Insights
Defined Contribution

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Beyond the Benchmark
Assessing Fixed Income in Target Retirement Strategies

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Here, we explore whether adding active fixed income to target retirement strategies strikes the right balance between cost and potential outperformance — the key question plan sponsors consider when making an informed decision.

In 2018, we wrote the following paper exploring whether incorporating active fixed income exposures in target date fund strategies could strike the right balance between cost and potential outperformance. Comparing State Street's granular, index-based approach to a large active target-date strategy using data back to 2005, we found that while active management has the potential to outperform commonly used benchmarks, this modest outperformance has historically come at the expense of a higher correlation to risk assets, and ultimately higher portfolio risk — calling into question the efficacy of active fixed income in periods of market volatility. The equity market drawdown during the first quarter of 2020 presented a new test of the themes discussed in this paper, with the benefit of a broader set of data from more active managers. For our findings, please refer to or request our June 2020 addendum.

In the following paper, we use a case study comparing two different approaches to assess the case for active fixed income in target retirement strategies. We highlight our key findings below, and emphasize that plan sponsors must consider more than benchmark-relative performance for individual asset classes when selecting appropriate allocations for target retirement strategies.

- Skilled active bond managers have been able to reliably outperform common benchmarks, but they have often done so by holding higher exposure to higher-risk, growth-sensitive assets.

- Beating a benchmark within a single asset class and delivering retirement readiness for participants are very different objectives. Plan sponsors considering active fixed income must consider the case for each asset class within the context of the broader target retirement solution.

- Adding higher-risk fixed income exposures (e.g., high yield and emerging market debt) may limit downside protection in times of market stress and ultimately reduce portfolio efficiency.

- No target retirement strategy is purely “passive.” For strategies implemented using underlying index funds, each manager makes active allocation decisions. While there are complexities with issuance-weighted benchmarks, a thoughtfully managed index-based approach may provide a more efficient means of improving outcomes.

Incorporating active strategies requires additional governance and oversight from plan sponsors beyond what is required for index-only solutions, but for target retirement managers looking to improve returns in today’s lower growth environment, earning alpha via underlying funds is an attractive proposition. Asset managers have endured well-documented struggles to beat benchmarks in certain asset classes for years, but US core fixed income stands out as a clear case for the value of active management.

While a target retirement approach that uses active management across all asset classes comes with significant cost and complexity, focusing on active management within fixed income may reduce (but not eliminate) this impact. But in assessing this trade-off, it is important to consider how active strategies align with the investment objectives of plan participants. That is, how portfolio components interact — in addition to how they perform in isolation — is a crucial consideration when seeking to achieve successful outcomes.

With this in mind, we present three key questions that plan sponsors should ask when considering active fixed income in a target retirement strategy.

1. **What is driving excess performance?**
   Is it greater skill or more risk? Does this align with participant risk tolerance?

2. **Are objectives aligned?**
   Are you seeking to improve outcomes or beat a benchmark?

3. **Is there a way to gain desired exposures more efficiently?**
   Can you improve outcomes while maintaining low costs and transparency?

A clear view on these questions may help plan sponsors see the forest for the trees, ensuring that they don’t lose sight of the objective that target retirement strategies are ultimately designed to achieve: successful participant outcomes.

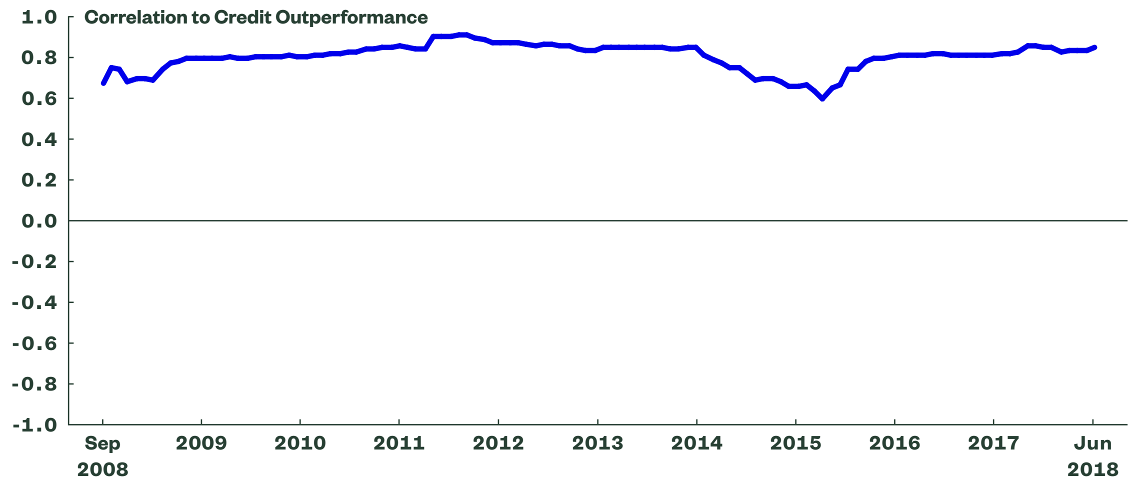
What is Driving Excess Performance?

