BMO ETF Portfolio Strategy Report

Fourth Quarter 2020

BMO EXCHANGE TRADED FUNDS

Managing Headwinds

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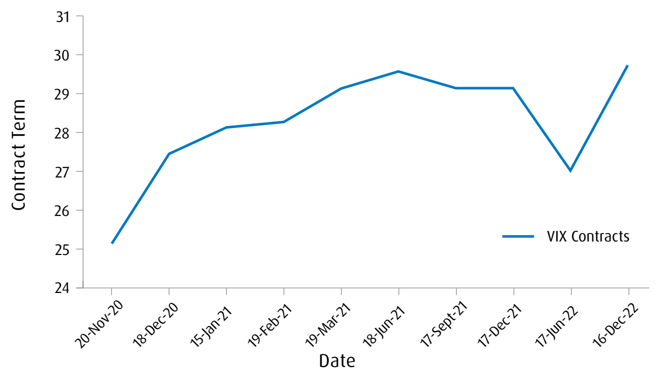
In this report:

All prices, returns and portfolio weights are as of market close on October 12, 2020, unless otherwise indicated.

- **The recovery in risk assets had seemingly stalled in September with the return of cyclical sectors flat-lining relative to defensive stocks.** The market is also anticipating volatility to remain elevated over the next several months as evidenced by the upward slope in the front end of the VIX futures term structure (Chart A). This uncertainty has mainly been a result of three factors: The upcoming U.S. presidential elections; impact of a second-wave of COVID-19; as well as a repricing of risk, given the market rally has likely surpassed underlying economic fundamentals.
- **While equities have bounced back to a degree in October on the hopes of another round of fiscal stimulus, the amount of funds is still being debated between Republicans and Democrats.** President Trump, who had previously mentioned that relief may be provided only after the elections, could likely be posturing, as too many small businesses would be hard hit without it. Regardless, the uncertainty will likely add to further volatility. This instability could also be exacerbated post-election if the eventual loser of the presidential race claims some form of voter fraud, through the use of "mail-in ballots," and further delays an outcome.
- **The shape of the recovery has been debated by many economists.** Optimists are anticipating a V-shaped trajectory, while those more pessimistic are anticipating a W-shape, and those in between are expecting more of a "swoosh." Some market participants have noted that asset prices have become disconnected with the economy, as accommodative monetary policy has led to a reflationary effect on risky-assets. Many are now touting the recovery to be "K-shaped," which suggests it will not be uniform and more likely benefit asset owners. The "K-shaped" recovery has been pointed out by Democrats, when in fact the reflationary impact of quantitative easing has been in play since 2009. While volatility is anticipated in the near future, we believe both monetary and fiscal stimulus should be supportive of stocks and bonds over the longer term.
- **A second wave of COVID-19 looks to be underway, with a growing number of cases seen in many countries since September.** The case fatality rate, however, does seem to be dropping and is now estimated to be 2.7% according to CDC data (Chart B), with most deaths skewed towards the 65 years and older population, and/or people with underlying health conditions. This is likely a result of better treatment protocols and more testing, which has identified a larger amount of positive cases (case fatality rate moving closer to infection fatality rate), predominantly from a younger demographic. Armed with more knowledge compared to earlier in the year, some countries may take a more systematic approach to a lockdown. This would offer a "sweet spot" that would allow the economy to recover, while also keeping the pandemic at bay. Should an effective vaccine and/or the pandemic peter out, yields can quickly shoot to the upside, particularly if the velocity of money accelerates. We believe investors should have a small part of their portfolio allocated to assets that benefit from rising rates, should assets quickly reprice if COVID-19 concerns abate quicker than expected.
- **While changes in some industries have not been primarily caused by the coronavirus, its effect has certainly sped up the process.** Retailers have been reducing their physical store footprint, and increasingly moving online. In energy, a combination of an oil-supply glut and focus on environmental values has reduced the emphasis on fossil fuels. Energy now makes up only 2.1% of the S&P 500 Composite and many of the constituents will likely no longer meet the criteria of inclusion in upcoming rebalances. Selling pressure in U.S. energy stocks may cause Canadian oil and gas companies to face headwinds as valuations will have to follow suit.

