PRUDENTIAL INVESTMENTS » MUTUAL FUNDS

INSIGHTS ON INVESTING

FIXED INCOME OPTIONS WITHIN DC PLANS

WHITE PAPER

AN OPPORTUNITY TO ENHANCE DC INVESTMENT MENUS

Because defined contribution (DC) plans historically have been used as savings accumulation vehicles, it is not surprising that today's DC investment menus typically include numerous equity choices but only a few fixed income offerings. This may no longer be prudent. The shift from defined benefit (DB) plans to DC plans as the primary workplace retirement offering has left individuals with more responsibility not only for saving for retirement, but also for transforming their savings into a sustainable stream of income once they stop working. Today's equity-heavy investment menus may not be up to this task. Beyond the shift from DB to DC plans, other trends suggest that plan sponsors should be adding more fixed income choices to their investment menus:

- Increased customization of investment options
- A growing focus on income generation and risk aversion

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When adding fixed income investment options to their DC plans, sponsors should make sure those options meet two key criteria. First, they should offer a robust investment rationale, particularly for retirement investors. Second, they should facilitate the construction of better investment portfolios, either by participants directly or by plan advisors building custom qualified default investment alternatives (QDIAs) from a plan's investment offerings.

This paper will explore these issues and trends in greater detail, and describe three types of fixed income funds that could be particularly attractive additions to many DC investment menus: high yield bond funds, global bond funds, and floating rate income funds.

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INTRODUCTION

The shift from the DB plan to the DC plan as the primary workplace retirement offering has given individuals more responsibility to save for retirement and to invest their savings appropriately. To help them achieve those goals, plan sponsors have tried to construct well-diversified DC investment menus. Often, however, they have concentrated their diversification efforts on equity offerings. To some extent, this reflected the widely held perception that DC plans were primarily savings accumulation vehicles. Now, a number of trends are prompting sponsors to take a fresh look at how to build appropriately diversified investment menus for their DC plans.

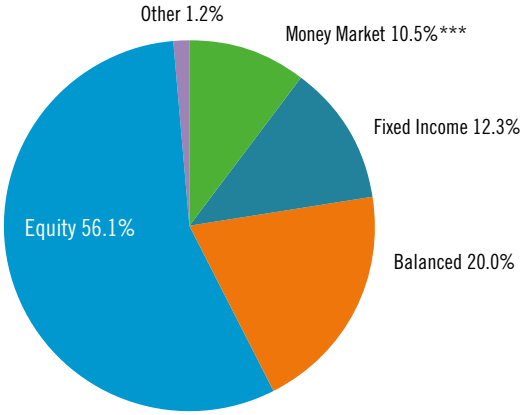
- **Increased customization of investment offerings.** Having watched their employees take on the risks associated with the investment performance of their retirement savings accounts, plan sponsors are recognizing the need to balance a robust investment menu with a simplified investment selection process for employees. As a result, many have been adopting professionally managed and packaged investment vehicles. At the same time, some are shifting away from the use of "off-the-shelf" target-date and target-risk funds as their QDIAs and are building custom QDIAs instead. By adding more fixed income options to their investment menus, sponsors and their advisors would find it easier to tailor these QDIAs to the specific needs of their plan participants.

- **Growing focus on income generation and risk aversion.** In 2008, only 33% of the participants in private-sector, employment-based retirement plans had a DB plan, down from 84% in 1979.[1] Because fewer individuals are entering retirement covered by DB plans, DC plans have evolved from supplemental savings accumulation vehicles to a primary source of retirement income. As a workforce dependent on DC plans ages, its members are becoming increasingly focused on converting retirement savings to retirement income. Some are also embracing more conservative investment strategies in the wake of the 2008 financial crisis and the steep stock market decline that accompanied it.

To support plan participants in their efforts to build and protect an asset base that will generate retirement income, sponsors of DC plans should consider strengthening their lineup of fixed income offerings. According to the nonprofit Plan Sponsor Council of America, the average DC plan has 18 offerings on its investment menu, but only two or three are fixed income funds.[2] As shown in exhibit 1, about 56% of funds offered in DC plan menus are equity funds, followed by balanced funds (20%), and fixed income funds (12%).[3] The most common fixed income offerings are domestic bond funds.[4]

EXHIBIT 1: FIXED INCOME FUND REPRESENTATION ON DC PLAN INVESTMENT MENUS

Average number of investment options in DC plan menus: 18*
Distribution of investment options offered within DC plans**



Sources:

* Profit Sharing/401(k) Council of America, "53rd Annual Survey," 2010, tables 55 and 57.

