# BMO ETF Portfolio Strategy Report

First Quarter 2021 BMO EXCHANGE TRADED FUNDS

## A Fresh Yet Cautious Start


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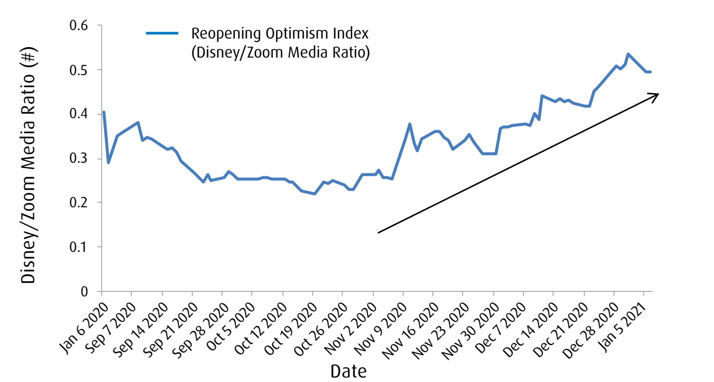
### In this report:



**All prices, returns and portfolio weights are as of market close on January 5, 2021, unless otherwise indicated.**

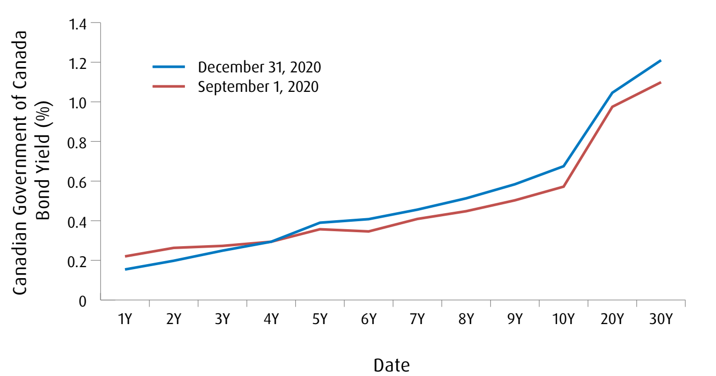
- **After a tumultuous year, investors will be glad to turn a new page to a hopefully more promising run in 2021.** Market confidence around an economic reopening has been high since the news of the Pfizer vaccine broke. Since November 1, our *"Reopening Optimism Index"*, which is simply a ratio of Walt Disney Co. to Zoom Video Communications Inc. (DIS/ZM), has increased 90.0% (Chart A).
- **This optimism has already been priced into many risk assets.** For example, the *CDX High Yield* spreads was trading at 290 bps at the start of the new year, which is a mere 10 bps away from pre-COVID levels. Investment grade bonds offer a bit more spread compression opportunities on a relative scale, but also seem rich, leading investors to rotate into equities.
- **The *S&P 500 Composite* and the *S&P/TSX Composite* are trading at 29.5x and 26.5x the current price-to-earnings (P/E) ratio, which are already significant premiums to their long-term averages.** However, with earnings of many companies being compressed last year, forward earnings per share will likely increase, leading to further potential multiple expansion opportunities.
- **Though markets have reason to be hopeful, investors should take caution as there are various stumbling blocks that remain, such as a timely vaccine rollout, the efficacy of existing and future vaccines against mutated COVID strains, as well as new and unforeseen geo-political risks.** While we are optimistic, we don't envision a straight path to recovery. As a reminder, the years that followed the Great Financial Crisis of 2008 were also met with relative uncertainty and various bouts of volatility. Consequently, even though we anticipate equities to outpace bonds this year, fixed income will still play a critical role in providing stability within a portfolio provided it is strategically positioned.
- **A third coronavirus lockdown recently imposed across the U.K. is an example of potential risks that remain.** With many businesses being forced to shutter again, social unrest will likely be on the rise as many face insolvency. Public frustration may also grow in reaction to evidence that vaccine distribution plans have not been effective, particularly with a reported 54% of doses being unused in New York. However, this issue will probably be addressed as many public health workers return from much-needed holiday breaks, and as new vaccines are rolled out that are easily transportable and/or have longer shelf-lives.
- **While we anticipate a period of uncertainty in the coming months, overall optimism should drastically improve compared to last year.** As such, the rotation into equities will likely cause the yield curve to steepen further (Chart B). We expect near-term yields inside of two years to remain flat, given the implications of the central bank keeping its overnight rates unchanged until 2023, but rates beyond the next three years to rise gradually. We anticipate the U.S. Federal Reserve (Fed) to counter at some point this year by implementing an Operation Twist to flatten the yield curve by buying less shorter-dated maturities in order to buy more longer-dated treasuries.

