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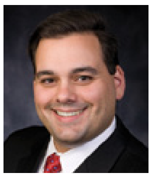
John Hancock INVESTMENTS

Six fixed-income investment ideas for 2015 and beyond



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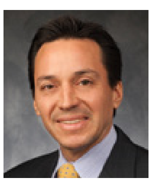

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Key takeaways

- With historically low interest rates and the U.S. Federal Reserve (Fed) poised to begin normalizing monetary policy, a passive, index-oriented strategy is unlikely to meet many fixed-income investors' goals.
- Taking a more flexible approach with core allocations and allocating to more credit-sensitive areas of the market can better position investors for a future rise in rates.
- Should markets continue to be volatile through this transitional period, active management may prove vital to generating attractive total returns.

Executive summary

It's been a challenging few years for fixed-income investors. In May 2013, the Fed announced its plans to begin tapering its monthly bond purchase program, known as quantitative easing; interest rates spiked in response, sending many core indexes into negative territory for the year. Then in 2014, as the Fed began scaling back purchases, ending them completely in October, interest rates steadily fell, with the 10-year U.S. Treasury yielding less than 2% for much of the first quarter of 2015.[1] With the behavior of the markets, and interest rates in particular, proving so difficult to anticipate, how do investors position their bond portfolios today for income and stability?

In the following pages, our network of veteran fixed-income managers offers its take on how to build more resilient portfolios for today's markets. Leo Zerilli discusses why bond investors need to be ready for anything; Howard Greene describes how to achieve that flexibility in a core allocation. Dan Janis, Roberto Sanchez-Dahl, and Paolo Valle offer a closer look at the opportunity set in global developed and emerging markets. And, finally, Roger Lavan and Kon Kizunov describe why they believe active management will be such a difference maker in 2015.

1. Prepare to navigate a changing landscape

Leo M. Zerilli, CIMA
Head of Investments
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"… a passive approach subjects fixed-income investors in large part to the most prevalent risk in the bond markets today—that of rising interest rates."

The bond markets have reached an inflection point. Fixed-income investors have had the wind at their backs for the past 30 years, but now, with interest rates near historical lows, that's unlikely to be the case going forward. To offer some context, in 1981 the yield on 10-year U.S. Treasuries hit an all-time high of 15.84% before trending steadily downward for three decades, touching an all-time low of 1.43% in July 2012.[1] That trend has been the catalyst for an unprecedented bull market in bonds, but it's one we know can't last. Today, a passive approach to fixed-income investing—one that relies on declining interest rates as the primary driver of returns—isn't likely to deliver the kind of performance in the coming years that investors have grown accustomed to. In fact, a passive approach subjects fixed-income investors in large part to the most prevalent risk in the bond markets today—that of rising interest rates.

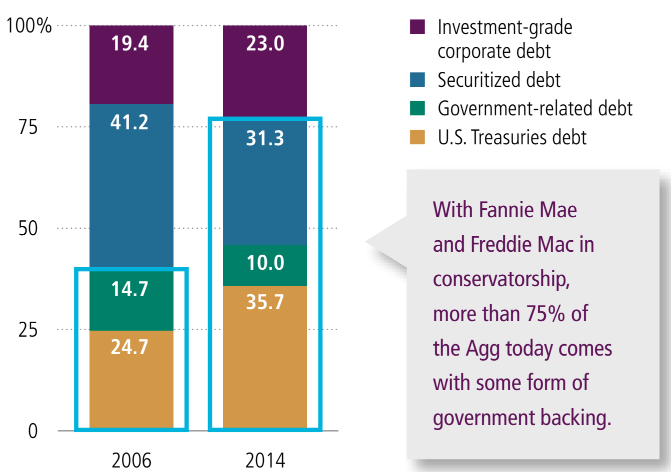
Consider this: Over the past 30 years, the duration, or interest-rate sensitivity, of the Barclays U.S. Aggregate Bond Index (U.S. Agg) has been creeping steadily higher, while its yield has steadily fallen. The result is that today investors would suffer losses in excess of 3% over a 12-month time horizon given a 100 basis point increase in interest rates. Those kinds of losses are not immaterial for an allocation that often represents the most conservative portion of investors' portfolios.