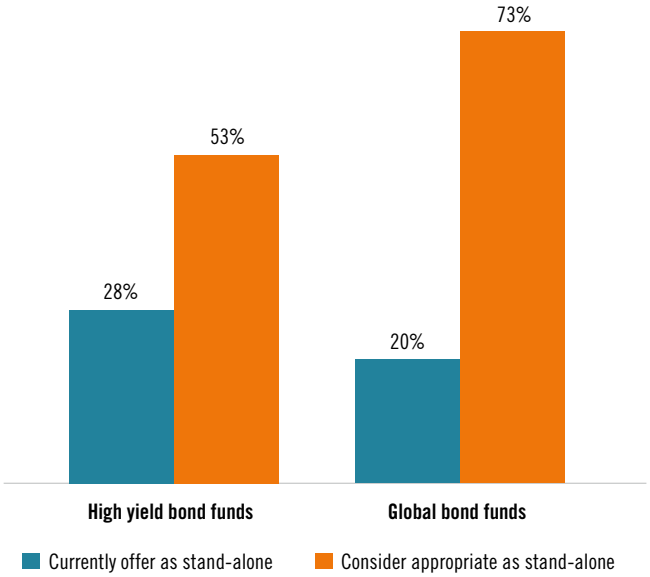
** Tang and Mitchell, "The Efficiency of Pension Plan Investment Menus: Investment Choices in Defined Contribution Pension Plans," 2008. Based on 1,500 Vanguard funds.

*** Includes investment contracts.

Other types of fixed income funds are offered far less frequently. As shown in exhibit 2, a survey of plan sponsors found that fewer than 30% of plans offer high yield bond funds or global bond funds as stand-alone menu options.[5] On the other hand, over 50% of sponsors would consider these asset classes appropriate as stand-alone menu options.

EXHIBIT 2: LESS WIDELY OFFERED DC FIXED INCOME INVESTMENT OPTIONS

Percent of sponsors that offer versus consider appropriate to offer



Source: Mercer LLC, "U.S. Defined Contribution Investment Survey," August 2011, pages 4–7.

There are several plausible reasons why plan sponsors offer relatively few fixed income options to plan participants. As noted, DC plans have long been viewed primarily as asset accumulation vehicles, and equities historically have generated higher long-term returns than bonds—albeit with more volatility. Also, many plan sponsors have limited the overall growth of their investment menus in recent years on the theory that too many choices can overwhelm participants. In fact, academic research suggests that rather than creating an optimal portfolio from their investment menu, participants have a propensity to evenly allocate their investments across each of the available investment choices.[6,7] In any event, the average number of investment choices on DC plan menus peaked at about 19 options in 2005 and has since stabilized and decreased slightly to 18.[8]

Meanwhile, plan sponsors have become more focused on increasing the use of QDIAs, such as target-date and target-risk funds, by their plan participants.[9, 10] A typical QDIA provides participants with access to a diversified portfolio within a single investment selection. Plan sponsors may have been disinclined to add other investment options to their menus because they believed QDIAs already provided participants with convenient access to a wide range of asset classes, all with the added benefit of professional asset allocation.

Although plan sponsors may have had sound reasons for limiting the number of DC menu choices, it may be time to revisit the number of fixed income choices they offer, both to address the more conservative, income-conscious needs of their older plan participants and to facilitate the construction of custom, appropriately diversified QDIAs.

This article explores this imperative in greater detail, along with three types of fixed income funds that could be particularly helpful in meeting the evolving needs of retirement plan participants: high yield bond funds, global bond funds, and floating rate income funds.

The percentage of DC target-date assets that is customized is projected to more than double, from 17% in 2008 to 37% in 2018.[12]

BEHIND THE TRENDS IMPACTING DC INVESTMENT MENUS

The key trends impacting the way plan sponsors should now be constructing investment menus for their DC plans are broad and are likely to be long lasting. The first of the approximately 78 million baby boomers born between 1946 and 1964 are just now retiring, and many of the challenges they are facing will continue to challenge those who follow them.

