MFS® White Paper

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Revisiting the Role of Fixed Income Along the Retirement Savings Journey

From Theory to Practice

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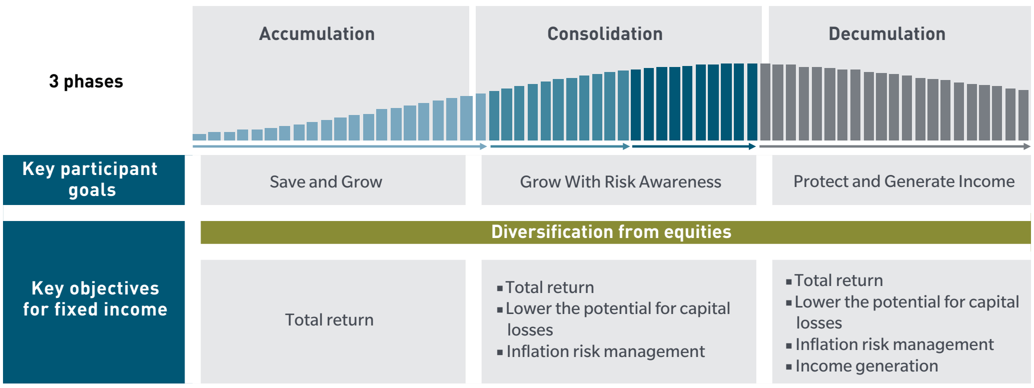
In brief:

- Target date fund risk profiles should align with evolving participant objectives along the retirement savings journey. We believe fixed income plays a critical role in managing risk.
- In our view, glidepath construction should focus on managing risk and the distribution of potential future returns, particularly for participants approaching retirement, as opposed to solely focusing on maximizing returns. This more balanced approach should increase the likelihood of participants attaining their desired outcomes.
- Target date fund managers allocate fixed income along a glidepath in many ways. We highlight this data for sponsors and demonstrate how it can result in a wide variety of potential outcomes for participants.
- We encourage sponsors to take another look — this time through a fixed income lens — at the plan's target date glidepath to ensure it aligns with the ultimate objectives of the retirement program.

We see the retirement savings journey as a framework that could help defined contribution (DC) plan sponsors explore the types of fixed income exposure offered to participants. Within each phase of the journey, there are key objectives for a participant's fixed income allocation, which evolve as a participant ages, as outlined in Exhibit 1.

This paper takes the retirement savings journey from theory to practice by sharing our views on how fixed income should evolve across a glidepath, exploring both the absolute level of the fixed income allocation and its composition in terms of fixed income sub-asset classes.

Exhibit 1: The retirement savings journey



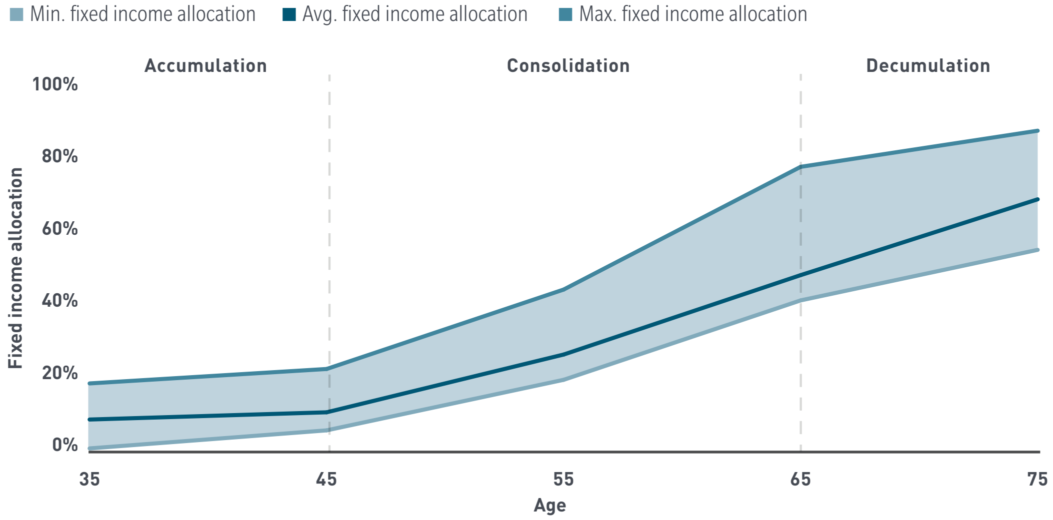
For illustrative purposes only.

