Manulife Investments

ETFs

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Incorporating ETFs into your portfolio

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

KEY TAKEAWAYS

- Since their introduction in the U.S. over 20 years ago, 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.
- In Canada, investors have allocated more than CAD $107 billion to strategic beta ETFs across a wide range of styles, including return-oriented strategies that screen for attributes such as dividends, value, growth, momentum, buybacks, and quality.[1]
- In the more developed U.S. market, 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 $2 trillion industry today. In Canada, the pick-up rate has been similar with an asset growth rate (CAGR) of 18.5% over the last five years.[2] 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 advisors and portfolio managers employ ETFs in the construction of portfolios alongside active strategies. At Manulife Investments, our research working with 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,

[1] Morningstar, Morningstar Research Observer. "Introducing the Morningstar Analyst Ratings for ETFs," November 2016.
[2] Investor Economics, Canadian Wealth Management Industry; Update Focus on Investment Funds; August 2016.

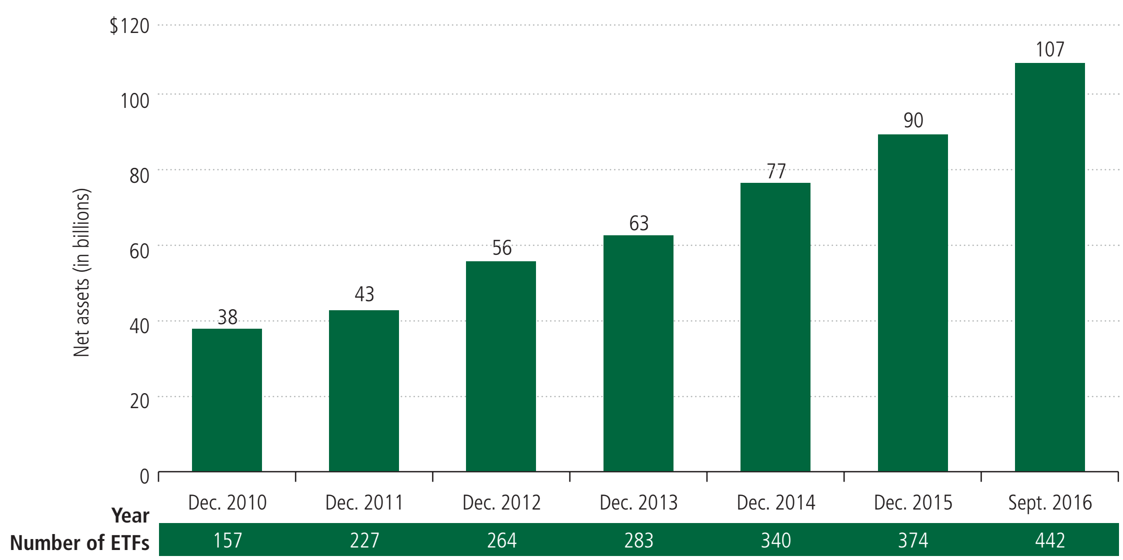
we discuss the history and characteristics of ETFs and examine some common strategies for implementing them in a diversified portfolio.

THE ALLURE OF ETFs: BLENDING THE LOW-COST EXPOSURE OF INDEXES WITH THE INTRADAY TRADING CONVENIENCE OF STOCKS

In the U.S., the first ETF was launched in 1993 and tracked the S&P 500 Index. Over time, ETFs gained acceptance in both the U.S. and Canada as investment vehicles that combine the simplicity and low cost of index mutual funds with the flexibility of individual stocks. Most ETFs in Canada are structured as open-end funds 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, ETFs can be bought and sold throughout the business day at the calculated market price; by contrast, mutual fund purchases and redemptions are executed at the close of the trading day.

The assets and number of ETFs have grown sharply in recent years
Net assets (CAD) and total number of ETFs



Source: Investor Economics, Strategic Insight. ETF and Index Funds Report, third quarter 2016.

Since their debut, ETFs have grown to become a staple of individual and institutional investor portfolios. Beyond the convenience of intraday trading, ETFs have also become significantly more diverse. Initially designed to closely track the performance of U.S. equity indexes, in Canada, ETFs today number nearly 450, with countless varieties designed to match indexes in international, fixed-income, commodity, currency, and other specialty markets.[3]

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. In the U.S. today, for the first time in their history, ETFs have become more highly recommended by professionals than mutual funds; they were recommended by a narrow 81% to 78% margin, respectively, in a 2015 survey.[4]

Comparison with actively managed mutual funds

Passively managed ETFs and actively managed mutual funds have many similarities. They are both governed under National Instrument (NI) 81–102 and regulated by the Canadian Securities Administrators. 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. However, passively managed ETFs differ from actively managed mutual funds in several ways that make them attractive to many investors.