ADOPTION OF CUSTOM QDIAS

The nascent shift away from using pre-packaged, "off-the-shelf" funds as QDIAs in favor of custom QDIAs is likely to persist, simply because it gives plan sponsors the opportunity to better tailor those funds to the characteristics of their participant populations.[11] Working with advisors and consultants, sponsors can construct custom target-date funds, for example, that specify the asset allocation mix and the underlying investments within those funds. The percentage of custom target-date assets in DC plans is projected to more than double, from 17% in 2008 to 37% by 2018,[12] as sponsors seek to capitalize on their benefits:

- **Control over the underlying investments and managers in the QDIA.** Sponsors implementing a custom target-date fund can select the managers and underlying investments within the fund.

- **Improved portfolio construction.** Sponsors that use, or are considering using, custom target-date funds indicate that the asset classes currently found in prepackaged target-date funds are insufficient to mitigate the risks of longevity, market volatility, and inflation. These sponsors want to include additional asset classes, such as global bonds and Treasury inflation protected securities (TIPS).[13]

- **Alignment of the QDIA with participant needs.** Custom QDIAs can be tailored to the demographics and needs of a retirement plan's participants. For example, a sponsor whose participants frequently take loans from their accounts may want to offer funds with a more conservative asset allocation mix than can be found among off-the-shelf funds, given that frequent borrowing may be inconsistent with a long-term investment strategy.

More than 70% of plan sponsors use their plan's existing investment options when developing a custom target-date fund or similar QDIA,[14] in part because they have already conducted extensive due diligence on those options. The more investment options available as building blocks, the greater the opportunity to create the best possible funds.

Unlike other types of investment platforms that offer professionally constructed portfolios, however, DC plans generally have a narrower range of fixed income investments with which to work. An anecdotal review of the major discretionary, retail, managed account platforms indicates that the platforms typically offer six to eight fixed income funds within their conservative risk and moderate risk model portfolios, for example, including total return, corporate, inflation adjusted/protected, short-duration, high yield, and international bond funds.[15] This compares to an average of two to three fixed income funds offered by most DC plans.[16]

Plan sponsors concerned about adding too many additional funds to their investment menus, and perhaps overwhelming participants with too many fund choices, could simplify their menus by offering a limited number of packaged portfolio products. For example, sponsors might offer one fixed income fund of funds rather than multiple, individual fixed income funds. That fund of funds could include a higher number of fixed income funds than is typically found in DC plans today.

THE EVOLVING NEEDS OF DC PARTICIPANTS

Participants in DC plans are becoming more interested in fixed income investments for two reasons. First, the workforce is aging, and older workers, in a bid to safeguard assets they will someday need to generate retirement income, tend to allocate a higher portion of their retirement savings to fixed income than younger investors. According to the nonprofit Employee Benefit Research Institute, participants in their 60s hold 37% of their assets in fixed income funds, money market funds, or stable value funds, while participants in their 20s hold just 14% of their assets in those investments.[17]

Second, retirement plan participants have become more conservative investors in the wake of the financial crisis of 2008. Research by Prudential Financial indicates that 28% of U.S. consumers say that they have invested more conservatively over the past year, for example, while only 12% invested more aggressively.[18] In another survey, 54% of plan sponsors indicated that recent market volatility has heightened the priority for adopting more conservative investment options in DC plans.[19]

There are multiple types of fixed income investments that can accommodate participants' growing investment conservatism and need for retirement income. Funds that invest in TIPS or floating rate bank loans may appeal to participants seeking protection against inflation or rising interest rates, for example, while high yield bond funds may be attractive to participants seeking higher levels of income from their retirement assets.

EVALUATING FIXED INCOME INVESTMENT OPTIONS

Plan sponsors considering new investment options for their retirement plans should insist that those offerings meet strict criteria. Specifically, they should ask:

1. Does the investment offering have a robust investment rationale, particularly for retirement investors?
2. Does the investment offering enable the construction of better portfolios, either by participants on their own or by a plan advisor constructing a custom QDIA using the plan's investment options?

High yield bond funds, global bond funds, and floating rate income funds meet these criteria, and they can enhance the investment menus of DC plans. Yet they are underrepresented in DC plans today. High yield funds, for example, are offered in fewer than a third of all such plans.

