

# International investing at John Hancock Investments: an opportunistic approach



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## Key takeaways

- John Hancock Investments sees select investment opportunities in today's widely differentiated international equity markets.
- The diverse international equity strategies employed by the funds highlighted in this paper are well positioned to address these opportunities.
- The global scope of opportunities within international equities creates a rich environment to potentially add value through bottom-up stock picking as well as through quantitative and rules-based approaches.

## Executive summary

At a time when the world's major economies are out of sync, John Hancock Investments sees select investment opportunities for actively managed international equity strategies. Our lineup of international funds employs a wide range of approaches, each offering a distinctive way to enhance portfolio diversification. In this paper, the lead portfolio managers of some of our top international equity funds describe their investment approaches and current thinking on the markets. Among the authors are two practitioners of traditional bottom-up stock picking, one focusing on quality-oriented growth equities and the other on stocks that exhibit low valuation, positive business momentum, and strong business fundamentals. For investors seeking income as well as capital appreciation, one of the funds that we highlight focuses on stocks generating dividends and other sources of shareholder yield. Rounding out the group is a fund that employs a quantitative approach to value investing and another that targets reliable sources of equity returns in the emerging markets.

# The manager of managers: why invest internationally today?



**Leo M. Zerilli, CIMA**  
Head of Investments  
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Investments

*“We view this environment of wide market differentiation as opportune for active managers of international equity strategies.”*

At John Hancock Investments, we see opportunities for highly selective investors in the economic challenges that many global markets face. While the U.S. economic expansion has remained relatively strong, Europe and Japan have recently struggled, leaving the world's major economies out of sync. Outside the developed world, growth has recently slowed in many emerging markets. Yet, in aggregate, the International Monetary Fund projects that the GDP of emerging markets will expand at 5.0% in 2015 versus 2.3% for developed economies.

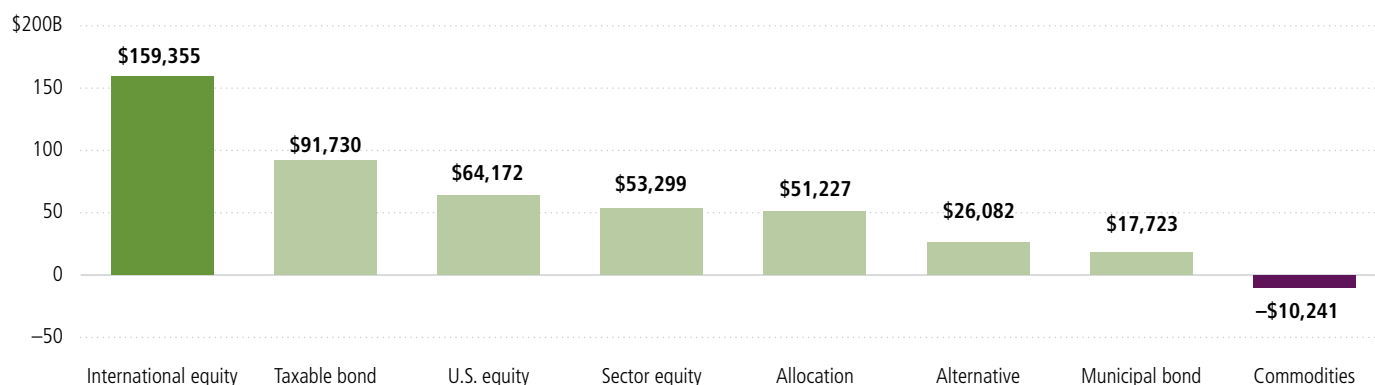
We view this environment of wide market differentiation as opportune for active managers of international equity strategies. The best-equipped managers, in our view, are those who can add value by removing much of the noise from headlines and focusing on whether individual stocks or groups of securities are fairly priced. Recent underperformance in international markets has reduced valuations of certain stocks to levels that may make them attractive long-term investments. Some of the best opportunities may be found among multinational companies whose prospects are tied less to their home markets than to emerging markets.

Indeed, interest in international markets has remained high, despite the recent economic setbacks. International equity funds attracted a 35% share of industrywide net inflows during the 12-month period ended November 30, 2014, and the international group's inflow total of \$159 billion was by far the largest among eight long-term fund categories.

