

# Combining active, passive, and strategic beta investing



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“Proponents of active and proponents of passive are quick to find enduring reasons for category supremacy. But in our view, it makes better sense to evaluate—category by category—the likelihood and potential magnitude of actively managed products’ outperformance of their relevant benchmarks over time.”

## Key takeaways

- Optimal roles for active, passive, and strategic beta can be defined across equity and fixed-income markets.
- To do this, we measure the propensity and magnitude of outperformance for active strategies across markets, style classifications, and U.S. versus international stocks.
- Using our equity allocation framework, investors and their advisors can build portfolios that may maximize return potential and minimize potential volatility and cost.

## Executive summary

Investors today have plenty of options to consider when it comes to building their portfolios, but the proliferation of options can lead to chronic indecision. Unsurprisingly, the increased availability of different investment types, particularly the explosion of exchange-traded fund (ETF) offerings and the evolution of hybrid strategies such as strategic beta, has raised important questions over how investors should develop an asset allocation plan.

Against this backdrop of complex choice, we sought to provide a new starting point for asset allocation decisions. In our study, we began by assessing how reasonable it is to maintain allocations to actively managed products, particularly as fee pressures and volatility concerns carry high significance for long-term investors. As a result of our analysis, we affirmed that there are important and complementary roles to be played in most portfolios by actively managed mutual funds, market-cap-weighted passive index products, and the newer but rapidly growing category of strategic beta ETFs.

### For financial professionals

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# Establishing an allocation framework

Advisors and investors practice many different approaches to asset allocation across equities, fixed income, and alternatives. For the purposes of this study, we assume that an investor’s equity portfolio is already being set up to allocate across the style-based and market cap spectrum defined by the Morningstar Style Box. We don’t seek to prescribe allocations to categories such as small, mid, and large caps, or to value, blend, and growth. Instead, we ask—and attempt to answer—What should the allocation be within these categories? That is, how might an investor reasonably decide whether and how much to allocate to active, passive, and strategic beta within any given segment?

## How should you determine allocations within categories?

|       | Value | Blend                            | Growth                           |
|-------|-------|----------------------------------|----------------------------------|
| Large |       | Active<br>Multifactor<br>Passive |                                  |
| Mid   |       |                                  |                                  |
| Small |       |                                  | Active<br>Multifactor<br>Passive |

Source: Morningstar asset categories, 2022.

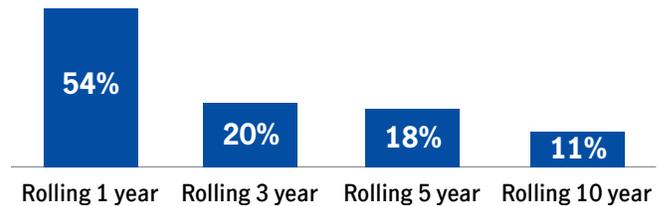
How might an investor reasonably decide whether and how much to allocate to active, passive, and strategic beta within any given segment?

## On the supposed death of active management

As it happens, core equity investment categories today may appear to be infertile ground for active management. This isn’t only a function of newspaper headlines—although these do play a role—as investors’ recent experience with active funds in a category such as large blend equity is anything but uniformly positive. Indeed, in categories such as large blend, claims that active managers face structural challenges may contain the seed of a legitimate critique.

### Active management can appear inherently challenged

Large blend funds outperforming the index



Source: MPI Stylus, using data provided by Morningstar and the Russell 1000 Index, as of 12/31/21. Fund data is based on the oldest share class of each fund/ETF in the Morningstar large blend fund category. The Russell 1000 Index tracks the performance of 1,000 publicly traded large-cap companies in the United States. It is not possible to invest directly in an index.