Is it greater skill or more risk? Does this align with participant risk tolerance?

If active managers have been able to systematically add value over commonly used indices, how are they doing it? Are they highly skilled or are they taking more risk? Most likely both, and for an organization, risk tolerance should be a key consideration.

As the story goes, applying diligent credit research and greater flexibility to a broad opportunity set allows active bond managers to consistently add alpha over issuance-weighted benchmarks. But a deeper analysis of historical performance reveals that excess manager returns are highly correlated with outperformance from credit and high yield markets. In other words, when risky assets outperform lower-risk government bonds, active bond managers follow suit, a trend that has only increased in the low-yield environment following the global financial crisis. To consistently beat a benchmark, the first step is to move further out on the credit risk spectrum.

Figure 1
Active Core Bond Managers Outperform When Credit Outperforms



Source: State Street Global Advisors, Bloomberg Barclays, eVestment as of June 30, 2018. Excess core manager return compared to BBG Barclays US Aggregate Index. Credit excess return measured by taking combined excess return of all securities within BBG Barclays US Corporate Credit index relative to duration-matched treasuries.

Fixed income's role in a target retirement strategy is to complement growth assets in order to efficiently address key risks that participants face — namely market volatility, inflation and longevity risks. An active core manager may be able to improve returns by overweighting credit and expanding the opportunity set to sectors like high yield, but this may lead to undesired interactions with the broader portfolio. To illustrate, State Street Global Advisors conducted a case study using Morningstar data to compare the fixed income allocation in our retirement portfolio to that of a large, actively managed target retirement series. Taking more risk within fixed income has allowed the active manager to provide attractive returns, but this comes at the expense of higher correlation to credit and equity markets, reducing diversification within the target retirement portfolio.

Figure 2
Case Study Shows Higher Returns from Active Management Means Lower Diversification

	Manager A	Manager B
Return (%)	3.94	3.69
Risk (%)	3.14	2.84
Sharpe	1.26	1.30
Correlation to Credit	0.72	0.25
Correlation to Equity	0.56	0.26

Source: SSGA Defined Contribution, Morningstar as of June 30, 2018. Performance history is for State Street Income Fund and Manager A 2005 fund. Performance inception is March 2005. Equity represented by MSCI ACWI index. Credit represented by BBG Barclays U.S. Aggregate Credit Index.

A wider opportunity set can improve expected returns, but it may lead to undesired interactions with the broader portfolio.

Are Objectives Aligned?

Are you seeking to improve outcomes or beat a benchmark?

Fixed-income strategies with higher credit risk can increase correlations with growth assets in the portfolio and may ultimately jeopardize the ability of the portfolio to perform in times of market stress. A thoughtfully constructed strategy should take this into account.

If active fixed income managers are generally assuming greater credit risk to outperform their benchmark, consider how this approach impacts a target retirement strategy. Balancing the key risks that participants face over time requires careful consideration of the characteristics of each asset class and how they are expected to interact with one another. The mandate for a fixed income fund to outperform its own benchmark may be misaligned with the objectives of the target retirement strategy and lead to undesired consequences in the form of reduced protection in down markets, and ultimately to less efficient wealth creation.