**Chart A: Optimism for Economic Rebound Jumps 90% Since Vaccine News**




Source: BMO Global Asset Management, Bloomberg, January 6, 2020 – January 5, 2021.

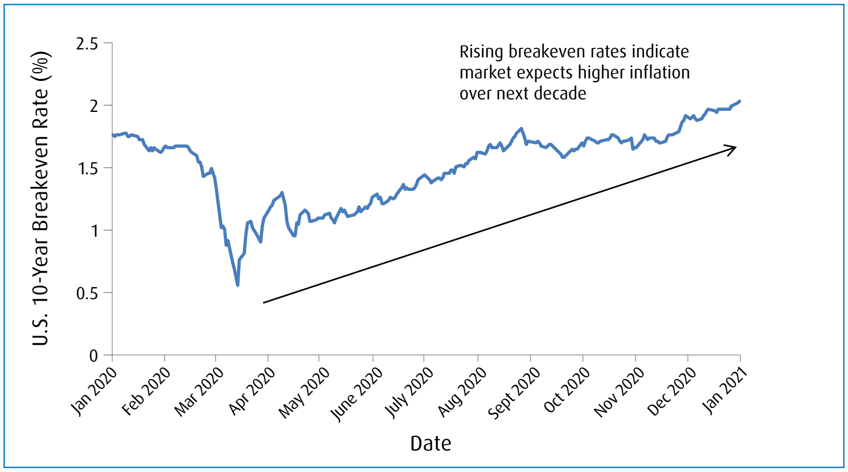
**Chart B: Yield Curve to Steepen Further as Investors Rotate into Equities**




Source: Bloomberg.

BMO Exchange Traded Funds

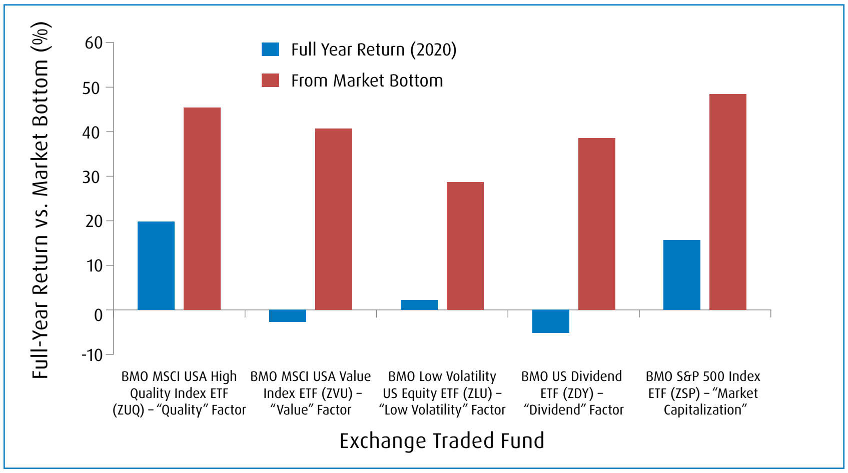
## Things to Keep an Eye On




Source: Bloomberg, January 6, 2020 – January 5, 2021.

Inflation has become a growing concern for many market participants over the last several months. While the accommodative measures of central banks vis-à-vis ultra-low monetary policy and quantitative easing have created a potential inflationary backdrop, supply and demand imbalances are the more immediate concern. Lockdowns have created shortages of inventory in many sectors, creating cost-push inflation. In industries where some suppliers have become insolvent, those that have survived will benefit from increased pricing power.

