

# Understanding strategic beta



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*Structuring and implementing a rules-based strategy that alters the traditional market-cap-weighting scheme can be a goal well worth pursuing.*

## Key takeaways

- Traditional market-capitalization-weighted indexes inherently neglect the equity of smaller, potentially more promising firms in favor of larger-cap companies that have already experienced significant growth.
- Countering this embedded bias is a varied and growing group of rules-based, or strategic beta, investment approaches, many of which track alternatively weighted indexes.
- Leveraging goals of both active and passive management, strategic beta may be an attractive alternative for investors seeking inexpensive, diversified equity exposure with market-beating potential.

## Executive summary

Alternative beta, smart beta, and strategic beta: While some of the language used to describe its essence may be relatively new, the idea behind these roughly synonymous terms has roots dating back decades. Part of a broader trend toward rules-based investing that can seek a premium (or more than one premium for multifactor approaches) over cap-weighted indexes, strategic beta has enjoyed growing attention in recent years. Investors have been drawn to strategic beta's cost, style purity, tax efficiency, transparency, and potential trading advantages—particularly when embedded within an exchange-traded fund (ETF)—benefits that can complement other allocations within a portfolio. However, not all methodologies are conceived, structured, or implemented equally. Just as any potential investment deserves diligent assessment, it's important to examine the range of objectives, expected return drivers, and potential risks across the spectrum of strategic beta offerings in order to find the right fit for your asset allocation program.

## What is strategic beta?

Strategic beta—along with alternative beta, multifactor investing, smart beta, fundamental indexing, and a few other related phrases—broadly refers to a diverse and growing category of rules-based approaches to investing in various markets. Often, the methodologies behind strategic beta portfolios are designed to screen an investment universe for securities with certain specified characteristics that are believed to offer the opportunity for better returns, less (or sometimes more) risk, or some other desired attribute, such as income generation. So far, universal consensus on the most appropriate term, not to mention its precise definition, has proved elusive. For the purposes of this discussion, we define strategic beta as a rules-based index approach that deviates from market capitalization weights.

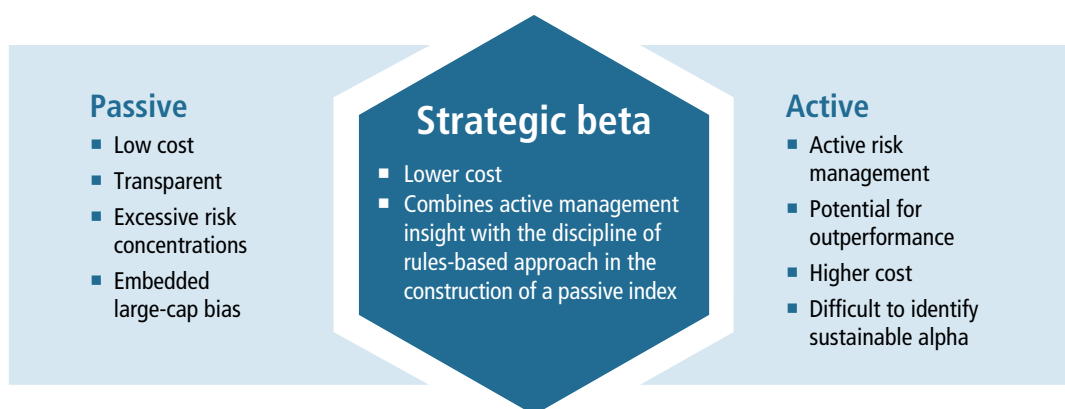
### **The benefits of strategic beta include outperformance potential at a lower cost**

Leveraging goals of both active and passive management, strategic beta may offer complementary portfolio exposure for investors seeking inexpensive, diversified equity approaches with market-beating potential.

Traditional cap-weighted index-tracking funds have provided investors with expedient and low-cost access to broad market exposure for more than 40 years. While their virtues are significant, these passive funds aren't as intrinsically neutral as they might seem on the surface.

### Strategic beta: seeking to build a better index

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Source: John Hancock Investment Management. For illustrative purposes only.