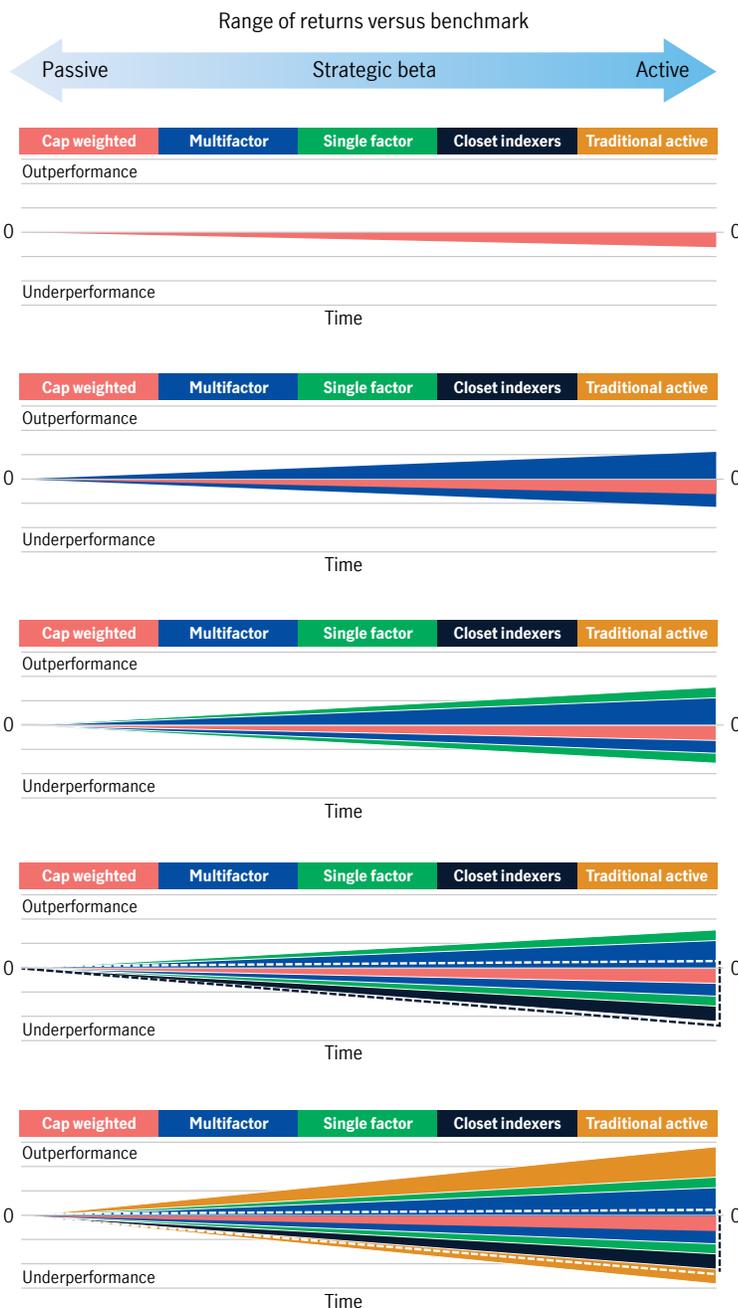
For example, only 54% of large blend equity strategies—including active, single factor, and multifactor products—beat the Russell 1000 Index for the year ended 2021. Investors’ experience in this category worsens over long timeframes. Only 20% of large blend equity products beat the benchmark over the trailing three years, and only 18% came out ahead over the trailing five years. With statistics like these, actively managed large-cap blend products may seem like their own worst enemy.

What about the other timeframes and other investment categories? Proponents of active and proponents of passive are quick to find enduring reasons for category supremacy. But in our view, it makes better sense to evaluate—category by category—the likelihood and potential magnitude of actively managed products’ outperformance of their relevant benchmarks over time. Once we have a clearer view on these issues, we may have better grounds for setting guidelines for allocations to active, passive, and multifactor strategic beta.

## Defining the range of potential returns

Investors commonly use active or passive strategies to capture different ranges of potential returns and volatility with a varying level of cost. In portfolio allocation practice, this is typically implemented in light of an investor’s stated goals. What’s less frequently considered is the role of strategic beta strategies among their better-known active and passive counterparts. In our accompanying spectrum charts, we illustrate a generic form of return expectations that investors should become more familiar with as they consider their overall portfolio.

### The spectrum of potential returns is wide



#### Market-cap-weighted passive strategies

While these strategies may achieve a return virtually identical to that of the market in the short term, they’re unlikely to achieve this over time. Indeed, investors should expect such strategies to see a slow deterioration of performance due to fees.

#### Multifactor strategies

Here, investors should expect a range of performance that includes above- and below-benchmark results, depending on whether the targeted factors are in or out of favor over a given period.

#### Single-factor strategies

In this category, investors can expect a more volatile performance range, whether to the upside or downside, depending on the fortunes of the single factor under consideration.

#### Closet indexers

These are higher-fee active strategies that aren’t so active, but behave—in terms of positioning—more like market-cap-weighted passive approaches. Here, investors can find outperformance, but also a wide range of underperformance due to fees.

#### Traditional active strategies

With these strategies, investors can reasonably expect to see the widest possible range of outperformance or underperformance relative to a benchmark over time.

Source: John Hancock Investment Management, 2022.

## Propensity: identifying the likelihood of active outperformance

At this point, we can begin to address the foundation of our portfolio construction framework. As we stated at the outset of our discussion, we argue that each of the three strategy types—active, passive, and strategic beta—has a positive role to play in most investors’ portfolios. For the purposes of our discussion, single-factor strategic beta products fall into the active allocation as the decision to choose a certain factor is actively made by the investor or advisor. But our analysis must start with active: Where does it make sense to emphasize and where doesn’t it make sense to emphasize actively managed funds in an equity portfolio?