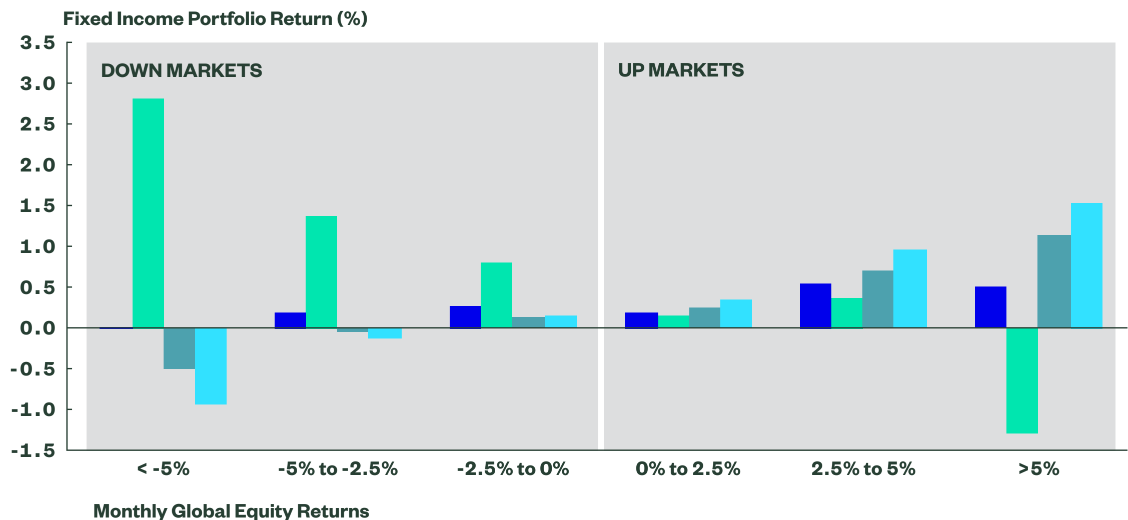
Using the same active manager as an example, historical results, unsurprisingly, show a strong dispersion in returns across equity market environments. The active approach has added value, but only during periods when riskier assets have outperformed. The strategies have lagged in down markets, accelerating losses for target retirement investors at a time when downside protection would be quite valuable — especially for participants with shorter time horizons.

Better aligning the fixed-income portfolio with participant objectives requires action, but not necessarily in the risk-seeking manner that many active managers have historically employed. The State Street approach breaks out its fixed-income exposure across six fixed-income indices, seeking to provide a more balanced return profile across all market environments, while also considering the objectives of participants at each stage of their careers.

> The active approach has added value, but only during periods when riskier assets have outperformed.

Figure 3
State Street's Fixed Income Allocation Outperforms in Down Markets: Most Pronounced When Equity Weights Are Highest

- SSGA Income FI Return
- SSGA Long-Dated FI Return
- Mgr A 2005 FI Return
- Mgr A Long-Dated FI Return



Source: State Street Global Advisors, Morningstar as of June 30, 2018. The 2005 fund used for Manager A was the closest fund to retirement with available data. Long-dated funds used were 2040 for State Street Global Advisors and 2045 for Manager A to reflect long-dated fund with longest available track record. Fixedincome returns take the monthly performance of each underlying fund, weighted by the portfolio weight as a percentage of total fixed income as of each month's end. Equity returns represented by MSCI ACWI index. Please refer to "Focus on the Long Run" for a short paper describing State Street Global Advisors' use of long government bonds in longer-dated vintages. Past performance is not a reliable indicator of future performance.

Is There a Way to Gain Desired Exposures More Efficiently?

Can you improve outcomes while maintaining low costs and transparency?