In selecting and monitoring the international equity teams highlighted in this paper, our experience as a manager of managers puts us in a unique position to evaluate their skill sets, track records, and experience. Generally, these managers employ focused approaches that we believe are better suited to today's dynamic international markets than broad, passive strategies. In addition, these funds' modest yet still substantial asset bases afford their managers relative freedom from the capacity constraints that some of the industry's largest international funds face.

## International equity funds dominated 12-month flows

Net flows by long-term mutual fund category during the 12-month period ended 11/30/14



Source: Morningstar, Inc., 2014. Morningstar Direct asset flows.

# The stock picker: seeking growth and quality in international equities



**John A. Boselli, CFA**  
Portfolio Manager,  
John Hancock  
International  
Growth Fund  
Wellington Management

*“An approach that emphasizes both quality and growth offers the potential to consistently generate strong returns with lower volatility over market cycles.”*

Since the global financial crisis of 2008–2009, there has been a widespread perception that the demand for high-quality stocks has driven this segment of the equity market to excessive valuations. At the same time, growth stocks have been bid up, because growth has been a scarce commodity as global economies and companies recover from the impacts of lower demand and consumer deleveraging.

Despite these challenges, there is still a sizable universe of stocks that provide the unusual combination of high quality and strong growth. These stocks can be purchased at reasonable valuations, in our view, provided you know where, and how, to look. The growth that these stocks have historically offered has allowed for strong upside participation in rising markets, while their quality and valuation characteristics have helped to provide a measure of portfolio protection during market declines. An approach that emphasizes both quality and growth offers the potential to consistently generate strong returns with lower volatility over market cycles.

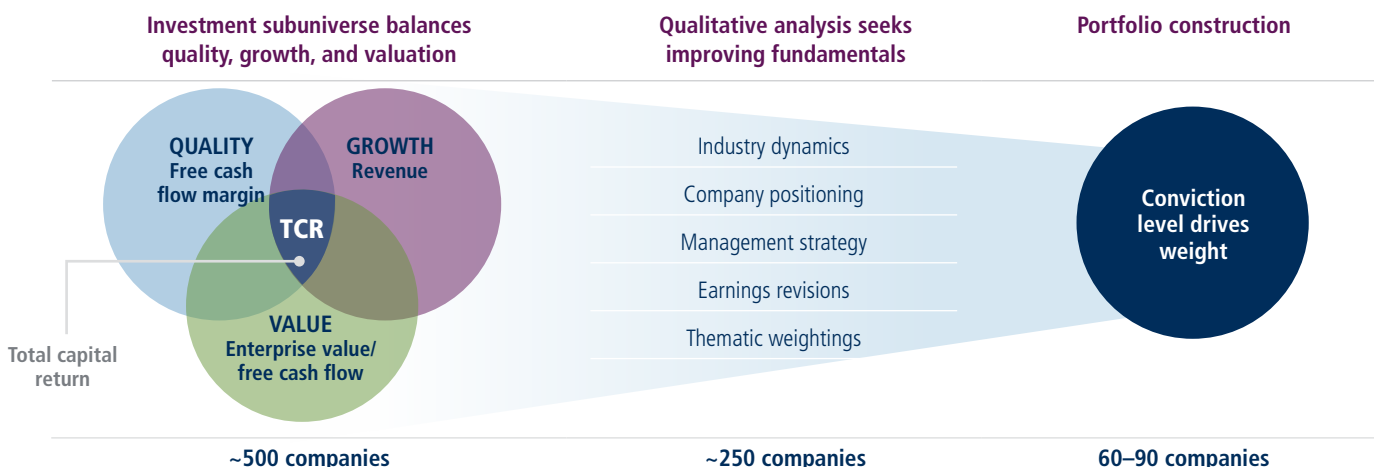
When researching these opportunities, we assess four primary factors: growth, quality, valuation, and capital returns. Each individually is useful. When used in combination, these factors can provide a powerful indicator of the long-term potential to outperform an equity benchmark, in our view.