In our analysis, it makes good sense to allocate more heavily to active strategies where:

- The likelihood of finding outperforming active strategies is higher
- The potential size of active strategies’ outperformance is greater

We refer to these characteristics as propensity and magnitude.

To explain propensity, we like to use a fishing analogy: If you want to go fishing, you want to go somewhere you can find lots of fish. In investing terms, you naturally want to allocate more to active management in those areas in which a relatively larger number of active managers have proven they can outperform the index.

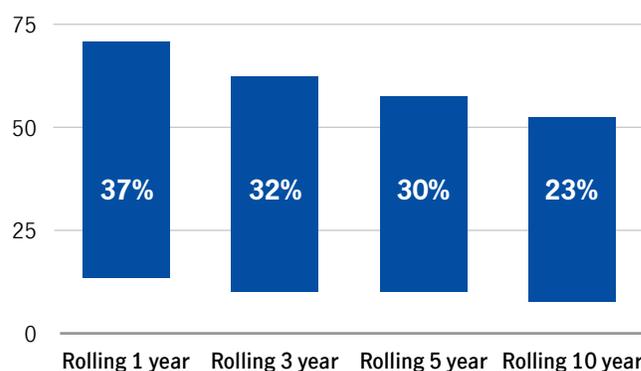
### Large-cap blend equity: low-level propensity

By returning to the large-cap blend category, we can make the negative case first—although we have some moderately better news to offer for purely active products. In our accompanying chart, the range indicated by each blue bar represents the percentage of large-cap blend equity funds that beat the benchmark over the respective rolling periods over the previous 20 years. For this part of our analysis, we removed cap-weighted index, multifactor, and single-factor products to get a better sense of what active products have delivered. Inside the full range of rolling period results, from best to worst, we indicate the average percentage of funds that beat the benchmark. By using rolling period data, we offer a more holistic view of potential outperformance for active large-cap blend—and, by extension, a view on the potential outperformance of every other category that we investigated across the equity style box.

Looking at 10-year data for large-cap blend, we show that during

### Propensity for outperformance: active large blend fund category

Active funds outperforming the index (rolling periods, calculated monthly)



the best rolling 10-year period—which corresponds to the top of the right-most dark blue bar—roughly 52% of active large-cap blend equity products outperformed the large-cap benchmark. By contrast, over the worst rolling 10-year period—or the bottom of the same bar—only about 7% of actively managed products in this category outperformed the benchmark.

On average, only 23% of actively managed large-cap blend products outperformed the benchmark over rolling 10-year periods. In other words, roughly one-quarter of large-cap blend funds have outperformed the Russell 1000 Index over longer timeframes. This suggests that selecting an active large-cap blend manager that can consistently outperform this benchmark is challenging. With proper due diligence and patience, it is possible to find active managers who can outperform in this equity category, but other categories may present less of a hurdle to do so.

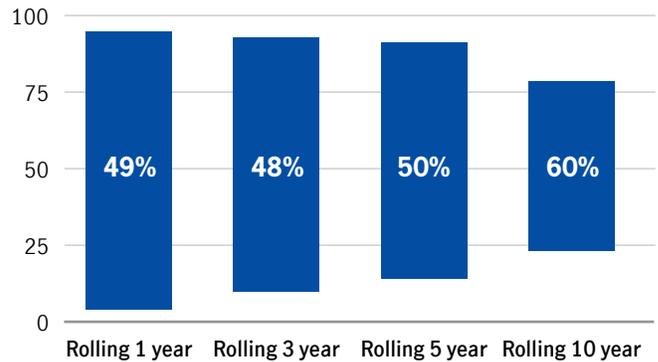
Active products in the large blend category also don't show a very high propensity to outperform. Indeed, we'd say the category exhibits a low-level propensity to outperform. While this is an intuitive and sensible qualification of the term, it's also a piece of nomenclature that we come back to after we review another, contrasting, category.

**Small-cap value equity: high-level propensity**

Turning to small-cap value equity, the history of rolling returns for active products in this category contrasts sharply with that of actively managed large-cap blend products.

**Propensity for outperformance: small value fund category**

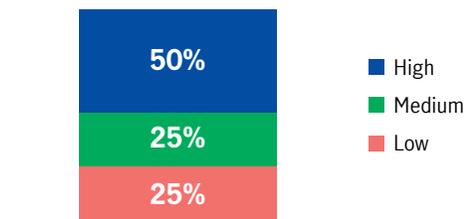
Active funds outperforming the index (rolling periods, calculated monthly)



Source: MPI Stylus, using data provided by Morningstar and the Russell 2000 Value Index, as of 12/31/21. Active funds are defined as the oldest share class of any fund/ETF in the small value fund category that is not identified as an index fund by Morningstar. The Russell 1000 Index tracks the performance of 1,000 publicly traded large-cap companies in the United States. It is not possible to invest directly in an index.

