Dividend Investing with Covered Calls

BMO Covered Call Canadian Banks ETF Fund
BMO Covered Call Canada High Dividend ETF Fund
BMO Covered Call U.S. High Dividend ETF Fund
BMO Covered Call Europe High Dividend ETF Fund

Investors are looking for alternative ways to generate sustainable yield without taking on additional risk. Covered call strategies, also known as buy-write strategies, are efficient solutions that can add yield to a portfolio without increasing equity risk. BMO Global Asset Management (BMO GAM) uses exchange traded funds (ETFs) to efficiently access covered call strategies. BMO GAM launched covered call ETFs in 2011 and is the Canadian leader in this space. Building off the success of the ETFs, BMO GAM offers these covered calls in ETF based mutual funds to address the income needs of investors.

Why Dividend Investing?

In a low interest rate environment, the demand for income may not be met by fixed income investments alone, requiring an equity allocation for both income and growth. Over the long term, equities have delivered capital appreciation, with a superior return profile when the equity selection process focuses on dividend-paying stocks. Historically, dividend-paying stocks have consistently outperformed non-dividend paying stocks with the added benefit of less volatility.

Why Covered Call Writing on Dividend Paying Companies?

Covered call option strategies allow the portfolio to generate income from the written call option premiums in addition to the dividend income from the underlying stocks. Constructing a portfolio with less volatile dividend stocks, allows for a lighter touch when it comes to writing covered calls, as the underlying holdings provide a strong yield base.

Where Does The Yield Come From?

ETF	BMO S&P 500 Index ETF – ZSP	BMO US Dividend ETF – ZDY	BMO US High Dividend Covered Call ETF – ZWH
Yield	1.55	2.86	5.47

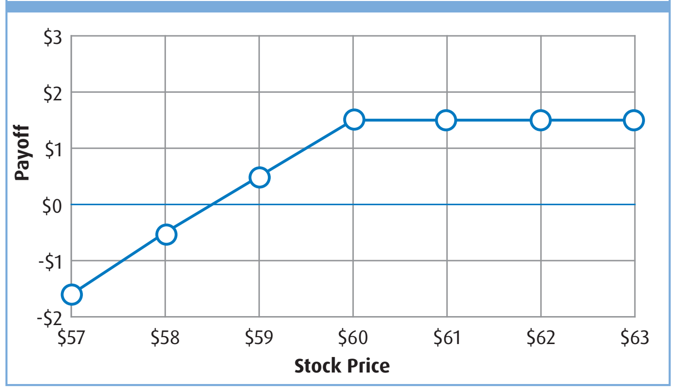
Yield as of March 29, 2018.

Understanding Covered Calls

Covered calls are implemented by writing (selling) a call on the underlying stock. The portfolio receives a premium, providing additional yield, by selling the buyer the option to purchase the stock at a later date at an agreed upon price (the “strike” price).

Example:
A portfolio consists of 100 shares of a stock with a current price of $60, for a total value of $6,000. At the money call options (strike price of $60) that expire in one month are valued at a premium of $1.50 per contract. To implement a covered call strategy, the portfolio writes call options on 100 shares and receives $150 in premium.

Payoff Characteristics of Owning 100 Shares and Selling 1 ATM Call Option



For illustrative purposes only

BMO GAMs Covered Call Strategy

BMO GAM's covered call strategies provide exposure to dividend yielding companies in Canada, U.S. and Europe, with lower volatility and higher income. The covered call option strategy is most effective when the underlying stocks are not overly volatile resulting in a portfolio that is less susceptible to significant declines and does not hit the call option ceiling as frequently.

The Canadian Banks Fund, equally weights the largest banks in the country. The Canadian, U.S. and European high dividend funds screen the underlying holdings based on our proprietary dividend methodology which focuses on historical dividend growth and sustainability while also taking into account option liquidity. Our covered call strategy effectively creates an additional income stream from equity investments while reducing equity risk, making it an efficient portfolio construction tool.

More on BMO GAMs Covered Call Writing

- Sell 'Out of the money' (OTM) options on approximately 50% of the portfolio, which gives the investor an enhanced yield and still allows for participation in rising markets.
- Sell further OTM options when volatility increases. This allows the ETF to have further potential upside participation. Conversely, if volatility decreases, BMO GAM selects options that are closer to the market price, as there is less potential for significant short term price appreciation.
- Short dated call options, typically 1 – 2 months to expiry, in order to take advantage of time decay and to reset the portfolio in rising markets.

Call Writing Implementation

The written percentage of the portfolio is consistent across our suite of funds. The option's strike price will depend on the available option premiums and general economic conditions.