HIGH YIELD BOND FUNDS

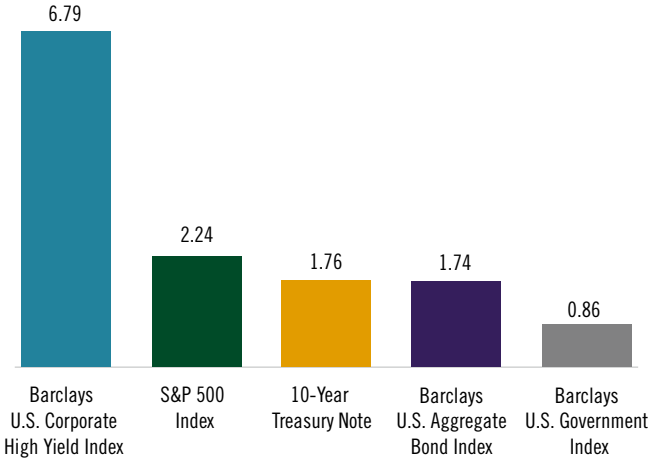
High yield bond funds invest in below-investment-grade corporate bonds, typically with maturities ranging from five to 10 years. The underlying bond portfolio is often diversified in terms of credit quality, maturity date, and issuer industry. A diversified portfolio helps provide protection against credit defaults, which are much more likely for high yield bonds than for investment-grade bonds.

The investment rationale for high yield bonds is compelling for retirement investors. It includes the typically high levels of current income these bonds could generate, their efficiency in generating attractive levels of return for the risks they carry, and their potential to outperform other fixed income investments in a rising interest rate environment.

- **Potentially high levels of current income.** Over the past 18 years, high yield bonds provided an average of 600 basis points of incremental yield, or spread, over Treasury bonds[20] before taking into account credit defaults. As illustrated in exhibit 3, high yield bonds continue to provide an opportunity for retirement investors to potentially reap substantially higher levels of current income than they can from other investment options in today's low interest rate environment.

EXHIBIT 3: COMPARATIVE YIELDS ON VARIOUS INDICES

Yields (as of 12/31/12)



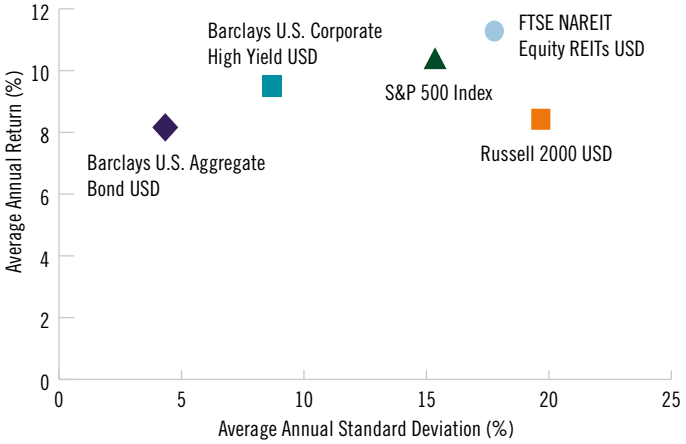
Source: Prudential Financial analysis.

Past performance is no guarantee of future results.

- **Efficiency.** The spreads that high yield bonds offer relative to Treasuries and investment-grade corporate bonds come, of course, with additional risks. High yield bonds historically have had higher default rates than investment-grade bonds. However, high yield bonds can be efficient investments given the returns they provide relative to their risk. Since 1983, high yield bonds have provided 93% of the average annual returns of equities but with only 56% of the volatility, as measured by standard deviation.[21] This risk-return history relative to other asset classes is illustrated in exhibit 4.

EXHIBIT 4: RISK-RETURN CHARACTERISTICS OF VARIOUS INDICES

Average annual return and standard deviation of key asset classes 07/01/83 to 12/31/12*



* Starting date of 7/1/1983 selected to coincide with inception of Barclays U.S. Corporate High Yield Index.

Source: Prudential Financial analysis.

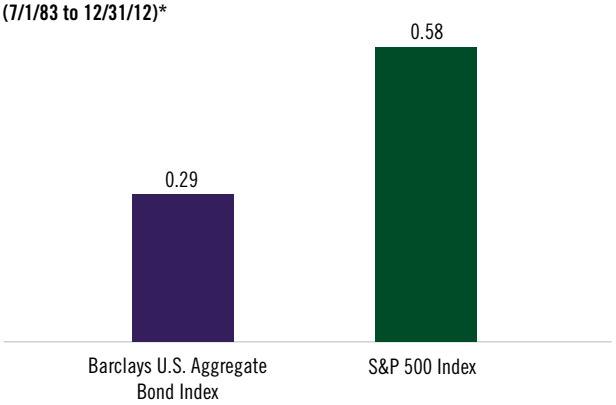
Past performance is no guarantee of future results.