Fixed income along a glidepath

A typical glidepath illustration highlights the level of equity along the path, which reflects the DC industry's historical focus on the accumulation phase of the retirement savings journey. To shine a spotlight on the fixed income allocation within that path, we took the current paradigm and turned it on its head. When viewed this way, we typically see an upward slope as participants' fixed income exposure increases while the number of years until retirement declines.

We encourage sponsors to consider the level of the fixed income allocation and how it evolves along the glidepath when selecting and monitoring a target date fund.

Exhibit 2: Reverse glidepath illustration



MFS Investment Management® analysis based on the 25 largest target date mutual fund series by assets under management as of 31 December 2022 as provided by Morningstar Direct. Fixed income allocation includes dedicated fixed income strategies, fixed income within asset allocation funds and cash. Please see endnotes for a list of these fund series.[1]

In keeping with our theme of taking the retirement savings journey from theory to practice, the following are questions we hear from sponsors around how to structure fixed income exposure along a glidepath in terms of level and composition.

Evaluating the level of fixed income

As Exhibit 2 illustrates, there is a wide range of practices in the allocation to fixed income along glidepaths. Depending on how much or how little fixed income a participant has at different points, retirement outcomes can vary significantly. We encourage sponsors to consider the level of the fixed income allocation and how it evolves when selecting and monitoring a target date fund.

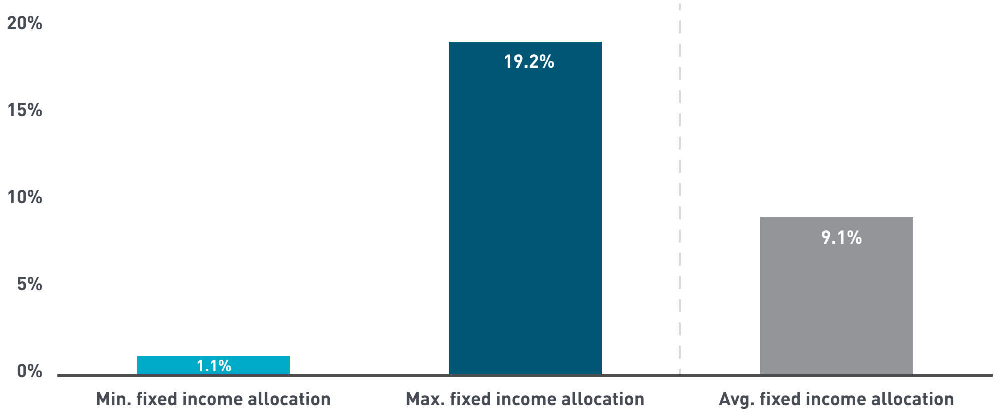
Should early-career participants have exposure to fixed income?

The US Department of Labor's 2007 Qualified Default Investment Alternatives (QDIA) guidance states that for a fund to qualify as a QDIA it must provide a mix of equity and fixed income exposures.[2] Within this context, sponsors should consider just how much fixed income exposure early accumulation phase participants really need.

The average fixed income allocation for a participant invested in a 2055 target date fund is approximately 9.1%; however, the minimum and maximum allocations range between 1.1% and 19.2%, respectively. While a larger fixed income allocation in far-dated vintages might feel "conservative," and therefore more comfortable for some sponsors, it can potentially inhibit participants' ability to grow and compound their savings.

Participants in the accumulation phase should seek to maximize capital appreciation.

Exhibit 3: Top 25 largest target date mutual fund series — total dedicated fixed income allocation in 2055 funds



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In the accumulation phase of the retirement savings journey, which includes participants in their early 20s through mid-40s, the most important objectives are to save as much as possible, maximize employer-matching contributions and grow these savings through compounding investment returns. Accordingly, we believe participants in this phase should have minimal fixed income exposure and seek to maximize capital appreciation through the higher growth potential of equity and other higher-returning asset classes. With a long time horizon until retirement, these participants have time to recover from market downturns and can generally withstand the greater volatility associated with more risk exposure. A higher allocation to equities in this phase can help build a larger retirement account balance, which can allow for participants to potentially take less risk later.

