisors should consider re-examining the fixed income allocation in their TDF to ensure that the risk/return profile is aligned with participant risk tolerances—particularly as the fund gets closer to the target date.

Reason 1: Today's extended low-rate climate can lead to excessive risk-taking in fixed income

A primary distinction between active and passive fixed income strategies is that active managers generally have the ability to overweight/underweight sectors and invest in individual securities based on where they see relative investment value, in an effort to pursue stronger long-term total returns. This can result in overweights to yield and credit exposures compared to their passively managed counterparts, which usually maintain fixed allocations directly aligned to a benchmark, such as the Bloomberg Barclays U.S. Aggregate Bond Index.

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We believe that the recent period of low interest rates has encouraged many active fixed income managers to take on increasing credit risk to secure the same yield that they may have earned in the past. At the same time, almost a decade of generally strong credit markets may be providing managers and investors alike with a false sense of security about exactly how much additional risk this "stretching for yield" has potentially entailed.

For example, in 2007, fixed income managers could use U.S. Treasury securities to secure a 5% yield, with virtually no credit risk. Two years later, they would have needed to invest in U.S. corporate investment grade bonds to achieve that same yield. More recently, a similar 5% interest rate would require venturing into U.S. high-yield bonds, representing a significant increase in credit risk relative to U.S. Treasuries (see Exhibit 2).

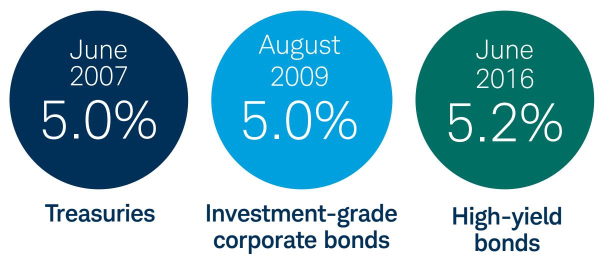
Reason 2: Extra risk-taking can cause fixed income exposures to behave more like equities

Perhaps the biggest threat for TDFs with greater exposure to higher-yielding corporate credits at this stage of the cycle is that the fixed income allocation may start behaving like equity investments. The Bloomberg Barclays U.S. Aggregate Bond Index has historically had a low correlation to the S&P 500® Index, allowing it to perform as an effective cushion against stock market downturns.

Investment-grade and high-yield corporate credits have failed to offer the same degree of protective attributes (see Exhibit 3), instead moving more in tandem with stocks. TDFs with exposure to higher yielding credit securities means the fixed income allocation is potentially more correlated to the equity allocation, which can subject investors' retirement savings to greater downside exposure just when they need the protection most—when equity markets fall.

Exhibit 2: Chasing a 5% yield

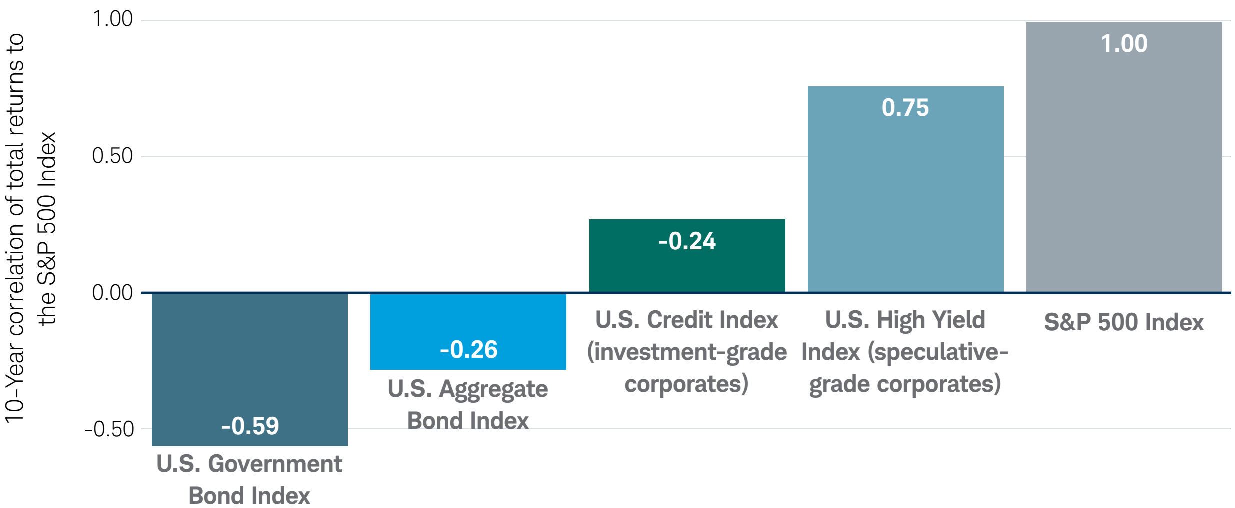
The extended period of low interest rates has increased the relative risk necessary to maintain a 5% yield target.[2]