Of particular note, the longer the timeframe, the higher the average number of outperforming funds—and the narrower the range between best and worst rolling period results. In our view, this presents striking evidence of the category's high propensity for active fund outperformance.

**Propensity to outperform an index**



Source: John Hancock Investment Management, 2022.

## Assembling a propensity schematic

We applied the same methodology across the equity style box to determine propensity levels for each of the most common investment categories. The simple heuristic we derived labels those categories exhibiting the lowest quartile results as low propensity, the third quartile we label as medium propensity, and categories in which active funds show a 50% or greater likelihood of outperforming the index we say have a high propensity to outperform.

Interestingly, our next chart shows the heaviest weight of categories falling in the medium-propensity zone, while three categories—mid-value, large-cap blend, and mid-cap blend—reside in the low propensity tier.

### Propensity to outperform across the style box

All-active peer group outperforming the index (%)

| Category                    | 10-year rolling average |
|-----------------------------|-------------------------|
| Bank loan                   | 85 (10)*                |
| High-yield bond             | 71 (9)*                 |
| Multi-sector bond           | 82                      |
| Intermediate core-plus bond | 76                      |
| Foreign small/mid-growth    | 70                      |
| Small value                 | 60                      |
| Foreign small/mid-blend     | 53                      |
| Intermediate core bond      | 51                      |
| Small growth                | 49                      |
| Foreign large growth        | 47                      |
| Nontraditional bond         | 47                      |
| Foreign large value         | 46                      |
| Diversified EM equity       | 44                      |
| Small blend                 | 42                      |
| Corporate bond              | 42                      |
| Large value                 | 41                      |
| Foreign large blend         | 38                      |
| Mortgage-backed funds       | 38                      |
| Foreign small/mid-value     | 35                      |
| Emerging-market bond        | 34                      |
| Mid-growth                  | 32                      |
| Large growth                | 28                      |
| Mid-value                   | 24                      |
| Large blend                 | 23                      |
| Mid-blend                   | 11                      |

Source: MPI Stylus, using data provided by Morningstar for constituent active funds and their respective representative indexes, as of 12/31/21.

\*Because some high-yield issues are illiquid and hard to trade at a fair price in a timely manner, replicating some common high-yield benchmarks is extremely difficult. As a result, a more relevant comparison for investors is the propensity of active high-yield managers to outperform investable passive options, such as the SPDR Bloomberg High Yield Bond ETF (JNK), which are based on high-yield indexes with above-average liquidity. Using JNK as the reference asset since its November 2007 inception, the 10-year rolling average propensity score for active high-yield managers is 71%.

On the one hand, this data reveals remarkably widespread opportunities for investors to identify outperforming active funds across much of the equity style box. On the other hand, from a more cautious investment perspective, this reveals a wide variety of areas in which passive and multifactor strategic beta may be prudently applied.

## Magnitude: identifying the relative size of potential outperformance

The second key metric we examined in our study is magnitude, by which we mean the degree or size of outperformance. Returning to our fishing analogy, magnitude relates to the size of the fish: Investors in active funds typically want to fish in ponds that have many fish but, more particularly, they'd prefer to fish in ponds with many big fish. In other words, if we can identify categories where the historical data indicates that the potential upside for outperformance is greater, it makes good sense to consider higher active weights in these categories.

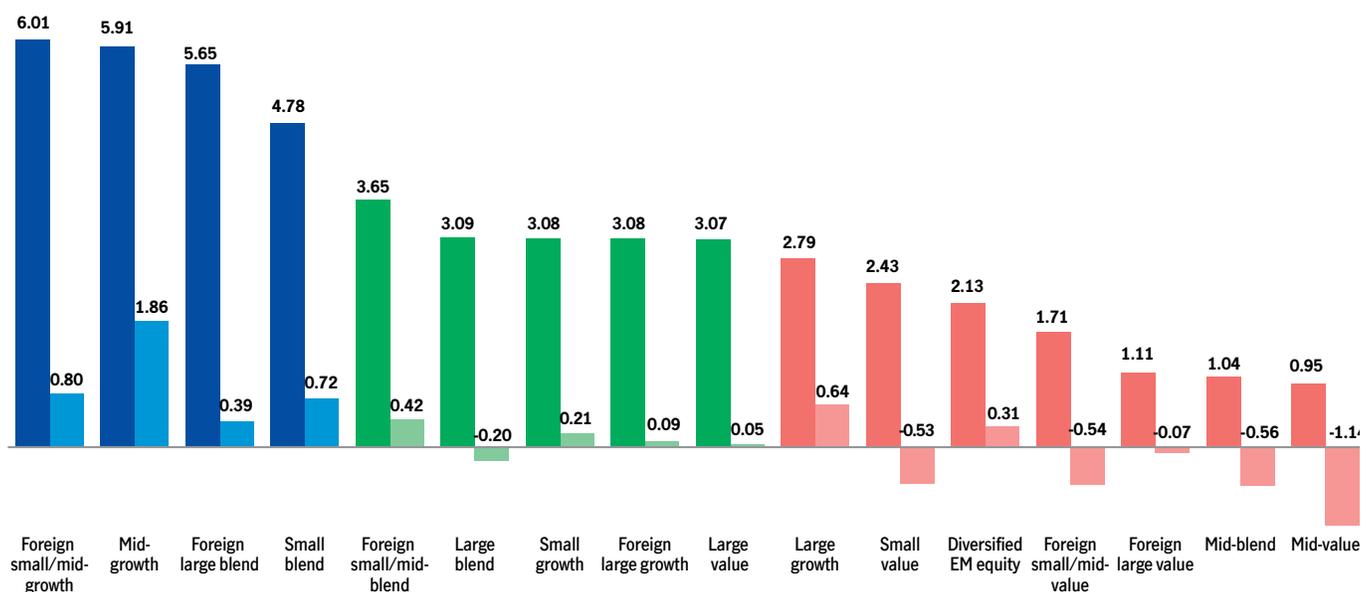
Put another way, we want to understand which areas—if we picked the right active manager—are more likely to offer the highest levels of outperformance. Again, using 10-year rolling periods to frame our conclusions, we ranked categories by the top 1% rolling 10-year data across the equity style box.