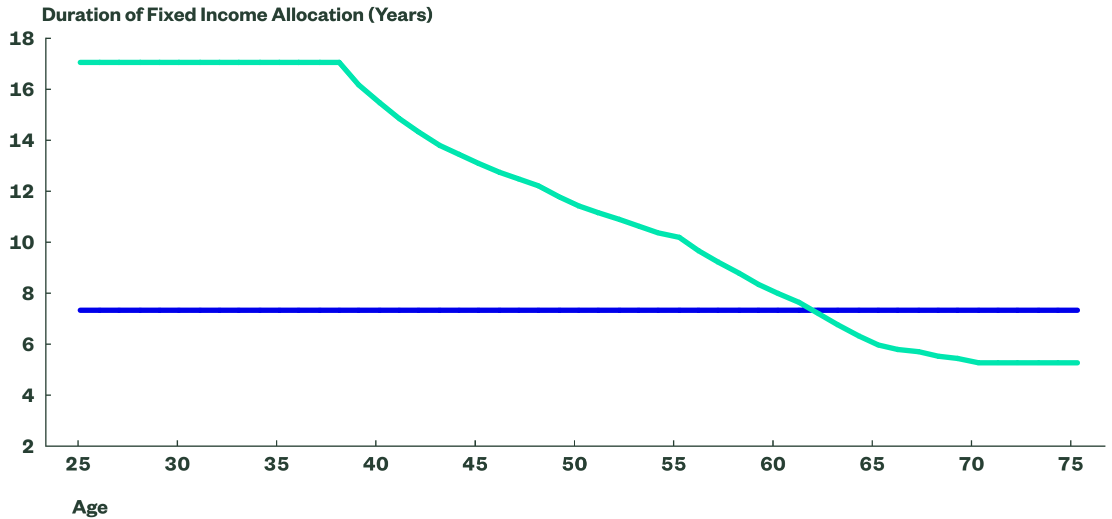
Just because active fixed income funds can often beat a benchmark does not inherently mean that those funds improve outcomes when used in a multi–asset class portfolio. But the standard approach to "passive" fixed income — namely concentrated exposure to the Bloomberg Barclays US Aggregate Bond Index ("The Agg") — presents its own set of challenges. As an issuance-weighted benchmark, the Agg has become increasingly concentrated in lower-yielding, higher-duration government debt in recent years. This shift in composition has made the index less ideally positioned to deliver the risk-and-return profile that it has historically offered. The need for an active decision, however, is not necessarily the same as the need for an actively managed fund.

We believe that the decision to diversify away from the Agg can be done in a transparent, low-cost manner that allows for greater control over the full fixed income portfolio, ensuring that its purpose is aligned with the broader target retirement solution. State Street breaks out its fixed income exposure across the maturity and yield spectrums throughout the glidepath to better align with the key risks that participants are facing at each stage of their careers. For younger employees, we hold a dedicated allocation to long government bonds due to the historical diversification benefits of the asset class and the relatively low importance of interest-rate risk for participants with long time horizons. As participants age, we transition our portfolio to a mix of one- to three-year government/credit, intermediate TIPS, and a small allocation of high yield, in addition to US aggregate bonds in order to better manage against the impact of rising interest rates and to strike the appropriate balance between capital preservation and yield. This approach stands out relative to both active approaches, which may overemphasize risky assets in an effort to improve returns, and common passive approaches, which tend to rely on a large allocation of US aggregate bonds. Strategies concentrated in aggregate bonds may provide insufficient diversification for young participants, create increased interest-rate risk for retirees, and ultimately allow for very little control due to their issuance-weighted nature.

Why does this matter? Each year of portfolio duration can be roughly expected to cause a 1% decline in the fixed-income portfolio per 100-basis-point increase in interest rates. The duration of the US Aggregate Index has risen from four years in 2008 to more than six years today. By breaking out the Agg into its component parts, State Street is able to reduce the interest-rate risk that participants face as they age, even against the backdrop of rising durations across common indices during the last decade, while maintaining a higher yield than the Aggregate Index.

The need for an active decision is not necessarily the same as the need for an actively managed fund.

Figure 4
State Street Uses More Underlying Funds to Better Manage Interest-Rate Risk with Great Stability
Duration of Fixed Income Allocation (Years)



Duration Comparision (Years)	2008	2018
US Agg	4.38	6.01
State Street Income Fund	3.63	3.68
Yield Comparision		
US Agg	4.91	3.29
State Street Income Fund	5.05	3.38