By definition, market-cap weighting, the methodology used by the S&P 500 Index and many other traditional benchmarks, places greater emphasis on shares of larger, more expensive companies, which can produce unintended risk concentrations at particularly inopportune times. These indexes inherently neglect the equity of smaller, potentially more promising firms in favor of larger-cap companies that have already experienced significant growth. Moreover, as they are instruments designed to mimic the market rather than to beat it, investors in passive cap-weighted index-tracking funds forfeit the potential of realizing relative outperformance.

Active management, on the other hand, does allow for outperformance potential, but it's generally more costly to implement than passive exposure, and not all active managers have provided investors with benefits commensurate with the price.

By attempting to sidestep the drawbacks of cap-weighted indexing and active management, strategic beta aspires to offer investors the best of both approaches—the potential for outperformance by emphasizing specific segments of the market, on the one hand, and the low cost and transparency of a rules-based indexing approach, on the other hand.

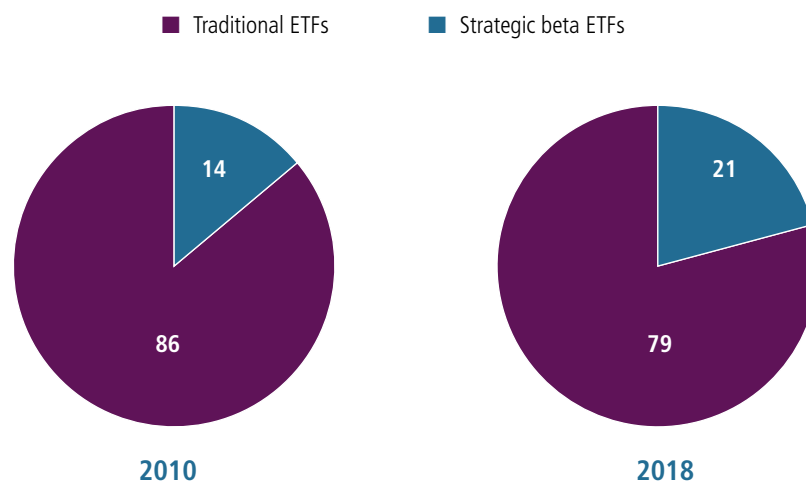
*“... as they are instruments designed to mimic the market rather than to beat it, investors in passive cap-weighted index-tracking funds forfeit the potential of realizing relative outperformance.”*

### The size of the strategic beta market is growing

According to Morningstar, \$710 billion was invested in strategic beta ETFs as of December 31, 2017. With over 700 strategic beta ETFs on offer today, they now account for 21% of all ETF assets, up from 14% in 2010. A 2019 ETF.com and Brown Brothers Harriman survey of financial advisors revealed that 83% of respondents plan to maintain or increase their exposure to strategic beta in the next year. More advisors and investors are coming to appreciate the value of incorporating strategic beta into investment portfolios. ETFs, well suited to systematic and transparent approaches, represent the primary vehicle for strategic beta implementation.

### Strategic beta is gaining share in the ETF market

Strategic beta as a percentage of the ETF market, 2010 and 2018 (%)



Source: Morningstar Direct, 2018.

## From single factor to multifactor approaches, variants abound

By any definition, strategic beta is a broad category that allows room for many variations on the alternative indexing theme, and investors seem to be using them to pursue a variety of investment objectives.

According to a recent FTSE Russell survey, U.S. advisors who use strategic beta appear equally likely to employ these strategies to provide alpha, improve diversification, or provide downside protection. Reasons for using strategic beta vary by country, as well, as the study revealed that U.K. and Canadian advisors most frequently use strategic beta to improve diversification and increase yield.<sup>1</sup>