With that in mind, investors have already begun to take action, replacing narrowly defined, interest-rate-dependent strategies with more flexible, go-anywhere mandates. It's a trend we believe is not likely to reverse course anytime soon.

At John Hancock Investments, our manager-of-managers approach allows us to offer investors a wide range of fixed-income options, including broadly diversified multi-sector funds as well as funds that target opportunities in areas that are less dependent on declining interest rates to drive returns. We have long been advocates of pursuing a deeper level of diversification by combining a variety of philosophies and approaches when building portfolios. Given the challenges of today's bond markets, we believe that adopting such an approach will serve investors well in the years ahead.

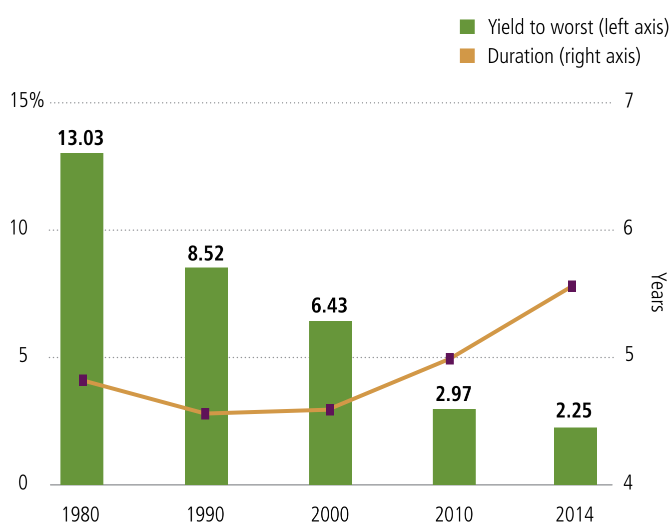
The Barclays U.S. Aggregate Bond Index: dominated by government-backed debt and vulnerable to rising rates

Composition of the Barclays U.S. Agg



Source: Barclays Capital, as of 5/5/14. It is not possible to invest directly in an index. Past performance does not guarantee future results.

The yield of the Barclays U.S. Agg has fallen while its duration has risen



Source: Barclays Capital, Morningstar Direct, John Hancock Asset Management, as of 12/31/14. For illustrative purposes only. See the last page for index definitions. It is not possible to invest directly in an index. Past performance does not guarantee future results.

2. Be flexible with your core allocation

Howard C. Greene, CFA
Senior Portfolio Manager
John Hancock Asset Management

One of the few things we can say with certainty about the bond markets is how difficult they are to predict. Take the U.S. Treasury market. At the end of 2013, the yield on the 10-year note stood at 3.04%. With the Fed poised to begin scaling back its monthly bond-buying program, and with the potential for significantly less demand in the market as a result, the consensus was for higher rates in 2014. Yet, as of the end of December, yields had fallen all the way to 2.17%, and have fallen further since.[1] How did we get here? The short answer is that the anticipation of quantitative easing measures coming out of the European Central Bank, a strengthening U.S. dollar, and strong institutional demand have kept downward pressure on U.S. Treasury yields, which continue to appear comparatively attractive on the global stage.

Given how difficult forecasting interest rates is, the question for investors, then, is how to liberate their bond portfolios so their performance is not entirely dependent on the direction of rates. One way we as managers can do that is by reducing duration outright through the use of Treasury futures. As the Fed begins what could be a long process of normalizing rates, we think it is prudent to maintain a slightly lower duration profile—the key word being *slightly*. Our belief is that the Fed's normalization of rates will be slow and gradual, and that betting heavily on rates rising is just as risky as taking the opposite stance.

Another, simpler way of expanding the drivers of returns is to hold a broader range of bonds. Investing in areas beyond the bellwether Barclays U.S. Agg is not a recipe for taking on more risk; rather, we would argue it represents a diversification of risks, and therefore offers the potential for reducing overall volatility. For example, consider that nearly two-thirds of emerging-market sovereign debt is rated investment grade, and that the issuing countries in many cases have stronger balance sheets and demographic trends to support them than their developed-market counterparts. In the case of emerging-market corporates, the demographic trends are often just as supportive. Or consider that in an environment of rising rates (which usually corresponds with an improving economy), the fundamentals in the high-yield market are typically improving, which can actually be good for prices. Or for outright protection from the effects of rising rates, consider that floating-rate corporate and mortgage securities, whose coupons periodically reset to reflect changes in short-term interest rates, posted solid gains in 2004, 2005, and 2006—the last cycle of Fed rate tightening.

