John Hancock Investment Management

Incorporating ETFs into your portfolio

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In discussing portfolio construction with financial advisors, we find that there are essentially three implementation approaches, each of which includes varying degrees of active and passive exposure.

Key takeaways

- In little more than 20 years, ETFs have become a staple in many investor portfolios, and for good reason: They provide intraday liquidity, transparency, tax efficiency, and access to specific markets at a relatively low cost.
- Investors have allocated more than $836 billion to strategic beta ETFs globally across a wide range of styles, including return-oriented strategies that screen for attributes such as dividends, value, growth, momentum, buybacks, and quality.[1]
- Financial advisors generally approach ETF implementation in one of three ways, and with varying degrees of active and passive exposure in each portfolio.

Executive summary

Since their U.S. launch in 1993, exchange-traded funds (ETFs) have grown from a single S&P 500 Index-based ETF with $6.5 million in assets to a $3.9 trillion industry today. The investment vehicle's devoted following is due in large part to its ability to offer a wide variety of investment objectives and risk profiles in a cost-effective manner. This flexibility is a key reason financial advisors and portfolio managers employ ETFs in the construction of portfolios alongside active strategies. At John Hancock Investment Management, our research working with financial advisors reveals that ETFs are typically allocated in one of three ways: as a minority position to achieve tactical exposure, as roughly half of a portfolio's beta, or as the primary vehicle for market exposure. In this paper, we discuss the history and characteristics of ETFs and examine some common strategies for implementing them in a diversified portfolio.

The allure of ETFs: blending the low-cost exposure of indexes with the intraday trading convenience of stocks

The first ETF was launched in 1993 and tracked the S&P 500 Index. Over time, ETFs gained acceptance as investment vehicles that combine the simplicity and low cost of index mutual funds with the flexibility of individual stocks. Most ETFs in the United States are structured as open-end investment companies or unit investment trusts, and investors can buy or sell ETF shares through a brokerage account, just as they would shares of a publicly traded company.

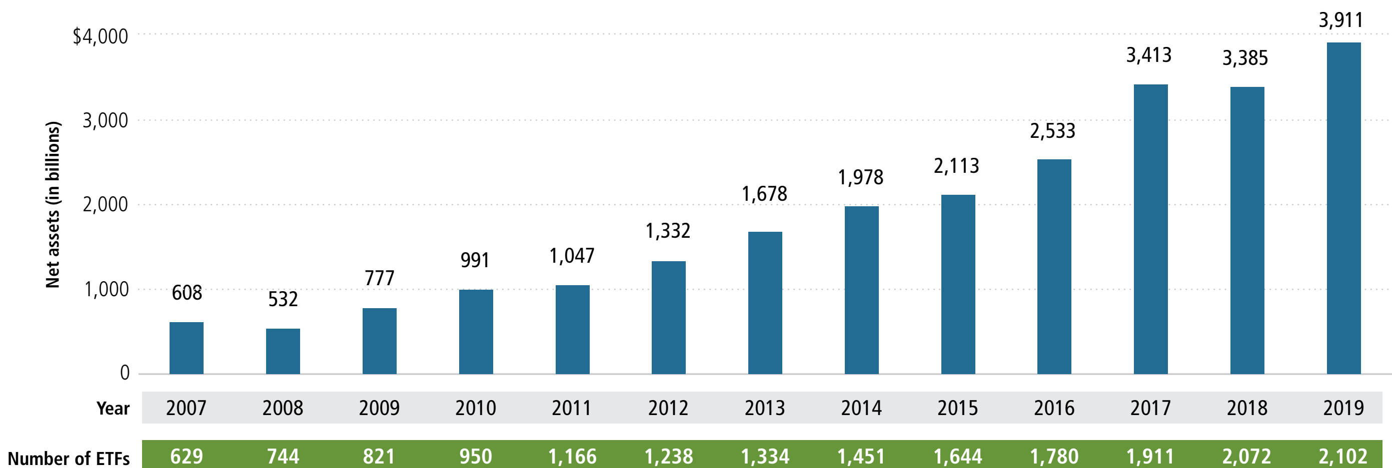
As with mutual funds, an ETF must calculate its net asset value (NAV)—the value of its assets minus its liabilities—every business day, which it typically does at market close. However, approximately every 15 seconds throughout the business day, an ETF's estimated NAV is calculated and distributed through quote services. Often, an ETF's intraday value can be found by searching for the ETF's ticker symbol, just like a stock.