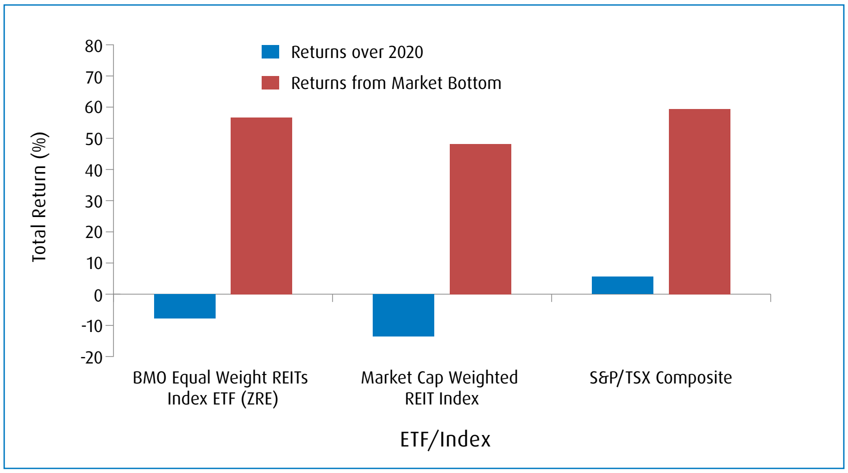
**Recommendation:** The vaccine has turned the tide, signalling an economic reopening in the near future. However, increasing demand will add to the already short supply, potentially creating demand-pull inflation. Investors should start building a small position in a portfolio dedicated to inflation protection, whether it's through base metals, real estate investment trusts (REITs), or short-term U.S. Treasury Inflation-Protected Securities (TIPS).




Source: BMO Global Asset Management, Bloomberg, as of December 31, 2020.

The market recovery in 2020 was remarkable and largely owing to the monetary policy of central banks and government fiscal policy. Though imperfect, the stimulus was necessary to not only prevent a collapse in asset prices, but also to contain social unrest. The recovery was not only uneven across sectors, but various market factors performed differently both over the course of the year and from the market bottom.

**Recommendation:** The quality factor was our top recommendation, particularly in U.S. equities last year. During the sell-off, we recommended "buying quality on a discount," underpinning the ***BMO MSCI USA High Quality Index ETF (ZUQ),*** which has been a central part of our portfolio strategy in the last several years. While the ***BMO Low Volatility US Equity ETF (ZLU)*** was a laggard, particularly from the market bottom, we do believe it is an ideal complement to quality and provides necessary downside protection in a portfolio. Furthermore, we are confident that the long-term secular preference for low volatility stocks will continue to be in play given that the majority of investable assets reside with the aging demographic.




Source: BMO Global Asset Management, Bloomberg, as of December 31, 2020.

Lower interest rates and a transition to work-from-home have placed a greater demand on residential property. Commercial real estate, however, has had a much tougher time during the recovery as offices remain vacant and shopping has largely moved online. Over the next several years, we will likely see many companies take more of a flexible work approach, allowing employees to work partially from home. This doesn't mean commercial real estate will be on the decline, but we will likely see a transition over the coming decade. .

**Recommendation:** Some of these transitions within commercial real estate will likely see office-related REITs reduce their footprint by moving to "office hoteling." Retail properties could give way to industrial warehousing to store online goods, while apartment and rental property REITs will likely remain resilient as people work remotely and the cost of home ownership rises. We believe REITs is one area which offers attractive valuations. However, investors may want to consider the ***BMO Equal Weight REITs Index ETF (ZRE),*** which places less emphasis on larger-cap office and retail REITs, and more focus on industrial and residential real estate.

## Changes to Portfolio Strategy

| Sell/Trim | Ticker | (%) | Buy/Add | Ticker | (%) |
|---|---|---|---|---|---|
| BMO Covered Call US Banks ETF | ZWK | 6.0% | BMO Equal Weight US Bank Index ETF | ZBK | 6.0% |
| BMO S&P/TSX Capped Composite Index ETF | ZCN | 3.0% | BMO Equal Weight REITs Index ETF | ZRE | 3.0% |

### Asset Allocation:

- Despite taking a more defensive tilt within our asset classes, our portfolio strategy has kept pace with our benchmark *(60% S&P/TSX Composite and 40% FTSE/TMX Canada Bond Universe)* over 2020. This was largely due to utilizing a more diversified approach, which includes non-traditional assets alongside bonds and equities. Slightly increasing our allocation to equities in the fourth quarter also allowed us to participate more in the vaccine-led market rally that capped off 2020. Our expectation is for equities to outperform fixed income over the new year. Since we are already overweight equities, we will not make any changes to our asset allocation mix for this quarter.

