Topic Paper
September 2018

FIXED INCOME INNOVATION:
Improve Diversification with a Simple Multi-Manager Approach

To date, we believe some plan sponsors haven't spent much time reviewing the fixed income offerings in their defined contribution plan. Why should they? For decades, core bond funds benchmarked to the Bloomberg Barclays U.S. Aggregate Index (BAGG) strove to offer predictable total returns and income, capital preservation, and low equity correlations. Although returns were relatively boring compared with equities, core bond funds offered a simple counterweight to the complexities and (sometimes) roller coaster-like returns of stocks. With equities frequently hogging the spotlight, the average defined contribution plan offered twelve equity options, but just three for bonds.[1]

1. BrightScope and Investment Company Institute. 2018. The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2015. San Diego, CA: BrightScope and Washington, DC: Investment Company Institute. Available at www.ici.org/pdf/ppr_18_dcplan_profile_401k.pdf.

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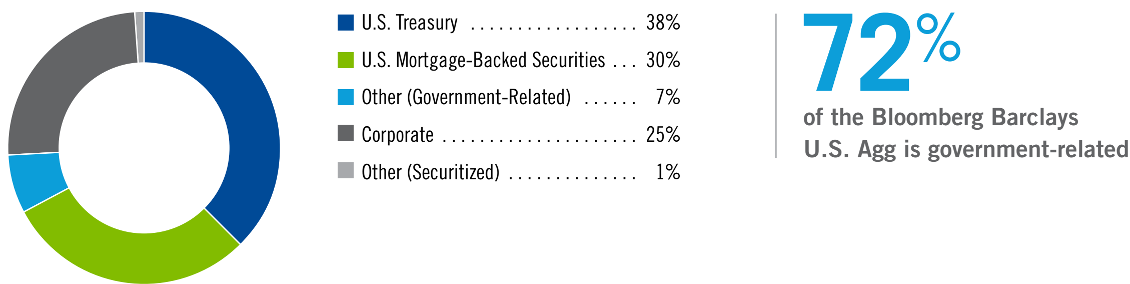
Now, with the U.S. Federal Reserve (Fed) well on its path of raising interest rates, and the core BAGG starting 2018 with its first negative quarterly return in over a year, bonds are grabbing some attention back from equities. Though bond performance remains considerably less volatile compared with stocks, two questions loom large for plan sponsors as they ponder today's shifting fixed income landscape. Are we still offering plan participants the right fixed income building blocks to achieve diversification, and will participants use them the right way? This topic paper addresses those questions and explores the concept that instead of offering more flavors of bond funds for participants to pick from, diversification might be better achieved through a single, multi-manager option.

Start with a solid U.S. core

Just as some plan sponsors offer low-cost passive indexing so participants can build core equity exposures efficiently, the same option can make sense for core bond allocations. For funds that replicate the BAGG, it's important to understand what that index does and doesn't provide within the context of a comprehensive, all-weather allocation to fixed income. As shown in Exhibit 1, the BAGG is wholly comprised of U.S. dollar-denominated securities, the majority of which are government-related, such as U.S. Treasuries. From a diversification standpoint, what's missing are bonds outside the U.S. and more credit-oriented sectors.

EXHIBIT 1: Breakdown of the Bloomberg Barclays US Aggregate Index composition
As of May 31, 2018



Source: Bloomberg, May 31, 2018. Sector weightings are subject to change.
Indexes are unmanaged and one cannot invest directly in an index. U.S. government-sponsored entities may be chartered by acts of Congress; their securities are neither issued nor guaranteed by the U.S. government. Portfolio composition is historical and may not reflect current or future portfolio characteristics.