Since their debut more than two decades ago, ETFs have grown to become a staple of individual and institutional investor portfolios. Beyond the convenience of intraday trading, they have also become significantly more diverse. Initially designed to closely track the performance of U.S. equity indexes, ETFs today number nearly 2,000, with countless varieties designed to match indexes in international, fixed-income, commodity, currency, and other specialty markets.

While the adoption of ETFs by do-it-yourself individual investors has been a fairly recent phenomenon, acceptance among investment professionals has a much longer record. Today, ETFs have become more highly recommended by professionals than mutual funds; they were

The assets and number of ETFs have grown sharply in recent years

Net assets and total number of ETFs



Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Number of ETFs	629	744	821	950	1,166	1,238	1,334	1,451	1,644	1,780	1,911	2,072	2,102

Source: Strategic Insight, April 2019.

recommended by an 87% to 73% margin, respectively, in a 2018 survey.[2] That finding indicates a rapid rate of acceptance since 2006, when just 40% of advisors indicated that they used or recommended ETFs. The most significant advantages that advisors cited were lower costs, tax efficiency, trading flexibility, transparency of holdings, and diversification.

Comparison with actively managed mutual funds

Passively managed ETFs and actively managed mutual funds have many similarities: They're both registered as investment companies under the Investment Company Act of 1940 and both are regulated by the SEC. Both are constructed as a grouping of investments (stock, bonds, and/or derivatives), and new shares can be created or redeemed at any time. They both also follow the same valuation procedure and calculate their NAVs at the close of trading each day (although ETFs estimate a NAV throughout the day). However, passively managed ETFs differ from actively managed mutual funds in several ways that make them attractive to many investors.

Passively managed ETFs are typically less expensive than actively managed mutual funds

- Most ETFs track indexes, and tracking an index is inherently less expensive than daily active management.
- ETFs are traded through a brokerage account, and the ETF sponsor doesn't need to account for the expense of shareholder recordkeeping.

Passively managed ETFs are structurally more tax efficient than actively managed mutual funds

- ETFs generate tax savings from their structure. When dealing with fund flows, especially redemptions, ETFs can minimize the likelihood of generating taxable capital gains by exchanging securities in kind (not through a monetary transaction).
- ETFs have a much lower turnover than mutual funds because most ETFs passively track an index.

Passively managed ETFs are transparent due to the daily disclosure of assets

- ETFs make their holdings available on a daily basis, while mutual funds generally do so only monthly or quarterly, with semiannual updates.
- ETFs disclose whether they lend out securities and give detail of the collateral they hold, while mutual funds are not required to do so.

ETFs vs. mutual funds: key differences

Passively managed ETFs	Actively managed mutual funds
Authorized participants (market makers) are the only shareholders of record	Individual shareholder recordkeeping
Lower capital gains due to the in-kind process to create/redeem shares outstanding	Higher capital gains, as redemptions may require selling underlying securities to raise proceeds
Lower expense ratios	Higher expense ratios
Daily transparency of holdings	Monthly or quarterly transparency of holdings in arrears
Trade intraday on an exchange; may trade below or above NAV	Trade at market close at NAV
May have brokerage commission costs; all ETFs will have a bid/ask spread (difference in buy and sell price)	May have a load associated with purchase or sale; no bid/ask spreads
Underlying index portfolio changes infrequently	Underlying portfolio can change often

Implementing ETFs: real-world examples

In the second part of this paper, we detail how professional portfolio managers and financial advisors employ ETFs in the construction of client portfolios.