### Fixed Income:

- Fixed income had strong returns last year with our broad-based ***BMO Aggregate Bond Index ETF (ZAG)*** delivering a total return of 8.56% in 2020. As mentioned, credit spreads have tightened significantly since the height of the market crisis in March. Canadian investment grade corporate spreads are now just 17bps wider than pre-COVID levels, while some provinces are presently trading even tighter than February levels. Additionally, with central banks moving to more accommodative monetary policies, interest rates have moved lower across the curve. This may limit the opportunities in fixed income for the coming year, particularly if inflation becomes more topical as the economy slowly reopens.

- Within a balanced portfolio, fixed income should be strategically placed. A broad-based ETF such as ZAG or its more tax-efficient equivalent ***BMO Discount Bond Index ETF (ZDB),*** should make a core holding, while tactically-positioned exposures need to be framed around the peripheral. Although we anticipate the U.S. yield curve to continue steepening as the economy reopens, we believe our positioning in the ***BMO Long-Term US Treasury Bond Index ETF (ZTL)*** is still crucial in offsetting occasional bouts of equity market volatility. As already mentioned, we expect the Fed to look at flattening the yield curve through an Operation Twist at some point in 2021. To offset the risk of rising rates, we will defer to our exposure in rate-reset preferred shares to partially balance duration risk for the portfolio.

- In terms of credit, given the spread compression that has already transpired in high-yield bonds, we prefer investment grade bonds both in Canada and the U.S. from a risk-reward perspective. As such, we believe our overweight to the ***BMO High Quality Corporate Bond Index ETF (ZQB)*** and the ***BMO Mid-Term US IG Corporate Bond Index ETF (ZIC)*** continues to be justified.

### Equities:

- As aforementioned, we believe our exposure to the ***BMO MSCI USA High Quality Index ETF (ZUQ)*** will continue to make an effective core position. The quality factor tends to provide better downside protection than a market-capitalization weighted index, while also providing growth opportunities. Over the last several years, ***ZUQ*** has become our second largest position in our portfolio strategy.

- We believe U.S. banks are well-positioned to participate in an economic reopening. Regional banks in particular will benefit from increased lending activities, which will likely pick-up in demand and also benefit from a steepening yield curve. Currently, we have exposure through the ***BMO Covered Call US Banks ETF (ZWK),*** but will look to shift the entire 6.0% position into the ***BMO Equal Weight US Banks Index ETF (ZBK).*** We believe the non-covered call version will be better-positioned to participate in the potential upside.

- As mentioned, we believe REITs are an area that has lagged, compared to the broader market and represents attractive value. While the industry will likely undergo a transition in the coming years, the ***BMO Equal Weight REITs ETF (ZRE)*** places more emphasis on smaller cap industrial and apartment REITs, which are more strategically positioned for the post-COVID economy. We will replace our 3.0% position in the ***BMO S&P/TSX Capped Composite Index ETF (ZCN)*** with ***ZRE.***

### Non-Traditional/Hybrids:

- Preferred shares will continue to play a vital role to a portfolio's income allocation. In addition, the ***BMO Laddered Preferred Share Index ETF (ZPR)*** will be critical in providing protection to rising mid-term rates. As mentioned, we believe short-term rates inside two years will remain stable given the central bank's indication for keeping its overnight rates unchanged at least for the year. However, bond yields beyond the three-year mark will likely rise as we see a continued rotation into equities. Furthermore, our position in the ***BMO US Preferred Share Hedged to CAD Index ETF (ZHP)*** will provide diversification benefits and stable yield.

**Investment Objective and Strategy:** The strategy involves tactically allocating to multiple asset-classes and geographies to achieve long-term capital appreciation and total return by investing primarily in ETFs.

