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Factor investing

Factor investing has been around for many decades. It involves targeting quantifiable characteristics that can explain investment returns. Each Factor has defining attributes which explain its returns and can offer different risk adjusted exposures. Factors can be used to change a portfolio's risk profile or to generate alpha.

A factor is any characteristic that can explain the risk and return performance of an asset (equity or fixed income). Over the last fifty years, research has identified hundreds of factors.

There are a few basic criteria to define a factor:

- Have explanatory power
- Distinguish returns (eg: high value stocks perform differently than those with low value)
- Represent intuitive market themes or concepts (eg: high quality)

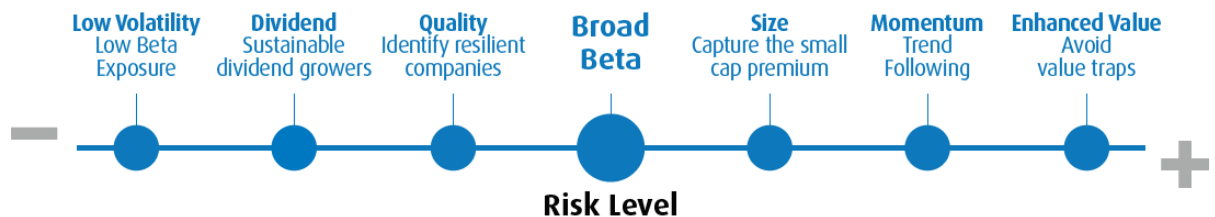
Some of the most widely used equity Factors include: volatility, yield, momentum, quality, value, size.

When determining which factors to invest in, an investor should make several key considerations:

- Risk appetite
- Economic cycle
- Correlations between factors
- Geographic exposure

MSCI has identified six factors which demonstrate outperformance in all markets. The Factor Spectrum below indicates that Low Volatility, Dividend and Quality Factors have provided outperformance for less risk than the broad index from which they were constructed.

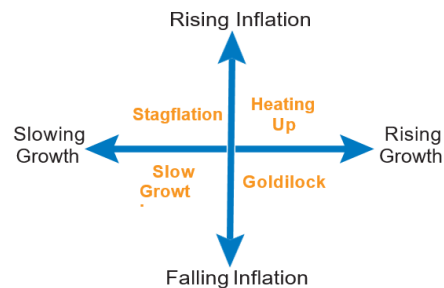
In contrast, Size, Momentum and Value have outperformed, but have a higher risk profile than the broad index.



Factor rotation and the economic cycle

Not all factors have the same macroeconomic drivers, and therefore some factors will outperform others based on inflation, the interest rate environment, and the economic cycle.

Smart/Factor Beta – Factors in Changing Economic Conditions



	Heating Up	Goldilocks	Slow Growth	Stagflation
World Equal Weighted Index	0.0%	0.4%	0.0%	-0.1%
World Dividend Index	-0.1%	0.0%	0.3%	0.2%
World Low Volatility Index*	-0.5%	-0.3%	0.4%	0.4%
World Quality Index	0.1%	-0.2%	0.3%	0.3%
World Enhanced Value†	0.3%	0.7%	0.1%	-0.2%