- **Potentially favorable reaction to a rising interest rate environment.** The value of a fixed income security typically declines in a rising interest rate environment.[22] High yield bonds are not immune to this phenomenon. However, high yield bonds may provide some degree of protection for fixed income investors in a rising rate environment for two reasons. First, high yield bonds tend to be short- or intermediate-term in duration, and shorter-duration bonds are typically impacted less by rising rates than longer-duration bonds. Second, interest rates often rise when economic conditions are improving, and improving economic conditions can bolster the financial health of high yield issuers, lowering their chances of defaulting on their debt.

In addition to possessing a compelling investment rationale, high yield bonds can function as attractive components of an individual investment portfolio or custom QDIA. As illustrated in exhibit 5, the returns from high yield bonds historically have had a low correlation to the returns from other bonds and a moderate correlation to the returns of the S&P 500 stock index. As a result, high yield bonds can provide meaningful diversification within a portfolio.

EXHIBIT 5: VALUE OF HIGH YIELD AS A PORTFOLIO DIVERSIFIER

Correlation of Barclays U.S. High Yield Index to selected investments (7/1/83 to 12/31/12)*



* Starting date of 7/1/1983 selected to coincide with inception of Barclays U.S. Corporate High Yield Index.

Source: Prudential Financial analysis.

The potential benefit of including high yield bonds in an investment portfolio is shown in exhibit 6. Specifically, this graphic illustrates the impact of adding a 10% allocation to high yield bonds in a portfolio originally divided 60/40 between the S&P 500 and the Barclays U.S. Aggregate Bond Index. The high yield bonds replace stocks, reducing the total allocation to the S&P 500 to 50%.

Based on historical data, the average annual return of the new portfolio would have been 9.86% for the time period illustrated, compared to 9.92% for the original portfolio. However, the average annual volatility would have fallen to 8.74% from 9.71%. In short, adding high yield bonds had a negligible impact on returns, but substantially lowered risk. In addition, it improved the risk-adjusted return, as measured by the Sharpe Ratio, to 0.64 for the new portfolio, versus 0.59 for the original portfolio.[23]

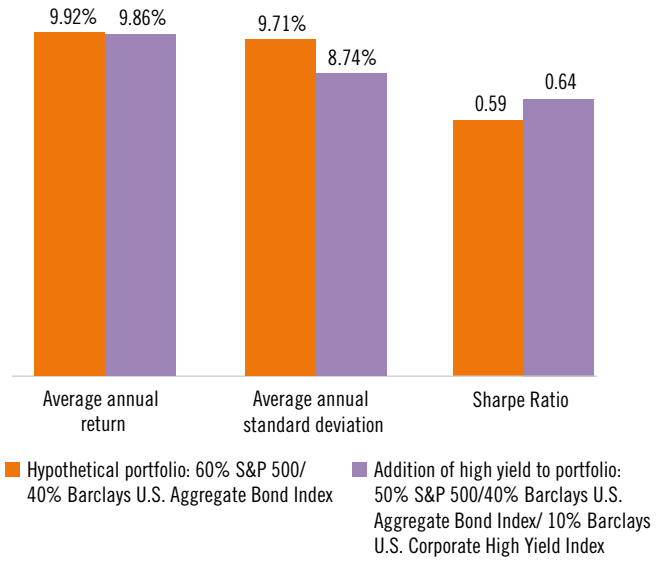
This example highlights how including high yield securities in a DC plan's investment menu can help plan sponsors construct well-diversified, customized QDIAs using their plans' own investment options. As a point of reference that provides insight

A recent survey indicates that over 30% of DB plan sponsors identify high yield bonds as one of the product innovations that delivered the most value over the last decade.[24]

into how institutional investors think about high yield debt, a recent survey indicates that over 30% of DB plan sponsors identify high yield bonds as one of the product innovations that delivered the most value over the last decade.[24]

EXHIBIT 6: IMPACT OF ADDING HIGH YIELD TO A HYPOTHETICAL RETIREMENT PORTFOLIO

7/1/83 to 12/31/12*



* Starting date of 7/1/1983 selected to coincide with inception of Barclays U.S. Corporate High Yield Index.

Source: Prudential Financial analysis.

Past performance is no guarantee of future results. This hypothetical is presented for illustrative purposes only and is not indicative of any particular investment.