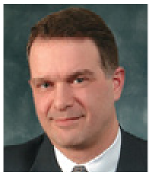
These are just some of the levers available to pull for managers with broad mandates. And while having more options doesn't guarantee a better outcome, in today's market, generating attractive returns in the constraints of an Agg-centric strategy looks increasingly difficult.

Bond market leadership is constantly changing

	2009	2010	2011	2012	2013	2014
BEST	High-yield bonds 57.71%	High-yield bonds 15.91%	10-year U.S. Treasuries 17.14%	Emerging-market debt 17.44%	High-yield bonds 7.45%	10-year U.S. Treasuries 10.72%
	Floating-rate notes 44.87%	Emerging-market debt 12.24%	IG corporates 8.15%	High-yield bonds 15.59%	Floating-rate notes 6.15%	IG corporates 7.46%
	Emerging-market debt 29.82%	Floating-rate notes 9.98%	Emerging-market debt 7.35%	IG corporates 9.82%	IG corporates –1.53%	Emerging-market debt 7.43%
	IG corporates 18.68%	IG corporates 9.00%	High-yield bonds 4.38%	Floating-rate notes 9.43%	Emerging-market debt –5.25%	High-yield bonds 2.50%
WORST	10-year U.S. Treasuries –9.71%	10-year U.S. Treasuries 7.90%	Floating-rate notes 1.82%	10-year U.S. Treasuries 4.18%	10-year U.S. Treasuries –7.83%	Floating-rate notes 2.06%

Source: Morningstar Direct, as of 12/31/14. Performance figures assume reinvestment of dividends and capital gains. The performance for the asset classes above is measured by representative indexes. See the last page for index definitions. It is not possible to invest directly in an index. Past performance does not guarantee future results.

3. Take a global view of the bond markets



Daniel S. Janis III
Senior Portfolio Manager
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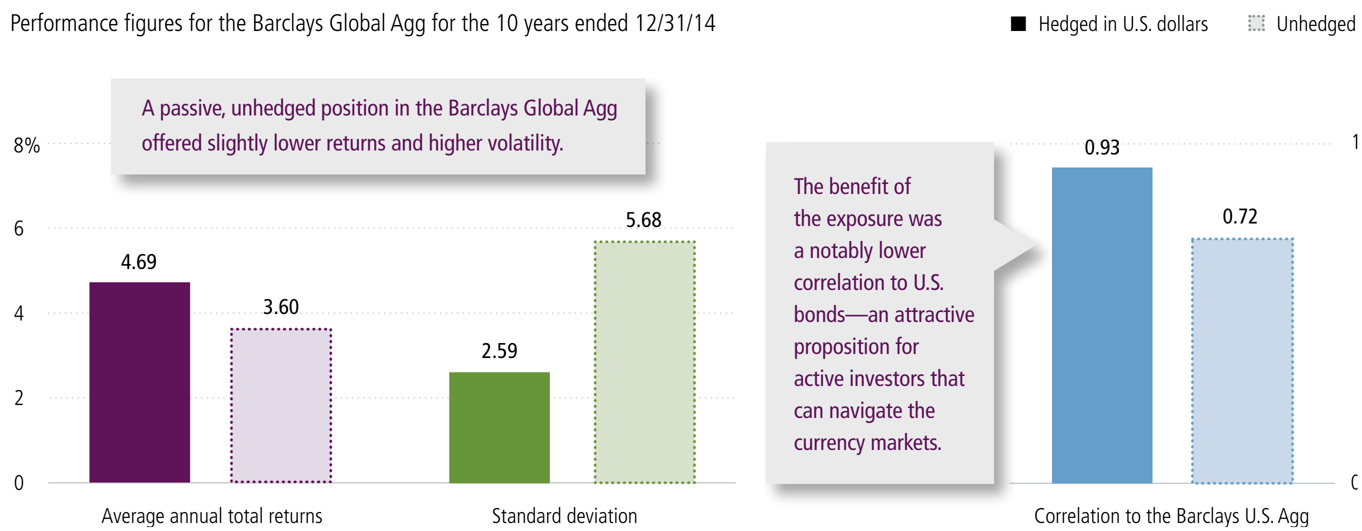
The 2008 financial crisis had a profound effect on the debt markets in the United States, but its consequences were at least as severe in the other G5 nations, which include the United Kingdom, Germany, France, and Japan. Of the G5, only Germany weathered the crisis without being downgraded, its AAA rating remaining intact. But all of these nations have faced challenges in tackling the legacy of rising public debt levels. Against this backdrop, interest rates in the G5 economies remain extremely low as central banks in these markets have turned to monetary policy to stimulate growth. For fixed-income investors, this scarcity of yield both in the United States and across many developed markets creates an obvious problem.