Chart A: VIX Futures Point to Elevated Volatility



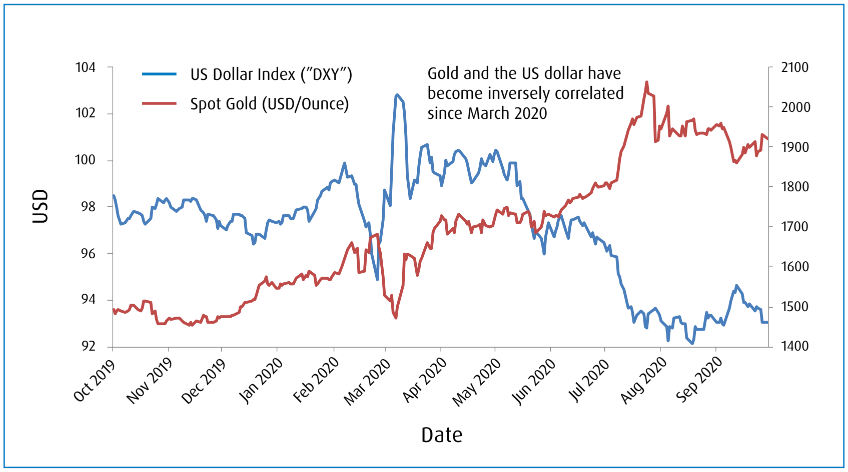
Source: Bloomberg.

Chart B: Analytics Can Be Used to Manage COVID-19 and the Economy

Age	Cases	Deaths	Case Fatality Rate
0 to 4	103,969	34	0.03%
5 to 17	386,129	62	0.02%
18 to 29	1,328,191	822	0.06%
30 to 39	928,087	2,055	0.22%
40 to 49	850,215	4,946	0.58%
50 to 64	1,145,920	23,998	2.09%
65 to 74	422,003	32,485	7.70%
75 to 84	239,388	40,811	17.05%
85+	175,516	48,846	27.83%

Source: Centers for Disease Control and Prevention (CDC) COVID Data Tracker as of October 12, 2020; Based on U.S. data only.

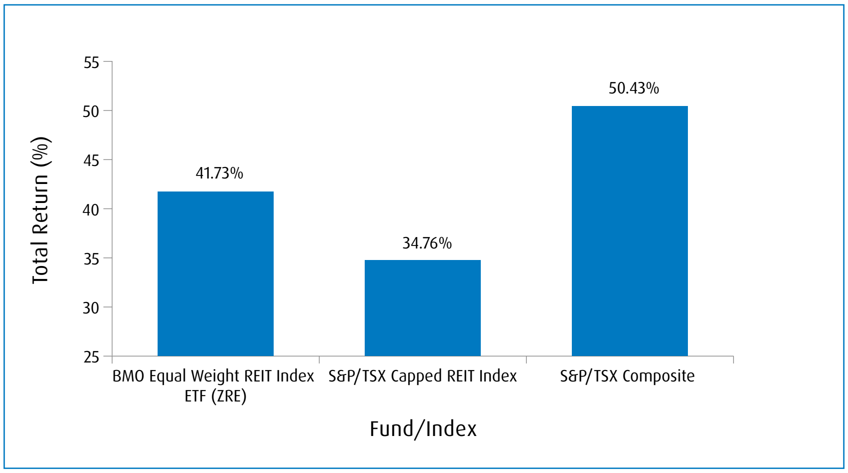
Things to Keep an Eye On



Source: Bloomberg, October 14, 2019 – October 12, 2020.

Gold prices have recently faced some headwinds after reaching an all-time high of US$2,063 per ounce in August. Despite the recent challenges, however, we believe the long-term reasons for owning gold remain intact. For instance, central banks continue to diversify their reserves away from currencies, especially as they weaken owing to rising debt across countries globally. Add to this, intensifying macro-economic and political uncertainty will likely continue despite the outcome of the U.S. presidential elections.

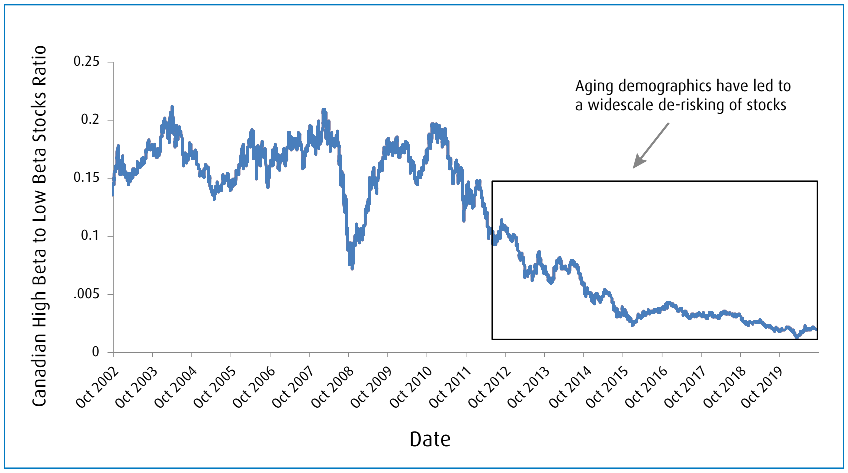
Recommendation: The pull-back in gold prices in recent weeks has so far been due to technical demand and supply. The majority of gold investors in the past year have been using the asset as a hedge against a weakening US dollar (USD). However, disruptions, due to the presidential race and the second wave of coronavirus, have led to currency strengthening, as illustrated by the U.S. Dollar Index (DXY). This has led investors to participate in profit-taking through gold and/or cover margin bets. Looking further out, we do believe the secular reasons for owning gold persist. The ***BMO Equal Weight Global Gold Index ETF (ZGD)*** provides diversified exposure to gold companies.