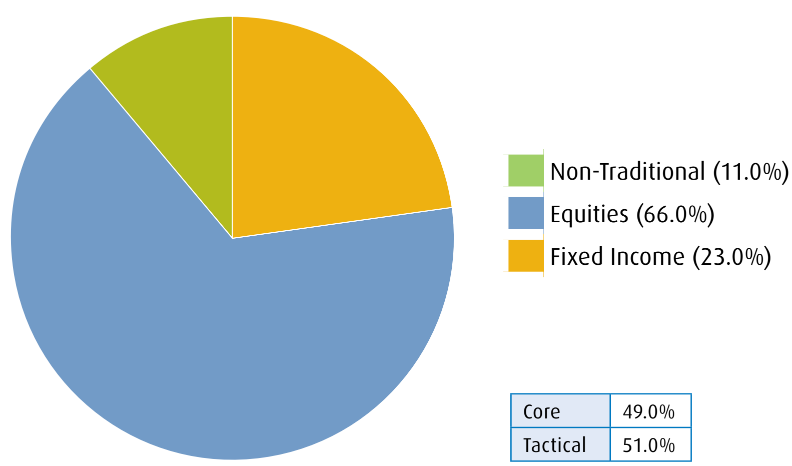
## Stats and Portfolio Holdings

| Ticker | ETF Name | | Position | Price | Management Fee* | Weight (%) | 90-Day Vol | Volatility Contribution | Yield (%)** | Yield/ Vol |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Fixed Income** | | | | | | | | | |
| **ZDB** | BMO DISCOUNT BOND INDEX ETF | Fixed Income | Core | $17.42 | 0.09% | 7.0% | 3.3 | 1.9% | 2.1% | 0.62 |
| **ZIC** | BMO MID-TERM US IG CORPORATE BOND INDEX ETF | Fixed Income | Tactical | $20.09 | 0.25% | 6.0% | 7.8 | 3.8% | 3.5% | 0.44 |
| **ZQB** | BMO HIGH QUALITY CORPORATE BOND INDEX ETF | Fixed Income | Tactical | $30.81 | 0.10% | 5.0% | 0.9 | 0.3% | 2.5% | 2.85 |
| **ZTL** | BMO LONG-TERM US TREASURY INDEX ETF | Fixed Income | Tactical | $61.10 | 0.20% | 5.0% | 3.2 | 1.3% | 2.3% | 0.71 |
| | **Total Fixed Income** | | | | | 23.0% | | 7.2% | | |
| | **Equities** | | | | | | | | | |
| **ZLB** | BMO LOW VOLATILITY CANADIAN EQUITY ETF | Equity | Core | $34.15 | 0.35% | 17.0% | 11.7 | 15.9% | 2.8% | 0.24 |
| **ZRE** | BMO EQUAL WEIGHT REITS INDEX ETF | Equity | Tactical | $21.59 | 0.05% | 3.0% | 19.7 | 4.7% | 4.9% | 0.25 |
| **ZLU** | BMO LOW VOLATILITY US EQUITY ETF | Equity | Core | $38.11 | 0.30% | 8.0% | 12.1 | 7.7% | 1.7% | 0.14 |
| **ZLD** | BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF | Equity | Core | $23.86 | 0.40% | 7.0% | 14.0 | 7.9% | 2.5% | 0.18 |
| **ZEQ** | BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF | Equity | Tactical | $25.08 | 0.40% | 5.0% | 16.0 | 6.4% | 1.9% | 0.12 |
| **ZUH** | BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF | Equity | Tactical | $73.06 | 0.35% | 4.0% | 19.2 | 6.2% | 0.3% | 0.01 |
| **ZEB** | BMO S&P/TSX EQUAL WEIGHT BANKS INDEX ETF | Equity | Tactical | $29.00 | 0.55% | 6.0% | 15.0 | 7.2% | 4.1% | 0.28 |
| **ZUQ** | BMO MSCI USA HIGH QUALITY INDEX ETF | Equity | Core | $49.24 | 0.30% | 10.0% | 16.5 | 13.2% | 1.0% | 0.06 |
| **ZBK** | BMO COVERED CALL US BANKS ETF | Equity | Tactical | $25.89 | 0.35% | 6.0% | 34.4 | 16.5% | 2.7% | 0.08 |
| | **Total Equity** | | | | | 66.0% | | 85.6% | | |
| | **Non-Traditional/Hybrids** | | | | | | | | | |
| **ZPR** | BMO S&P/TSX LADDERED PREFERRED INDEX ETF | Hybrid | Tactical | $9.90 | 0.45% | 5.0% | 8.9 | 3.6% | 5.5% | 0.62 |
| **ZHP** | BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF | Hybrid | Tactical | $24.61 | 0.45% | 6.0% | 7.5 | 3.6% | 5.4% | 0.72 |
| | **Total Alternatives** | | | | | 11.0% | | 7.1% | | |
| | **Total Cash** | | | | | 0.0% | 0.0 | 0.0% | 0.0% | |
| | **Portfolio** | | | | **0.32%** | **100.0%** | **12.5** | **100.0%** | **2.7%** | **0.22** |