The most straightforward solution to this challenge, as many investors have begun to realize, is to adopt a broader mandate. Shifting from a U.S.-based investment set to a global one triples the size of the fixed-income investment universe, and doing so need not entail significantly higher levels of credit risk. Australia, New Zealand, and South Korea—three highly rated developed markets—all offered higher yields on their 10-year government debt than the United States as of the end of March.[2] The same was true among certain investment-grade emerging-market countries, including Mexico, Thailand, and the Philippines. Furthermore, by broadening the opportunity set to include investments across sectors, credit qualities, and the capital structure, a strategy has the potential to consistently add value while reducing risk. In an environment where many market watchers are anticipating coupon-like returns in the fixed-income markets, pursuing high-quality and higher-yielding opportunities could have a significant impact on performance.

But country, sector, and security selection is only part of the story in the global bond markets. Currencies also play a significant role in driving returns—as well as increasing diversification—but can significantly impact risk if not properly managed. Consider that a U.S. dollar hedged allocation to the Barclays Global Aggregate Bond Index (Global Agg) posted returns nearly identical to the Barclays U.S. Agg over the trailing 10 years, but did so with a lower standard deviation. Over the same time period, passively adding currency exposure to the mix offered a slightly lower return compared with the hedged index; however, volatility increased more than 2.5 times. This heightened volatility shouldn't be viewed as simply adding risk to an investment: The unhedged global index provides diversification benefits and had a significantly lower correlation to the Barclays U.S. Agg than the hedged version. Both the fully hedged and unhedged approaches have distinct advantages and potential drawbacks; however, by actively managing the currency exposures of a global bond portfolio, an investor has the potential to capture the benefits of each.

Currency exposure can add diversification, but requires an active approach

Performance figures for the Barclays Global Agg for the 10 years ended 12/31/14



Source: John Hancock Investments, as of 12/31/14. See the last page for index definitions. 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. Past performance does not guarantee future results.