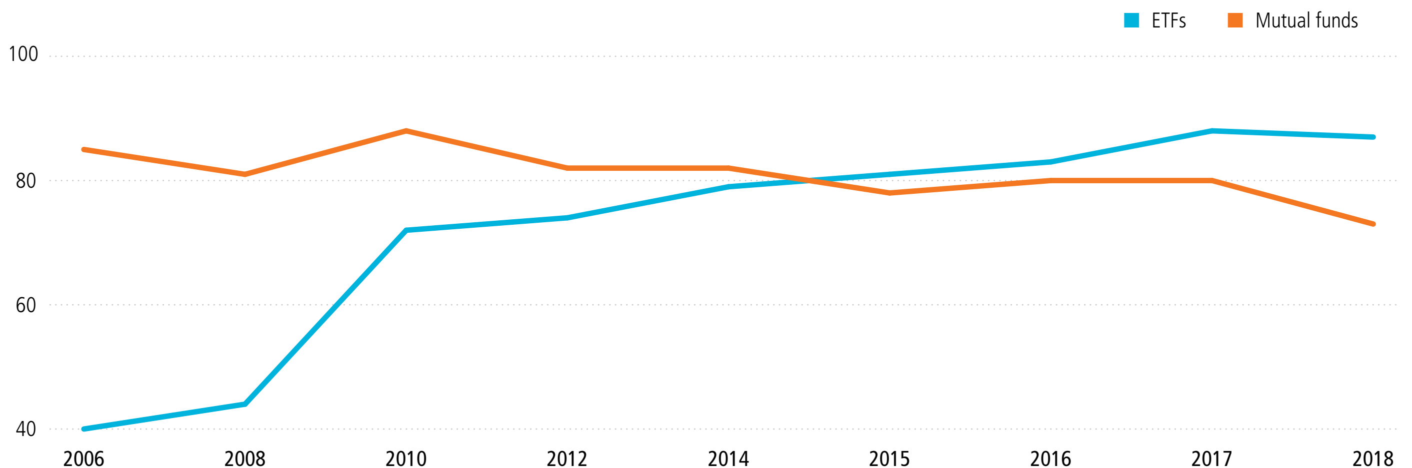
Most financial advisors recommend a blend of ETFs and active strategies

The debate over whether an investor should choose a purely active or purely passive approach is misguided, in our opinion, because investors can benefit greatly by combining both approaches in the same portfolio. Passive ETF strategies can achieve broad market exposure inexpensively and efficiently or enable tactical exposure to certain asset classes and markets. Active strategies can extend the reach of that portfolio—producing uncorrelated sources of return—or help mitigate risk and add performance alpha, depending on an investor's goals. As a result of these complementary qualities, we believe blending active and passive management is most advantageous for investors, and we're not alone in our thinking. According to the "2018 Trends in Investing Survey," 65% of financial advisors prefer a blend of the two asset management styles when overall portfolio cost was a consideration.[2]

> *65% of financial advisors recommend a blend of active and passive approaches for their clients.*

As the variety of ETFs has grown beyond the category's index-replication roots, so too has the potential for executing strategies that borrow from the ideas of active portfolio construction. Strategic, or smart, beta is a good example. Strategic beta investment strategies seek to improve on traditional market-capitalization-weighted indexes by pursuing many of the same goals as actively managed portfolios. But unlike active funds, strategic beta indexes and the portfolios that track them tend to follow rules-based, highly transparent, and lower-cost approaches to

Financial advisors have increasingly recommended ETFs alongside mutual funds



Source: "2018 Trends in Investing Survey," Financial Planning Association, Research and Practice Institute, *Journal of Financial Planning,* 2018.

investing. For example, by altering the composition of the S&P 500 Index so that securities are weighted equally rather than proportionally by market capitalization, a strategic beta strategy can emphasize smaller-capitalization names without day-to-day active management. 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 (as happened during the 2000 tech bubble and the 2008 financial crisis). The goal of the equal-weighted strategic beta strategy in this case is to outperform the S&P 500 Index while maintaining the low-cost structure of a passive approach. In addition to specific portfolio construction rules, strategies can also be constructed to suit particular investor objectives.