How we define these factors is critical. Our definitions are largely based on fundamental behaviors related to a company’s financial health and how these actions are rewarded, or penalized, by the market. In addition to considering these four factors, we assess the strength of improvement in a company’s financial fundamentals. This assessment is particularly useful in determining when to invest in a given stock.

We use the measures of growth, quality, and valuation to identify the 250 highest-ranked companies within our team’s investment universe, and then employ fundamental and qualitative analysis in an attempt to identify potential for outperformance. This quality growth approach has also shown potential to provide a measure of downside protection in times of market stress. High-quality companies generally have clean balance sheets and high free cash flows—characteristics that may enable them to continue returning capital to shareholders via stock buybacks or high dividends.

## John Hancock International Growth Fund investment process

Focuses on companies with high revenue growth, superior business models, improving fundamentals, and strong free cash flow



The characteristics presented are sought during the portfolio management process. Actual experience may not reflect all of these characteristics or may be outside of the stated ranges.

# The value practitioner: a disciplined approach to international equities



**Christopher K. Hart,  
CFA**

*Portfolio Manager,  
John Hancock  
Disciplined Value  
International Fund  
Robeco Investment  
Management*

*“... irrespective of  
where a company is  
headquartered, stock  
performance is driven  
by the same set of  
characteristics ...”*

At Robeco Investment Management, we embrace an approach developed in the 1980s for U.S. large-cap equities. Over the years, we have successfully adapted it across a wide range of market capitalizations, and we began applying it internationally in 2004. This broadened application reflects our belief that the time-tested approach used in the U.S. market applies equally well to a global universe of stocks.

This belief is rooted in our conviction that, irrespective of where a company is headquartered, stock performance is driven by the same set of characteristics that make up the three critical elements of our stock selection: attractive valuations, strong business fundamentals, and a positive catalyst for change. Stocks selected for our equity portfolios must exhibit each of the following attributes:

- Low valuation, meaning that they must be cheaply or reasonably priced relative to the market
- Positive business momentum, or the ability to grow earnings
- Good business fundamentals with strong cash flow

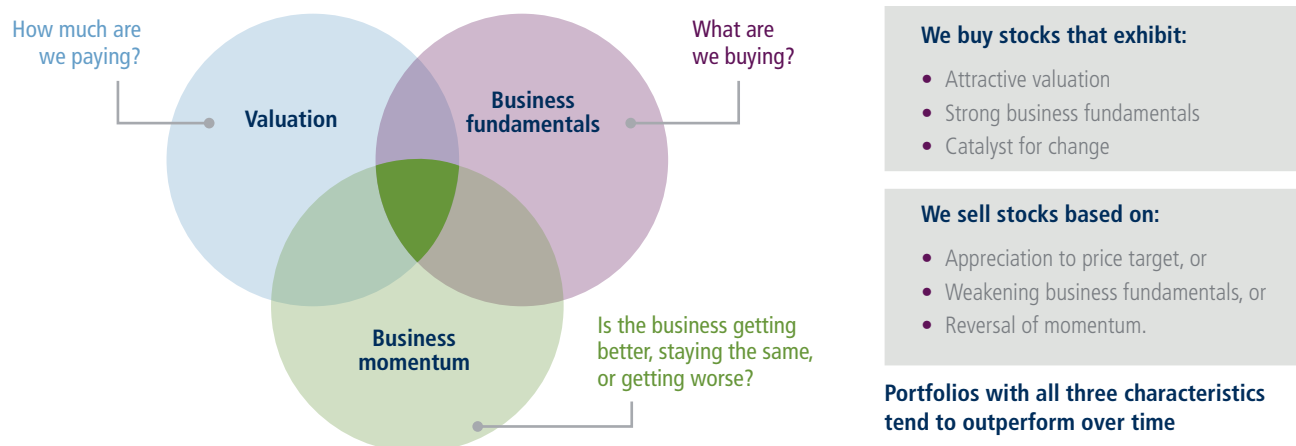
This approach works, in our view, because in our experience low-valuation stocks have been shown to outperform higher-valuation stocks over time.<sup>1</sup> Meanwhile, companies with strong fundamentals, such as high returns on invested capital, tend to outperform those with poor fundamentals. Stocks with positive business momentum resulting from improving trends or rising earnings generally outperform those with negative momentum.