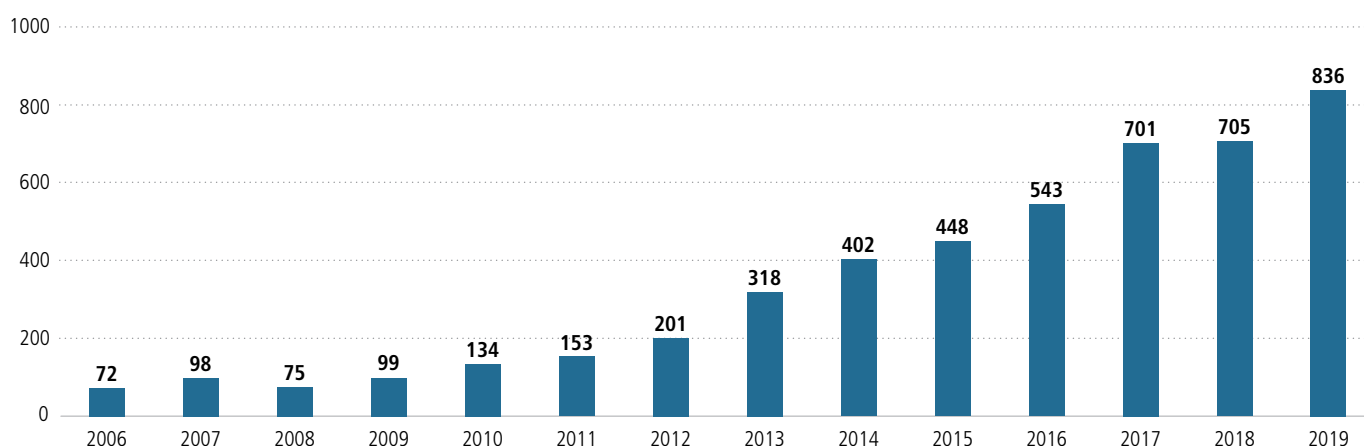
To bring greater order to the study and evaluation of these approaches, Morningstar groups strategic beta investments into three major categories—return oriented, risk oriented, and other—with a range of secondary attributes falling under each.

### Return-oriented strategies

Morningstar defines return-oriented strategic beta investments as those that seek to improve returns relative to standard core benchmarks, and includes value- and growth-based indexes in this category. Strategies following dividend-weighted methodologies also fall into this group. In essence, a return-oriented strategy aims to capture a specific factor or source of expected return by emphasizing securities with a particular trait. There are also return-oriented variations known as multifactor approaches that, at the portfolio level, pursue more than one type of premium—a concept we'll explore in further detail before the end of this paper.

### Strategic beta ETF assets have more than tripled in the last five years

Strategic beta ETF asset growth, 2006–2019 (\$ billions)



Source: Morningstar Direct, as of 3/31/19.

*“There are also return-oriented variations known as multifactor approaches that, at the portfolio level, pursue more than one type of premium ...”*

### **Fundamental weighting, an example of a return-oriented strategy**

Fundamentally weighted strategies, which fall under the return-oriented strategies banner, seek to weight securities by a company’s economic influence, measured through variables such as book equity, sales, cash flows, and dividends.

Fundamental indexers break the link between a stock’s market capitalization and its weight in a portfolio. The pioneers of this methodology pursued it out of “concern that market capitalization is a particularly volatile way to measure a company’s size or its true fair value,” and results of their published research found fundamental indexing delivered “consistent, significant benefits relative to standard cap weighted indexes.”<sup>2</sup>

Fundamental weighting enthusiasts argue that a portfolio that uses fundamental variables rather than market prices to weight securities has the potential for higher average returns.

### **Risk-oriented strategies**

Continuing with Morningstar’s strategic beta classifications, risk-oriented strategies aim to alter the level of portfolio risk relative to a standard benchmark. Two of the most common examples pursue opposite objectives: Low volatility strategies aim to pare back a portfolio’s level of market risk and high beta strategies deliberately seek to dial the risk level up.

### **Low volatility, an example of a risk-oriented strategy**

Low volatility strategies select and weight their holdings based upon historical volatility, endeavoring to generate better risk-adjusted returns than the market. Stocks that have demonstrated more price stability in the past are favored over those that have experienced greater fluctuations.

