BMO ETF Portfolio Strategy Report

Third Quarter 2020

BMO EXCHANGE TRADED FUNDS

Restoring Order

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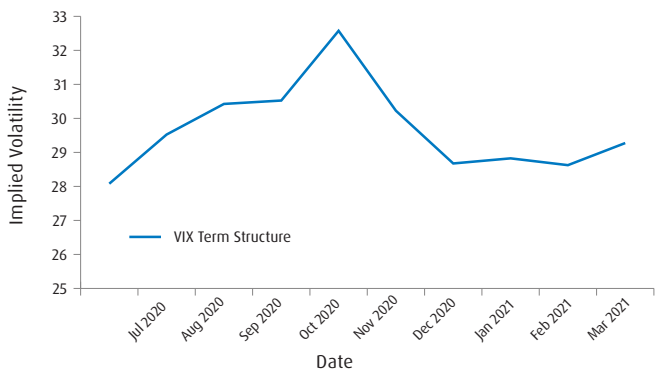
In this report:

All prices, returns and portfolio weights are as of market close on July 8, 2020, unless otherwise indicated.

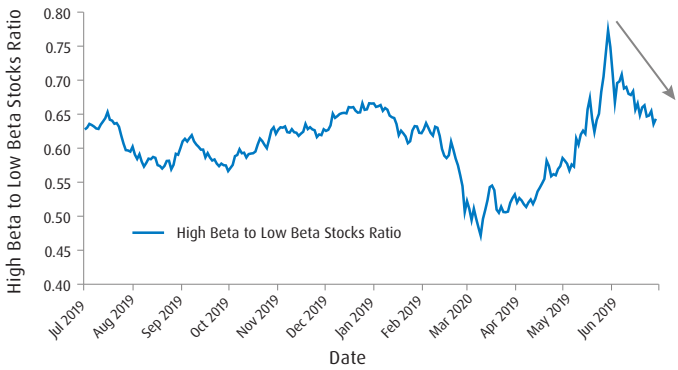
- **After experiencing one of the most vicious sell-offs in market history, risk assets quickly bounced back over the second quarter, despite ongoing concerns of a second COVID-19 wave.** Over the quarter, the *S&P/TSX Composite, S&P 500 Composite and the FTSE/TMX Canadian Bond Universe* are all up 20.0%, 18.6% and 6.2%, respectively, on a total return basis in local terms.
- **Many investors have watched from the sidelines, however, questioning the validity of the rally.** While the shape of the economic recovery is up for debate, investors should note that a large part of the sell-off in March was due to a lack of liquidity. During the onset of the economic shutdown, desperation increased as investors were willing to take any bid, leading the markets to gap lower. Since then, central banks have added a number of liquidity measures to provide a backstop to the market. These measures would make a notable impact should we experience a retracement in risk-assets due to a resurgence in coronavirus infection rates.
- **In March, there was significantly more uncertainty in terms of the actual COVID-19 mortality rate, but with more data now in hand, another shutdown of the economy would be unlikely even in the absence of a vaccine.** This is because improved testing and analytics can potentially be used to better manage infections within the population. The greater concern heading into the latter half of the year that could likely disrupt markets is growing civil unrest around the globe, and the upcoming U.S. presidential election.
- **The futures market seems to be in agreement that volatility may return in the Autumn, as the CBOE Volatility Index® (VIX) term structure currently peaks with October contracts (Chart A).** While risk assets have rallied considerably in recent months, investors should remain prudent and have core exposures dedicated to low volatility and quality assets in their portfolios. High-beta stocks typically outperform coming off market bottoms, but their momentum typically wanes as euphoria fades. Already, we are seeing the relative strength of high-beta stocks weaken against their lower-beta counterparts (Chart B).
- **The U.S. dollar (USD) index has also come down considerably since mid-March,** as USD funding needs have decreased considerably. This has been a result of a decline in central bank usage of USD swap lines in recent months, a further indication that liquidity has been restored. We would still maintain some USD exposure in a portfolio for diversification purposes, however, as the Canadian economy still faces some headwinds such as lower oil prices.