Please note yields of equities will change from month to month based on market conditions.

| Ticker | Name | Weight |
|---|---|---|
| **ZLB** | BMO LOW VOLATILITY CANADIAN EQUITY ETF | 17.0% |
| **ZUQ** | BMO MSCI USA HIGH QUALITY INDEX ETF | 10.0% |
| **ZLU** | BMO LOW VOLATILITY US EQUITY ETF | 8.0% |
| **ZDB** | BMO DISCOUNT BOND INDEX ETF | 7.0% |
| **ZLD** | BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF | 7.0% |
| **ZIC** | BMO MID-TERM US IG CORPORATE BOND INDEX ETF | 6.0% |
| **ZEB** | BMO S&P/TSX EQUAL WEIGHT BANKS INDEX ETF | 6.0% |
| **ZBK** | BMO EQUAL WEIGHT US BANKS INDEX ETF | 6.0% |
| **ZHP** | BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF | 6.0% |
| **ZQB** | BMO HIGH QUALITY CORPORATE BOND INDEX ETF | 5.0% |
| **ZTL** | BMO LONG-TERM US TREASURY INDEX ETF | 5.0% |
| **ZEQ** | BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF | 5.0% |
| **ZPR** | BMO S&P/TSX LADDERED PREFERRED INDEX ETF | 5.0% |
| **ZUH** | BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF | 4.0% |
| **ZRE** | BMO EQUAL WEIGHT REITS INDEX ETF | 3.0% |

Source: Bloomberg, BMO Asset Management Inc. (As of December 31, 2020).



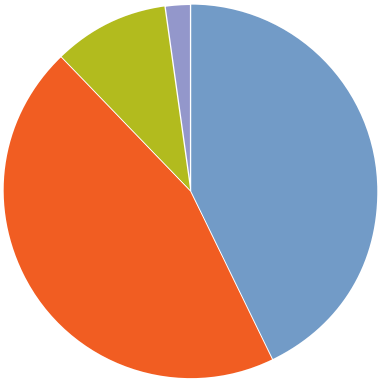

| | |
|---|---|
| Core | 49.0% |
| Tactical | 51.0% |

*Management Fee as of December 31, 2020.

**Yield calculations for bonds is based on yield to maturity, which includes coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity and for equities it is based on the most recent annualized income received divided by the market value of the investments.

## Portfolio Characteristics

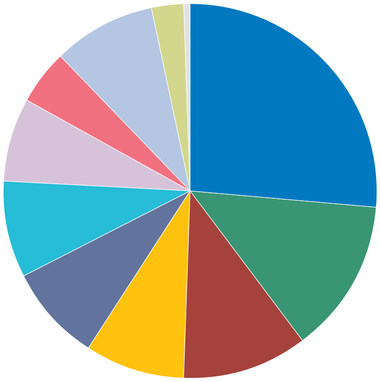
### Regional Breakdown (Overall Portfolio)



| | |
|---|---|
| Canada | 43.0% |
| United States | 45.0% |
| Europe | 9.9% |
| Asia | 2.1% |

*Regional Breakdown includes equities, fixed income and non-traditional/hybrid sleeves.

### Equity Sector Breakdown



| | |
|---|---|
| Financials | 26.60% |
| Health Care | 13.28% |
| Consumer Staples | 10.81% |
| Utilities | 8.54% |
| Industrials | 8.51% |
| Information Technology | 8.36% |
| Consumer Discretionary | 7.04% |
| Communication Services | 4.83% |
| Real Estate | 8.87% |
| Materials | 2.66% |
| Energy | 0.50% |

### Fixed Income Breakdown

| | |
|---|---|
| Federal | 29.4% |
| Provincial | 10.8% |
| Investment Grade Corporate | 59.8% |
| Non-Investment Grade Corporate | 0.0% |

| | |
|---|---|
| Weighted Average Term | 11.26 |
| Weighted Average Duration | 9.14 |
| Weighted Average Coupon | 2.7% |
| Weighted Average Current Yield | 2.4% |
| Weighted Average Yield to Maturity | 1.4% |

Weighted Average Current Yield: The market value weighted average coupon divided by the weighted average market price of bonds.