In addition to high yield bond funds, there are two other fixed income investment products that can help DC plan participants meet their evolving investment needs.

GLOBAL BOND FUNDS

As of June 2011, U.S. bonds accounted for only 25% of the world's total bonds outstanding.[25] Among the remaining 75%, many are bonds issued in countries that are enjoying strong economic growth. From 2011 to 2013, for example, emerging economies are expected to enjoy a three-year average growth rate of 6.5%, versus 2.4% for developed countries.[26] Accordingly, global funds may be well-suited to investors seeking to add geographic diversity to a domestic portfolio, or simply to take advantage of attractive investment opportunities without limiting themselves to U.S.-based investments.

Global funds invest in a diversified portfolio of fixed income securities issued within the U.S. and other countries, and they typically comprise a mix of government-issued bonds, corporate bonds, and other fixed income securities, such as bank loans. Since 1990, their average annual returns have been comparable to those available from U.S. bonds.[27] However, global bonds significantly outperform domestic bonds during periods when the U.S. dollar is weakening,[28] which generally happens when the U.S. trade deficit is growing.[29]

FLOATING RATE INCOME FUNDS

Floating rate income funds invest in loans where the interest rate periodically resets based on changes in a specified benchmark interest rate, such as the London Interbank Offered Rate (LIBOR). The issuers of these loans are typically below-investment-grade borrowers.

For investors, the primary benefit of floating rate loans is that they usually outperform other fixed income securities during periods of rising interest rates. As shown in exhibit 7, the returns on floating rate loans significantly exceeded those of the Barclays U.S. Aggregate Bond Index during periods of rising interest rates over the last two decades. This is due to the fact that the income generated by floating rate loans increases when interest rates rise.[30]

Investors looking to benefit from a rising interest rate environment and protect against inflation may find floating rate income funds a valuable addition to their portfolios. With interest rates at historically low levels,[31] these funds could be especially appealing to some investors right now, as rates simply cannot fall much lower. They also may appeal to investors who view the highly leveraged U.S. balance sheet as an indication that interest rates and inflation rates will ultimately rise. The nation's gross debt as a percentage of gross domestic product is 100% today, versus 89% for countries in the eurozone, collectively, and 36% for emerging countries.[32]

EXHIBIT 7: HISTORICAL AVERAGE ANNUAL RETURNS OF FLOATING RATE LOANS DURING RISING RATE PERIODS

TIME PERIOD	MONTHS	FED FUNDS RATE	FLOATING RATE LOANS	BARCLAYS U.S. AGGREGATE BOND INDEX
2/94–2/95	13	3.00% to 6.00%	10.4%	0.01%
6/99–5/00	12	4.74% to 6.50%	3.9%	2.1%
6/04–6/06	25	1.00% to 5.25%	12.6%	6.5%

Source: Prudential Investments LLC calculations using data presented in Morningstar software products. All rights reserved. Used with permission. Floating rate loans represented by Credit Suisse Leverage Loan Index. Past performance is no guarantee of future results.

Naturally, plan sponsors will need to evaluate the investment products discussed in this article carefully and confirm that they are appropriate for the participants in their retirement savings plans. Sponsors unsure of whether their participants would use these products responsibly could opt to make them available only as part of a custom QDIA managed by a plan advisor or consultant.

CHOOSING A FIXED INCOME INVESTMENT MANAGER

Selecting an appropriate fixed income investment manager is critical to building a robust DC plan menu with a diversified selection of fixed income offerings. Competencies to evaluate when considering such a partner include:

- **Risk management.** Evaluate the resources the investment manager dedicates to risk management. Among other things, look at how the manager performed during the financial crisis of 2008 and confirm that the manager bases investment decisions on a combination of sophisticated, quantitative risk modeling and the judgment of its own research analysts.

- **Credit research.** Consider working with a fixed income partner whose research analysts specialize by sector and also develop their own credit ratings independent of rating agencies. A manager who can rank the relative values of securities both within and across sectors can help to ensure that sectors are fairly weighted in the portfolios it manages and that the best opportunities within each sector are selected.

- **Portfolio management.** Look for a partner with the size and scale to access popular debt offerings, negotiate purchase terms at attractive prices, and secure time with industry leaders and executives who can provide insight into investment risks. At the same time, investigate whether a manager has become so large that it cannot trade as nimbly as its smaller counterparts and must therefore rely heavily on derivatives transactions to make portfolio adjustments. In sum, seek a partner that has sufficient size and scale yet can still remain flexible in its trading activities.