These types of approaches can be beneficial in dialing the level of equity risk in a portfolio up or down, and for that reason have an obvious appeal. But like any other investment approach, there are unknowns involved. For example, tactical over- or underweights to beta are essentially market calls, with lower volatility being

preferable in down markets and higher exposure to risk being desirable during market rallies. As history shows, anticipating inflection points in the equity markets is virtually impossible.

As for employing these types of investments as long-term strategic allocations, other challenges remain. One example can be found in the relatively high valuations of many dividend-paying stocks today as a result of investors seeking income in stocks due to historically low bond yields. This segment of the market has traditionally been viewed as defensive, and therefore less volatile than the market as a whole. And while that may continue to be true over long stretches of time, investors need to be wary of how a passively constructed low beta strategy invests. An overweight allocation to an overpriced sector is unlikely to produce the kind of results investors are looking for.

### **Other strategies**

Following the return-oriented strategy and risk-oriented strategy categories, Morningstar’s final strategic beta attribute group encompasses a variety of approaches, ranging from nontraditional commodity benchmarks to multi-asset indexes and equal-weighted strategies.

### **Equal weighting, an example of other strategies**

Incorporating perhaps the simplest of strategic beta methodologies, an equal-weighted approach assigns a uniform weight to its constituent holdings without regard to price, underlying fundamentals, or anything else; no one security is emphasized more than another.

Its advocates argue that, by breaking the connection between price and position size, equal-weighted approaches avoid a structural overweight to overvalued securities. Supporters of equal-weighted indexing also point out that, because the approach requires frequent rebalancing, there’s a buy-low-and-sell-high discipline embedded in the methodology.

The drawbacks of equal-weighted strategies can include unintended factor concentrations, arbitrarily driven by the number of securities that happen to be listed under a particular sector, industry, or country. Moreover, in assigning the smallest stock the same position size as the largest stock, an equal-weighted portfolio’s risk profile is radically different from the broader market. Another consideration for potential investors is that the frequent rebalancing needed to maintain an equally weighted portfolio drives up its transaction costs.

## Multifactor investing in context

Representing a vigorous form of return-oriented strategic beta investing, multifactor approaches pursue more than one type of premium rather than relying exclusively on a single factor. While single factor approaches account for more than 90% of strategic beta assets, multifactor ETF assets have more than doubled since 2013, and they hold almost \$60 billion in assets across 177 different funds today.<sup>3</sup> While this represents only 8% of the strategic beta ETF market, multifactor approaches are growing quickly, and they have more relevance as core long-term portfolio holdings.

*“Multifactor ETFs help diversify the risk of having concentrated exposure to a single factor at the wrong time.”*

Deliberately combining multiple complementary factors into one ETF can be a more comprehensive and consistent method of investing than choosing among a sea of single factor approaches, some of which may generate overlapping exposures with the others. While any given factor may lead the others at any one time, knowing exactly when a factor will outperform is virtually impossible to forecast. Multifactor ETFs help diversify the risk of having concentrated exposure to a single factor at the wrong time.

Of course, an eye toward balance and parsimony count in constructing multifactor portfolios. More factors aren’t necessarily better than fewer factors, and, when taken to the extreme, multifactor models can quickly become unwieldy. A degree of restraint can be a virtue in multifactor investing. What’s important is understanding the specific purpose of each factor in the portfolio and how those factors interact with one another in different market environments.