Source: Bloomberg, March 23, 2020 – October 12, 2020.

Real estate is an asset class that typically performs well as monetary policy becomes more accommodative. This benefits property values as they are typically financed through borrowing. In addition, an easy monetary policy tends to benefit hard assets, such as real estate, as it would require more of a currency to buy an asset in real terms. Given the recent surge in residential home prices globally, investors have looked to real estate investment trusts (REITs) in hopes of similar gains.

Recommendation: While Canadian REITs are also up significantly since the end of March, it should be noted that commercial real estate has been impacted far differently by COVID-19 than residential. Office and retail REITs have been negatively impacted whereas industrial and health care have been better insulated from the pandemic. Office and retail REITs tend have a larger market capitalization, which means a greater representation in traditional indices. Smaller alternatives, such as industrial, residential and health care, tend to be better represented in an equal-weighted index. The ***BMO Equal Weight REITs Index ETF (ZRE)*** is an efficient way for investors to gain exposure to REITs while minimizing company specific risk.



Source: Bloomberg, October 15, 2002 – October 12, 2020.

Similar to the last stock market-cycle, which ended earlier this year, we believe the current cycle will favour more defensive growth. With aging demographics in developed countries, the wide scale de-risking of portfolios will continue. However, given low bond yields, longer life expectancy and higher cost of living, lower-risk equities will be used to provide growth in retirement portfolios. As such, we believe low-volatility equities and high-quality blue-chip stocks will continue to provide a safe haven for the majority of investors.

Recommendation: We are already starting to see the shift from lower-quality high-beta stocks (which tend to outperform coming out of a trough) to higher-quality lower-beta names. As illustrated in the Canadian high- to low-beta stocks in the previous two cycles, lower volatility options were far more favoured since 2012. This is due to the influence of aging investors, who make up the majority of asset owners either directly or through pensions, and have been de-risking from cyclical stocks to more conservative choices. We anticipate this trend to continue throughout the current cycle, which is why we utilize the ***BMO Low Volatility Canadian Equity ETF (ZLB)*** as one of our core positions.

Changes to Portfolio Strategy

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Mid-Term US IG Corporate Bond Index ETF	ZIC	2.0%	BMO Long-Term US Treasury Bond Index ETF	ZTL	2.0%
BMO Laddered Preferred Share Index ETF	ZPR	2.0%	BMO MSCI USA High Quality Index ETF	ZUQ	2.0%

Asset Allocation:

- This quarter, we are making a slight change to our asset mix by increasing our allocation to equities by 2.0%. The expected near-term volatility may provide investors with an attractive entry point to get into high-quality stocks. In order to better balance the growth in our portfolio, however, we will make some slight adjustments to our allocations within asset classes.

Fixed Income:

- While bond yields have gradually grinded lower in the last decade, rates became further compressed in the wake of the Coronavirus outbreak. Central banks have relaxed monetary policy by taking overnight rates to near-zero or negative and rolled out non-traditional measures, such as quantitative easing. While this will provide a better opportunity for the economy to get back on its own two-feet, it will make sourcing yield for investors more challenging. The Canadian and U.S. 10-year bond yield currently sit at 0.63% and 0.77%, respectively. While it may be near impossible to extract sufficient yield from fixed income, bonds still play a critical role in portfolio construction as they offset volatility from the equity side of a portfolio.

- In light of the anticipated heighted volatility, we are increasing our position in the ***BMO Long-Term US Treasury Bond Index ETF (ZTL).*** While this position may be volatile in isolation, it tends to have a strong negative correlation with risk-asset such as equities. As we increase risk on the equity side of the portfolio, we will use the increased allocation to ZTL to offset the risk.