ETFs versus 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	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

[3] Investor Economics, Strategic Insight. ETF and Index Funds report, third quarter 2016.
[4] "2015 Trends in Investing Survey," Financial Planning Association, Research and Practice Institute, *Journal of Financial Planning*, 2015.

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 does not 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.

IMPLEMENTING ETFs: REAL-WORLD EXAMPLES

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

Most 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.

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 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 in Canada have allocated nearly CAD $107 billion to strategic beta across a wide range of styles, including return-oriented strategies that screen for attributes such as dividends, value, growth, momentum, buybacks, and quality.[5] 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 non-correlated 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 research reveals three widely used approaches to ETF implementation

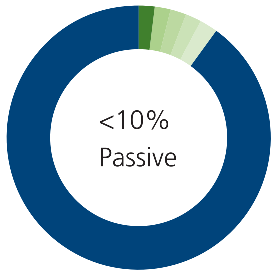
In the U.S., almost two-thirds of advisors use some form of passive investment vehicle (usually ETFs) when constructing client portfolios. Allocations to ETFs range from a mere 3% in more active portfolios to a 73% ETF allocation, on average, in more passive portfolios.[6]

We find that there are generally three implementation approaches: mostly active, partially passive, and mostly passive.[7]

[5] Morningstar, Morningstar Research Observer. "Introducing the Morningstar Analyst Ratings for ETFs," November 2016.
[6] Ignites, May 2015.
[7] Data obtained from John Hancock Asset Management, July 2015.

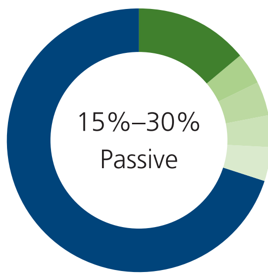
Examples of implementation styles employed by advisors

Percentage of portfolio allocated to passive investments



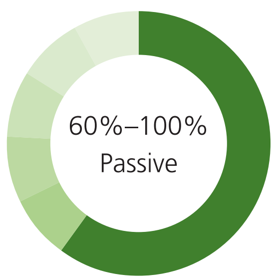
Mostly active – ETFs used to efficiently achieve tactical exposure

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.

Active Passive

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

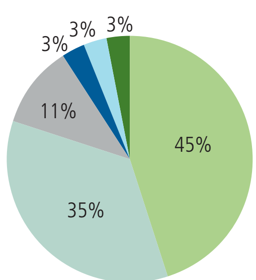
Advisor sample portfolios

Style 1
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. Style 1 is made up of mostly active investments (80%), with the primary objective of pivoting between wealth accumulation strategies and wealth preservation strategies.

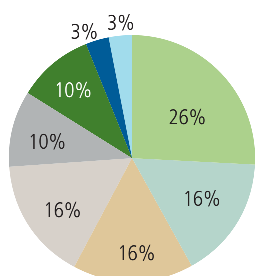
Style 2
Style 2 is approximately 15%–30% passive – core with some active, some passive, and strategic beta. This is different from Style 1 in that the objective is to carve beta out with the passive strategies and then be extremely active with the active strategies. This style is somewhat cost aware, and ETFs are used to gain exposure to various factors.

Style 3
The third style is made up of almost all passive assets, focusing on main beta exposure, with some strategic beta. The objective of Style 3 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.

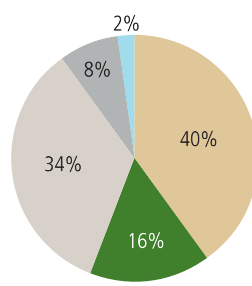
Goal of ETFs:
tactical tilts/factor exposure



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: Manulife Investments, June 2015. 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 in both the U.S. and Canada, and today they represent a key component of many investor portfolios. Most advisors recommend a blend of active and passive strategies when constructing portfolios for their clients, a sentiment echoed by our own view. When discussing specific portfolio construction ideas with 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.

For more information contact your advisor or visit manulife.ca/etfs

ETFs are subject to trading costs, and frequent trading of ETFs may accrue significant expenses that outweigh the benefits of a lower expense ratio.
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 is typically used to represent the value added or subtracted by active investment management strategies.
Alternative investments are not categorized as stock, bond, or cash investments.
Beta measures the volatility of a security or portfolio in comparison with the market as a whole.
Correlation measures the relationship between two investments—the higher the correlation, the more likely they are to move in the same direction for a given set of economic or market events.
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—broadly refers to a diverse and growing category of rules-based approaches to investing in various markets.
Tracking error measures the divergence between the price behaviour of a portfolio and that of a benchmark index.

Diversification does not guarantee a profit or eliminate the risk of a loss.
Past performance does not guarantee future results.
Large company stocks could fall out of favour. 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.

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