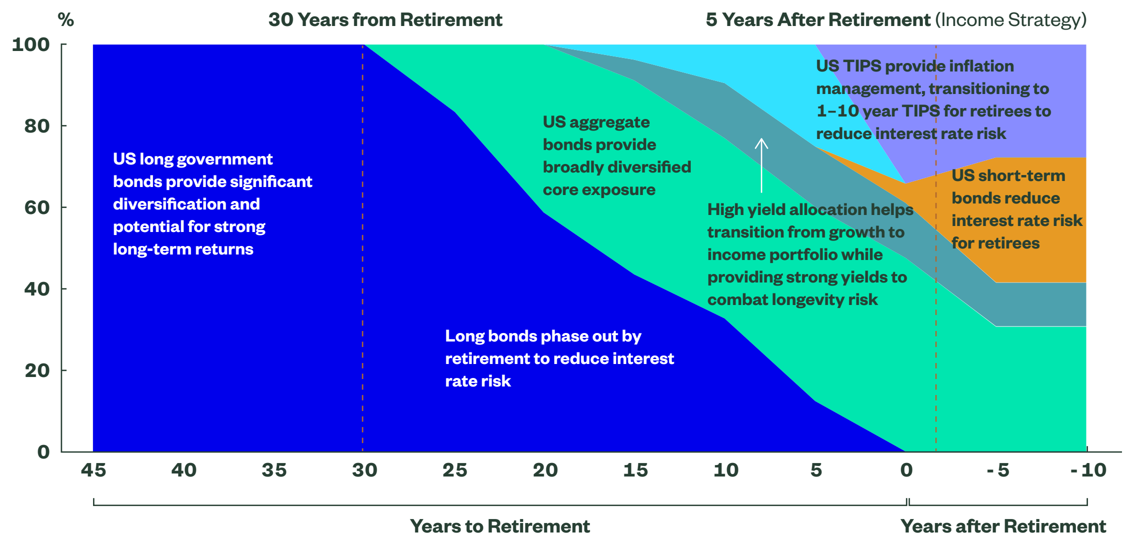
Source: State Street Global Advisors, Bloomberg Barclays as of June 30, 2018.

Focus on Outcomes

Commonly used approaches to "passive" fixed income present challenges that need to be addressed. Active core bond strategies may be able to add alpha, but they have historically done so by moving further out on the credit risk spectrum. Meanwhile, active managers have struggled to outperform in these riskier fixed-income asset classes. To wit, 93% of active US high yield and 86% of emerging market debt funds have underperformed their respective benchmarks over the last five years.[1] This suggests that active managers that outperform core benchmarks are often doing so via asset allocation decisions, not security selection.

At State Street, we take a different approach. We believe that the optimal design marries strategic asset allocation with a diverse array of underlying index funds. This approach allows us to intelligently manage the key risks that participants face as they evolve over time in a consistent manner, while maintaining the low costs and transparency that plan sponsors desire. This management style has led to strong peer-relative performance, outperforming 91% of the Morningstar Target Retirement universe since inception, with risk lower than 73% of our peers, with a demonstrated history of outperformance over both active and passive strategies in down markets.[2] Using the right building blocks makes for a target retirement strategy that is better designed to deliver on the only objective that we believe really matters: successful retirement outcomes for participants.

Figure 5
State Street Global Advisors Thoughtfully Manages Fixed Income Allocations to Help Address Key Risks



- Long-Term Government Bonds
- US Aggregate Bonds
- High Yield Bonds
- 1–3 Gov't/Credit Bonds
- Tips
- Intermediate Tips

Source: State Street Target Retirement Strategies strategic asset allocation roll-down schedule, effective close of business June 30, 2018. Only the fixed income allocation is shown. The allocation begins at 10% of the portfolio and reaches 65% at retirement. The information contained above is for illustrative purposes only. Diversification does not ensure a profit or guarantee against loss.

Endnotes

1 SPIVA US Scorecard, Year-End 2017

2 FactSet, Morningstar as of June 30, 2018. State Street outperformed 92% of the peer universe on average in 2008 and 93% of the peer universe in 2011. Number of funds in Morningstar 2060+ US Universe by time period: Year 2008: 12; and Year 2011: 77. Number of funds in Morningstar 2046–2050 US Universe by time period: Year 2008: 109; and Year 2011: 181. Number of funds in Morningstar 2036–2040 US Universe by time period: Year 2008: 180; and Year 2011: 222. Number of funds in Morningstar 2026–2030 US Universe by time period: Year 2008: 189; and Year 2011: 219. Number of funds in Morningstar 2016–2020 US Universe by time period: Year 2008: 207; and Year 2011: 229. Number of funds in Morningstar Retirement Income US Universe by time period: Year 2008: 168; and Year 2011: 206.

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* This figure is presented as of March 31, 2020 and includes approximately $51.62 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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