- To fund the switch into ZTL, we will decrease our position in the ***BMO Mid-Term US IG Corporate Bond Index ETF (ZIC)*** by 2.0%. This move allows us to maintain our currency exposure as both ZTL and ZIC provide USD exposure.

Equities:

- While equities will likely experience some volatility over the next three to six months, we believe they will outperform other asset classes over the longer term. As previously mentioned, aging asset owners have tended to favour more defensive growth-oriented areas of the market. We believe "blue-chip" stocks that have competitive advantages in their industry provide growth, while also having less downside participation than the broader market. We are thus increasing our allocation to the ***BMO MSCI USA High Quality Index ETF (ZUQ)*** by 2.0%.

Non-Traditional/Hybrids:

- The ***BMO Laddered Preferred Share Index ETF (ZPR)*** has experienced significant gains since the announcement that banks will be issuing Additional Tier One capital bonds (AT1) to redeem outstanding preferred shares. We believe the banks focus on re-calling shares will provide the asset class with much needed stability in upcoming years. This should make preferred shares a critical component of portfolio construction as yield-oriented assets are becoming increasingly important. While we are still constructive on Canadian preferred shares, we are reducing our weight in ZPR by 2.0% to fund our increase in higher-growth equities.

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.

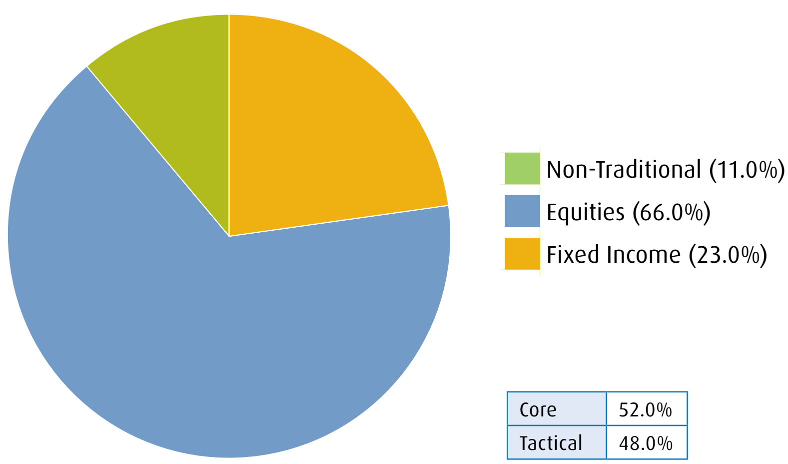
Stats and Portfolio Holdings

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	$17.36	0.09%	7.0%	3.5	1.8%	2.1%	0.58
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$20.63	0.25%	6.0%	7.9	3.4%	3.4%	0.43
ZQB	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$30.73	0.10%	5.0%	3.8	1.4%	2.5%	0.65
ZTL	BMO LONG-TERM US TREASURY INDEX ETF	Fixed Income	Tactical	$64.74	0.20%	5.0%	2.9	1.0%	2.1%	0.73
	Total Fixed Income					23.0%		7.5%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$33.00	0.35%	17.0%	14.1	17.2%	3.0%	0.21
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	Equity	Core	$22.28	0.05%	3.0%	15.8	3.4%	3.5%	0.22
ZLU	BMO LOW VOLATILITY US EQUITY ETF	Equity	Core	$39.07	0.30%	8.0%	13.8	7.9%	1.8%	0.13
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$22.62	0.40%	7.0%	15.8	7.9%	2.7%	0.17
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	Equity	Tactical	$23.78	0.40%	5.0%	17.8	6.4%	2.1%	0.12
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	Equity	Tactical	$68.55	0.35%	4.0%	21.4	6.1%	0.3%	0.01
ZEB	BMO S&P/TSX EQUAL WEIGHT BANKS INDEX ETF	Equity	Tactical	$25.75	0.55%	6.0%	17.5	7.5%	4.8%	0.27
ZUQ	BMO MSCI USA HIGH QUALITY INDEX ETF	Equity	Core	$48.40	0.30%	10.0%	17.3	12.4%	1.0%	0.06
ZWK	BMO COVERED CALL US BANKS ETF	Equity	Tactical	$21.79	0.65%	6.0%	32.1	13.8%	10.6%	0.33
	Total Equity					66.0%		82.5%		
	Non-Traditional/Hybrids									
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Hybrid	Tactical	$9.21	0.45%	5.0%	15.1	5.4%	5.9%	0.39
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	Hybrid	Tactical	$23.69	0.45%	6.0%	10.6	4.6%	5.7%	0.54
	Total Alternatives					11.0%		10.0%		
	Total Cash					0.0%	0.0	0.0%	0.0%	
	Portfolio				**0.33%**	**100.0%**	**14.0**	**100.0%**	**3.3%**	**0.24**

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 U.S. 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%
ZWK	BMO COVERED CALL US BANKS ETF	6.0%
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	5.0%
ZQB	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	5.0%
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	5.0%
ZTL	BMO LONG-TERM US TREASURY INDEX ETF	5.0%
ZUH	BMO EQUAL WEIGHT US HEALTH CARE HEDGED TO CAD INDEX ETF	4.0%
ZCN	BMO S&P/TSX CAPPED COMPOSITE INDEX ETF	3.0%

Source: Bloomberg, BMO Asset Management Inc. (As of October 12, 2020).



