Navigating Yields

Demystifying the Reliability of an 8% Target Yield with the BMO Strategic Equity Yield Fund

The asset management industry certainly does not have a shortage of yield generating offerings these days. Clients' need for cash flow stability has become an increasingly common topic and asset managers across the industry have been consistently developing offerings to try to meet this need. BMO Global Asset Management (GAM) has been at the forefront of this evolution for over a decade, and we feel strongly about ensuring that clients understand exactly how our offerings generate yield and what to expect from them to aid in their portfolio construction.

The BMO Strategic Equity Yield Fund (SEYF) has a target yield of 8%, which we feel very comfortable being able to maintain. The reasons why are directly tied to the basic factors of what influences coupons that we are able to collect on the underlying structured notes that we are exposed to (see link for a fulsome overview of SEYF).

Three drivers of coupon levels

Interest Rates

Equity Volatility[1]

Dividends

Lower interest rates means

- slightly lower coupons
- BUT partially offset by lower cost of derivatives required to achieve higher coupons. Think of this as an embedded cushion.
- i.e. not a 1 to 1 impact

Higher equity volatility means:

- higher coupons (monetizing volatility)
- example: in 2020 when rates were almost zero, the equity volaility drove coupons into the 20% range.
- i.e. lower interest rates should not be viewed as a sole contributor.

Higher Dividends means:

- higher coupons
- can target higher dividend payers if we choose

When constructing a portfolio with a diversified exposure to these structured solutions, the portfolio managers have a number of levers to pull on in order to ensure that our target yield is met while keeping portfolio diversification and risk management top of mind.

Our portfolio is constructed to ensure that a meaningful cushion is in place to increase the certainty of our expected coupon collection.

This is achieved by:

- A deeper buffer protection when volatility expectations are elevated.
- Diversified exposure to sectors and geographies with a focus on more defensive exposures when uncertainty is elevated.
- Diversified exposure to underlying notes
  - sizing of individual exposures
  - different entry points
- Remaining opportunistic
  - Actively take advantage of heightened volatility to deepen protection and increase coupons.
  - Upsize existing attractive positions.
  - Sell out of positions when better terms appear in the market.

SEYF has the benefit of marrying the structure and income[2] stability of structured notes with the evergreen nature of a diversified and liquid mutual fund. BMO GAM has the unique ability to combine the skillsets of members with a deep background in structured notes creation on the capital markets side with those that have a deep background in managing investment funds, particularly focused on derivatives and asset allocation. Having this distinctive competitive advantage allows us to deeply understand the weeds of the notes market and know how to allocate accordingly to ensure risk management is achieved and stated outcomes are steadily attainable.

Speaking of risk management and active portfolio management, as we know that interest rates and volatility are the biggest drivers of coupon levels, we would like to share the output of a sensitivity analysis relating to these shocks in order to demonstrate the impact on coupons (i.e. portfolio yields) using a Canadian bank autocallable note as reference.

The interest rates section of the below table represents parallel interest rate shocks of 0 to -150 basis points (bps). Given that the Canadian Overnight Repo Rate Average (CORRA) is currently at 3.00%, a 150bps shock would bring the policy rate to about 1.5%, which is low versus historical levels. Interest rates have less of an impact than equity volatility, as you will see in the sensitivity table.

We also chose a shock on equity volatility of 0% and -3%, given that dropping the equity volatility of Canadian banks by 3% would bring it in line with historical lows.

Coupon	Interest Rate (bps)	Equity Volatility (1yr ATM vol[3])
11.910%	0.00	0.000%
11.310%	-25.00	0.000%
11.050%	-50.00	0.000%
10.790%	-75.00	0.000%
10.250%	-100.00	0.000%
9.840%	-125.00	0.000%
9.470%	-150.00	0.000%

Coupon	Interest Rate (bps)	Equity Volatility (1yr ATM vol)
9.300%	0.00	-3.000%
8.940%	-25.00	-3.000%
8.470%	-50.00	-3.000%
8.170%	-75.00	-3.000%
7.700%	-100.00	-3.000%
7.350%	-125.00	-3.000%
6.960%	-150.00	-3.000%

Source: BMO GAM

As you can see, we would have to be in a historically low interest rate and low equity volatility environment, in order for our current exposures to risk reaching the target 8% target yield. Firstly, we do not anticipate being in that environment given our current economic backdrop. Secondly, if we happen to experience this, the stability that this type of economic backdrop brings would then allow the portfolio managers to comfortably adjust the structure to take on slightly higher risk to get higher yields by:

1. Reducing the protection level
2. Considering higher volatility names
3. Considering barrier instead of buffer protection
4. Higher allocation to different structures of notes, which could pick up 100bps to 200bps depending on the structure

In a nutshell, not only are we comfortable achieving a target yield of 8% in this environment given our current positioning, having the ability to deeply understand the weeds of the notes market and know how to allocate accordingly, ensures that our stated outcomes are steadily attainable in a wide range of economic backdrops.

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[1] Volatility: Measures how much the price of a security, derivative, or index fluctuates. The most commonly used measure of volatility when it comes to investment funds is standard deviation.

[2] This income comes directly from the notes and in no way means that the distribution from the fund will be income only.

[3] 1-year at the money volatility: Refers to how much an asset's price is expected to fluctuate over the next year, as implied by the prices of options that have a strike price close to the current stock price and expirations around one year.