THE VAULT

BMO ETF Investment Counsel & Family Office Newsletter

September 30 2020

Welcome to the inaugural BMO Exchange Traded Fund Quarterly Investment Counsellor & Family Office Newsletter. Supported by significant technological changes and inspired by the desire to provide independent advice, the Investment Counsel and Family Office model has grown enormously in Canada over the last few years. The Portfolio Managers Association of Canada (PMAC), now comprises over 275 firms managing over $2.75 trillion.

Investment Counsellors and Family Offices provide more than mere investment advice – they are built on comprehensive Wealth Management, starting with coherent Financial Plans, expressed through Investment Policy Statements and supported by detailed Insurance, Tax and Will & Estate Planning.

The demographic evolution was a catalyst for the wealth management industry to improve both the scope and the quality of the services it provides to a burgeoning High Net Worth and Ultra High Net Worth investor class. Practitioners with the Discretionary Portfolio Manager designation combine the knowledge and experience required to serve a sophisticated and demanding clientele.

The major distinction between a Discretionary Portfolio Manager and an investment advisor lies in the Fiduciary responsibility incumbent on PMs. Under Common law, Fiduciaries are obliged to ensure client interests are paramount under all considerations. Anyone can perform asset allocation, but Fiduciaries are held to a Standard of Care when selecting products to capture exposures and must ensure effective execution in their delivery.

Our objective is to make this newsletter a valuable resource for all Investment Counsellors and Family Office practitioners. Exchange Traded Funds, being low cost, transparent and tax effective mechanisms, provide a solid foundation for PMs to express high convictions in client portfolios. Our articles will cover core themes like Fixed Income, Equity Factors, ESG, and taxation. We pledge to provide material which you can use in discussions with your clients, guidance to deepen your relationships and to hone your practices. As part of our commitment to supporting you through educational resources please see links below to some of our key documents:

- Road Map: EN / FR
- Quick Reference Guide; EN / FR
- What's Trending: EN / FR
- BMO FTSE Russell Monthly Fixed Income Report; EN / FR
- BMO MSCI Quarterly ESG Report Card; EN / FR

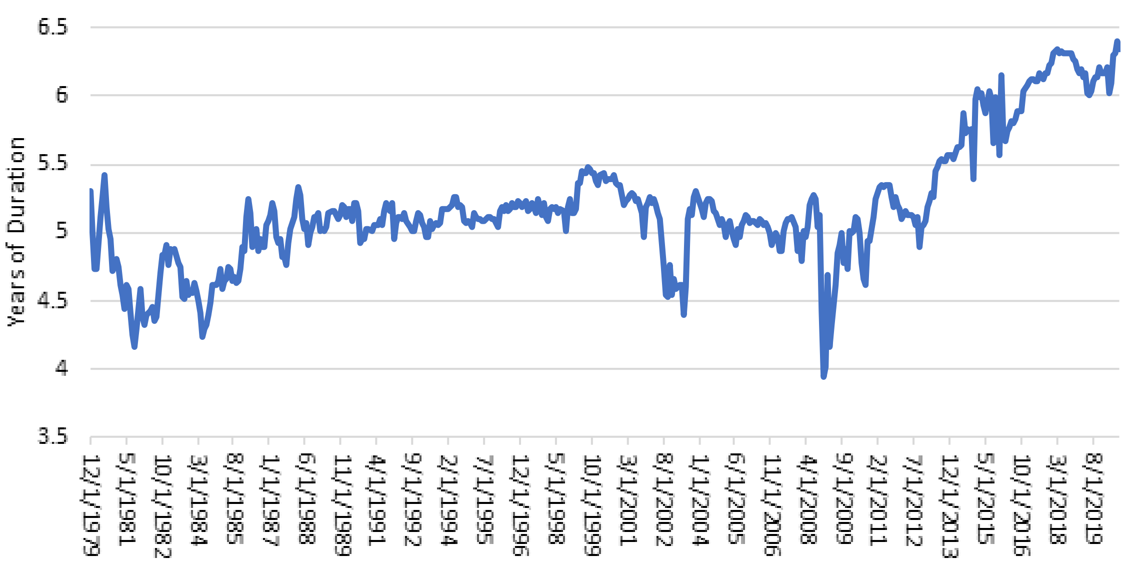
The 60/40 Portfolio in Question

"The biggest room in the world is the room for improvement." – Helmut Schmidt

Frederick Demers
Director, Investment Strategy & Portfolio Manager, Multi-Asset Solutions

The 60/40 balanced stock-bond portfolio had a great run for a number of decades, but rumours of its death are back with the collapse of interest rates across the yield curve. Should we retire the 60/40 given the 10-year Government of Canada bond barely yields 0.5 per cent and the 30-year bond is hovering near one per cent? Our answer: it's a bit early to write the obituary for the 60/40 portfolio. True, balanced portfolios have greatly benefited from the 40-year downtrend of interest rates. However, the main reason why we think the balanced portfolio remains attractive to long-term investors is how well of a diversifier bonds are to the equity portion of the balanced portfolio. That remains true even in today's low-yield environment, although global investors are increasingly exposed to interest-rate duration risk (See Chart 1). There is no doubt the industry must continue to adapt and innovate to address the low-yield environment. Balanced portfolios have helped dull some of the market volatility during the historical COVID-19 market storm and such volatility dampening effects can support investors' ability to maintain a long-term view during challenging markets.