Sources: Bloomberg; Charles Schwab Investment Management, Inc.
Past performance is no guarantee of future results.

Exhibit 3: High-yield bonds have a material correlation to stocks

High-yield corporate bonds, and to a lesser extent investment-grade corporate bonds, are correlated with stocks, providing smaller diversification benefits than higher-quality bonds.[3]



Sources: Bloomberg; Charles Schwab Investment Management, Inc.

In addition, increased credit risk increases the possibility of security default. While this risk may seem inconsequential during periods when corporate bond default rates are relatively low, it's imperative to remember the critical role fixed income plays in helping to protect retirement assets, especially during periods of market distress which often results in a sharp increase in demand for safe-haven securities.

Increased credit exposure can subject investors to lasting losses from an allocation that is intended to mitigate downside exposure.

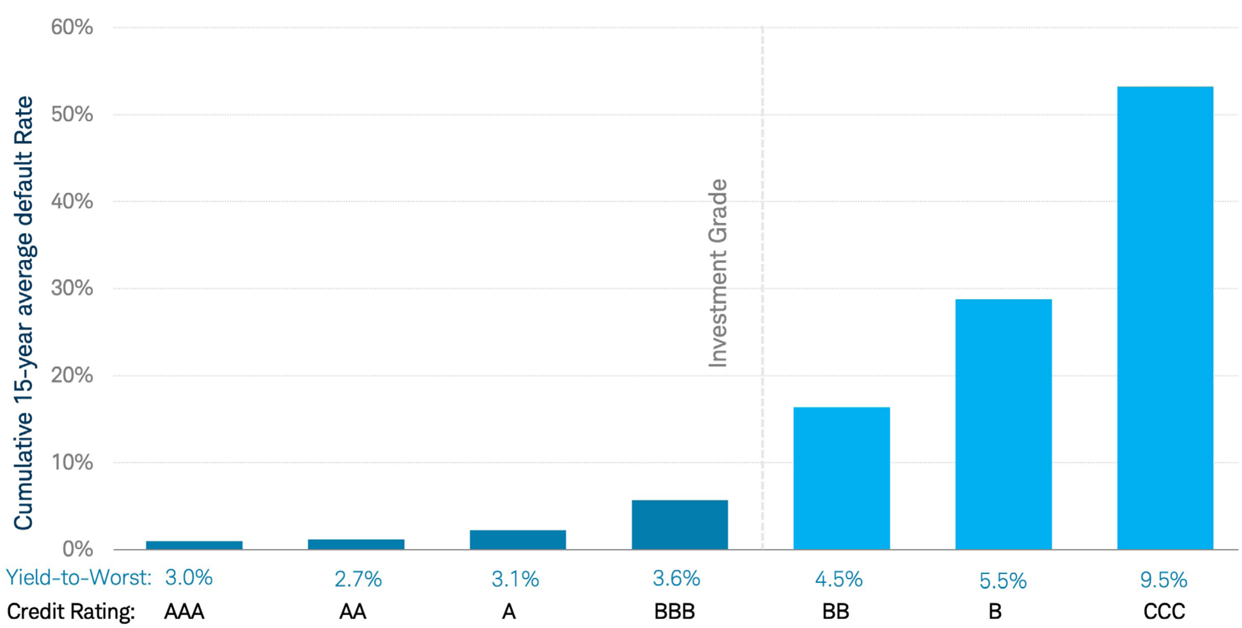
History shows that when credit markets begin to deteriorate, general volatility and the risk of defaults can quickly escalate (see Exhibit 4). Hence, increased credit exposure can subject investors to lasting losses from an allocation that is intended to mitigate downside exposure.