Weighted Average Yield to Maturity: The market value weighted average yield to maturity includes the coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity.

Weighted Average Duration: The market value weighted average duration of underlying bonds divided by the weighted average market price of the underlying bonds. Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates.

Source: Bloomberg, BMO Asset Management Inc. (As of December 31, 2020).

## The Good, the Bad, and the Ugly

**Conclusion:** The introduction of a vaccine over the last quarter provides a light at the end of the tunnel. While logistical issues remain, particularly in some U.S. states where doses have been reported unused, other countries such as Israel have had an effective distribution strategy, which will allow the global economy to slowly reopen in the coming months. While this is positive news, we believe supply and demand imbalances, coupled with the increasing velocity of money, will make higher inflation a growing concern. As such, investors should balance a portfolio between equity growth and income, while using strategically placed fixed income positions to provide defence and protection against both inflation and rising mid-term rates.

| | Global-Macro/Geo-Political | Fundamental | Technical |
|---|---|---|---|
| **Good** | • U.S. unemployment continues to move lower to 8.8%, which does provide some slack and can mitigate inflation to some respect.<br>• Political risk seems to be on the decline, as long as there is a somewhat smooth transition in the White House. | • Credit spreads of various bonds from provincials and corporates to high-yield are back to normalized levels, indicating a healthy credit environment. | • Fear/greed levels are now much flatter, which is positive, meaning the market is better balanced between buyers and sellers. However, for market participants looking for easy gains, those opportunities have likely passed.<br>• Put-to-call ratio for U.S. equities is at 0.45, which indicates a balanced market.<br>• Stocks that have been negatively impacted by lockdowns have rallied significantly against stocks that performed well during those periods. |
| **Bad** | • Household debt in Canada is still one of the main concerns, and the recent easing of monetary policy will only intensify this further.<br>• A second and third lockdown in certain regions will put some sections of the population at a disadvantage.<br>• The economic backdrop seems primed for inflation to pick up. With the economy reopening and a rise in activity, the velocity of money could potentially increase, leading to higher inflation. | • Risk assets are looking extremely expensive at this point. High yield spreads have tightened almost to pre-COVID levels, while there is still an expectation for more insolvency.<br>• Equities also look expensive at current valuations, but if earnings increase, there is an opportunity for multiple expansion. | • Shorter-term oscillators have been very flat, making it difficult for traders, although this has been positive for longer-term investors. |
| **Ugly** | • While political risk has been on the decline in recent weeks, there is a possibility that social unrest will continue, particularly if lockdowns continue and vaccines remain unused. | | • Margin debt is still one of the key contributors in how quickly risk-assets can rise and fall. The central banks' moves to increase their bond-buying programs will only lead this to increase. Expect even more velocity during the next crisis. |

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The viewpoints expressed represents herein is our assessment of the markets at the time of publication. Those views are subject to change without notice as markets change over time.

Commissions, management fees and expenses all may be associated with investments in exchange traded funds. Please read the ETF Facts or prospectus of the BMO ETFs before investing. The indicated rates of return are the historical annual compound total returns including changes in prices and reinvestment of all distributions and do not take into account commission charges or income taxes payable by any unitholder that would have reduced returns. Exchange traded funds are not guaranteed, their value change frequently and past performance may not be repeated.

For a summary of the risks of an investment in the BMO ETFs, please see the specific risks set out in the BMO ETFs prospectus. BMO ETFs trade like stocks, fluctuate in market value and may trade at a discount to their net asset value, which may increase the risk of loss. Distributions are not guaranteed and are subject to change and/or elimination.

The payment of distributions is not guaranteed and may fluctuate. The payment of distributions should not be confused with a fund's performance, rate of return, or yield. If distributions paid by the fund are greater than the performance of the fund, your original investment will shrink. Distributions paid as a result of capital gains realized by a fund, and income and dividends earned by a fund are taxable in your hands in the year they are paid. Your adjusted cost base will be reduced by the amount of any returns of capital. If your adjusted cost base goes below zero, you will have to pay capital gains tax on the amount below zero. Please refer to the fund's distribution policy in the prospectus.



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BMO Exchange Traded Funds