By emphasizing capital appreciation through a relatively small fixed income allocation early in the glidepath, we can also begin to address longevity risk, one of participants' greatest concerns in retirement. Longevity risk seems to be a topic most talked about as retirement approaches, but we believe this risk should be an explicit objective across the retirement savings journey. Growing capital early on is as important as growing it and protecting it later in life.

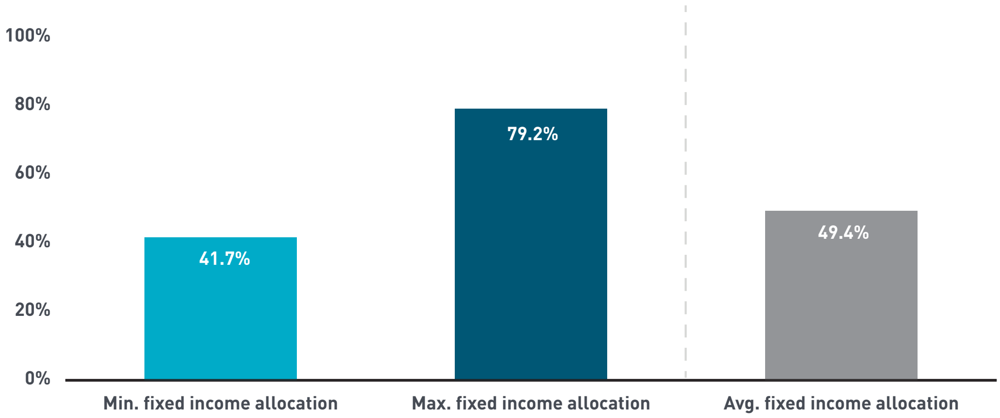
How much fixed income exposure should participants have in the later years of the consolidation phase and into the decumulation phase?

As discussed above, too much fixed income in the accumulation phase can inhibit a participant's ability to benefit from compounding investment returns. In the consolidation and decumulation phases, we believe too much equity exposes participants to excess drawdown and sequencing risk. We prioritize lowering the potential for capital losses above capital appreciation in the later years, which requires greater exposure to fixed income.

The range between the minimum and maximum fixed income allocations is significantly wider in near-dated vintages when a participant is close to retirement age, indicating less agreement among target date managers on how much to allocate to fixed income. While an analysis of the 2055 vintages shows a range of 18.1% between the minimum and maximum fixed income allocations, the 2025 vintages exhibit a range of 37.5%. These data illustrate the varying views of target date fund managers in determining an appropriate level of fixed income exposure.

Lowering the potential for capital losses should be prioritized above capital appreciation in the later years of the retirement savings journey.

Exhibit 4: Top 25 largest target date mutual fund series — total dedicated fixed income allocation in 2025 funds



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We often hear the argument that participants nearing and in retirement should continue to hold a significant allocation to return-seeking assets because they need a higher level of return for their savings to last through a long lifespan. It is also sometimes argued that participants who have not saved enough must maintain a return-seeking posture, which implies that late-career and retired participants can invest their way out of suboptimal savings behavior. We believe that longevity risk can be managed in a number of different ways and that higher equity allocations are not necessarily the most effective way to accomplish this. Furthermore, participants who have been unable to save enough are generally more financially fragile and have less ability to weather a market downturn, making a high-equity allocation late in the retirement savings journey potentially even less appropriate.

We believe that near-dated vintages should hold a relatively high allocation to fixed income, with the goal of lowering the potential for capital losses and managing sequence of returns risk. This can help to mitigate the impact of significant market declines as participants approach their retirement date, when there is less time to recover and a sharp drop in assets could have major implications, such as a postponement of retirement or a reduction of a participant's standard of living in retirement. In other words, a larger fixed income allocation in near-dated vintages positions participants more conservatively at this crucial stage of the retirement savings journey.

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Theory to practice: The impact of fixed income allocations on participant outcomes

As plan participants near retirement, it becomes increasingly important for target date funds to shift objectives from accumulation to capital preservation. Large losses in the years leading up to retirement may have an impact on a participant's retirement income stream, and in some cases, could force the participant to delay retirement.