Chart 1: Increasing Interest Rate Duration for Bloomberg Barclay US Aggregate Index



Source: Bloomberg, BMO Global Asset Management, as of August 2020

Government bonds as a risk buffer: Some diversification and lots of duration

Even with ultra-low bond yields heading into 2020 and the COVID-19 crisis, balanced portfolios benefited from having safer fixed income investments and from falling interest rates. While negative correlations make for greater diversification benefits, low positive correlations or the absence of abysmal negative outcome from fixed income versus equities offers a first layer of downside protection to balanced portfolios. The negative correlation between stocks and bonds that has prevailed for the past 20 years (See Chart 2) has made the balanced portfolio the tennis star Roger Federer of investing: he's getting old, but still wins.

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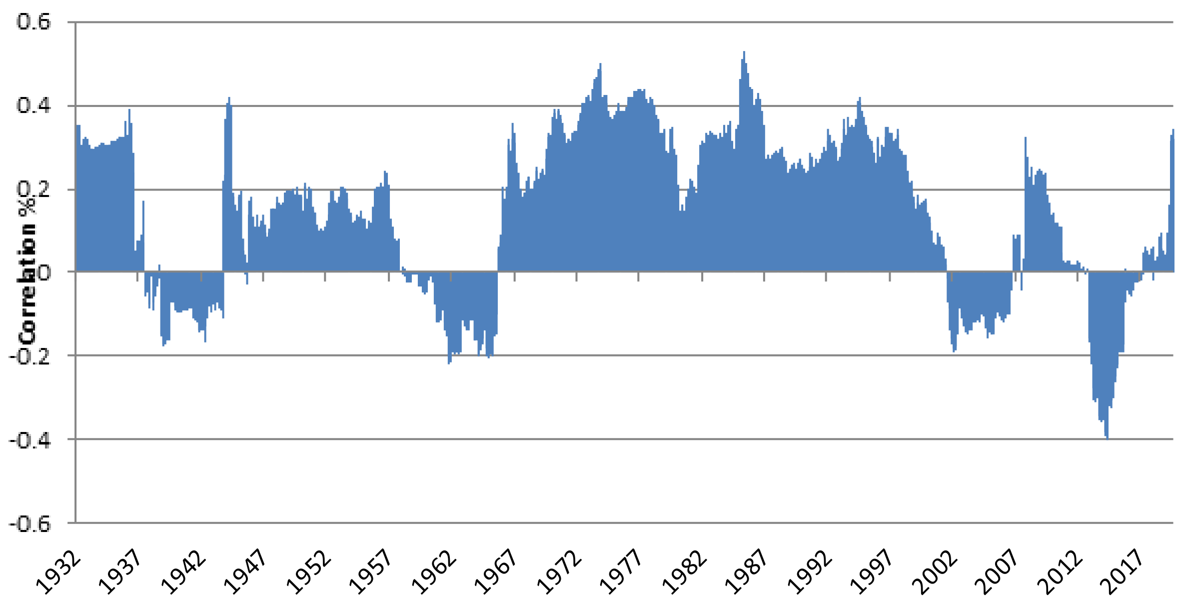
Chart 2: 5-year Rolling Correlation between Stocks and Bonds



Source: Federal Reserve Bank of St. Louis, Bloomberg, BMO Global Asset Management. Note: Bond returns calculated based upon the hypothetical total return derived from the Moody's Seasoned Aaa Corporate Bond Yield Index. Stock returns are represented by the S&P 500 Index. As of 08/26/20.

With a yield of about 2.5 per cent, barely above long-term inflation of two per cent and less than half of what it was in 2001, it's fair to say the lemon has been squeezed although there remains a bit of juice.

Looking at current yield levels for the constituents of Canada's fixed income benchmark, the FTSE TMX Canada Universe Bond Index, we estimate that portfolios would earn roughly nine per cent over one year if a large negative macro shock brought interest rates down to zero per cent on the entire spectrum of Canadian fixed income assets.

In this context of low long-term return expectations for benchmark fixed income assets, investors are yield starved more than ever. For longer term investors who have greater leeway to sustain portfolio volatility given their lower liquidity needs, adding riskier or alternative assets is a possible solution to low yields.

The 70/30 as the new 60/40?