In the following chart, the first percentile foreign small/mid-cap growth fund over a rolling 10-year period outperformed the benchmark by 601 basis points (bps) annually. The first percentile large-cap value fund outperformed by 307bps annually. And the first percentile mid-cap blend equity fund outperformed the benchmark by 104bps annually.

On the whole, this evidence from top-performing funds over longer timeframes illustrates that the global markets are differentiated in terms of the magnitude of outperformance results historically available to active managers.

### Magnitude of potential outperformance

Top 1% excess return/top 33% excess return (rolling 10 years, calculated monthly)



Source: MPI Stylus, using data provided by Morningstar for constituent funds and their respective representative indexes, 1/1/01–12/31/21.

The chart also addresses more conservative assumptions. Given that finding the top-performing managers in any category may feel impractical, we also calculate magnitude results for funds in the top third of their respective categories over rolling 10-year periods. While results for funds in the top 33% aren't an exact match with results for the top 1% of funds, they bear a strong family resemblance overall.

Furthermore, the evidence for both top performers and high-performing, top-third funds suggests we can divide equity categories into three groups: The highest-magnitude results belong to categories where top-performing funds outpace the benchmark by 400bps or more annually. For categories showing results between 300bps and 400bps, we say they exhibit medium magnitude, and for categories under 300bps, we say they exhibit low-magnitude results.

### Assembling a propensity/magnitude schematic

At this point, we have enough data to put propensity and magnitude results side by side across the equity style box components. As we'll see in the next section, our return analysis allows for a simple labeling scheme that can help guide allocation decisions.

Of particular note, only three categories—multi-sector bond, foreign small/mid-cap growth, and foreign small/mid-cap blend—show both high-propensity and high-magnitude results. Likewise, only three categories—mid-cap value, large-cap blend, and mid-cap blend—exhibit both low propensity and low magnitude. In between, more than half of all categories display mixed results, some of which tilt to the downside—such as foreign small/mid-cap value and large-cap growth (medium propensity, low magnitude)—or to the upside, such as foreign large-cap growth and diversified emerging-markets equity (medium propensity, high magnitude). In our view, this variation

underscores both the wide-ranging opportunities available to investors seeking to employ actively managed funds and the opportunity costs of relying exclusively on passive managers.

### Propensity and magnitude across categories

All-active peer group outperforming the index (%)

| Category                    | 10-year rolling average | Magnitude |
|-----------------------------|-------------------------|-----------|
| Bank loan                   | 85 (10)*                | 0.84      |
| Multi-sector bond           | 82                      | 4.50      |
| Intermediate core-plus bond | 76                      | 2.71      |
| High-yield bond             | 71 (9)*                 | 0.73      |
| Foreign small/mid-growth    | 70                      | 5.91      |
| Small value                 | 60                      | 2.79      |
| Foreign small/mid-blend     | 53                      | 5.65      |
| Intermediate core bond      | 51                      | 1.84      |
| Small growth                | 49                      | 3.65      |
| Foreign large growth        | 47                      | 6.01      |
| Nontraditional bond         | 47                      | 2.23      |
| Foreign large value         | 46                      | 2.13      |
| Diversified EM equity       | 44                      | 4.78      |
| Small blend                 | 42                      | 3.07      |
| Corporate bond              | 42                      | 1.51      |
| Large value                 | 41                      | 3.08      |
| Foreign large blend         | 38                      | 3.08      |
| Mortgage-backed funds       | 38                      | 2.78      |
| Foreign small/mid-value     | 35                      | 1.11      |
| Emerging-market bond        | 34                      | 1.97      |
| Mid-growth                  | 32                      | 3.09      |
| Large growth                | 28                      | 2.43      |
| Mid-value                   | 24                      | 1.04      |
| Large blend                 | 23                      | 1.71      |
| Mid-blend                   | 11                      | 0.95      |

Source: MPI Stylus, using data provided by Morningstar for constituent active funds and their respective representative indexes, as of 12/31/21.