Historically, portfolios with higher fixed income allocations have protected capital better in down markets than those with higher equity allocations. In addition, diversifying the fixed income allocation beyond a core allocation to one that incorporates a wider array of fixed income building blocks can be beneficial in a rising rate environment. In Exhibit 5, we compare historical annual returns over the past 15 years for three hypothetical portfolios to highlight the impact of having a higher allocation to fixed income, as well as to highlight to benefits of a diversified fixed income portfolio. The three hypothetical portfolios have the following allocations:

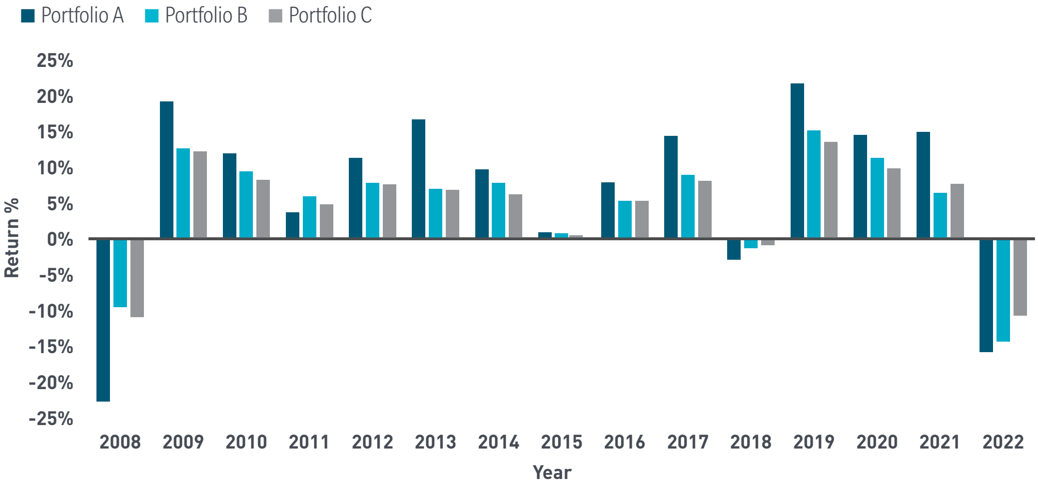
- Portfolio A: 60% equity/40% core fixed income
- Portfolio B: 30% equity/70% core fixed income
- Portfolio C: 30% equity/70% diversified fixed income

Over that period, there have been three years with meaningful equity drawdowns (2008, 2018 and 2022). In each of these years, Portfolio B outperformed Portfolio A, most notably in 2008, when the higher fixed income portfolio lost 9.5% compared to a 23% loss for the higher equity portfolio.

We also see in Exhibit 5 that diversifying the fixed income allocation to one that incorporates a wider array of fixed income building blocks beyond core bonds, including short-term bonds, TIPs, global bonds, emerging market debt and high yield, generally provided better outcomes, with Portfolio C outperforming Portfolio B in 2018 and 2022 by 0.4% and 3.6% respectively.

We do, however, see that Portfolio C underperformed Portfolio B in 2008 by 1.4%, mainly driven by underperformance in higher risk fixed income building blocks such as high yield and emerging market debt. This highlights the importance of selecting a skilled active manager who can construct portfolios through careful security and sector selection to help manage challenging market environments. As an example, in 2008, the top quartile managers for US High Yield and Emerging Market Debt, saw an outperformance of 4% and 2% respectively versus their benchmarks.[3]

Exhibit 5: Annual performance for hypothetical portfolios



Source: FactSet. See Assumptions and Methodologies for details on portfolios.