Investors have allocated more than $800 billion to strategic beta ETFs globally across a wide range of styles, including return-oriented strategies that screen for attributes such as dividends, value, growth, momentum, buybacks, and quality. There are also risk-oriented strategies that attempt to minimize volatility, achieve a low or high beta, or use other risk-weighting methods.

An asset allocator's perspective

From an asset allocator's perspective, we believe it's a good idea to blend both active and passive investment management styles by using passive strategies for low-cost beta exposure and surrounding them with the alpha opportunities that active strategies can generate.

The potential applications for combining active and passive strategies in a portfolio include:

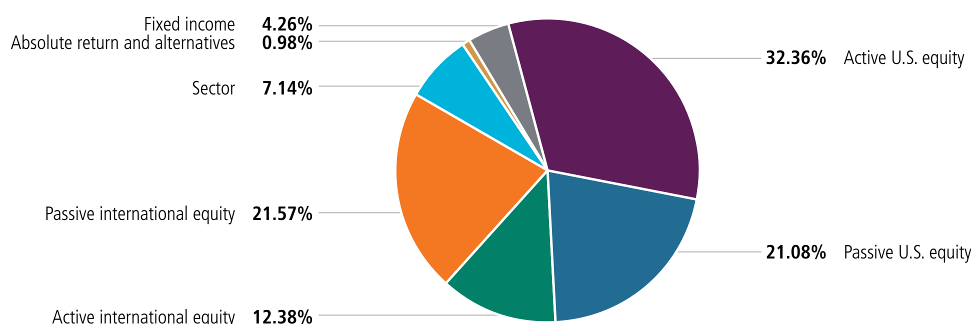
- Using active management as a core, flexible holding and passive management as a low-cost source of beta in efficient markets
- Using active management to provide noncorrelated sources of return and passive management to provide precise, tactical exposure to certain asset classes
- Using active management to mitigate risk and/or produce performance alpha and passive management to reduce the overall cost of the portfolio

Our experience combining active and passive strategies

The asset allocation team at Manulife Investment Management has been blending active and passive strategies since 2005. Passive strategies are used as low-cost solutions to implement long-term structural, broad market, and strategic exposures, and are also sometimes used to achieve tactical exposures. Rather than gaining exposure and then removing it in the short term, passive strategies have the flexibility to tilt portfolios toward certain areas of the market.

John Hancock's retirement portfolios blend active and passive strategies

John Hancock Multimanager 2050 Lifetime Portfolio asset allocation



Source: John Hancock Investment Management, data is as of 3/31/19.

> *It's important to have both active and passive strategies available in the tool kit when managing portfolios over the long term.*

The asset allocation team also makes portfolio construction decisions with a view toward the cyclical nature of performance. For example, certain market conditions drive better relative performance in active management versus passive management, and vice versa. Having both active and passive strategies available can be beneficial because investment styles can move in and out of favor.