4. Pursue targeted opportunities in emerging markets

Roberto Sanchez-Dahl, CFA
Senior Portfolio Manager
John Hancock Asset Management

Paolo H. Valle
Senior Portfolio Manager
John Hancock Asset Management

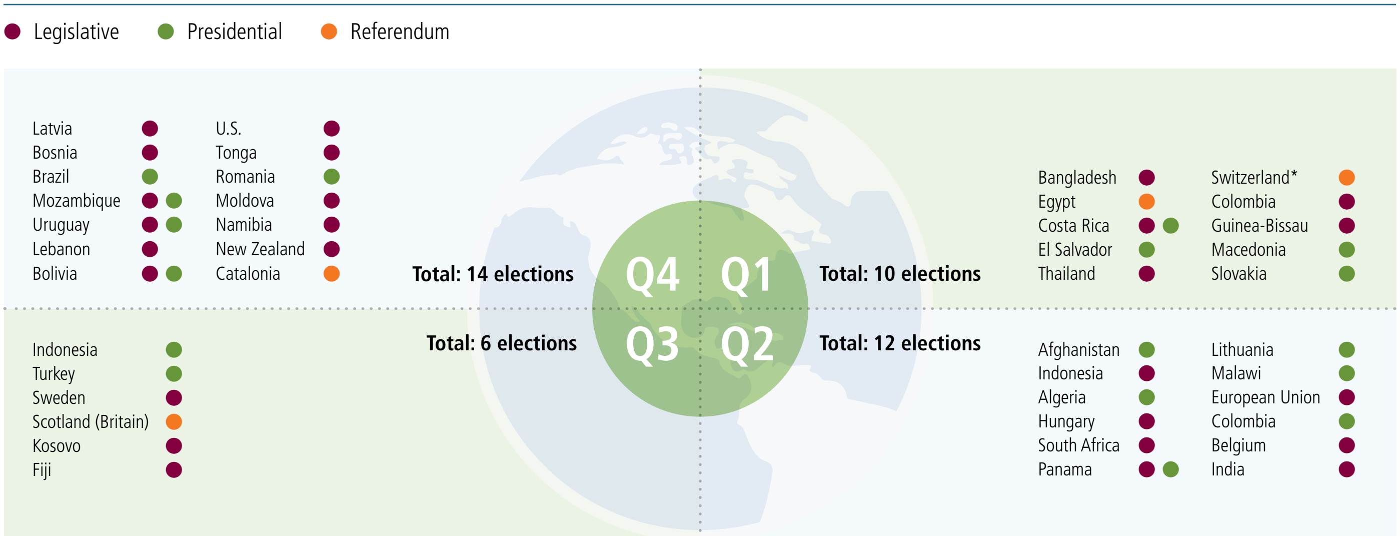
Politically, it was a busy year last year in emerging markets—at least one country in every region held an election of some kind. This hectic political activity meant that the pursuit of economic reforms all but ground to a halt as governments held back on significant proposals while the outcomes were being decided. Of the numerous elections in 2014, the most high profile were those in Turkey, India, Brazil, South Africa, and Indonesia—nations collectively dubbed the fragile five because of their economic imbalances and reliance on foreign capital flows. Of those countries, Turkey, South Africa, and Brazil reelected their incumbent leaders, while India and Indonesia elected new governments with fresh policies and ideas.

This attention on emerging-market politics is well founded. Reducing the high rate of informal employment, improving social services, and removing infrastructure bottlenecks are key challenges for many emerging nations, especially for the fragile five. But doing so won't be easy—or cheap. Should we face a significant slowdown in global economic growth, we believe that countries such as Indonesia, South Africa, Turkey, Brazil, and India with high current account deficits may be negatively impacted, just as they were midway through 2013, when the Fed first introduced the idea of tapering its asset purchase program. Conversely, those that are in the process of implementing structural reforms, such as Poland, Mexico, and others that have a clear plan for reforms ahead, are more likely to have the financial firepower to better insulate their economies from global headwinds. For investors, the ability to differentiate between these countries is likely to be even more important in the years ahead.

Looking beyond sovereign debt, we believe that structural reforms are likely to bring opportunities for new companies to come to the market, broadening the depth of hard currency local credit markets. India and Indonesia, while among the largest emerging economies, are significantly underrepresented in the J.P. Morgan Corporate Emerging Markets Bond Index. India represents more than 5% of the corporate bond benchmark, while Indonesia accounts for around 1%.[3] Considering the populations of those countries, we believe there is opportunity for further growth.

Ultimately, we believe that the market will continue to be affected by positive news on reform plans, as well as disappointment at any delays surrounding their implementation. Importantly, the expectations of market participants together with each country's ability to bring forward the approval and implementation of these reforms, in our opinion, will be a significant differentiator among emerging economies. The likely disparity should drive investment opportunities in the short to medium term for active, research-driven managers.

A spate of world elections in 2014 has set the stage for more meaningful reform in 2015



* Popular initiative called via signatures, not by government. Source: John Hancock Asset Management, electionista, as of 12/31/14.