While macroeconomic factors such as falling currencies or monetary policy affect all markets, top-down approaches that incorporate such factors cannot identify the best long-term opportunities, in our view. We favor a bottom-up approach based on a repeatable process applied to each stock, without specific regard to industry sectors, currencies, geographic regions, or countries.

As a result, we often do not follow the herd instincts of the broader market, which tends to react to news events and tries to predict earnings with near-perfect precision. Inevitably, something goes wrong, the broad market overreacts, and many companies' share prices fall disproportionately to the issues that their businesses face. We believe that stocks exhibiting such dislocations between a company's valuation and its business fundamentals offer the best potential to limit downside risk in falling markets while keeping pace in rising markets, and to generate long-term growth of capital.

## John Hancock Disciplined Value International Fund investment process

Targets companies with attractive relative valuations, strong fundamentals, and positive business momentum



Source: Robeco Investment Management, 2014.

<sup>1</sup> Robeco Investment Management, 2014.

# The yield harvester: focus on free cash flow



**Eric L. Sappenfield**  
Portfolio Manager,  
John Hancock Global  
Shareholder Yield Fund  
Epoch Investment  
Partners

*“... we are transitioning from a P/E-driven market to one where earnings growth and dividends are more significant factors. Both of these sources of return are derived from companies’ cash flows and underpin our global shareholder yield strategy.”*

The global shareholder yield strategy at Epoch Investment Partners is designed to endure amid the constant changes in the hierarchy of three factors that drive equity returns: earnings, dividends, and price-to-earnings (P/E) ratios. Historically, the relative impact of each factor has shifted as the economic landscape has changed. For example, rising P/E ratios were the principal catalysts in the 1980s and 1990s, decades of strong stock market price appreciation.

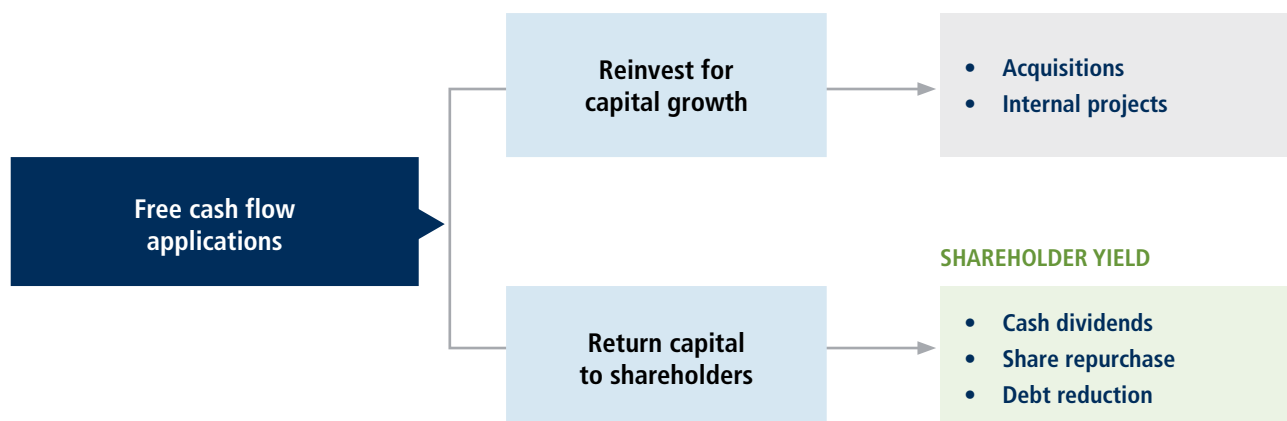
A similar situation emerged in 2012–2013; the accommodative policies of key central banks sent real interest rates down to 0%, and equity prices surged. The banks’ stated commitment to expand these policies as needed to revive the global economy provided further support for equities, sending P/E ratios higher.

In our view, as interest rates rise from recent historic lows, P/E ratios are unlikely to climb. As a result, we are transitioning from a P/E-driven market to one where earnings growth and dividends are more significant factors. Both of these sources of return are derived from companies’ cash flows and underpin our global shareholder yield strategy.