### Morningstar’s strategic beta taxonomy places multifactor approaches in the strategic beta category

Strategic beta group	Index selection	Index weighting
<ul style="list-style-type: none"> <li>■ Dividend</li> <li>■ Fundamentals</li> <li>■ Growth</li> <li>■ Momentum</li> <li>■ <b>Multifactor</b></li> <li>■ Quality</li> <li>■ Risk-oriented</li> <li>■ Value</li> </ul>	<ul style="list-style-type: none"> <li>■ Beta</li> <li>■ Buyback/shareholder yield</li> <li>■ Committee</li> <li>■ Dividend</li> <li>■ Earnings</li> <li>■ Fixed</li> <li>■ Fundamentals</li> <li>■ Growth</li> <li>■ Liquidity</li> <li>■ Market capitalization</li> <li>■ Momentum</li> <li>■ Optimization</li> <li>■ Proprietary</li> <li>■ Quality</li> <li>■ Sector</li> <li>■ Small size</li> <li>■ Value</li> <li>■ Volatility</li> <li>■ Yield</li> </ul>	<ul style="list-style-type: none"> <li>■ Beta</li> <li>■ Buyback/shareholder yield</li> <li>■ Dividend</li> <li>■ Earnings</li> <li>■ Equal</li> <li>■ Fixed</li> <li>■ Fundamentals</li> <li>■ Growth</li> <li>■ Liquidity</li> <li>■ Market capitalization</li> <li>■ Modified market capitalization</li> <li>■ Momentum</li> <li>■ Optimization</li> <li>■ Production</li> <li>■ Proprietary</li> <li>■ Quality</li> <li>■ Revenue</li> <li>■ Size</li> <li>■ Tiered</li> <li>■ Value</li> <li>■ Volatility</li> <li>■ Yield</li> </ul>

Source: “A Global Guide to Strategic-Beta Exchange-Traded Products,” Morningstar, 2018.

## Incorporating strategic beta into your portfolio

Many strategic beta investment approaches, particularly those of the multifactor variety, can be viable candidates to either replace or complement a portfolio's core equity exposures. For those investors who rely on active management exclusively, incorporating some strategic beta into an investment program may provide a route for reducing overall management fees. For devoted market-cap-weighted indexers, introducing strategic beta into a portfolio's mix can also introduce the potential for outperformance. Finally, for those investors already blending active and passive allocations, strategic beta can provide yet another tool to fine-tune the potential for outperformance while remaining cognizant of its incremental expenses.

Multifactor approaches can often serve as a replacement for core exposure, but single-factor strategies typically address more limited objectives within a portfolio. Just as some investors tilt toward different equity sectors at different points in the

market cycle, they can also rotate their portfolios' exposures to factors such as value, momentum, or quality.

Regardless of how it's implemented, strategic beta deliberately attempts to emphasize specific characteristics—either in isolation or through multifactor combinations—that are more likely to be rewarded.

The compensation for bearing various investment risks is not equally distributed. Similarly, not all strategic beta approaches are conceived, structured, or implemented equally. Just as any potential investment deserves diligent assessment, the strategic beta buyer would be wise to examine the range of different objectives, expected return drivers, potential risks, and implementation methods in the marketplace before selecting the best fit.

### Representative equity return factors can be used in isolation or in combination

Factor	Rationale
<b>Market</b>	Stocks have earned returns exceeding those of bonds and cash
<b>Liquidity</b>	Expected stock returns are inversely proportional to trading volume; investors demand a premium for holding less liquid stocks
<b>Momentum</b>	Stocks with strong recent performance have earned returns exceeding those of stocks with weak recent performance
<b>Profitability</b>	Stocks of companies generating high profits have earned returns exceeding those of stocks of companies generating low profits
<b>Quality</b>	Quality stocks—those of growing, profitable, well-managed companies—have, on average, commanded higher prices than stocks lacking those attributes
<b>Size</b>	Stocks of small companies have earned returns exceeding those of stocks of large companies
<b>Value</b>	Stocks with low relative prices have earned returns exceeding those of stocks with high relative prices
<b>Volatility</b>	Stocks with low volatility have earned better risk-adjusted returns than stocks with high volatility
<b>Multifactor</b>	Portfolios combining factors to exploit more than one premium in an integrated investment approach

Source: John Hancock Investment Management, 2018. Past performance does not guarantee future results.

**1** "Smart beta: 2018 survey findings from US, Canadian, and UK financial advisors," FTSE Russell, 2018. **2** "Fundamental Indexation," Robert D. Arnott, Jason Hsu, Philip Moore, *Financial Analysts Journal*, March/April 2005. **3** Strategic Insight, Morningstar, 3/31/19.

Predicted active risk represents the expected divergence between the price behavior of a fund and the price behavior of the market as a whole.

Diversification does not guarantee a profit or eliminate the risk of a loss.

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