Chart A: CBOE Volatility Term Structure Suggests Autumn Peak



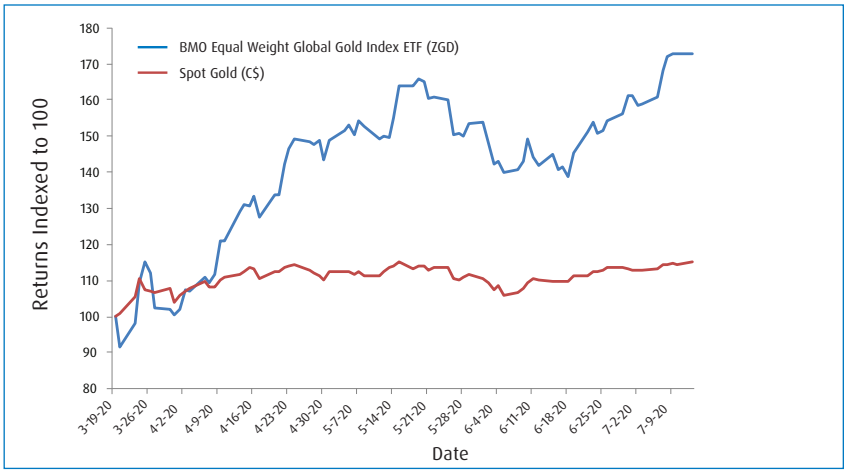
Source: Bloomberg, July 8 2020. Past performance is no guarantee of future results.

Chart B: High-Beta Strength Beginning to Fade Relative to Low-Beta



Source: Bloomberg, July 10, 2019 – July 9, 2020. Past performance is no guarantee of future results.

Things to Keep an Eye On



Source: Bloomberg, March 19, 2020 – July 9, 2020. Past performance is no guarantee of future results.

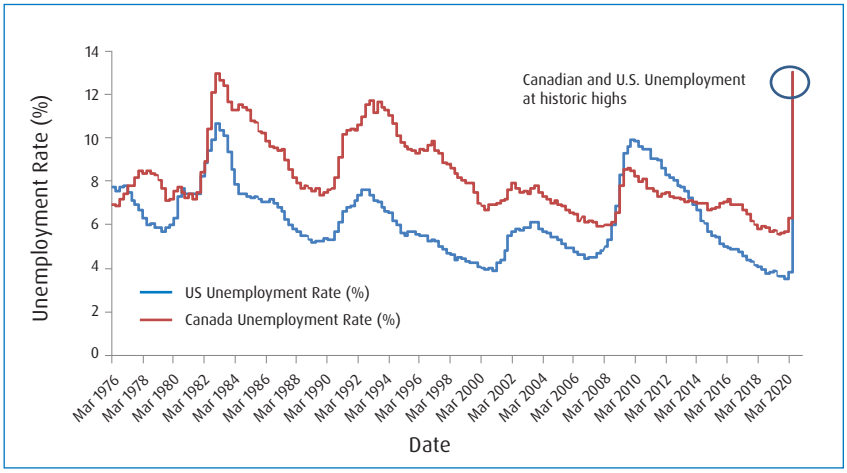
Gold prices have continued to trend upward despite the fact that macro-economic uncertainty has faded since March. Recent gains have been a reflection of USD weakness. However, the commodity's longer-term gains have been due to central banks buying gold to diversify from USD, which we believe is a secular trend. In the last several months, a growing number of central banks have utilized non-traditional forms of monetary policy, such as quantitative easing to combat the economic shock from the Coronavirus pandemic. Gold should benefit until central banks signal the tapering of balance sheet usage.

Recommendation: At the current stage of the market cycle, investors looking for exposure to gold may want to consider gold-related companies rather than bullion itself. With the once-in-a-decade de-leveraging event now in the rear view, equities may offer more upside to gold prices given the balance sheet leverage usage of gold stocks. The ***BMO Equal Weight Global Gold Index ETF (ZGD)*** provides investors with exposure to a portfolio of larger-cap gold companies.

Source: Bloomberg, July 15, 2019 – July 13, 2020. Past performance is no guarantee of future results.

Mainland Chinese stocks (A-Shares) have experienced a resurgence since the end of May, delivering a total return of 24.8%, compared to the 4.6% of the MSCI World Index (all in USD terms). This has been largely driven by a significant increase in retail trading, with margin usage in online accounts picking up on the back of state-run media encouraging investors to buy stocks. The parabolic nature of the recent moves would indicate that there is a noteworthy amount of euphoria behind the rally.