This strategy pursues attractive total returns with an above-average level of income by investing in a diversified portfolio of U.S. and international companies with strong and growing free cash flow, or cash available for distribution to shareholders after capital expenditures and taxes. Acquisitions and capital improvements should be undertaken only when the return is greater than the firm’s average cost of capital, in our view. Otherwise, capital should be returned to shareholders via its other potential uses: dividend distributions, share buybacks, or debt reductions. We call these three uses shareholder yield. To manage risk in the portfolio, no single company is relied upon for the portfolio to meet its objectives, and portfolio companies must demonstrate continuing abilities to grow dividends, pay shareholder yield, and wisely allocate capital.

## Invest in companies able to generate free cash flow

Free cash flow is the cash available for distribution to shareholders after capital expenditures and taxes



# The patient contrarian: finding long-term value in international markets



**Thomas R. Hancock,  
Ph.D.**  
*Portfolio Manager,  
John Hancock  
International Core Fund  
GMO*

*“Investors who can embrace the advantages of their long horizon are best positioned to capitalize on long-term value opportunities.”*

At GMO, patience is a critical component of our value-oriented investment philosophy. Our process is designed to identify stocks whose intrinsic values aren't fully reflected in their current prices, as a result of such varied factors as shifts in investor sentiment or behavioral biases. The market's cyclical shifts from expensive to fair value to cheap and back again create opportunities. Realizing those opportunities requires having the patience to wait for undervalued stocks to revert to their intrinsic values, and bearing short-term risk while market forces sort themselves out. Investors who can embrace the advantages of their long horizon are best positioned to capitalize on long-term value opportunities.

In practice, the waiting period for a security's return to fair value can vary widely and is hard to predict. However, there appears to be some consistency at the asset class level. The analysis of our asset allocation team suggests that seven years is a reasonable time to expect asset classes to mean revert, or shift from fairly priced to either under- or overvalued and then back to intrinsic value.

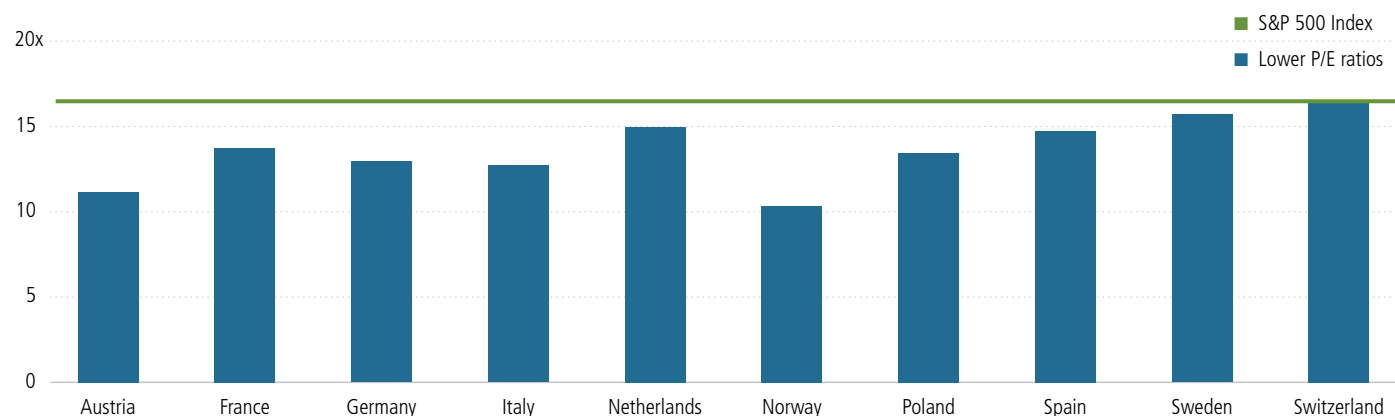
As a result of this analysis, our asset allocation team maintains a seven-year forecast of asset class performance. The forecast values groups of companies with common economic characteristics by four primary attributes: price-to-earnings ratios, profit margins, earnings growth, and yields. For every component, we ask what each group's current level is, and then consider what we expect its future level will be. By examining every component individually and then adding the implied expected returns from the four components, we arrive at a forecasted return for a group of stocks.