5. Add credit flexibility to your conservative allocation

Roger M. Lavan, CFA
Portfolio Manager
Stone Harbor Investment Partners

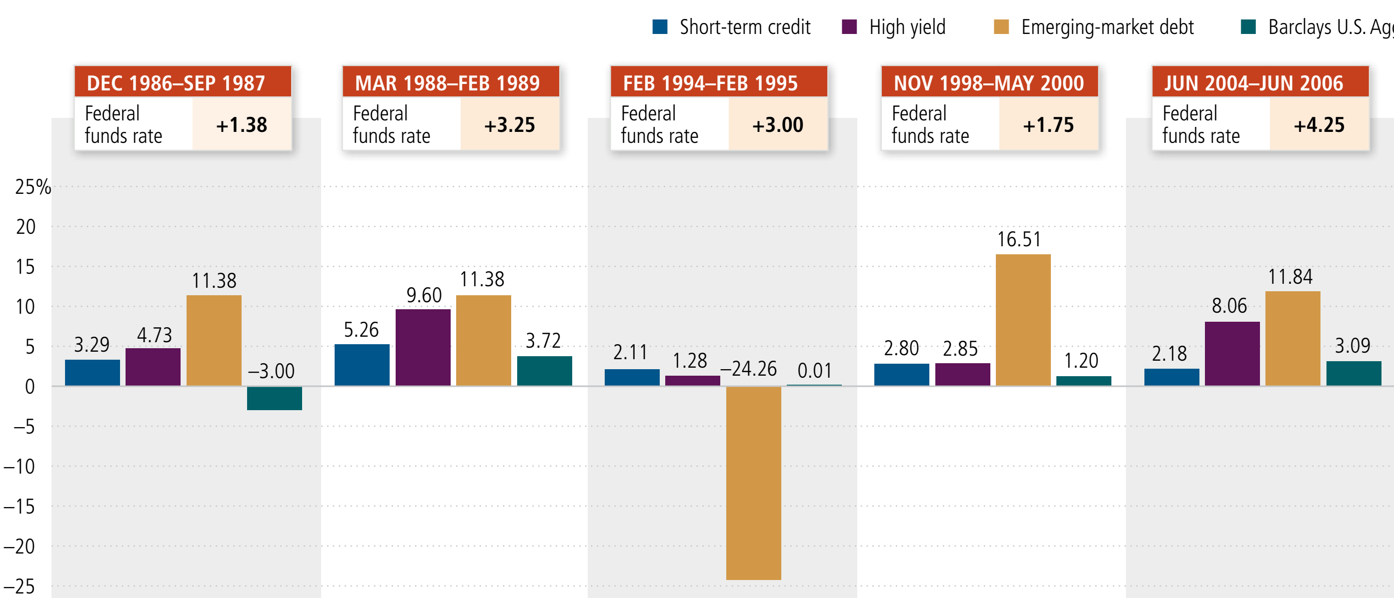
Not that long ago, generating income from a highly liquid, high-quality portfolio was a relatively straightforward goal. Between 1994 and 2007, cash investments (as measured by 3-month U.S. Treasuries) returned at least 3% in 11 of those 14 years. Those days feel like a distant memory: The average return for cash since 2008 is a small fraction of 1%.[4]

This poses a significant challenge for fixed-income investors: How does one generate income without taking on an excessive amount of risk, either through longer duration or lower quality? While there's (still) no such thing as a free lunch, we would argue that by investing in a broadly diversified portfolio that combines specific credits in specific proportions, one can create an attractive income stream without having to endure wide swings in performance.

Take, for example, an allocation to highly rated corporate debt: An investor could buy a portfolio of AA-rated bonds and know that they were exposed to only a minimal amount of credit risk. The chances of those corporations defaulting would be quite small. By allocating some of that capital across the investment-grade spectrum, however, the investor would achieve two things: First, incrementally higher income from the A-rated and BBB-rated holdings, and second, a potential reduction in the interest-rate sensitivity of his or her portfolio. All else being equal, higher-rated credits are more vulnerable to swings in interest rates, while lower-rated securities are more driven by credit fundamentals. This is the trade-off, and we believe it is a small one. The second, more diversified portfolio offers higher income potential with less interest-rate sensitivity, all while maintaining an average credit profile that is not meaningfully different from the original AA-rated mix.