Recommendation: Investors looking to gain exposure to Chinese stocks may want to consider the ***BMO China Equity Index ETF (ZCH).*** Chinese stocks, including H-Shares and American Depository Receipts (ADR), have not risen as much as their counterparts that trade on the mainland exchanges. The valuation difference exists even for companies with shares listed on both mainland (A-Shares) and externally (H-Shares) and ADRs.



Source: Bloomberg, March 31, 1976 – July 13, 2020. Past performance is no guarantee of future results.

Unemployment rates in both the U.S. and Canada have hit unprecedented levels, both recently registering at 13.0%. It has been debated whether this will be a V-, U-shape, or longer economic recovery. The answer will likely be a combination with most sectors likely seeing a consolidation where operationally-strong companies prevail. As such, sticking to high-quality, blue-chip companies is one way investors can position their portfolios given the uncertainty in the wake of Coronavirus.

Recommendation: High-quality companies have been a core part of our portfolio strategy. We continue to favour this factor as screening for businesses that exhibit high return on equity (ROE), low earnings variability and low financial leverage isolates companies that exhibit robust competitive advantages in their fields. The ***BMO MSCI USA High Quality Index ETF (ZUQ)*** is a diversified portfolio of U.S. companies that demonstrate these high-conviction characteristics. In addition, the ***BMO MSCI All Country World High Quality Index ETF (ZGQ)*** is a one-ticket solution for investors that want exposure to global blue-chip stocks that have the balance sheets to thrive in the new world.

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Mid-Term US Treasury Bond Index ETF	ZTM	3.0%	BMO Long-Term US Treasury Bond Index ETF	ZTL	3.0%
BMO Mid-Term US IG Corporate Bond Index ETF	ZIC	2.0%	BMO Equal Weight US Health Care Hedged to CAD Index ETF	ZUH	1.0%
			BMO Equal Weight Banks Index ETF	ZEB	1.0%

Asset Allocation:

- Since the market bottomed in late March, stocks have gained relative strength against bonds, while risk-taking in higher-beta assets has been rewarded. This does not come as a surprise, however, as riskier assets have historically outperformed coming out of market troughs, though they tend to fade as markets normalize. Given the tilt in our portfolio strategy to more defensive growth areas, we have slightly underperformed our benchmark on a relative level, but still delivered strong performance over the quarter. As already mentioned earlier in the report, the momentum in higher-beta stocks is already beginning to wane against its lower-beta counterparts. While growth opportunities in higher-risk equities may now be moderated, we believe defensive growth-oriented stocks offer more upside relative to fixed income and non-traditional assets over the next twelve months. Consequently, we will be slightly increasing our weight to equities this quarter.

Fixed Income:

- In our fixed income strategy, we are overweight corporate bonds relative to the *FTSE/TMX Canada Bond Universe.* Although we are taking more risk in fixed income, we are doing so largely by overweighting higher quality corporate bonds that are rated A and higher through the ***BMO High Quality Corporate Bond Index ETF (ZQB).*** Downgrade risk remains one of the main concerns in fixed income amongst lower-rated BBB issuers, which generally reflect businesses that would be impacted more significantly should the reopening of the economy become prolonged.

- As a portfolio diversifier, we are switching our 3.0% exposure in the ***BMO Mid-Term US Treasury Bond Index ETF (ZTM)*** into the ***BMO Long-Term US Treasury Bond Index ETF (ZTL).*** Longer-term bonds tend to have a stronger negative correlation to equities and risk assets. We have been waiting to make this switch, but have been hesitant to do so until the 20-year U.S. Treasury yield had stabilized.

Equities:

- Although we are not adding any new equity positions to our portfolio strategy, we are increasing our weight toward each of the ***BMO Equal Weight US Health Care Hedged to CAD Index ETF (ZUH)*** and the ***BMO Equal Weight Banks Index ETF (ZEB)*** by 1.0%. Our position in health care stocks has always been based on a long-term secular view due to aging demographics, but now the sector will play a vital role as we focus on the impact of the Coronavirus pandemic.

- We also believe Canadian bank stocks are attractively valued right now. While the sector has underperformed the broader *S&P/TSX Composite* since the market bottomed, it plays an integral part of the Canadian economy and currently offers an extremely appealing dividend yield.