In all cases, competency levels in these areas will be dependent upon the quality and experience of the manager's investment professionals.

CONCLUSION

The landscape is changing for DC plans. Plan participants at or near retirement age are putting a new focus on using their plans not just to accumulate assets, but to generate a sustainable stream of income once they stop working. Many have also become more risk averse in the wake of the 2008 financial crisis and the ensuing stock market volatility. In response, plan sponsors are beginning to re-think some of the investment options offered by their plans, often creating custom offerings—particularly customized QDIAs—that are tailored to the needs and demographics of their participant populations.

Unfortunately, many plan sponsors are limited in these efforts by having too few fixed income investment options in their DC plans—options that could be critical to meeting the new demands participants are placing on their retirement savings accounts. To compete in this changing landscape, plan sponsors should consider broadening the number and type of fixed income investments they offer their plan participants. By adding high yield bond funds, global bond funds, and floating rate income funds to their DC investment menus, plan sponsors may help to improve retirement outcomes for American workers.

For more information please contact:

Michael Rosenberg
Senior Vice President, Prudential Investments
1-973-367-5430
michael.rosenberg@prudential.com

Sources

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[3] Tang and Mitchell, "The Efficiency of Pension Plan Investment Menus: Investment Choices in Defined Contribution Pension Plans," 2008. Based on 1,500 Vanguard funds.

[4] Plan Sponsor Council of America (formerly the Profit Sharing/401k Council of America), "53rd Annual Survey Reflecting 2009 Plan Experience," 2010, table 57.

[5] Mercer LLC, "U.S. Defined Contribution Investment Survey," August 2011, pages 4–7.

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[7] Benartzi, Shlomo, and Thaler, Richard H., "Naïve Diversification Strategies in Defined Contribution Saving Plans," 2001.

[8] Plan Sponsor Council of America (formerly the Profit Sharing/401k Council of America), "53rd Annual Survey Reflecting 2009 Plan Experience," 2010, tables 55 and 57.

[9] As provided by the Pension Protection Act of 2006, plan sponsors receive safe harbor protection if they automatically enroll participants into DC plans and default participants' savings into QDIAs.

[10] Since the establishment of QDIAs in 2006, usage has grown such that about two-thirds (65%) of DC plans with automatic enrollment use QDIAs as their default investment. Deloitte, "Annual 401(k) Survey Retirement Readiness, 2010 Edition," 2011, pages 7–8.

[11] Casey Quirk, "Target-Date Retirement Funds: The New Defined Contribution Battleground," 2009, pages 8–10.

[12] Casey Quirk, "Target-Date Retirement Funds: The New Defined Contribution Battleground," 2009, pages 8–10.

[13] Casey Quirk, "Target-Date Retirement Funds: The New Defined Contribution Battleground," 2009, pages 9–10.

[14] Plan Sponsor Council of America (formerly the Profit Sharing/401k Council of America), "PSCA Target-Date Funds Survey," 2009, page 5.

[15] Prudential Investments analysis.

[16] Plan Sponsor Council of America (formerly the Profit Sharing/401k Council of America), "53rd Annual Survey Reflecting 2009 Plan Experience," 2010, tables 55 and 57.

[17] Employee Benefit Research Institute, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2010," 2011, page 21.

[18] Prudential Financial consumer research, 2011.

[19] CFO Research and Prudential Financial, results of research study, 2012.

[20] Prudential Financial analysis based on historical data from 1994 to 2011; spreads measured from 1994 onward based on availability of Barclays data; spreads measured over Treasuries with similar duration as the Barclays U.S. Corporate High Yield Index; spreads do not reflect credit defaults.

[21] Prudential Financial analysis; volatility measured as standard deviation of annual returns. Returns for all categories reflect defaults.

[22] Assumes a rise in interest rates for other fixed income securities with a similar duration.

[23] The Sharpe Ratio measures risk-adjusted performance; it is calculated by subtracting the risk-free rate from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

[24] Includes DB pension plans from the U.S., Europe, and Asia. CREATE, "Investment Innovations: Raising the Bar," 2011, pages 5 and 31.

[25] Bank for International Settlements, "BIS Quarterly Review," September 2011, table 14B, page A121.

[26] International Monetary Fund's April 2011 *World Economic Outlook*.