\*Because some high-yield issues are illiquid and hard to trade at a fair price in a timely manner, replicating some common high-yield benchmarks is extremely difficult. As a result, a more relevant comparison for investors is the propensity of active high-yield managers to outperform investable passive options, such as the SPDR Bloomberg High Yield Bond ETF (JNK), which are based on high-yield indexes with above-average liquidity. Using JNK as the reference asset since its November 2007 inception, the 10-year rolling average propensity score for active high-yield managers is 71%.

## Implementation and impact

We can now develop guidelines for portfolio construction. In our first implementation table, we begin with a neutral portfolio—that is, a portfolio that’s not being guided by any particular bias toward active, passive, or multifactor strategies.

Color coding in the leftmost columns of this table continues to signal high, medium, and low propensity and magnitude. In this way, as you consider a given category’s signals—such as foreign small-mid cap growth’s high propensity and high magnitude—our table offers an allocation that strongly biases an exposure to actively managed funds. Again, in a category such as foreign small-mid cap growth, historical return data suggests that you can reasonably expect to be fishing in a pond that contains many big fish.

Allocation percentages shift accordingly wherever we see results tilting toward neutral or more mixed. Considering a category with a uniformly medium signal (e.g., large-cap value), we think it’s worth considering equal allocations to passive, multifactor strategic beta, and active strategies. Where we see propensity

### Sample portfolio allocations for the neutral investor (%)

| Propensity | Magnitude | Passive | Multifactor | Active |
|------------|-----------|---------|-------------|--------|
| Blue       | Blue      | 0       | 11          | 89     |
| Blue       | Green     | 0       | 33          | 67     |
| Blue       | Red       | 33      | 33          | 33     |
| Green      | Blue      | 0       | 33          | 67     |
| Green      | Green     | 33      | 33          | 33     |
| Green      | Red       | 67      | 33          | 0      |
| Red        | Blue      | 33      | 33          | 33     |
| Red        | Green     | 67      | 33          | 0      |
| Red        | Red       | 89      | 11          | 0      |

Source: John Hancock Investment Management, 2022. For illustrative purposes only, not intended as investment advice.

or magnitude scores turning from medium to low, it may be warranted to consider commensurately higher allocations to passive and multifactor strategies.

### Measuring ranges of potential return, volatility, and cost

In the implementation table below, we quantify the potential outperformance, volatility, and cost impacts of our suggested allocations across three different categories: foreign small/mid blend, large value, and large-cap growth, which are calculated at both the category and portfolio levels.

To begin discussing the data shown here, we focus our attention first on foreign small/mid blend, where, as we suggested, we

stress active strategies to the point of allocating 89% of a portfolio’s small growth budget to active funds and 11% to multifactor strategic beta.

In the case of multifactor strategic beta, there aren’t that many funds in each of the relevant universes, so we assume the low end of a common multifactor strategic beta performance target. That is, we assume 50bps of outperformance, as most multifactor strategic beta options seek to outperform relevant benchmarks by 50bps to 100bps annually. For fees and standard deviation, we used the median for each category. In the case of active, where there’s a large number of funds for each category, our data represents the range of performance of the top 1% to top 33% of the peer fund category and the broad category average for standard deviation and median fees.

#### Impact: neutral portfolio<sup>1</sup>

| Category: foreign small-mid blend        | Propensity |                            | Magnitude               |             |
|--|------------|----------------------------|-------------------------|-------------|
|  | Passive    | Multifactor strategic beta | Active (top 33%–top 1%) | Portfolio   |
| Allocation within category               | 0%         | 11%                        | 89%                     | 100%        |
| Range of potential outperformance        | -0.39%     | 0.50%                      | 0.39%–5.65%             | 0.40%–5.08% |
| 3-year average annual standard deviation | 16.87%     | 16.37%                     | 16.94%                  | 16.88%      |
| Fee                                      | 0.39%      | 0.40%                      | 1.17%                   | 1.09%       |