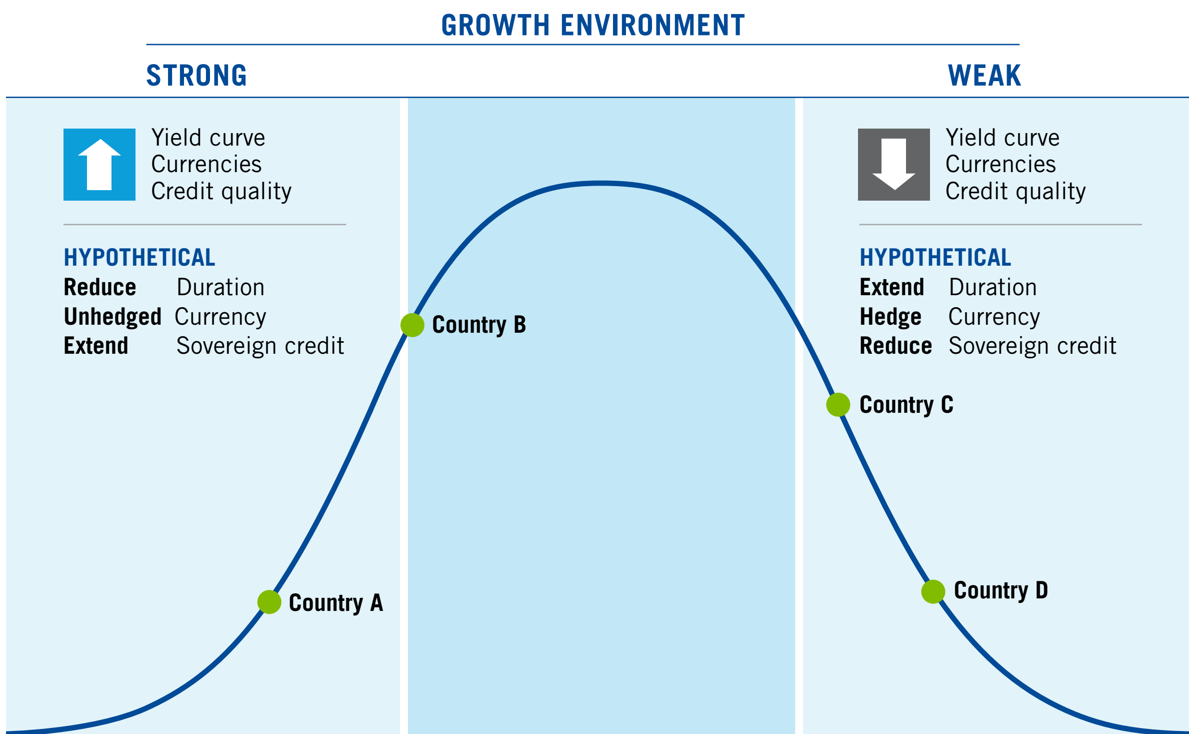
To help diversify away from a passive core, adding active 'core plus' managers with the flexibility to venture outside the U.S. and deeper into non-government sectors like high yield can potentially generate stronger long-term returns. Equally important in today's rising rate environment is an active manager's ability to tactically adjust bond duration exposure. Generally speaking, the higher a bond's duration, the more its value falls when interest rates rise. By flexibly shortening duration exposures, active managers can help manage risks in ways that passive strategies typically can't.

Diversify globally

While the majority (98%) of plan sponsors offer domestic bond funds, only a third offer international bond options.[1] One look at today's global economy, and more plan sponsors might consider diversifying their bond line-up globally. Outside of developed economies, higher yielding sovereigns in select emerging countries look particularly attractive. Various countries that were once riskier bets because of corruption and debilitating economic policies have moved firmly towards more credible monetary policies, and pro-business trading practices.

Since the world's economies don't often move in lock-step fashion through economic cycles, investing globally requires a discerning bond selection process. For example, some developed countries may trail the U.S. economy's growth trajectory by two years or more. That means sovereign bonds in countries like Europe and Japan won't necessarily correlate with the performance of U.S. Treasuries, as their central banks aren't synchronized with the United States Fed rate hikes. Depending on a country's position along the economic growth curve, active managers can potentially adjust positions across a number of dimensions, including duration and currency exposures as shown in Exhibit 2.

EXHIBIT 2: Economic expansion by region



This is a hypothetical example intended solely to illustrate a potential investment process. It is for illustrative purposes only and is not intended to reflect any actual positioning of any Franklin Templeton portfolio and does not constitute investment advice.

1. BrightScope and Investment Company Institute. 2018. The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2015. San Diego, CA: BrightScope and Washington, DC: Investment Company Institute. Available at www.ici.org/pdf/ppr_18_dcplan_profile_401k.pdf.

Actively allocate across sectors

Headlines about negative bond returns from further Fed rate hikes typically focus on U.S. Treasuries, which are sensitive to changing rates. But not all sectors in the bond market react the same way to rising rates, as illustrated by the historical performance in Exhibit 3.

EXHIBIT 3: Bond market reacts to rising rates

The importance of Fixed Income diversification

This table shows the annual returns of key fixed income sectors, on a year-by-year basis from 2008–2017, ordered from high to low.

The outlined columns denote years when the Federal funds target rate and/or the 10-Year Treasury Bond Yield increased.

