Executive summary

Many registered investment advisors (RIAs) and other professional investors—not to mention all robo advisors—use model portfolios to assist with the complexity of managing their clients’ wealth. The benefits include being able to offer a consistent approach across all client portfolios with similar investment objectives while at the same time providing much-needed scale, as additional clients put into a model portfolio do not require additional research. When not properly constructed or implemented, however, model portfolios can have certain limitations, including the ability to protect against downside risk in volatile markets.

Recent research by the portfolio consulting team at John Hancock Investments reveals that many model portfolios can do more to help protect client assets in today’s uncertain market environment. Data was derived from model portfolios analyzed during calendar year 2015. To ensure apples-to-apples comparisons, only portfolios that contained an approximately 50% to 70% allocation to equities were included. There were 93 portfolios in the cohort. The model portfolios tended to be sourced from larger-producing advisors, and there were no robo advisors included in the study. We acknowledge a potential self-selection bias, as the models were mostly sourced from advisors who were likely to be using John Hancock funds in their models. This paper discusses the findings and offers solutions for bolstering downside protection in model portfolios.

Key takeaways

- RIAs and other advisors employing model portfolios express a desire for downside protection, yet often do not implement strategies sufficient to do so.
- A justifiable aversion to duration risk may be heightening downside volatility as advisors increase allocations to flexible bond funds with greater weightings in high-yield bonds and higher correlations to equities.
- Statement risk is a commonly cited concern for advisors who avoid alternatives and other potential diversifiers in an effort to keep things simple.
- The establishment of a performance blueprint would represent a positive step toward bridging the gap between intention and practice in model portfolios.

Few portfolios in our study contained strategies implemented specifically to address downside protection, despite it being a commonly stated objective.
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Volatile markets put model portfolios to the test

Roughly half of the advisors surveyed by the portfolio consulting team expressed a desire to protect client assets from downside risk. This is understandable in an environment of relatively low market returns, elevated volatility, and a great deal of macroeconomic uncertainty. From the standpoint of portfolio construction, however, few advisors had actually implemented strategies to address downside protection.

One unfortunate consequence of this dichotomy was poor relative performance in January’s volatile markets. We compared the performance of our financial advisor portfolios with that of the Morningstar moderate allocation fund category average, which also contains multi-asset portfolios with equity allocations in the 50% to 70% range. In January, our financial advisor model portfolios declined 3.85% on average, versus a Morningstar category average decline of only 3.48%.

While this doesn’t appear to be a large performance disparity on the face of it, the gap becomes wider when we adjust each portfolio by the size of its equity allocation (after all, we would expect lower performance from portfolios that had greater exposure to equities). We accomplish this by looking at how much a portfolio declined relative to the market, compared with how much each portfolio’s equity position suggests it should have declined.

\[
\left( \frac{\text{Portfolio return}}{\text{Market return}} \right) \div \text{Equity allocation}
\]

For the financial advisor model portfolios, this ratio averaged 1.36 in January, versus 1.19 for the Morningstar moderate allocation fund average. This suggests that, on average, financial advisor portfolios captured more of the market decline than the moderate allocation category, even after adjusting for differences in equity exposure. Clearly, other risks were lurking in the models, and there was insufficient exposure to uncorrelated assets.

The risk of too little duration risk

Many of the models included a strong preference for multi-sector and nontraditional bond funds. In fact, the average combined weight of multi-sector and nontraditional holdings at 11.8% was greater than the average weight of intermediate-term bond holdings at 10.5%. This represents a significant and understandable shift in allocation in an era of low yields and potential interest-rate risk. After 30 years of declining rates in the United States, the future drivers of fixed-income returns are not likely to mirror the past, and advisors have moved away from core bond holdings in order to limit duration risk.

However, the increase in flexible income strategies was a key factor in January’s underperformance of the moderate allocation models. While many flexible bond funds have little or no duration risk, they often come with additional high-yield bond exposure. In fact, in the models we studied, the nontraditional bond funds had high-yield allocations that ranged from 18% to 42% with an average allocation of roughly 27%. Whereas fixed-income duration exposure is one of the few exposures that has historically buttressed a portfolio in a risk-off environment, high yield has been much more highly correlated with equities during market sell-offs.
These findings suggest that the buildup in credit risk is being underappreciated as advisors increase allocations to flexible income strategies. Given that inflation expectations remain low, some advisors may wish to move more incrementally away from duration risk assets such as U.S. Treasuries.