This same philosophy can be applied to a broad range of bond market sectors, from securitized credits to high-yield and emerging-market debt. Expanding a portfolio selectively into more credit-sensitive areas of the market can meaningfully increase income potential while reducing its overall sensitivity to rate movements. And, in the case of the portfolio we oversee, that rate sensitivity can be managed outright through the use of U.S. Treasury futures, another tool for dialing in a target level of risk. While a short-duration portfolio is not a cash substitute, in today's environment of near-zero yields in the cash markets, we believe it makes for an attractive option for income-seeking investors' short-term allocations.

Short-duration and credit-sensitive sectors have a history of outperforming when the Fed tightens



Source: Stone Harbor Investment Partners, as of 12/31/14. Changes in the federal funds rate are represented by the effective federal funds rate. The performance for the asset classes above is measured by representative indexes. See the last page for index definitions. It is not possible to invest directly in an index. Past performance does not guarantee future results.

6. Look for stable income opportunities in high-yield debt

Konstantin Kizunov, CFA
Senior Portfolio Manager
John Hancock Asset Management

It's been an extraordinary six-year run for high-yield bonds. The cumulative returns for most high-yield indexes since the start of 2009 approaches 150%, and investors today are rightly concerned that the trend can't last.[3] In fact, that concern has materialized in the form of heightened volatility in the high-yield market in 2014, with substantial sell-offs in July, September, and November pushing the prices of high-yield bonds into negative territory for the year. While our outlook calls for continued bouts of turbulence in 2015, there is good news: First, we do not believe high-yield bonds represent a bubble in the process of bursting. Second, the risks in the high-yield market today are far from uniform. For investors that can navigate those risks, the asset class has much to offer.

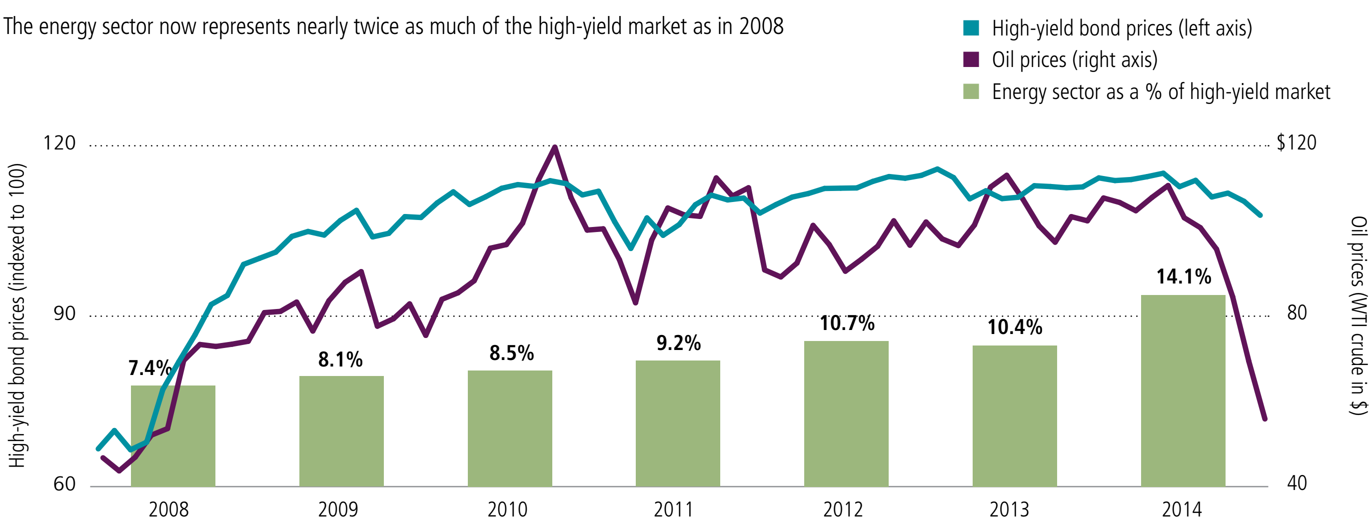
It may come as news to some investors that the energy boom in the United States has been financed in no small part by the issuance of high-yield debt. According to Barclays, the energy sector was a little more than 4% of the so-called junk bond market 10 years ago; today, that figure stands around 14%. Meanwhile, increased U.S. oil production, lackluster European and Asian economies, and heightened fuel efficiencies (particularly in automobiles) drove oil prices down more than 30% in 2014 alone, and there may be more to come. Saudi Arabia, OPEC's largest oil producer, recently speculated that oil prices could fall further before stabilizing at around $60 a barrel. While lower energy prices spell good news for consumers, it could be dangerous for many of the less-established energy companies in the high-yield universe: If prices bottom out below the most highly leveraged companies' break-even points, it will become increasingly difficult for them to meet their debt obligations. A meaningful uptick in defaults in the energy sector is a distinct possibility.