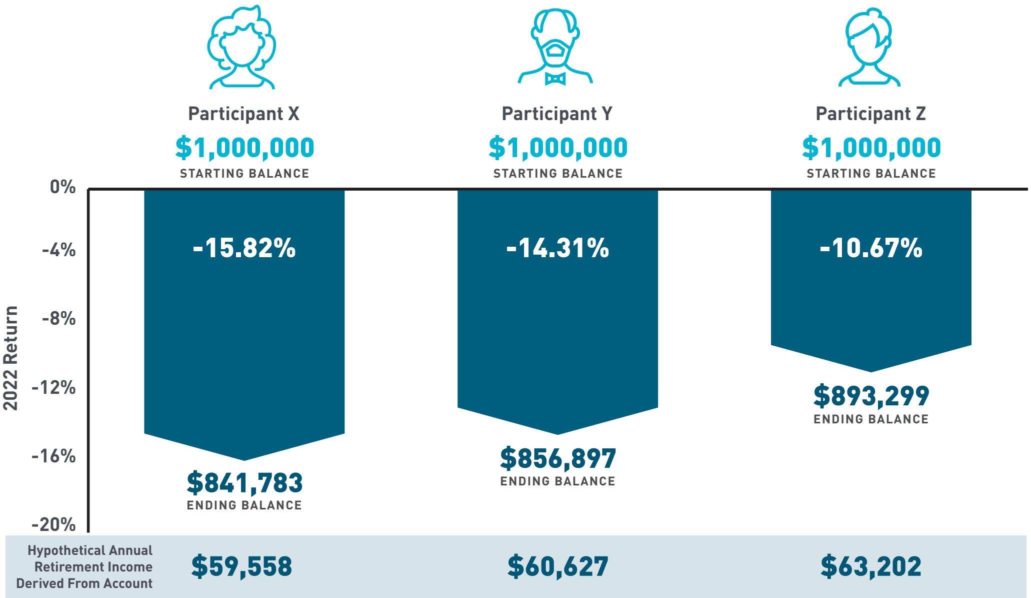
To take this a step further, we analyzed the potential impact of differing fixed income allocations on retirement outcomes by evaluating the impact of the 2022 market environment on three participants who were planning to retire on December 31, 2022, as noted below:

- Participant X was invested in Portfolio A (60% equity/40% core fixed income)
- Participant Y was invested in Portfolio B (30% equity/70% core fixed income)
- Participant Z was invested in Portfolio C (30% equity/70% diversified fixed income)

Our analysis assumes that all three participants had a retirement account balance of $1 million on January 1, 2022 and made no contributions to their account in 2022. Upon retirement, each participant intended to generate a level annual retirement income from their account over the next 20 years.

We believe in the broad diversification of fixed income throughout the glidepath.

Exhibit 6: Comparing hypothetical retirement outcomes

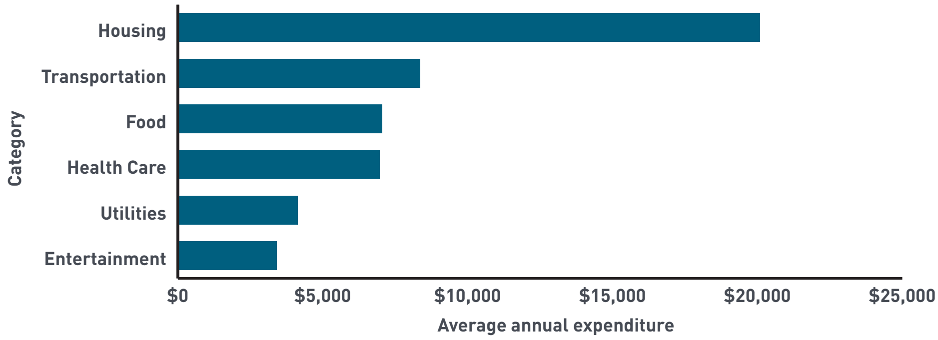


Source: FactSet. See Assumptions and Methodologies for details on assumptions used.

All three participants were impacted by challenging market conditions in 2022, as fixed income markets were down similar to equity markets, making the difference due to the high level asset allocation less impactful, with Participant X returning only about 1.5% less than Participant Y. However, while Participant Y and Participant Z had similarly conservative asset allocations, Participant Z's more diversified fixed income allocation had a significant impact on outcomes, resulting in a balance at the end of 2022 that was about $36,000 higher than Participant Y.

Further, we can see that this loss translated into nearly $4,000 per year less retirement income for Participant X versus Participant Z (and $2,500 less for Participant Y versus Participant Z). To put that into context, Exhibit 7 details average annual expenditures on various items for retirees.

Exhibit 7: Annual retirement expenditures



Source: Bureau of Labor Statistics, Consumer Expenditure Survey for 2021. Data is mean result for 65- to 74-year old for category shown.

For many retirees, every dollar counts, and even modest losses on their retirement accounts can have meaningful implications on their standard of living.