Non-Traditional/Hybrids:

- Canadian preferred shares appeared as if they lacked a catalyst for upside growth; however, that recently changed. Currently, there are talks of a major bank issuing an inaugural Additional Tier One capital bond (AT1), which has quickly led to a buying frenzy of preferred shares. If approved, there is speculation that the capital raised in AT1 bonds would be used to call back bank-issued preferred shares, as this new structure would qualify as Tier 1 capital, and would be "pari-passu" with preferred shares. If accurate, this would mean those bank-issued preferred shares that are call candidates would be redeemed at a par value of $25, which would be beneficial for the ***BMO Laddered Preferred Share Index ETF (ZPR).***

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.

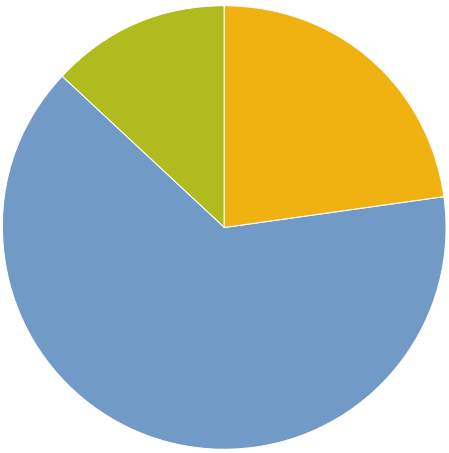
Stats and Portfolio Holdings

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	$17.53	0.09%	7.0%	7.0	1.2%	2.1%	0.30
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$21.36	0.25%	8.0%	21.7	4.3%	3.3%	0.15
ZQB	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$30.69	0.10%	5.0%	4.1	0.5%	2.5%	0.61
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	Fixed Income	Tactical	$70.24	0.20%	3.0%	7.5	0.6%	2.0%	0.27
	Total Fixed Income					23.0%		6.5%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$31.50	0.35%	17.0%	45.5	19.0%	3.2%	0.07
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	Equity	Core	$21.57	0.05%	3.0%	50.8	3.7%	3.6%	0.07
ZLU	BMO LOW VOLATILITY US EQUITY ETF	Equity	Core	$38.11	0.30%	8.0%	45.9	9.0%	1.8%	0.04
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$22.83	0.40%	7.0%	38.4	6.6%	2.9%	0.07
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD INDEX ETF	Equity	Tactical	$23.26	0.40%	5.0%	42.1	5.2%	2.1%	0.05
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	Equity	Tactical	$64.88	0.35%	4.0%	47.1	4.6%	0.3%	0.01
ZEB	BMO EQUAL WEIGHT BANKS INDEX ETF	Equity	Tactical	$24.73	0.55%	6.0%	61.0	9.0%	5.0%	0.08
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	Equity	Core	$45.75	0.30%	8.0%	47.5	9.3%	1.1%	0.02
ZWK	BMO COVERED CALL US BANKS ETF	Equity	Tactical	$21.25	0.65%	6.0%	70.2	10.3%	10.2%	0.15
	Total Equity					64.0%		76.8%		
	Non-Traditional/Hybrids									
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	Hybrid	Tactical	$9.06	0.45%	7.0%	40.9	7.0%	6.6%	0.16
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$22.29	0.45%	6.0%	65.7	9.7%	5.9%	0.09
	Total Alternatives					13.0%		16.7%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.34%**	**100.0%**	**40.7**	**100.0%**	**3.5%**	**0.09**

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%
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	8.0%
ZLU	BMO LOW VOLATILITY US EQUITY ETF	8.0%
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	8.0%
ZDB	BMO DISCOUNT BOND INDEX ETF	7.0%
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	7.0%
ZPR	BMO EQUAL WEIGHT BANKS INDEX ETF	7.0%
ZEB	BMO COVERED CALL US BANKS ETF	6.0%
ZWK	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%
ZHP	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	6.0%
ZQB	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	5.0%
ZEQ	BMO LADDERED PREFERRED SHARE INDEX ETF	5.0%
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	4.0%
ZTL	BMO LONG-TERM US TREASURY BOND INDEX ETF	3.0%
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	3.0%

Source: Bloomberg, BMO Asset Management Inc. (As of July 10, 2020).