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Best	10-Year US Treasury Bonds 20.42%	High-Yield Bonds 54.22%	High-Yield Bonds 14.42%	10-Year US Treasury Bonds 16.14%	High-Yield Bonds 14.71%	High-Yield Bonds 7.53%	10-Year US Treasury Bonds 10.57%	Mortgage-Backed Securities 1.51%	High-Yield Bonds 18.25%	Global Bonds 7.49%
	Global Bonds 10.89%	Investment-Grade Corporate Bonds 18.66%	Investment-Grade Corporate Bonds 9.00%	Investment-Grade Corporate Bonds 8.15%	Investment-Grade Corporate Bonds 9.82%	Mortgage-Backed Securities -1.41%	Investment-Grade Corporate Bonds 7.46%	10-Year US Treasury Bonds 1.13%	Investment-Grade Corporate Bonds 6.11%	High-Yield Bonds 7.03%
	Mortgage-Backed Securities 8.34%	Mortgage-Backed Securities 5.89%	10-Year US Treasury Bonds 7.89%	Global Bonds 6.35%	10-Year US Treasury Bonds 2.73%	Investment-Grade Corporate Bonds -1.53%	Mortgage-Backed Securities 6.08%	Investment-Grade Corporate Bonds -0.68%	Mortgage-Backed Securities 1.67%	Investment-Grade Corporate Bonds 6.42%
	Investment-Grade Corporate Bonds -4.94%	Global Bonds 2.55%	Mortgage-Backed Securities 5.37%	Mortgage-Backed Securities 6.23%	Mortgage-Backed Securities 2.59%	Global Bonds -4.00%	High-Yield Bonds 1.86%	Global Bonds -3.57%	Global Bonds 1.60%	Mortgage-Backed Securities 2.47%
Worst	High-Yield Bonds -26.17%	10-Year US Treasury Bonds -10.09%	Global Bonds 5.17%	High-Yield Bonds 5.47%	Global Bonds 1.65%	10-Year US Treasury Bonds -8.50%	Global Bonds -0.48%	High-Yield Bonds -4.93%	10-Year US Treasury Bonds -0.14%	10-Year US Treasury Bonds 2.13%

YEAR-END	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Federal Funds Target Rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.75%	1.50%
10-Year Treasury Bond Yield	2.25%	3.85%	3.30%	1.89%	1.78%	3.04%	2.17%	2.27%	2.45%	2.40%
6-Month CD Yield	1.70%	0.28%	0.40%	0.64%	0.33%	0.33%	0.43%	0.85%	1.27%	1.82%

Past performance does not guarantee future results.

This chart is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund. This information is for illustration and discussion purposes only and should not be relied upon as investment advice or a recommendation to buy, hold, or sell any security. Diversification does not guarantee a profit or protect against loss. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.

Source: Morningstar. **High-Yield Bonds** are represented by Credit Suisse High-Yield Index; **Global Bonds** are represented by Citigroup World Government Bond Index; **Mortgage-Backed Securities** are represented by Bloomberg Barclays US MBS Index; **Investment-Grade Corporate Bonds** are represented by Bloomberg Barclays; **10-Year US Treasury Bonds** are represented by Payden & Rygel's 10-Year US Treasury Index (1994–2015), Citigroup 10-Year US Treasury Index (2016–current). Indexes are unmanaged and one cannot invest directly in an index. Index returns do not reflect any fees, expenses or sales charges.

U.S. corporates, for example, currently benefit from a business-friendly environment that combines generally less burdensome regulations and lower tax rates. Active managers with deeper resources to analyze spread sectors like credit and securitized debt are often better equipped to weed out risks that passive approaches might overlook. By focusing on higher-quality issuers and tactically seeking out opportunities across sectors, a skilled multi-sector bond manager has the latitude to more safely position a bond portfolio across shifting market environments.