This forecast is incorporated into the top-down assessments that underpin our individual strategies, including global equities. In addition, the portfolio team performs bottom-up analysis, assessing the valuation of each company based on standard financial metrics, such as earnings and book value, and the intrinsic value of each company based on its quality. We select the most attractively valued stocks for the portfolio.

This process has led us to our currently favorable long-term view on European equities, especially among relatively low-priced value stocks. Recently disappointing economic news in the eurozone has weighed on European equities, resulting in attractive valuations for investors with the time horizon to wait for these stocks to revert to their intrinsic values.

## Several European markets represent compelling values today

Forward 12-month price-to-earnings ratios vs. the S&P 500 Index (as of 11/30/14)



Source: MSCI, 2014. 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.



# The market researcher: target the market segments with strong long-term potential



**Joseph H. Chi, CFA**  
Portfolio Manager,  
John Hancock Emerging  
Markets Fund  
Dimensional Fund  
Advisors

*“... our research-based approach seeks to actively focus on the most consistent sources of higher expected returns while managing risk through diversification.”*

For most investors, emerging-market equities represent an asset class often associated with higher risk and the potential for higher expected returns relative to developed markets. Despite the potential benefits, some investors may have concerns about emerging-market equities because of considerations such as trading costs or volatility relative to developed markets. Our approach to emerging-market equities is designed to manage the trade-off between pursuing sources of higher expected returns and the costs associated with targeting them. Rather than forecasting market movements or staying passively tethered to a benchmark index, our research-based approach seeks to actively focus on the most consistent sources of higher expected returns while managing risk through diversification.

Much of what Dimensional provides can be captured in the context of these sources of expected returns, or dimensions, as we call them. Academic research shows that differences in expected returns have been largely driven by company size, relative price, and profitability. Research shows that, over the long term, stocks of small companies produced higher expected returns than those of large companies, low relative price (value) stocks produced higher expected returns than high relative price (growth) stocks, and companies with high profitability produced higher expected returns than those with low profitability.<sup>1</sup> Our emerging-market strategy strives to provide consistent exposure to these segments of the market.

Implementation is also a key element to increasing expected returns. Turnover, particularly in emerging markets, is expensive. As a result, our emerging-market strategy seeks to achieve low turnover and to limit trading costs when we rebalance the portfolio. Estimates of both explicit (e.g., out-of-pocket costs) and implicit (e.g., market impact, bid/ask spread) trading costs are taken into consideration in the design and management of John Hancock Emerging Markets Fund. We have developed a philosophy and approach that considers these costs and adapts trading to the nuances of each market. This is an especially important consideration in some emerging markets, where higher costs, limited liquidity, and other constraints can create challenges for day-to-day portfolio management and trade execution.

## John Hancock Emerging Markets Fund investment process

Seeks to add value by actively managing the costs and trade-offs associated with capturing sources of higher expected returns



### THE MARKET

Use information in prices and fundamental data to pursue higher expected returns

### PORTFOLIO STRUCTURE

Identify the dimensions of expected returns and consider the interactions among premiums, diversification, and costs

### IMPLEMENTATION

Maintain strategy focus while balancing trade-offs among competing premiums, and use a flexible process to help control costs

Source: Dimensional Fund Advisors, 2014.

<sup>1</sup> "A Five-Factor Asset Pricing Model," Eugene F. Fama and Kenneth R. French, 2014.

**Diversification does not guarantee investment returns and does not eliminate the risk of loss.**

*Foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability. Value stocks may decline in price. Growth stocks may be more susceptible to earnings disappointments. Large company stocks could fall out of favor. The stock prices of small and midsize companies can change more frequently and dramatically than those of large companies, and illiquid securities may be difficult to sell at a price approximating their value. Currency transactions are affected by fluctuations in exchange rates, and frequent trading may increase fund transaction costs. Hedging and other strategic transactions may increase volatility and result in losses, if not successful. Fund distributions generally depend on income from underlying investments and may vary or cease altogether in the future. Please see the funds' prospectuses for additional risks.*

**A fund's investment objectives, risks, charges, and expenses should be considered carefully 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 800-225-5291, or visit our website at [jhinvestments.com](http://jhinvestments.com). Please read the prospectus carefully before investing or sending money.**



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