| Category: large value                    | Propensity |                            | Magnitude               |             |
|--|------------|----------------------------|-------------------------|-------------|
|  | Passive    | Multifactor strategic beta | Active (top 33%–top 1%) | Portfolio   |
| Allocation within category               | 33%        | 33%                        | 33%                     | 100%        |
| Range of potential outperformance        | -0.08%     | 0.50%                      | 0.09%–3.08%             | 0.17%–1.17% |
| 3-year average annual standard deviation | 14.33%     | 16.92%                     | 14.42%                  | 15.22%      |
| Fee                                      | 0.08%      | 0.34%                      | 0.84%                   | 0.42%       |

| Category: large growth                   | Propensity |                            | Magnitude               |             |
|--|------------|----------------------------|-------------------------|-------------|
|  | Passive    | Multifactor strategic beta | Active (top 33%–top 1%) | Portfolio   |
| Allocation within category               | 67%        | 33%                        | 0%                      | 100%        |
| Range of potential outperformance        | -0.08%     | 0.50%                      | -2.96%                  | 0.11%–0.11% |
| 3-year average annual standard deviation | 14.36%     | 16.84%                     | 15.47%                  | 15.19%      |
| Fee                                      | 0.08%      | 0.59%                      | 0.90%                   | 0.25%       |

Source: John Hancock Investment Management, 2022. For illustrative purposes only and not intended as investment advice.

As the data makes clear, multifactor strategic beta helps mitigate the volatility associated with active funds, as well as the higher costs associated with them. Importantly, it does this without hindering the potential outperformance across any given category; indeed, it exerts a demonstrably smaller curb on outperformance potential than would occur if an investor were to balance active foreign small-mid blend exposures exclusively with market-cap-weighted index funds.

Turning next to large value—a category with medium results in terms of propensity and magnitude—we allocate equally across passive, multifactor, and active. This helps maximize the range of potential outperformance for the category with slightly lower volatility and a significantly lower cost impact than would result if active strategies played a bigger role.

Looking at large growth, where propensity is medium and magnitude is low, our allocation model leans most heavily on passive approaches. While the data shows that this is truly a difficult category for active, we think the case for multifactor strategic beta here can be compelling, especially for investors who aren't committed to using passive exclusively. While the

**Results: neutral portfolio**

|  | U.S. equity   | International equity |
|--|---|----------------------|
| <b>Neutral approach</b>                  | Medium potential return, medium cost, lowest volatility |                      |
| Range of potential outperformance        | 0.06%–0.46%   | 0.41%–2.4%           |
| 3-year average annual standard deviation | 15.98%  | 16.52%               |
| Fee                                      | 0.32%   | 0.70%                |

Source: John Hancock Investment Management. For illustrative purposes only and not intended as investment advice.

reliance on passive can significantly lower costs, the introduction of multifactor strategic beta offers a modest boost to the range of potential outperformance. In the case of passive products in mid-cap blend, we use the lowest-cost ETF to populate fee data as well as the impact to benchmark-relative performance, and we use the category average for standard deviation.

**Modeling portfolio-level results**

In the next implementation table, we show how our portfolio construction method might play out for a U.S. equity portfolio and an international equity portfolio. Again, we begin by calculating results for the unbiased, neutral portfolio that offers medium-level potential return, volatility, and cost.

**Results: active, passive, and neutral portfolios**

|  | U.S. equity   | International equity |
|--|---|----------------------|
| <b>Active approach</b>                   | Highest potential return, highest cost, medium volatility |                      |
| Range of potential outperformance        | -0.01%–1.69%  | 0.60%–3.78%          |
| 3-year average annual standard deviation | 16.22%  | 16.58%               |
| Fee                                      | 0.70%   | 0.94%                |
| <b>Neutral approach</b>                  | Medium potential return, medium cost, lowest volatility   |                      |
| Range of potential outperformance        | 0.06%–0.46%   | 0.41%–2.4%           |
| 3-year average annual standard deviation | 15.98%  | 16.52%               |
| Fee                                      | 0.32%   | 0.70%                |
| <b>Passive approach</b>                  | Lowest potential return, lowest cost, highest volatility  |                      |
| Range of potential outperformance        | -0.10%–0.10%  | 0.27%–0.65%          |
| 3-year average annual standard deviation | 15.40%  | 16.78%               |
| Fee                                      | 0.14%   | 0.45%                |

Source: John Hancock Investment Management. For illustrative purposes only and not intended as investment advice.

For a U.S. equity portfolio, our method projects a range of potential outperformance between 6bps and 46bps. In the international equity portfolio, the method produces a moderately higher range of potential returns, but also commensurately higher standard deviation and fees.

In the real world, investor and advisor preferences and risk tolerance levels may tend to put asset allocation on a more aggressive or more risk-averse path. Accordingly, the allocation scheme we proposed early in our implementation discussion may be dialed up or down in terms of active or passive tilts. For an investor whose risk or fee tolerance demands a greater focus on passive, for example, even the highest levels of propensity

and magnitude may warrant only an equal-weighted allocation across active, passive, and multifactor strategic beta. For this same investor, the portfolio may all but exclude actively managed funds in most categories and rely instead on multifactor strategic beta for a modest active tilt in those areas with clearly higher propensity and magnitude results.