[27] Based on comparing the returns of the Barclays Global Aggregate Bond Index to the Barclays U.S. Aggregate Bond Index.

[28] Prudential Financial analysis.

[29] Knowledge @ Wharton, "Is the World Losing Faith in the U.S. Dollar?" September 2, 2009.

[30] Prudential Financial analysis; based on a comparison of the Credit Suisse Leveraged Loan Index to the Barclays U.S. Aggregate Bond Index during rising rate environments between 1995 and 2011.

[31] Yahoo Finance. Historical lows for the 10-year Treasury yield as of September 2011.

[32] International Monetary Fund, World Economic Outlook Database, September 2011.

Index Definitions

S&P 500 Index, a market-capitalization-weighted index of 500 companies primarily traded on the New York Stock Exchange.

Barclays U.S. Aggregate Bond Index, an unmanaged index which covers the U.S.-dollar-denominated, investment-grade, fixed rate, taxable bond market of SEC-registered securities.

Barclays U.S. Corporate High Yield Index, an unmanaged index which covers the universe of fixed rate, non-investment-grade debt.

Barclays Government Index, an unmanaged index which covers the total universe of investment-grade fixed income securities issued by the U.S. government or its agencies.

Russell 1000® Growth Index, an unmanaged index which measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000® Index, an unmanaged index which measures the performance of the 2,000 smallest companies in the Russell 3000® Index.

FTSE NAREIT Equity REITs Index, an unmanaged index which measures the performance of all real estate investment trusts listed on the New York Stock Exchange, the NASDAQ National Market, and the American Stock Exchange.

Indices are unmanaged and an investment cannot be made directly in an index.

Term Definitions

Correlation—The statistical measurement of the relationship between two asset classes.

Sharpe Ratio—This statistic measures the quality of the returns for an investment on a risk-adjusted basis over a given period. It is defined as the excess returns of an investment divided by the standard deviation of returns. Excess returns are the returns of the investment minus the risk-free rate of return offered in the market, typically measured by short-term government instruments such as 3-month T-bills.

Standard Deviation—This statistic measures the volatility of a stream of data compared to its average value. Applied to investment performance, standard deviation measures how "choppy" the monthly returns are over a period of time. 66% of all monthly values would fall within one standard deviation of the average, while 95% of all values would fall within two standard deviations of the average.

Target-Date Fund—A mutual fund in the hybrid category that automatically resets the asset mix (stocks, bonds, cash equivalents) in its portfolio according to a selected time frame that is appropriate for a particular investor.

Target-Risk Fund—A fund that attempts to expose its investors to a specified amount of risk. The fund manager of a target risk fund is responsible for overseeing the fund's allocation to ensure that the level of risk isn't greater or less than the fund's target amount of risk exposure.

A Word About Risks

Mutual fund investing involves risk. Some funds have more risk than others. The risks associated with investing in these funds include but are not limited to: **risk of investment in loans**, where the ability to receive payments in connection with loans depends on the financial condition of the borrower (failure to receive such payments may reduce the value of an investment's assets), use of **hedging techniques** to enhance returns; **gold-related securities**, which are subject to market price movements, regulatory changes, and economic conditions, as well as adverse political and financial factors; **derivative securities**, which may carry market, credit, and liquidity risks; **short sales**, which involve costs and the risk of potentially unlimited losses; **leveraging**, which may magnify losses; **Treasury inflation-protected securities**, which are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations; **high yield ("junk") bonds**, which are subject to greater market risks; **small/mid-cap stocks**, which may be subject to more erratic market movements than large-cap stocks; **foreign securities**, which are subject to currency fluctuation and political uncertainty; **real estate**, which poses certain risks related to overall and specific economic conditions as well as risks related to individual property, credit, and interest rate fluctuations; and **mortgage-backed securities**, which are subject to prepayment and extension risks. **Sector funds** and **specialty funds** may not be suitable for all investors. Such funds are **nondiversified**, so a loss resulting from a particular security will have greater impact on the fund's return. Investments in **emerging markets** are subject to greater volatility and price declines. **Fixed income investments** are subject to interest rate risk, and their value will decline as interest rates rise. Investing in **municipal bonds** involves credit and market risks. Asset allocation and diversification do not assure a profit or protect against loss in declining markets. The risks associated with each fund are explained more fully in each fund's respective prospectus. There is no guarantee a fund's objectives will be achieved.

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