Alternatively, portfolio construction can help compensate for the additional credit risk of flexible income strategies by dialing down potential risk in some other part of the portfolio (e.g., by using alternatives). In fact, several categories of alternative funds outperformed high-yield bonds during the three most recent market pullbacks. Given current spreads on high-yield bonds, alternatives may offer a comparable return profile but with significantly better downside protection potential.
Expanding the set of diversification opportunities

Model portfolios are failing to take advantage of several potential diversifiers such as foreign small-cap stocks and alternative beta categories, including real estate and natural resources. Some advisors expressed a desire to limit the number of strategies they use in their models. Complexity is a common concern, as many said they just don’t have the bandwidth to evaluate a wide range of investment opportunities. Statement risk was also frequently mentioned. Many advisors are reluctant to have funds in their models that clients might single out as unfamiliar, representing esoteric asset classes, or having maverick risk.

One clear example is the use of alternative strategies. At first glance, alternative strategies appear quite common in model portfolios. Nearly 60% of the models we analyzed included some form of alternative strategy, and 45% of the models that included alternatives exposure held more than one alternative position. However, these exposures were generally not a meaningful part of the overall asset allocation. In fact, 40% of models that used alternatives had allocations of 5% or less, which we find insufficient to provide real downside protection in volatile markets.

In our estimation, a more appropriate weighting for alternatives in moderate allocation portfolios would be 15% to 25%. For example, BCA Research recently analyzed the performance of 10 alternative assets since 1997 and found that adding a 20% allocation of a diversified basket of alternatives to a balanced portfolio with 50% equities shifted the efficient frontier, both increasing returns and lowering volatility.¹

It appears as if many advisors are still testing the waters when it comes to including alternative strategies in model portfolios. Among the reasons cited for not using alternatives were:

- Poor prior experience
- Lack of understanding of the strategies
- Difficulty in explaining alternatives to clients

The difficulty in explaining alternative strategies to clients may also explain why diversified alternative strategies were more common than targeted strategies such as market neutral funds or managed futures funds.

Defining a performance blueprint

Among the challenges facing advisors, the lack of a clear objective for performance may be the simplest to fix. Many advisors were vocal about what kind of performance they wished to achieve from their models, but few stated these performance goals with any degree of specificity. Many also expressed unreasonable performance potential for their models, given the mix of assets and the historical returns of the underlying asset classes. However, few could articulate a portfolio construction process that would help them pursue their stated return and volatility targets.

Most advisors who use alternatives in model portfolios prefer multi-alternative strategies

<table>
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<tr>
<th>Use of various alternative strategies by models employing alternatives</th>
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<tbody>
<tr>
<td>Use a multi-alternative fund</td>
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<tr>
<td>Use more than one alternative fund</td>
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<tr>
<td>Use long/short equity</td>
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<td>Use managed futures</td>
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<td>Use market neutral</td>
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<td>Use bear market</td>
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<td>Use trading-inverse debt</td>
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Source: John Hancock Investments portfolio construction, analysis of 93 portfolios as of February 2016. Categories are defined by Morningstar.

The potential for this kind of disconnect underscores the need for the development of performance blueprints. At John Hancock Investments, we believe the importance of establishing a performance blueprint for any model portfolio cannot be overstated. A blueprint provides an understanding of how a fund or portfolio should perform in various kinds of markets. Based on historical returns and volatility patterns, such a blueprint would help an advisory practice in a number of ways, such as:

- Setting performance expectations
- Helping make success measurable beyond simple percentile ranks
- Aiding in the evaluation of managers
- Allowing for a more meaningful discussion about performance while promoting better engagement
- Providing discipline to the portfolio construction and adjustment process

At John Hancock Investments, we establish a blueprint for every strategy we offer. These metrics include the results of stress testing, factor-based performance attribution, and other measures that have the goal of determining the drivers of return, the timing of performance alpha, and the likely performance in adverse markets. Having such a blueprint enables us to better evaluate the performance of managers and avoid knee-jerk reactions to short-term performance results.