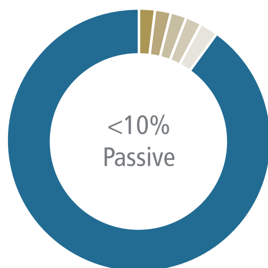
Our work with financial advisors reveals three widely used approaches to ETF implementation

In discussing portfolio construction with advisors, we find that there are generally three implementation approaches: mostly active, partially passive, and mostly passive.[3]

Examples of implementation styles employed by financial advisors

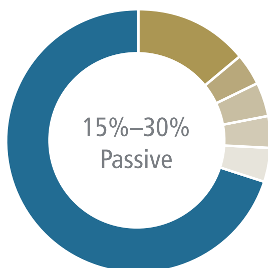
Percentage of portfolio allocated to passive investments

Active　Passive



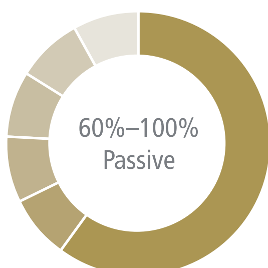
Mostly active—ETFs used to efficiently achieve tactical exposure

The **mostly active** approach often includes a portfolio with less than 10% of its assets allocated to passive investments that focus on a specific factor, such as sector movements or the direction of interest rates. The primary objective of employing ETFs is to access targeted exposure in an efficient way.



Partially passive—ETFs used as a part of the core market exposure

The **partially passive** approach typically involves a passive allocation of approximately 15% to 30%. The objective is to blend active and passive strategies, accessing lower-cost exposure through ETFs while also employing active managers to pursue performance alpha and actively manage risk.



Mostly passive—ETFs used as the main market exposure

The **mostly passive** approach employs a mix of ETFs and traditional index strategies. The objectives of this style are often to keep costs as low as possible and to be sensitive to potential tax ramifications.

Examples are hypothetical and are not actual portfolios. Examples may not be appropriate for all investors.

Advisor sample portfolios

Mostly active

The average advisor usually has 3%–8% of the portfolio in passive investments, with small amounts to use as tilts—an investment strategy focused on a specific factor, such as sector movements or the direction of interest rates. Active is made up of mostly active investments (80%), with the primary objective of pivoting between wealth accumulation strategies and wealth preservation strategies.

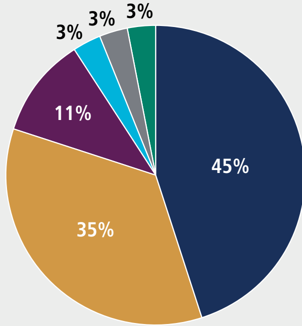
Partially passive

Partially passive is approximately 15%–30% passive—core with some active, some passive, and strategic beta. This is different from active in that the objective is to carve beta out with the passive strategies and then be extremely active with the active strategies. This style is somewhat cost aware, and ETFs are used to gain exposure to various factors.

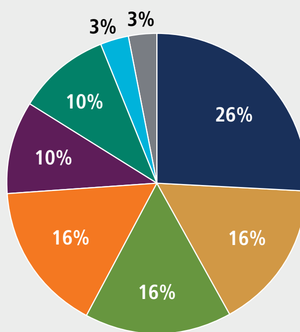
Mostly passive

Heavy users of passive approaches focus on beta exposure, with some strategic beta. The objective of this style is to keep costs as low as possible, avoid underperformance, and be sensitive to potential tax ramifications. The methodologies behind strategic beta exposures 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) volatility, or for some other desired attribute, such as income generation.

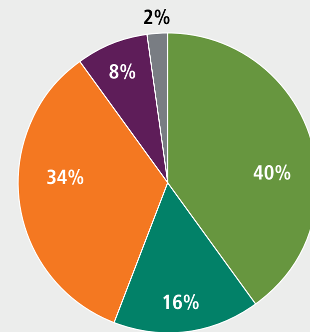
Goal of ETFs: tactical tilts/factor exposure



Goal of ETFs: core beta exposure



Goal of ETFs: main beta exposure



Active equity · Active bond · Passive equity · Passive bond · Alternatives · Smart beta · Niche alpha · Passive regional/sector tilt

Source: John Hancock Investment Management, June 2018. Examples are hypothetical and are not actual portfolios. Examples may not be appropriate for all investors.