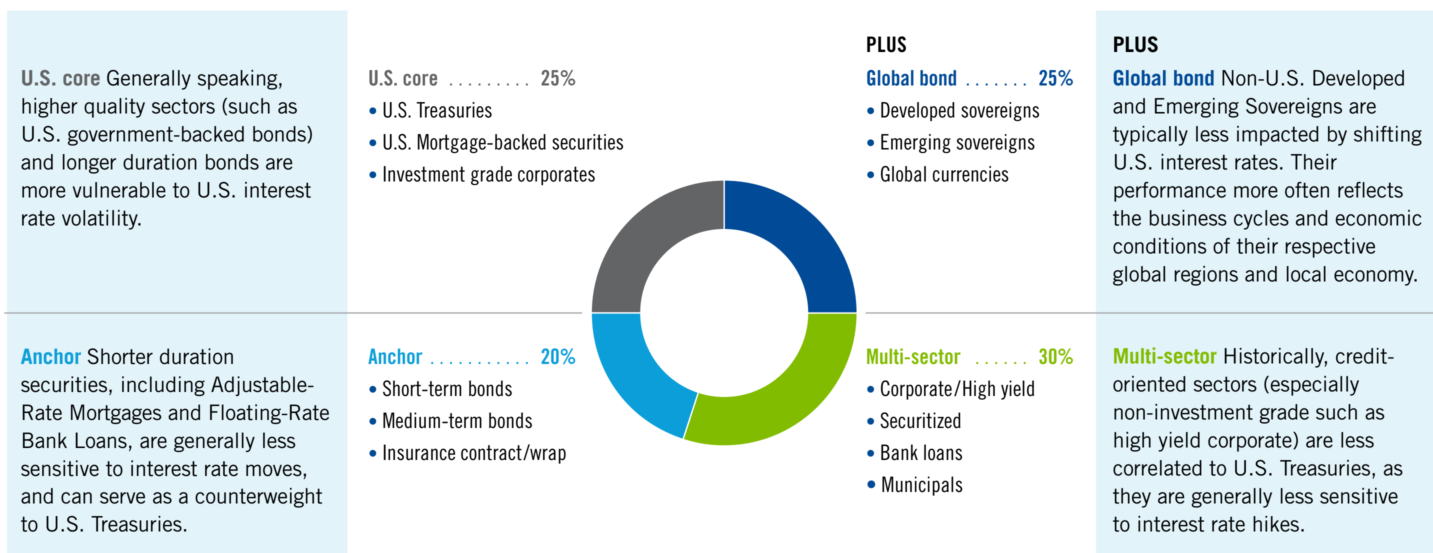
Round out with a stable anchor

For plan sponsors looking to offer a diversified set of fixed income building blocks, adding a fund that focuses on short- to intermediate-term bonds can potentially give plan participants a healthy ballast to core plus managers who venture further out on the risk spectrum. While returns on short-dated bonds were rather anemic following the Great Financial Crisis, in the wake of the Fed's recent rate hikes, two-year U.S. Treasury notes (which are typically considered relatively safe) are finally offering positive after-inflation yields. Because returns on short-dated bonds are generally predictable, they often form the core of capital preservation strategies, including Stable Value Funds, which add an extra layer of stability by incorporating insurance contracts to deliver a constant Net Asset Value (NAV).

Consider a pre-mixed solution

When it comes to building a diversified bond portfolio from a spectrum of core, global, multi-sector and stable value funds, some plan participants may find it challenging to combine them in the right proportions. Participants may simply invest in a single, less diversified core fund, or shift their assets into a new fund based mainly on past performance, without achieving the diversification they need going forward. A simpler solution for plan sponsors to consider might involve offering this diversification in a single solution. As shown in Exhibit 4, a Collective Investment Trust (CIT) could bring together a diverse line-up of bond funds from multiple managers, then monitor and tactically adjust allocations to seek enhanced diversification across time. For example, in a rising rate environment the CIT manager could trim (but not eliminate) assets from the passive core, then re-allocate to stable value, since short-dated bonds generally fair better when rates rise.

EXHIBIT 4: CIT strategy breakdown (hypothetical example)



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All investments involve risks, including possible loss of principal. *Diversification does not guarantee a profit or protect against loss. U.S. government-sponsored entities may be chartered by acts of Congress; their securities are neither issued nor guaranteed by the U.S. government. The risks associated with higher-yielding, lower-rated securities include higher risk of default and loss of principal. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. In addition, interest rate movements will affect the fund's share price and yield. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. Investment in foreign securities also involves special risks, including currency fluctuations, and political and economic uncertainty.*

Solving complexity more simply

Whether it is solving for problems like rising interest rates, giving participants the ability to diversify globally, or offering passive funds to help lower costs, many plans sponsors reflexively expand the number of investment options over time. But simply increasing the quantity of funds doesn't mean plan participants will use them properly, or experience better results. One option more plan sponsors are now considering involves consolidating offerings with a customized CIT. Generally less expensive than mutual funds, customized CITs can deliver a wide range of sophisticated benefits including broader diversification across multiple managers, enhanced alpha opportunities and sophisticated risk management, all combined within a single, easy-to-use offering.

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JASON COLAROSSI
National Retirement Strategist
Defined Contribution Division – U.S.

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