Increasing the equity portion of a portfolio is the first option for investors seeking to boost their expected returns without adding new assets to their portfolio. However, moving away from a 60/40 to a 70/30 mix entails a significant impact to portfolio risk, notably in light of the equity pain inflicted by the COVID-induced crash or the great financial crisis. Adding 10 percentage points of equities while reducing bonds by the same amount increases the long-term expected volatility from about 12 per cent to 14 per cent.

Yield starvation will cause wild yield hunting season

A more subtle option is to reshuffle exposures within the fixed-income portion of the balanced portfolio. For many investors, re-allocating away from low yielding government bonds to higher yielding provincial, municipal or corporate debt is generally easier to implement as a quick fix to increase the yield of a portfolio, but even that simple re-allocation has limits and inevitably translates into higher portfolio risk and tracking error versus benchmarks.

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However, given that central banks continue to act boldly with asset purchasing programs to support markets, investors are highly confident that policymakers will keep supporting markets in case of an economic slump or adverse market event. We expect flows toward credit assets to remain strong as monetary policy sticks to its whatever-it-takes mantra.

Yield starvation will increase appetite for alternatives

The rise of alternative investments has been partly fueled by collapsing bond yields during the past decade and the proliferation of easy-to-access alternative investment opportunities. We expect investors to further reduce their allocation to traditional stocks and bonds for a greater allocation to alternatives such private equity, liquid alternatives, or commodities.

Sound manager selection and a thorough due diligence process are critical ingredients when investing in alternative opportunities, such as Hedge funds or private investment vehicles that tend to be more opaque and less liquid. The greatest portfolio benefits of adding alternatives depend more crucially on sound portfolio construction than tactically picking investment styles or managers. We believe a well-diversified multi-strategy portfolio of alternatives is more likely to deliver robust risk-adjusted returns rather than tactically shifting from say global macro to real-estate. Tactically allocating amongst alternatives – much like the market timing of stock vs bonds – is never easy and may be liquidity constrained.

A potential hurdle against alternatives for some institutional investors are the higher fees associated with alternative investments. This is even more a concern for investors because of the decline in alpha generation observed across core alternative investment styles such as long-short equities or macro managers in recent years. The potential diversification benefits must, therefore, be weighed against the expected returns and the fee structures attached to such investment opportunities.

Higher equity allocation, but paying to hedge against downside risks

Another option for investors is to increase their equity allocation, but spend a few percentage points of the portfolio value every year to purchase stock-index put options for downside protection. While such a strategy sounds attractive on paper, the equity-volatility risk premium is such that the costs to passively purchase such hedges are generally prohibitive and eat away a large portion of the extra return obtained by the higher equity allocation.

Conclusion

Asset allocation remains the single most important decision for meeting client objectives. Investment managers have access to more asset classes but they may want to consider the costs and unintended risks some alternatives may pose to long-term portfolio performance. The traditional 60/40 asset mix remains a compelling model which can be managed for minimal cost and without liquidity risk. Adapting credit exposure and geographic equity exposures as markets change may provide some of the Alpha and risk reduction investors seek through alternatives.

Alternatives remain an interesting solution for sophisticated investors who can perform the required due diligence. Larger Institutions which have long-term investment horizons and adequate cash flow to cover liabilities can implement strategies which may be more difficult for smaller investors with shorter investment horizons or with more pronounced income needs.

Continued

Mark Webster
Director, Institutional and Advisory, Western Canada

Cannot see the forest for the trees

Interest in Environment, Social & Governance (ESG), has increased noticeably in recent years. The COVID-19 pandemic has been a sobering experience, highlighting the degree to which natural events shape the economy and society, forcing companies to confront governance issues.

Deloitte has forecast that money managed according to ESG principles may comprise half the asset base in the US industry by 2025 (Deloitte), a remarkable figure considering the US asset management industry is the world's largest.

There is a concurrent demographic catalyst which Investment Counselling and Family Offices should consider. Studies show that ESG interest is prominent across all age groups, but rises significantly amongst younger generations:

- Baby boomers (1949-1967): 67%
- Generation X (1978-1982): 79%
- Millennials (1983-2000): 86

Source: PRI 2018 Reporting Framework responses; "Global perspectives on sustainable investing – Global Investment study" Schroders, 2017; Wealth X and NFP Wealth Transfer Report, 2016.

Investment Counsellors and Family Offices, and clearly any advisor, should be aware that ESG may be a major discussion point when assets are bequeathed.

Responsible investing has evolved significantly. It started with Quaker groups in the 1920s when investors wanted to ensure their capital was being directed towards businesses whose practices did not contradict basic Quaker principles. Similar considerations emerged during the Great Depression when investors demanded that capital be directed towards good corporate citizens. In the late 1960s and into the 1970s, ecological & environmental concerns brought renewed focus on how companies behaved.