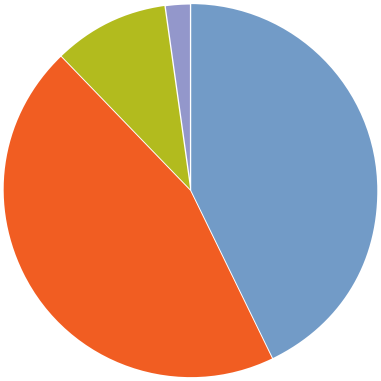
Core	52.0%
Tactical	48.0%

*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

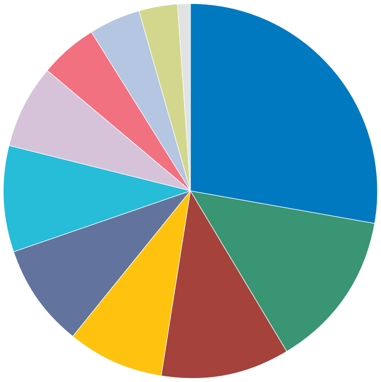
Regional Breakdown (Overall Portfolio)



Canada	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	27.95%
Health Care	13.51%
Consumer Staples	11.15%
Utilities	8.35%
Industrials	9.03%
Information Technology	8.96%
Consumer Discretionary	7.20%
Communication Services	5.10%
Real Estate	4.35%
Materials	3.40%
Energy	1.00%

Fixed Income Breakdown

Federal	29.2%
Provincial	11.0%
Investment Grade Corporate	59.8%
Non-Investment Grade Corporate	0.0%

Weighted Average Term	11.28
Weighted Average Duration	9.16
Weighted Average Coupon	2.8%
Weighted Average Current Yield	2.5%
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 October 12, 2020).

The Good, the Bad, and the Ugly

Conclusion: The number of risk items on the near-term horizon will likely lead to elevated market volatility. However, over the long run, we remain constructive of risk asset, such as equities, given the support of both fiscal and monetary stimulus. In addition, the coronavirus pandemic eventually will abate through a combination of the development of a vaccine, herd immunity and better logistical management. Eventually, this should pave the way for an economic recovery regardless of whom is elected the next "Leader of the Free World." As such, investors should position their portfolio defensively for the near term, while simultaneously building strategic positions in high-quality equities and corporate bonds. The stimulative measures, whether intentional or not, will be reflationary, leading to a "K-shaped" recovery, which likely will benefit those investors who remain invested.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• U.S. unemployment has ticked down to 8.8%, with many jobs coming back online. Continuing jobless claims is also trending lower. • Residential property values have been on the rise in many markets, due to lower interest rates and many moving towards a work from home (WFH) model. Higher home values allow investors to take out credit against their homes and better access necessary capital.	• While earnings-based valuations may be difficult to estimate, balance sheet strength is still applicable, with firms showing low debt and 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.	• Fear/greed levels are now much flatter, which is positive, and means n buyer/seller dynamics are more balanced. However, for market participants looking for easy gains, those opportunities are likely gone. • Bullish U.S. investor sentiment is on the rise, according to the American Association of Individual Investors.
Bad	• Household debt in Canada is still one of the main concerns, and the recent ease of monetary policy will likely expand this further. • While unemployment has improved, a second wave could put some of those jobs at risk. • Unemployment levels are at historic highs. While some may be temporary, others will be more permanent.	• Forward guidance on earnings estimates will continue to be difficult. As a result, traditional measures of valuations, such as the price to earnings ratio (P/E), will be less reliable.	• Increasing market reversals have been making it more difficult for trend followers, and quants using cross-asset signals to establish patterns.
Ugly	• After a re-opening in many parts of the economy, a clear second wave of COVID-19 is now forcing many economies to re-shutter. This will place further strain on many local economies. • Political posturing in the U.S. may delay the fiscal stimulus that many are in dire need of. This could cause many small businesses to fail.		• 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 phase of the crisis.

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