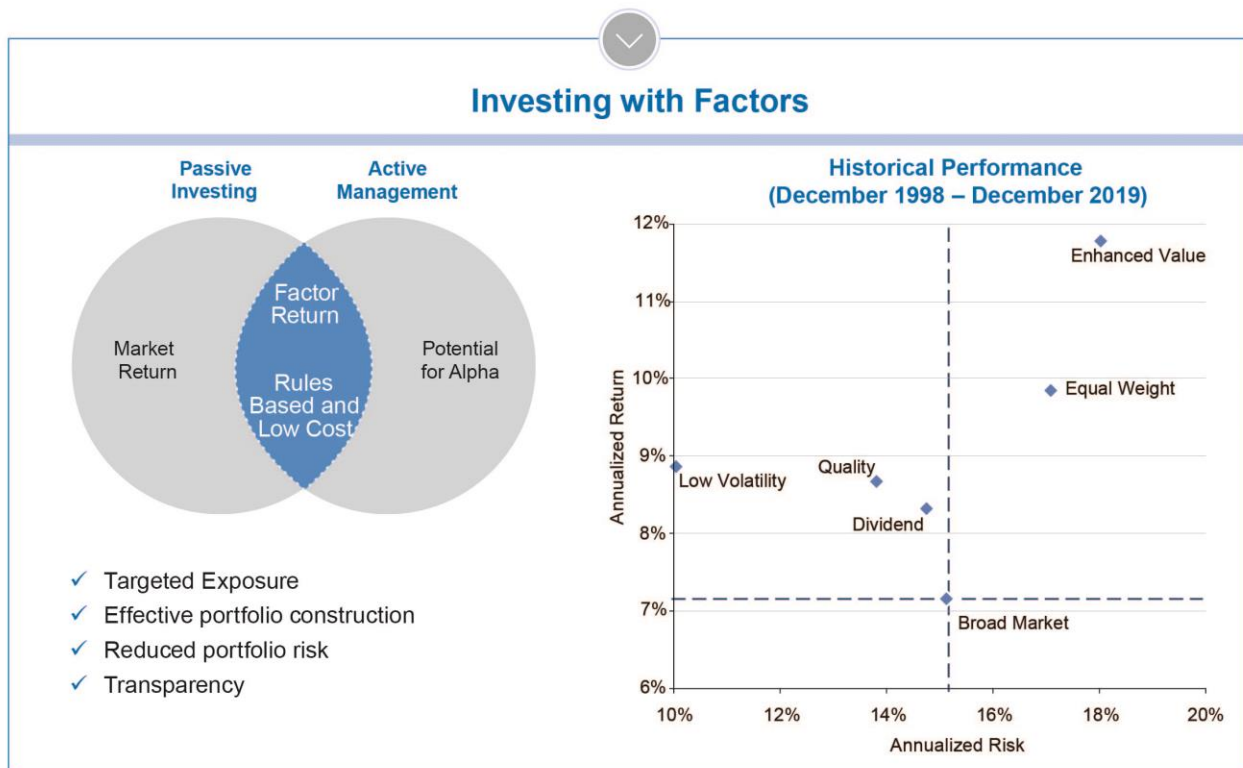
Source: MSCI Inc., December 2018

However, Kevin Gopaul, President of BMO ETFs states that factor or smart beta strategies “shouldn’t be predicated on the notion of outperformance. They should be viewed as another tool to manage the exposure you want in your portfolio.

Research continues to understand what drives returns. New Factors emerge after exhaustive research has determined the Factor has the following attributes:

- Proven – robust data set to eliminate reverse engineering
- Persistent – must be applicable across all markets and endure over time
- Explainable – numeric proof or foundation supported by rigorous academic research
- Investable – liquid and scalable

ETFs are the best tools to implement Factor investing – they can accurately target a Factor by selecting a basket of securities through a rules-based methodology, an advanced screening process which eliminates subjectivities and thus remains pure and repeatable. ETFs maintain this exposure by rebalancing to ensure the securities continue to align with a given Factor. Traditionally, the ability to access Factor exposure was associated with active managers in search of elusive Alpha but, Factor or Smart Beta ETFs provide access with greater transparency and at a lower cost.



Source: Morningstar, December 2019

Risk is defined as the uncertainty of a return and the potential for capital loss in your investment. Broad Market Proxy: MSCI ACWI Index (USD), Low Volatility Proxy: MSCI ACWI Minimum Volatility Index, (USD) Quality Proxy: MSCI ACWI Quality Index (USD), Dividend Proxy: MSCI ACWI High Dividend Yield Index (USD), Value Proxy: MSCI ACWI Enhanced Value Weighted Index (USD) Equal Weight Proxy: MSCI ACWI Equal Weight Index.

BMO Global Asset Management is the top provider of smart beta ETFs in Canada and it offers the largest suite of factor ETFs:

BMO ETFs Smart Beta Suite

Factor	Overview	ETF
Quality	BMO ETFs quality strategy selects companies with high quality scores based on 3 variables: high return on equity, stable earnings growth, and low financial leverage ratio.	<ul style="list-style-type: none"> • BMO MSCI All Country World High Quality Index ETF (ZGQ) • BMO MSCI Europe High Quality Hedged to CAD Index ETF (ZEQ) • BMO MSCI USA High Quality Index ETF (ZUQ)
Value	BMO's value ETFs provide a pure approach to the value factor using MSCI's Enhanced Value methodology. The result is a refined strategy, identifying and avoiding potential value traps.	<ul style="list-style-type: none"> • BMO MSCI Canada Value Index ETF (ZVC) • BMO MSCI USA Value Index ETF (ZVU) • BMO MSCI EAFE Value Index ETF (ZVI)
Low Volatility	BMO ETFs Low Volatility Strategy focuses on the risk of securities and analyzes the beta of a stock as the primary portfolio construction tool. BMO ETFs suite of Low Volatility ETFs provide investors with long-term solutions that provide downside protection.	<ul style="list-style-type: none"> • BMO Low Volatility Canadian Equity ETF (ZLB) • BMO Low Volatility US Equity ETF (ZLU, ZLU.U, ZLH) • BMO Low Volatility International Equity ETF (ZLI, ZLD) • BMO Low Volatility Emerging Markets Index ETF (ZLE)
Dividend	BMO ETFs dividend approach is a customized strategy that combines high yield with sustainable growth. Through an advanced 4 step screening process BMO ETFs analyzes each company's willingness and ability to pay dividends over time with additional forward looking considerations.	<ul style="list-style-type: none"> • BMO Canadian Dividend ETF (ZDV) • BMO US Dividend ETF (ZDY, ZDY.U, ZUD) • BMO International Dividend ETF (ZDI, ZDH)
Equal Weight	BMO ETFs applies an equal weight methodology to developed sectors which reduces security concentration often found in traditional sector based ETFs. Each security is allocated an equal weight rather than a market capitalization weight, which decreases security specific risk. Equal weighted ETFs eliminate a market capitalization bias bringing more focus on small capitalization and in turn, value companies. BMO ETFs Equal Weight Strategy is a more efficient way to implement a sector strategy and can complement or replace single stock holdings.	<ul style="list-style-type: none"> • BMO Equal Weight Banks Index ETF (ZEB) • BMO Equal Weight Oil & Gas Index ETF (ZEO) • BMO Equal Weight Utilities Index ETF (ZUT) • BMO Equal Weight REITs Index ETF (ZRE) • BMO Equal Weight Canada Industrials Index ETF (ZIN) • BMO Equal Weight US Health Care Hedged to CAD Index ETF (ZUH) • BMO Equal Weight US Banks Index ETF (ZBK) • BMO Equal Weight US Banks Hedged to CAD Index ETF (ZUB) • BMO Equal Weight Global Base Metals Hedged to CAD Index ETF (ZMT) • BMO Equal Weight Global Gold Index ETF (ZGD)

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