Conclusion

Over the past 20-plus years, ETFs have grown in both variety and assets under management, and today they represent a key component of many investor portfolios. Most financial advisors recommend a blend of active and passive strategies when constructing portfolios for their clients, a sentiment echoed by our own view and that of the asset allocation team responsible for managing some of the largest asset allocation funds in the industry. When discussing specific portfolio construction ideas with financial advisors, we find that they implement ETFs in one of three distinct ways: to achieve tactical exposure, as part of the core market exposure, or as the main market exposure.

1 Morningstar strategic beta definition, 2018. **2** "2018 Trends in Investing Survey," Financial Planning Association, Research and Practice Institute, *Journal of Financial Planning*, 2018. **3** Manulife Investment Management, 2018.

ETFs are subject to trading costs, and frequent trading of ETFs may accrue significant expenses that outweigh the benefits of a lower expense ratio.

An active investment strategy regularly takes investment positions that clearly differ from those of the portfolio's performance benchmark, with the objective of outperforming the benchmark over time. Passive strategies are designed to mimic market benchmark indexes and minimize trading costs. Alpha measures the difference between an actively managed fund's return and that of its benchmark index. An alpha of 3, for example, indicates the fund's performance was 3% better than that of its benchmark (or expected return) over a specified period of time. Alternative investments are not categorized as stock, bond, or cash investments. Beta measures the sensitivity of the fund to its benchmark. The beta of the market (as represented by the benchmark) is 1.00. Accordingly, a fund with a 1.10 beta is expected to have 10% more volatility than the market. Correlation is a statistical measure that describes how investments move in relation to each other, which ranges from -1.0 to 1.0. The closer the number is to 1.0 or -1.0, the more closely the two investments are related. Market cap weighting generally refers to an index whose individual components are weighted according to their market capitalization. Niche alpha refers to concentrated active investment exposure. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Strategic beta—along with multifactor investing, smart beta, fundamental indexing, and a few other related expressions—refers to indexes and the investment products that track them, the majority of which aim to enhance returns or minimize risk relative to a traditional market-capitalization-weighted benchmark. Tracking error is reported as a standard deviation percentage difference—the difference between the return received on an investment and that of the investment's benchmark. Past performance does not guarantee future results.

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

Large company stocks could fall out of favor. The stock prices of midsize and small companies can change more frequently and dramatically than those of large companies, and value stocks may decline in price. A portfolio concentrated in one sector or that holds a limited number of securities may fluctuate more than a diversified portfolio. ETF shares are bought and sold through exchange trading at market price (not NAV), and are not individually redeemed from the fund. Shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. A fund's holdings and returns may deviate from those of its index due to various factors. This deviation may be greater when markets are volatile or subject to unusual conditions. John Hancock retirement portfolios' performance depends on the advisor's skill in determining asset class allocations, the mix of underlying funds, and the performance of those underlying funds. The portfolio is subject to the same risks as the underlying funds and exchange-traded funds in which it invests: Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments; foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability; the securities of small companies are subject to higher volatility than those of larger, more established companies; and high-yield bonds are subject to additional risks, such as increased risk of default. Each portfolio's name refers to the approximate retirement year of the investors for whom the portfolio's asset allocation strategy is designed. The portfolios with dates further off initially allocate more aggressively to stock funds. As a portfolio approaches and passes its target date, the allocation will gradually migrate to more conservative, fixed-income funds. The principal value of each portfolio is not guaranteed, and you could lose money at any time, including at, or after, the target date. Liquidity—the extent to which a security may be sold or a derivative position closed without negatively affecting its market value, if at all—may be impaired by reduced trading volume, heightened volatility, rising interest rates, and other market conditions. Hedging and other strategic transactions may increase volatility and result in losses if not successful. Please see the portfolios' prospectuses for additional risks.

Request a prospectus or summary prospectus from your financial advisor, by visiting jhinvestments.com/etf, or by calling us at 800-225-5291. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should consider carefully before investing.

Investment Management

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