Takeaway

How correlated is your TDF's fixed income allocation to the equity allocation? A correlation analysis can offer insight into the downside protection potential of the TDF's fixed income holdings in a market downturn.

Exhibit 4: Higher-yielding credit securities are more at risk of default

Increased credit exposure in TDFs could potentially subject investors to default-related losses.[4]



Sources: Bloomberg, Charles Schwab Investment Management, Inc. As of 1/18/2017.

Reason 3: Elevated fixed income risks can jeopardize investors' accumulations when they are most vulnerable

A core premise behind TDF design is that a glide path becomes increasingly conservative as investors approach and enter retirement. Accordingly, the average non-equity allocation in TDFs steadily increases to more than 60% in the later stages of investor retirement savings, though the specifics can differ by strategy (see Exhibit 5).

This means average TDF fixed income allocations are at their greatest as participant account balances tend to reach their highest levels. Plan sponsors and their advisors should carefully consider how much downside risk they are willing to accept in this key asset class given the generally significant size of its allocation in later working years, and the fact that older investors may not have the time to recoup any outsized portfolio losses before they need to begin drawing down assets.

Markets are frequently unpredictable, sometimes dramatically so. Recall the painful lessons of the massive losses many investors suffered during the financial crisis of 2007–09 by being overexposed to risk, including in the fixed income segment.

In 2008, credit and high-yield option-adjusted spreads (OAS)—a proxy for risk/reward exposures relative to U.S. Treasuries—sharply increased, as investors unloaded their risk assets.

Passively managed fixed income strategies significantly outperformed most actively managed strategies against this backdrop. Indeed, the Bloomberg Barclays U.S. Aggregate Bond Index delivered a 5.2% total return in 2008, compared to a -4.7% loss for the average U.S. intermediate-term bond fund, more than 90% of which were actively managed. As credit markets rebounded in 2009, there was a strong reversal in OAS, and Morningstar, Inc.'s U.S. intermediate-term bond fund category rose, on average, an impressive 14.0%, compared to the 5.9% total return of the Bloomberg Barclays U.S. Aggregate Bond Index.[6]

A blended approach to fixed income within a TDF may deliver better results than exclusively employing an active or a passive strategy.

In our view, this highlights why a blended approach to fixed income within a TDF may deliver better results than exclusively employing an active or a passive strategy. Utilizing both types of strategies can provide closer alignment in appropriate fixed income exposures to changing risk/reward profiles as investors age, allowing for greater return potential in early saving years with tighter volatility and downside controls as retirement nears.

Exhibit 5: Less equity exposure means greater fixed income holdings as retirement approaches

Downside risk should be carefully considered given the large fixed income allocations in near-dated TDFs.

Morningstar, Inc. category	Average glide path non-equity allocation[5]
US Open End Target-Date 2020	54.7%
US Open End Target-Date 2015	59.1%
US Open End Target-Date 2000-2010	63.8%

Sources: Bloomberg; Charles Schwab Investment Management, Inc.; Morningstar, Inc. Data as of 6/23/2017.

Takeaway

How much exposure to fixed income does your TDF have at its target date? Make sure the fixed income risk/reward profile within the glide path is appropriate for participants, particularly those nearing retirement.