What is sequence of returns risk and why is it important?

Sequence of returns risk, or sequence risk, is the risk associated with the poor timing of negative investment returns materially impacting an investor's ability to realize their investment objectives.

Learn more about why sequencing risk is most pronounced in the later stages of the retirement journey in our Retirement Insights *Sequence of Returns Risk: Is Your Retirement Nest Egg Prepared*.

Deconstructing the fixed income allocation

The retirement savings journey (Exhibit 1) illustrates the many objectives a participant's fixed income allocation must achieve. We believe participants' fixed income exposure should offer diversification from equities but also contribute to total return, lower the potential for capital losses, help manage inflation risk and ultimately support income generation. Meeting these objectives can be a tall order for plans that rely primarily on a core fixed income allocation for participants' exposure to bond markets. We encourage sponsors to explore how incorporating fixed income strategies beyond a core fixed income allocation can help meet participants' evolving needs.

What are the underlying strategies that could comprise the total fixed income allocation?

We believe in the broad diversification of fixed income throughout the glidepath. Accordingly, we consider six fundamental building blocks when constructing fixed income allocations along that path (see Exhibit 8). The goal of constructing a diversified fixed income allocation is not to replace core bonds but rather to supplement the core bonds allocation, which acts as a foundation to address additional participant objectives.

Exhibit 8: Fixed income building blocks

For illustrative purposes only.

We encourage sponsors to review the fixed income allocation within their target date fund and how it evolves across the glidepath.

While participants do not always have exposure to every building block and the relative size of the allocation depends on the participant's position along the retirement savings journey, we feel that this diversified approach to fixed income exposure provides additional levers that can be employed to meet multiple objectives.

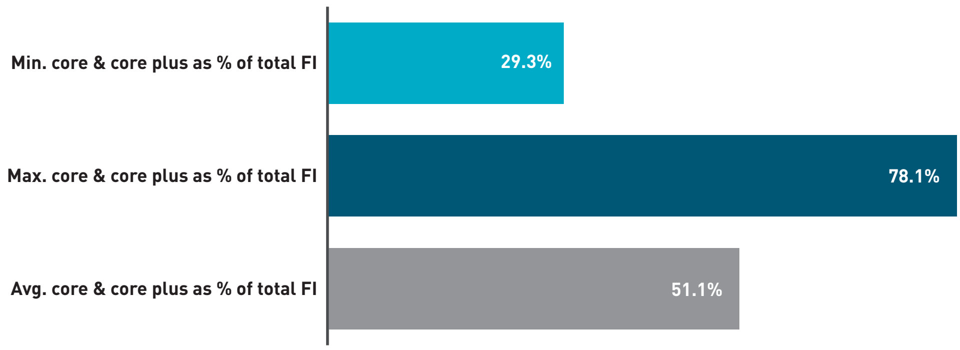
Building a well-diversified fixed income allocation along a glidepath

Many sponsors agree with the investment case for including exposures to fixed income strategies with higher risk and return profiles, such as emerging markets debt or high yield, but refrain from doing so on the core menu due to concerns that participants are not equipped to effectively allocate across these strategies. These concerns, however, are alleviated when the fixed income allocation is packaged within a target date fund glidepath. We encourage sponsors to review the fixed income allocation within their target date fund and how it evolves across the glidepath.

Do off-the-shelf target date managers offer diverse fixed income exposure for participants?

Some of the largest target date managers rely predominantly on core bond allocations — especially in near-dated vintages (*e.g.*, a 2025 fund) when the fixed income allocation is approximately equal to or greater than half of the participant's total portfolio.

Exhibit 9: Top 25 largest target date mutual fund series — Core bonds as a percentage of total dedicated fixed income allocation in 2025 funds



Source: MFS Investment Management® analysis based on the 25 largest target date mutual fund series by assets under management as of 31 December 2022 as provided by Morningstar Direct. Fixed income allocation includes dedicated fixed income strategies, fixed income within asset allocation funds and including cash. Core bonds includes the following categories: US Fund Intermediate Core Bond, US Fund Intermediate Core Plus Bond and US Fund Intermediate Government. Please see endnotes for a list of these fund series.

We encourage sponsors to look at the fixed income exposure in the target date fund and determine if it is appropriately diversified.