Non-Traditional (13.0%)
Equities (64.0%)
Fixed Income (23.0%)

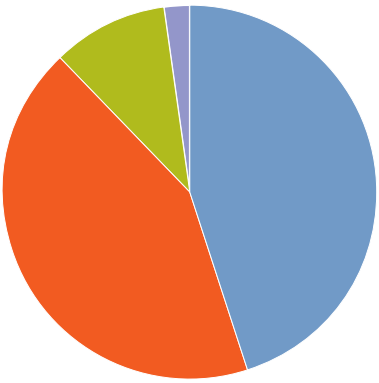
Core	50.0%
Tactical	50.0%

*Management Fee as of June 30, 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

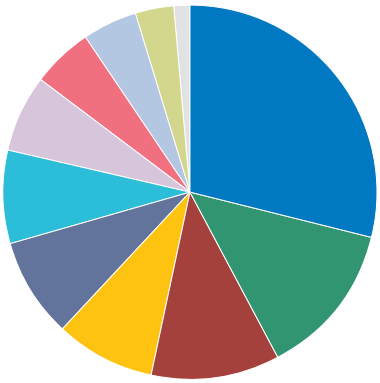
Regional Breakdown (Overall Portfolio)



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

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

Equity Sector Breakdown



Financials	29.00%
Health Care	13.48%
Consumer Staples	11.04%
Utilities	8.60%
Industrials	8.62%
Information Technology	7.94%
Consumer Discretionary	6.82%
Communication Services	5.21%
Real Estate	4.69%
Materials	3.46%
Energy	1.14%

Fixed Income Breakdown

Federal	21.8%
Provincial	10.5%
Investment Grade Corporate	67.7%
Non-Investment Grade Corporate	0.0%

Weighted Average Term	9.81
Weighted Average Duration	8.04
Weighted Average Coupon	2.9%
Weighted Average Current Yield	2.6%
Weighted Average Yield to Maturity	1.5%

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 July 10, 2020).

The Good, the Bad, and the Ugly

Conclusion: Risk assets have rallied back over the quarter, which has partially been due to a function of liquidity being restored. However, the extent of the rally may be over-exaggerated with equity benchmarks closing in on pre-pandemic highs. Markets are seemingly pricing in a V-Shape recovery, when in reality, some industries may have been transformed in perpetuity; consolidation is likely at the detriment of businesses with weaker balance sheets. We believe equities will likely continue to outperform over the next 12-months, but the market will again gravitate toward more defensive growth areas when the euphoria fades. As a result, higher quality companies with strong balance sheets in both equities and fixed income should constitute the core of portfolios, with more thematic exposures such as Canadian banks and health care making up the peripheral. As risk assets continue to grind higher, investors should still favour growth, but also exercise caution, especially with the uncertainty surrounding the upcoming U.S. presidential elections.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• Jobless numbers in the U.S. have often displayed positive surprises, which may indicate the economy is in better shape than the market is estimating. • Canada's economy is slowly moving toward phase-3 re-opening, as cases in the country seem to be more under control, especially relative to our neighbours south of the border.	• While earnings-based valuations may be difficult to estimate, balance sheet strength is still applicable, with companies showing low debt/assets still being fundamentally sound. • Credit spreads in higher quality corporate bonds have tightened more than BBB rated bonds over the quarter. Investors looking for BBB rated bonds may want to seek diversified exposure through an ETF, rather than an individual bond.	• The U.S. put/call ratios have been restored to normalized levels. This means there is less bearish sentiment compared to March. • The current levels of the CBOE Volatility Index® (VIX) have declined to near normal levels.
Bad	• COVID-19 cases in the U.S. continue to spike, which may intensify with increasing protests and social gatherings. • Further uncertainty may be in store with the U.S. presidential elections coming this fall.	• Forward guidance on earnings estimates will continue to be difficult. As a result, traditional measures of valuations, such as price to earnings ratios (P/E), will be less reliable.	• Fear/greed levels are now much flatter, which is positive, meaning the market has struck a better balance between buyers and sellers. However, for market participants looking for easy gains, those opportunities have likely passed.
Ugly	• Household debt in Canada is still one of the main concerns, and the recent easing of monetary policy will simply amplify the problem. • Unemployment levels are at historic highs. While some job losses may be temporary, others will be more permanent.		• Margin debt is still one of the key contributors in how quickly risk assets can rise and how quickly they can fall. The central banks' moves to increase their bond buying programs will only intensify this. Expect even more velocity during the next crisis.

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