On a macro level, however, the high-yield market looks healthy. Defaults continue to be well below their long-term average, below 2% as of the end of December.[5] At the same time, corporate balance sheets, particularly outside of the energy sector, are quite strong. And the fact remains that there continues to be a scarcity of yield in other segments of the bond markets, a persistent problem for income-seeking investors.

As for potential solutions, we believe that in today's environment, a passive allocation to high yield could spell trouble in an asset class that now clearly requires sector- and security-level scrutiny to uncover opportunities. In our own portfolio, we are maintaining a higher-than-usual cash position, at around 4% of net assets, so that we have some dry powder on hand to take advantage of the buying opportunities market volatility creates. For investors not yet at their target allocations to high yield, buying on the dips may prove prudent.

Lower oil prices put pressure on high-yield bonds

The energy sector now represents nearly twice as much of the high-yield market as in 2008



Source: FactSet, as of 12/31/14. High-yield bond prices are measured by the Bank of America Merrill Lynch High Yield Price Index, indexed to 100 on 1/10/95. See the last page for index definitions. It is not possible to invest directly in an index. Oil prices are represented by West Texas Intermediate (WTI) crude. Energy sector 2014 weight is as of 10/17/14. All other data is as of 12/31/14. Past performance does not guarantee future results.

1 U.S. Department of the Treasury, as of 12/31/14.

2 FactSet, as of 3/31/15.

3 J.P. Morgan, as of 12/31/14.

4 Morningstar Direct, as of 12/31/14.

5 Western Asset Management, as of 12/31/14.

10-year U.S. Treasuries are measured by the Bank of America Merrill Lynch 10-year U.S. Treasury Index, a one-security index, rebalanced monthly, comprising the most recently issued 10-year U.S. Treasury note. The Barclays Global Aggregate Bond Index tracks the performance of a wide range of global investment-grade fixed-income securities. The Barclays U.S. Aggregate Bond Index tracks the performance of U.S. investment-grade bonds in government, asset-backed, and corporate debt markets. Emerging-market debt is measured by the J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified Index, which tracks U.S. dollar-denominated Brady bonds, loans, and Eurobonds of external debt instruments in the emerging markets. Floating-rate notes are measured by the Credit Suisse (CS) Leveraged Loan Index, which tracks returns in the leveraged loan market. High-yield bonds are measured by the Bank of America (BofA) Merrill Lynch U.S. High Yield Master II Index, which tracks the performance of globally issued, U.S. dollar-denominated high-yield bonds, and by the Bank of America Merrill Lynch High Yield Price Index, which tracks the performance of globally issued, U.S. dollar-denominated high-yield bonds. Investment-grade corporate bonds (IG corporates) are measured by the Barclays U.S. Corporate Index, which tracks the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. Short-term credit is measured by the Barclays 1–5 Year U.S. Credit Index, which tracks the performance of U.S. government and international, U.S. dollar-denominated, investment-grade corporate bonds with maturities between one and five years. It is not possible to invest directly in an index. All performance figures assume reinvestment of dividends and capital gains. Past performance does not guarantee future results.

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

Fixed-income investments are subject to interest-rate and credit risk; their value will normally decline as interest rates rise or if a creditor is unable or unwilling to make principal or interest payments. Investments in higher-yielding, lower-rated securities include a higher risk of default. Foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability. Currency transactions are affected by fluctuations in exchange rates. Certain market conditions, including reduced trading volume, heightened volatility, and rising interest rates, may impair liquidity, the ability of the fund to sell securities or close derivative positions at advantageous prices. The use of hedging and derivatives could produce disproportionate gains or losses and may increase costs. 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. Please read the prospectus carefully before investing or sending money.

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