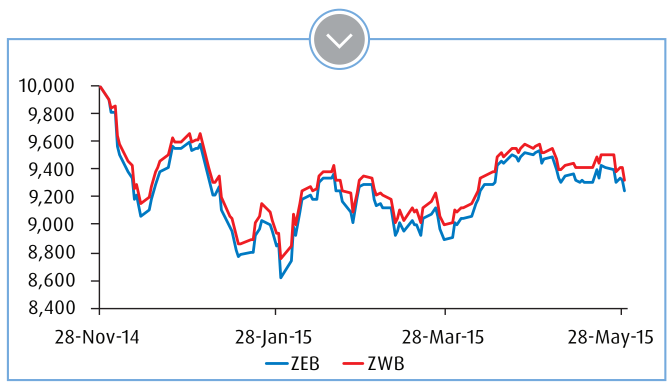
The covered call strategy sells further OTM when volatility rises and closer when volatility drops. When volatility rises, the option increases in price. This allows the portfolio managers to select further OTM options and still maintain the desired level of call premiums.

This dynamic selection process allows the ETF to have further upside participation in volatile markets. Conversely, if volatility decreases, we select options that are closer to the market price, as there is less potential for significant short-term price appreciation.

Impact on Market Conditions

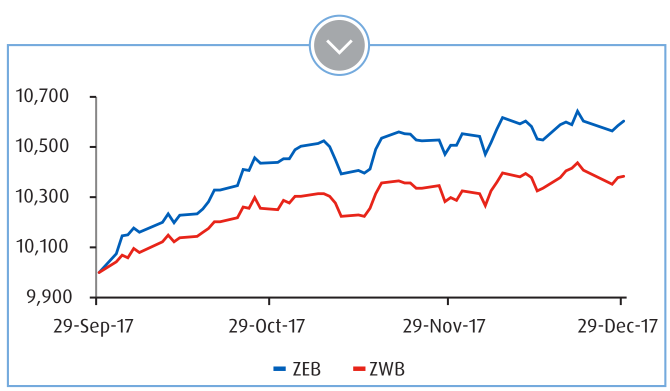
Historically, covered calls solutions have provided similar performance to the broad market with less volatility. Generally covered call strategies tend to outperform in slightly improving, flat or down markets, and underperform in periods of rapidly rising markets.

1. **Down Markets**
   The decline of the underlying stocks is partially offset by the call premium received. Generally covered calls will outperform their underlying portfolios.



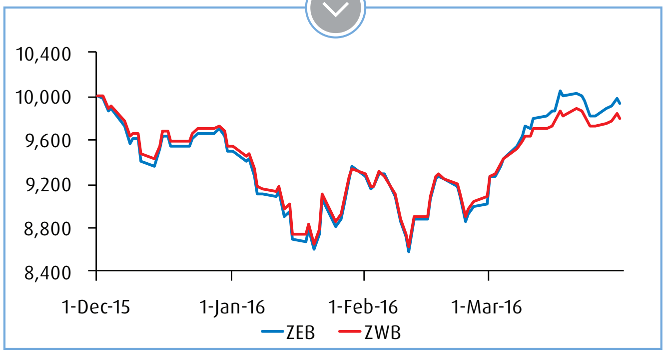
Source: Bloomberg. Daily returns from November 28, 2014 to May 29, 2015 for BMO Equal Weight Banks Index ETF (ZEB) and BMO Covered Call Canadian Banks ETF (ZWB).

2. **Rising Markets**
   When stock prices rise significantly and exceed the strike price, the call option will move into the money. This caps the gain for the call writer based on the strike price and premium received. Typically in rapidly rising markets, covered calls will underperform their underlying portfolios.



Source: Bloomberg. Daily returns from September 29, 2017 to December 29, 2017 for BMO Equal Weight Banks Index ETF (ZEB) and BMO Covered Call Canadian Banks ETF (ZWB).

3. **Volatile Markets**
   As markets become highly volatile, covered call strategies may underperform as the strike prices is written closer to the money and is reached more frequently. The covered call strategy may outperform if the strike prices are further out of the money. During volatile markets, covered calls performed similarly, but exhibited lower volatility.



Source: Bloomberg. Daily returns from December 1,2015 to March 30, 2016 for BMO Equal Weight Banks Index ETF (ZEB) and BMO Covered Call Canadian Banks ETF (ZWB).

Tax Efficiency

Covered calls appeal to investors who are looking for a high level of income, as well as the potential for capital gains. The funds treat the premiums earned from writing call options on the portfolio securities as capital gains. While the premiums earned are paid out as part of the monthly cash distributions, the premiums are combined with the gains and losses from selling underlying holdings which may result in higher return of capital.

Conclusion

BMO GAMs covered call portfolios are suitable for investors seeking better long-term risk adjusted returns, along with a tax efficient income stream. As covered call strategies are difficult and time consuming to run, mutual funds are an efficient way to access this strategy as the benefits of covered call strategies include enhancing income and lowering risk within an asset class, the strategies are very appealing to investors looking to generate more yield without layering on higher portfolio risk.