Understanding and identifying fixed income risks

Evaluating a fixed income strategy's potential risks is a matter of "knowing what you own." To help identify these risks, we suggest plan sponsors and advisors ask their TDF provider the following questions:

- What is the fixed income strategy's yield, and how is it being generated?
- What is the strategy's credit exposure across securities, and how does this differ from the benchmark?
- How have these attributes changed across different bond market cycles?
- Does the strategy have an explicit yield target, and if so, is this yield target static?

What about duration risk?

Many active fixed income managers suggest that greater credit exposures can help combat today's higher duration risk after years of scant yields have effectively curtailed any income cushion to absorb potential interest rate increases. Keep in mind that interest rate risk is inherent in all fixed income securities to varying degrees. By comparison, extending credit exposure introduces a potentially permanent risk that has at times been much more destructive to portfolio values.

Further, current low interest rates do not mean that significantly higher rates are necessarily imminent. Markets have been in the current low-rate cycle for many years, and yields could stay relatively subdued for much longer than is currently forecasted depending on the sizable macro risks and tepid economic growth overhanging markets worldwide. Even if rates do continue to move higher sooner rather than later, the Federal Reserve is not expected to act as aggressively as it often has in past tightening cycles. Consequently, the duration risk protection potentially provided by larger credit allocations may not be worth the added downside risk exposures in investors' later saving years, especially given the currently compressed credit spread environment.

Exhibit 6: Fixed income risks can be insidious

A comparison of the risks most prevalent in U.S. government and credit securities

Risks	U.S. government securities	Non-government securities
Price decline	Rising interest rates	Rising interest rates and credit spreads
Liquidity risk	Low	Increasing as credit deteriorates
Correlation to equities	Variable	Higher relative to U.S. Treasuries
Default risk	Nonexistent	Higher relative to U.S. Treasuries

Source: Charles Schwab Investment Management, Inc. For illustrative purposes only.

It can also be useful to review if and how a TDF's fixed income risk exposure may evolve at various points along the glide path.

It can also be useful to review if and how a TDF's fixed income risk exposure may evolve at various points along the glide path. Again, this is where a blended approach can offer distinct advantages in optimizing risk allocations across the full credit cycle.

Conclusion

A TDF's approach to fixed income management is critical in helping to optimize retirement outcomes, particularly in terms of mitigating drawdown risk at later stages in the glide path. While fixed income is often viewed as a staple market segment, years of low interest rates have encouraged many active managers to increase their allocations to higher-yielding credit securities, embedding greater downside risk in a core allocation typically engineered to reduce portfolio volatility. This comes at a cost: higher risk of capital loss should markets turn, or managers get their investment choices wrong.

Thus, plan sponsors and their advisors should consider re-examining their TDF's fixed income allocation, in order to help ensure that its risk exposure remains appropriately aligned with participants' best interests. The optimized solution may be a blended fixed income approach that incorporates both passive and active strategies to seek more consistent investment results across both strong and difficult credit cycles, while helping investors protect the assets they have worked so hard to accumulate.

About the Authors

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Brett Wander is Senior Vice President and Chief Investment Officer of Fixed Income for Charles Schwab Investment Management, Inc. (CSIM). He is responsible for all aspects of the firm's fixed income and money market portfolios, leading a team of more than 20 investment professionals.

With more than 25 years of investment management experience, Mr. Wander has been intimately involved in the design, development and oversight of a wide range of active, indexed and alternative fixed income strategies. His expertise spans a wide range of global and domestic markets and sectors. Prior to joining CSIM in June 2011, Mr. Wander was senior managing director at State Street Global Advisors, where he managed and directed the firm's $30 billion active fixed-income enterprise. He also held senior fixed-income leadership positions at Loomis Sayles, State Street Research and Payden & Rygel. In those roles, he designed investment processes, developed risk management methodologies, managed investment teams, and consistently generated strong investment performance track records.