**Conclusion**

Model portfolios offer many practical benefits. When properly implemented, models can help efficiently scale an advisory practice while providing consistent, diversified portfolio management to clients. Our study of moderate allocation models, however, found that portfolios face certain implementation challenges, including the lack of a stated objective for each model portfolio and the perceived statement risk represented by uncommon or difficult-to-explain strategies. Few portfolios in our study contained strategies implemented specifically to address downside protection, despite it being a stated objective. The result was insufficient downside protection and an unintended buildup of credit risk as advisors sought to address duration risk by leaning on flexible fixed-income strategies.

Our primary recommendation is the establishment of a performance blueprint for every model portfolio—to help set performance expectations and to help frame the discussion around portfolio positions that extend beyond traditional categories. Only by adding exposure to a broader set of uncorrelated strategies can professional investors hope to achieve their stated goal of offering better downside protection to their clients.
Portfolio consulting at John Hancock Investments

The portfolio consulting team at John Hancock Investments works with RIAs, financial planners, broker-dealers, and other intermediaries to assess the effectiveness of portfolio strategies. The team helps build and refine performance blueprints, which can help set expectations based on the objectives of a particular portfolio. Working collaboratively with advisors, the team follows a three-step process. First, they examine the risks and prospective returns of the equity, bond, and alternative investments in model portfolios. Second, they explore portfolio construction, stress testing, and asset allocation practices. Finally, they interpret the results, working alongside the RIA or other intermediary, underscoring the potential practical implications for each model portfolio.

A typical portfolio analysis includes:

- A comparison of a portfolio’s risk and potential return posture with that of institutional investors and other professional asset allocators
- An estimate of value at risk to help gauge the potential frequency and magnitude of prospective portfolio losses
- An estimate of the portfolio’s return during a 10% market correction
- A 2008 market simulation analysis
- An estimate of each underlying bond fund’s contribution to duration and a performance forecast in a scenario where interest rates increase by 1%
- An analysis of the portfolio’s alternative strategies

The data contained in any report generated by John Hancock Investments portfolio consulting services is provided for informational purposes only and does not constitute investment advice or an endorsement of any security, mutual fund, sector, or index. John Hancock Investments portfolio consulting services is not acting as your investment advisor and you should not rely on our reports alone to make any investment decision. You may implement any such analysis by investing in John Hancock funds or by investing in other funds not affiliated with John Hancock Investments.

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

The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. The MSCI World Index tracks the performance of publicly traded large- and mid-cap stocks of foreign developed-market companies. The MSCI All Country World Index (ACWI) Index tracks the performance of globally issued, U.S. dollar-denominated high-yield bonds. It is not possible to invest directly in an index. Standard deviation measures performance fluctuation, may not be indicative of future risk, and is not a predictor of returns. 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. Alpha is a measure of the difference between a fund’s actual returns and its expected performance, given its level of risk as measured by beta. Past performance does not guarantee future results.

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. The energy industries can be significantly affected by fluctuations in energy prices and supply and demand of energy fuels, energy conservation, the success of exploration projects, and tax and other government regulations. Values will fluctuate in response to issuer, political, regulatory, market, or economic developments. Fixed-income investments are subject to interest-rate and credit risk; their value will normally decline as interest rates rise or if a creditor, grantor, or counterparty is unable or unwilling to make principal, interest, or settlement payments. Investments in higher-yielding, lower-rated securities include a higher risk of default. 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. Absolute return funds are not designed to outperform stocks and bonds in strong markets. There is no guarantee of a positive return, of the fund achieving its objective, or that volatility-reducing strategies will be successful. The use of hedging and derivatives could produce disproportionate gains or losses and may increase costs. Currency transactions are affected by fluctuations in exchange rates. Please see the funds’ prospectuses for additional risks.
Clients should carefully consider a fund’s investment objectives, risks, charges, and expenses before investing. The prospectus contains this and other important information about the fund. To obtain a prospectus, contact your financial professional, call John Hancock Investments at 800-225-6020, or visit our website at jhinvestments.com. Please read the prospectus carefully before investing or sending money.