A guide to blending active and passive strategies

Develop a balanced approach to blending active, passive, and strategic beta

Making a decision between active or passive approaches—or alternatives that seek a middle ground between active and passive, such as strategic beta—is an important step in building a portfolio. But it can be confusing: How can you reasonably decide how to allocate across these different investment categories within any given market segment? At John Hancock Investment Management, we've taken up this question and provided some practical guidelines for portfolio construction.

Metrics to dispel the active/passive either-or

When building a client's portfolio, we believe it rarely pays to go all active or all passive. The answer is more commonly somewhere in the middle. To help find the right balance, we look at two metrics—the historical propensity for and magnitude of active strategies' outperformance.

When these metrics suggest strong results, we read that as an argument for an active tilt; when they offer weak or mixed results, we think that argues in favor of passive and strategic beta.

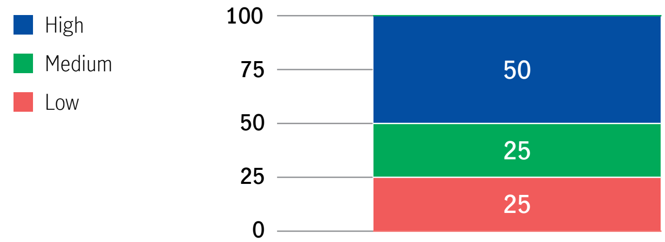
Consider the propensity to outperform

Sometimes, the desire for higher efficiencies around taxes and fees can drive advisors to elect passive investment options for their clients. Actively managed products carry high costs, the argument goes, so passive must be the better way to go. But what if it isn't?

To develop a more objective approach to making the choice between active and passive, we sought to identify, across the Morningstar Style Box, the propensity or percentage of active managers that was able to outperform representative indexes over rolling 10-year periods in a 20-year timeframe. The results were surprising.

The heaviest weight of categories falls in the medium-propensity zone—defined as categories in which 25% to 50% of the managers were able to outperform the category index. Only three categories—mid-value, large blend, and mid-blend—reside in the low propensity tier. On the one hand, this data reveals remarkably widespread opportunities for investors to identify outperforming active funds across equity styles. 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.

Propensity of managers who outperform an index (%)



Source: John Hancock Investment Management, 2022.

Propensity to outperform, across the style box

All-active peer group outperforming the index (%)

Category	10-year rolling average
Foreign small/mid-growth	70
Small value	60
Foreign small/mid-blend	53
Small growth	49
Foreign large growth	47
Foreign large value	46
Diversified EM equity	44
Small blend	42
Large value	41
Foreign large blend	38
Foreign small/mid-value	35
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.

Consider the magnitude of outperformance

In addition to looking at the likelihood of outperformance, it helps to understand where the biggest pots of potential alpha may be found among the available investment options. In other words, if you could pick top-performing active managers across any investment category, where could you arguably get the most bang for your buck?

Again, using 10-year rolling periods to frame our conclusions, we ranked categories by their average excess returns. Over rolling 10-year periods, the 1st percentile foreign large growth fund outperformed the benchmark by 601 basis points (bps) annually. Clearly, this is a category in which top managers may deliver higher expected return potential. Contrast that with a 1st percentile mid-cap blend equity fund, which on average outperformed the benchmark by 95bps annually.

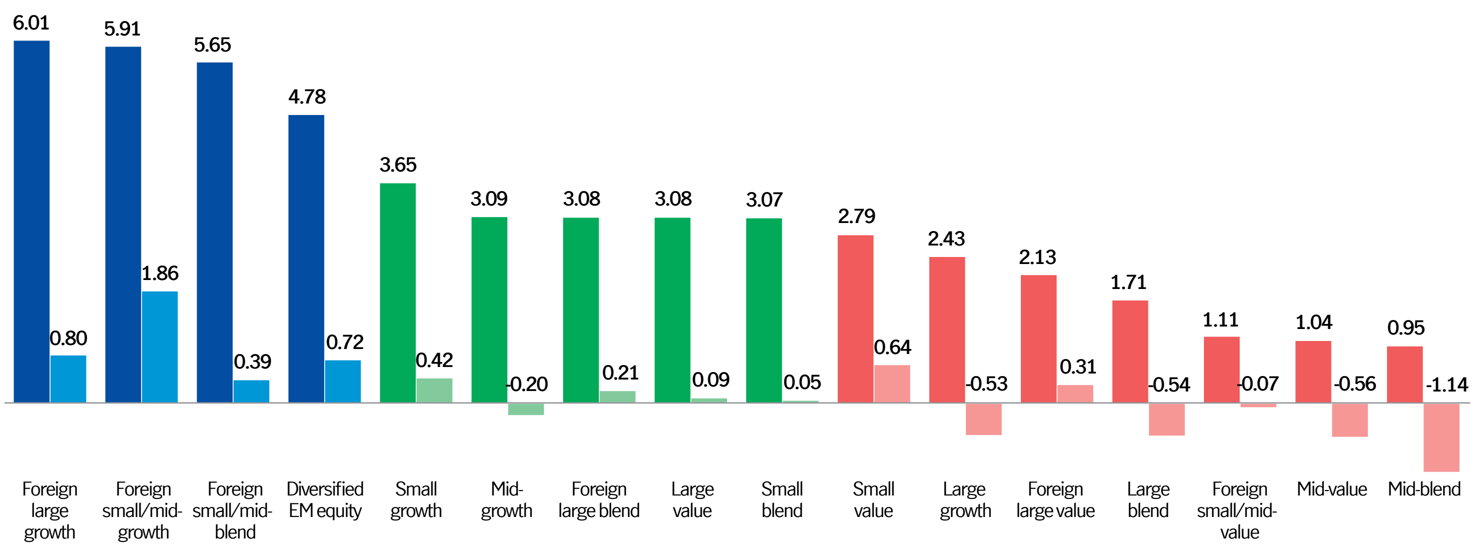
Develop a framework for allocation

To develop a framework for equity allocation, it helps to consider the big picture of propensity and magnitude signals. Where signals tend to be uniformly high, instead it may be reasonable to tilt toward actively managed funds. Where the signal is uniformly medium, instead it may be worth considering equal allocations to active, passive, and strategic beta. And where signals are more mixed or uniformly low, passive and strategic beta approaches may arguably warrant the lion's share of your attention.

For a more in-depth discussion of how to draw up a framework for equity allocations, we encourage advisors to review our white paper, "Combining active, passive, and strategic beta investing," available among our resources for financial professionals at jhinvestments.com/resources.

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, from 1/1/01–12/31/21. Past performance does not guarantee future results.

There is no guarantee that any of the strategies mentioned will be successful.

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