When we analyze the fixed income allocations of the 2025 vintages of the 25 largest target date mutual fund series, we see that the number of underlying fixed income strategies employed ranges from two to thirteen strategies. Furthermore, eleven target date fund managers have more than half of their total fixed income exposure invested in core bond strategies. Participants with high allocations to core bonds and limited exposure to other fixed income strategies are potentially missing out on the diversification that could be attained through broader access to fixed income building blocks. We encourage sponsors to look at the fixed income exposure in the target date fund and determine if it is appropriately diversified.

Conclusion

We believe that target date fund risk profiles should align with evolving participant objectives along the retirement savings journey and that fixed income plays a critical role in managing risk. Glidepath construction should focus on managing risk and the distribution of potential future returns, particularly for participants approaching retirement, as opposed to solely focusing on maximizing returns. This more balanced approach should increase the likelihood of participants attaining their desired outcomes.

Target date fund managers allocate fixed income along a glidepath in many ways. We highlight that for sponsors and demonstrate how this can result in a wide variety of potential outcomes for participants. We encourage sponsors to take another look — this time through a fixed income lens — at the plan's target date glidepath to ensure it aligns with the ultimate objectives of the retirement program.

Assumptions and methodologies

Exhibit 5

Returns for hypothetical portfolios based on weights and indices shown below. All returns are total returns.

	S&P 500 Total Return Index	MSCI ACWI Index	Bloomberg Barclays US Aggregate Bond Index	Bloomberg US Aggregate 1-3 Year Index	JP Morgan EMBI Global Diversified Index (Hedged)	Bloomberg Barclays US Corporate High Yield Index	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	Bloomberg Barclays US Government Index	Bloomberg Barclays Global Aggregate Index	FTSE 3 Month US T Bill Index
Portfolio A: 60% equity / 40% fixed income	50%	10%	40%							
Portfolio B: 30% equity / 70% fixed income	25%	5%	70%							
Portfolio C: 30% equity / 70% diversified fixed income	25%	5%	10%	10%	2.5%	2.5%	10%	10%	5%	20%

Exhibit 6

- Analysis assumes that each participant retires on December 31st, 2022 and makes first withdrawal in 2023.
- The hypothetical annual retirement income derived from the account is based on a 20-year level annuity payable at the beginning of the year using a discount rate of 4%.

Endnotes

[1] The 25 largest target date mutual fund series by assets under management, as of 31 December 2022, provided by Morningstar Direct include Vanguard Target Retirement Series, American Funds Target Date Retirement Series, Fidelity Freedom Series, T. Rowe Price Retirement Series, Fidelity Freedom Index Series, BlackRock LifePath Index, TIAA-CREF Lifecycle Index Series, TIAA-CREF Lifecycle Series, JPMorgan SmartRetirement Series, Principal LifeTime Series, Fidelity Advisor Freedom Series, State Street Target Retirement Series, JPMorgan SmartRetirement Blend Series, American Century One Choice Series, Fidelity Freedom Blend Series, Voya Index Solution Series, Mutual of America Retirement Series, JHancock Multimanager Lifetime Series, MassMutual Select TRP Retirement Series, Great-West Lifetime Series, JHancock Multi-Index Pres Series, Guidestone Funds MyDestination Series, Schwab Target Index Series, USAA Target Retirement Funds Series and MFS Lifetime Funds.

[2] A DOL Field Assistance Bulletin issued in April 2008 addressed the question, "Can an investment fund or product with zero fixed income qualify as a QDIA?" by reiterating the view that a QDIA must include some fixed income exposure.

[3] eVestment Alliance. Data is for calendar year 2008. Top quartile defined as the return needed to beat 75% of the strategies peers in the given year. Settings and criteria for managers selected for the High Yield universe cohort as follows: eVestment High Yield universe filtered for active managers only, benchmarked to the Bloomberg US Corporate High Yield 2% Cap index, including managers now defunct or inactive. Returns shown are for the default reporting vehicles are shown gross of fees, in USD. Settings and criteria for managers selected for the Emerging Markets Debt universe cohort as follows: eVestment Emerging Market Debt universe filtered for active managers only, benchmarked to the JPMorgan EMBI Global Diversified index, including managers now defunct or inactive. Returns shown are for the default reporting vehicles are shown gross of fees, in USD.