Alternatively, consider an investor who believes in using active approaches, but who wants to rein in costs. In this case, a slightly higher allocation to multifactor strategic beta in categories with lower propensity and magnitude can help reduce costs without dramatically lowering the range of the overall portfolio's potential outperformance.

**Flexible implementation for different portfolio types (%)**

| Propensity | Magnitude | Passive |       |        | Neutral |       |        | Active  |       |        |
|------------|-----------|---------|-------|--------|---------|-------|--------|---------|-------|--------|
|            |           | Passive | Multi | Active | Passive | Multi | Active | Passive | Multi | Active |
| Blue       | Blue      | 33      | 33    | 33     | 0       | 11    | 89     | 0       | 0     | 100    |
| Blue       | Green     | 60      | 40    | 0      | 0       | 33    | 67     | 0       | 0     | 100    |
| Blue       | Red       | 89      | 11    | 0      | 33      | 33    | 33     | 0       | 11    | 89     |
| Green      | Blue      | 60      | 40    | 0      | 0       | 33    | 67     | 0       | 0     | 100    |
| Green      | Green     | 89      | 11    | 0      | 33      | 33    | 33     | 0       | 11    | 89     |
| Green      | Red       | 100     | 0     | 0      | 67      | 33    | 0      | 0       | 40    | 60     |
| Red        | Blue      | 89      | 11    | 0      | 33      | 33    | 33     | 0       | 11    | 89     |
| Red        | Green     | 100     | 0     | 0      | 67      | 33    | 0      | 0       | 40    | 60     |
| Red        | Red       | 100     | 0     | 0      | 89      | 11    | 0      | 33      | 33    | 33     |

Source: John Hancock Investment Management. For illustrative purposes only and not intended as investment advice.

# Conclusion

The choices investors make today can define their portfolios' performance trajectory for years to come. Having a framework that can help articulate where it makes the most sense to choose active, passive, or strategic beta can streamline the decision-making process. As we've shown in our study, today's wide field of investment choice can be narrowed through the consideration of factors such as propensity and magnitude. The likelihood of finding outperforming active managers changes—and can change dramatically—depending on where you look. Similarly, the likelihood of finding more substantial outperformance varies by investment category.

In some areas of the global equity and fixed-income markets, strong relative performance for actively managed products isn't as hard to find as investors might have thought, and in other areas, the argument for passive appears to be inherently

stronger. In between these clearer signals of strength and weakness, we see a good argument for employing multifactor strategic beta, as this category allows for lower-cost solutions that don't necessarily sacrifice outperformance potential.

Our framework for portfolio construction is flexible and can be tilted toward passive or active, or used to help target a specific fee constraint. With respect to fees, we believe we've shown conclusively that it doesn't always make sense to invest in the cheapest vehicle. To exclusively employ market-cap-weighted passive products can mean that an investor is passing over alpha potential that might be better pursued with multifactor strategic beta. Using our framework as a flexible guide, we hope investors and their advisors can implement an allocation plan that helps them balance all of the available choices without having to compromise any of their key investment goals.

**1** Data shown in the impact table is based on sample allocations modeled for a neutral investor on page 8. In the passive category column, the range of potential outperformance is represented by category index returns adjusted by the expense ratio of the least expensive passive option in the respective Morningstar fund categories. Standard deviation is represented by the average rolling 5-year annualized standard deviation, calculated monthly, of each category's representative index. Fee is represented by the 1<sup>st</sup> percentile fee (i.e., the lowest fee) among all passive funds in the respective Morningstar fund categories. In the multifactor strategic beta category column, we assume modest (50bps) outperformance across all categories due to a lack of extensive performance history of multifactor strategic beta options. Standard deviation is represented by the average rolling 5-year annualized standard deviation, calculated monthly, of funds in the respective Morningstar categories that are defined as multifactor strategic beta funds. Fee is represented by the average expense ratio of funds in the respective Morningstar categories that are defined as multifactor strategic beta funds. In the active fund category column, the range of potential outperformance is represented by the range of excess returns achieved between the 33<sup>rd</sup> percentile fund and the 1<sup>st</sup> percentile fund, using monthly rolling 10-year excess returns described on page 7. Standard deviation is represented by the average rolling 5-year annualized standard deviation, calculated monthly, of funds in the respective Morningstar categories that are defined as actively managed funds. Fee is represented by the average expense ratio of funds in the respective Morningstar categories that are defined as actively managed funds. Portfolio-level calculations represent a weighted average of the modeled allocations to passive, multifactor strategic beta, and active fund categories.

Conclusions expressed in this article are based on the data collected in the John Hancock Investment Management study and may not be representative of all financial advisors.

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