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Jake Gilliam is the Head Client Portfolio Strategist for Multi-Asset Strategies for Charles Schwab & Co., Inc. supporting Charles Schwab Investment Management Inc.'s (CSIM) Asset Allocation and Sub-Advisor Oversight Committees. He contributes to strategic decisions for all multi-asset class portfolios as well as several single asset-class portfolios within CSIM and for the Schwab Bank Collective Trust Funds. He works closely with the Chief Investment Officers, Portfolio Managers, Research, and Sub-Advisor Oversight teams on a frequent basis. Mr. Gilliam also represents CSIM's multi-asset class strategies to the institutional marketplace, clients, and the media.

Previously, he was the day-to-day Senior Portfolio Manager for Schwab Bank's Collective Trust Funds and Head of Sub-Advisor oversight for CSIM. Additionally, Mr. Gilliam served as interim Head of Asset Allocation and Portfolio Manager for CSIM's Multi-Asset Class funds. Mr. Gilliam also developed the Schwab Corporate and Retirement Services Institutional Investment Analyst team and oversaw the due diligence process for maintaining the Schwab Focus List™. Earlier in his career, he also worked as a sell-side Equity Research Associate covering the food retail and restaurant industries.

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Rob Bourgeois is a Client Portfolio Strategist supporting Charles Schwab Investment Management, Inc. (CSIM). In this role, he is responsible for market communications and relationship development with clients and key partners regarding Schwab's Money Market and Fixed Income product suites.

Prior to supporting CSIM, Mr. Bourgeois served in multiple fixed income roles at Charles Schwab & Co., Inc. (Schwab), including five years as a research analyst for the Schwab Center for Financial Research and as a Fixed Income Product Manager. Previous to Schwab, Mr. Bourgeois also served as an investment manager for the City of Arvada, Colorado; and as an institutional mortgage bond trader at Raymond James Financial.

Charles Schwab Investment Management

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The values of the funds will fluctuate up to and after the target dates. There is no guarantee the funds will provide adequate income at or through retirement.

The funds are built for investors who expect to start gradual withdrawals of fund assets on the target date, to begin covering expenses in retirement. The principal value of the funds is not guaranteed at any time, and will continue to fluctuate up to and after the target date.

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[1] The average holdings of actively managed fixed income funds is represented by Morningstar, Inc.'s U.S. Intermediate-Term Bond Fund category, in which more than 90% of the funds were actively managed for the period shown. The Bloomberg Barclays U.S. Aggregate Bond Index was used to represent passively managed fixed income fund holdings.

[2] Charles Schwab Investment Management, Inc. calculated these findings based on data from Bloomberg. The Bloomberg Barclays U.S. Treasury Index was used to represent Treasuries, the Bloomberg Barclays U.S. Corporate Investment Grade Index was used to represent investment-grade corporate bonds, and the Bloomberg Barclays U.S. Corporate High Yield Index was used to represent high-yield bonds.

[3] Charles Schwab Investment Management, Inc. calculated these findings based on data from Morningstar, Inc., reflecting quarterly observations from 01/01/2007 to 12/31/2016. Each bond category represented by its corresponding Bloomberg Barclays index.

[4] Charles Schwab Investment Management, Inc. calculated these findings based on data from the Bloomberg Barclays U.S. Corporate Investment Grade Index and the Bloomberg Barclays U.S. Corporate High Yield Index, as of 01/18/17. Schwab Center for Financial Research was also leveraged, including data from its S&P 2015 Global Corporate Default Study.

[5] Charles Schwab Investment Management, Inc. calculated these figures based on allocation category data from Morningstar, Inc. Average glide path non-equity allocations represent combined group average totals including bond allocations, cash allocations, and other allocations.

[6] Charles Schwab Investment Management, Inc. calculated these findings based on data from Bloomberg and Morningstar, Inc. The Bloomberg Barclays U.S. Aggregate Bond 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.

The Bloomberg Barclays U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The Bloomberg Barclays U.S. Corporate Investment Grade Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating (by Moody's, Fitch, or S&P) is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays emerging markets country definition, are excluded.

The S&P 500® Index® is an index designed to measure the performance of 500 leading publicly traded companies from a broad range of industries.

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