These early responsible investment expressions were based on strong beliefs about what could be defined as an undesirable exposure. They were not wrong, but they posed significant concerns for Institutional and Discretionary managers because, as Fiduciaries, they are obliged to meet prescribed return objectives outlined in Investment Policy Statements. In January 2020 Harvard's Faculty of Arts & Sciences voted to demand Harvard Management Company, responsible for the Harvard Endowment, divest from carbon & fossil energy sources. As a Fiduciary, HMC could not comply because divestment and exclusion would constrain performance and returns (Harvard).

As McCarthy Tetrault has noted, incorporating qualitative ethical policies into the investment management process may pose unintended legal risks. Investment policy statements would have to be rewritten in order to state the qualitative objectives and to acknowledge their potential impact on returns (McCarthy Tetrault: Pension Fund Investment: Managing Environmental, Social & Governance (ESG) Integration, 1 May 2019).

Continued

ESG is much more than a preference to apply capital according to ethical guidelines; it is a sound investment concept rooted in risk management. In its essence, ESG seeks to allocate capital to well-managed businesses which have better future prospects than their competitors within a sector. The term *stranded assets* has been coined to describe businesses which face obsolescence as new, cleaner energy alternatives supplant traditional carbon or fossil sources. Stripped of its environmental cloak, a good asset manager should not invest in companies with uncertain future revenues.

Although more people acknowledge ESG's importance, the question remains - how to integrate ESG into the investment process? Becoming a UN PRI Signatory and buying data from a respected provider is very expensive and requires enormous resources. This may be suitable for large asset management firms which have the scale and the resources to devote, but it would be a risky endeavour for an Investment Counsellor or Family Office.

Instilling confidence on ESG is incredibly difficult because there are so many variables, invariably leading to different opinions. Simply put, ESG should strive to meet the United Nation's 17 Sustainable Development Goals, outlined below:

Given the divisive discussions which ensue when discussing ESG, it may be better to consider a transparent, rules-based index methodology which can be used to build consensus. Several large Asset Owners have used the MSCI ESG Leaders Indices because they couple a robust measurement and monitoring analysis with the ability to construct Benchmark investable indices. Transparency provides a firm foundation to discuss the exposure with stakeholders. The index construction is designed to capture 50% of the market capitalization in all sectors, to minimize Tracking Error and thus fulfill Fiduciary return considerations, but selects only those constituents which exhibit exemplary ESG scores in their sub-industry.

Forests are eco-systems whose health is measured in aggregate, not by measuring each tree or stream. If we start with the simple concept that a glass must be half full before it can be considered half empty, a methodical transparent, rules-based exposure like the MSCI ESG Leaders can be tabled to seek consensus so Capital can be responsibly allocated. When the aggregate exposure is measurable and understandable, stakeholders can establish a co-operative framework to integrate ESG into the investment process.

Continued

Much like the famous Brinson, Beebower & Hood study showed in 1988, security selection or omission is not material to meeting long-term objectives. Portfolio construction, its rules and regional exposures, are the major consideration. Applying similar thinking to integrating ESG into the investment process may help Investment Counsellors and Family Offices to establish consensus with clients on a very difficult topic.

BMO ESG ETFs

Equity

ESGA
BMO MSCI Canada ESG Leaders Index ETF
Mgmt Fee: 0.15%

ESGY
BMO MSCI USA ESG Leaders Index ETF
Mgmt Fee: 0.20%

ESGE
BMO MSCI EAFE ESG Leaders Index ETF
Mgmt Fee: 0.25%

ESGG
BMO MSCI Global ESG Leaders Index ETF
Mgmt Fee: 0.25%

Fixed Income

ESGB
BMO ESG Corporate Bond Index ETF
Mgmt Fee: 0.15%

ZESG
BMO Balanced ESG ETF
Mgmt Fee: 0.18%

ESGF
BMO ESG US Corporate Bond Index Hedged to CAD ETF
Mgmt Fee: 0.20%

ZWG ★
BMO Global High Dividend Covered Call ETF
Mgmt Fee: 0.65%

*ZWG is not index based but selects Sustainable Dividend Growers from a universe using ESG screening in the investment selection

Dan Stanley
Director,
Institutional and
Advisory,
Ontario

3 Simple Rules Trading ETFs

The foundation of wealth management hasn't changed over time: as a fiduciary it's first necessary to identify client risk tolerance and investment objectives, an exercise that requires both a mathematical and emotional understanding of client needs.

What has changed are the tools used to identify and execute various asset allocation strategies. Investment Counsellors and Portfolio Managers now have access to tools that were previously only available to the largest institutional investors. ETFs, for example, give portfolio managers the ability to allocate to strategies that required vast amounts of computing power as recently as the late 90s and early 2000s.

Along with these new ETF tools a consensus set of rules to follow (or ignore at your peril), has developed around the trading of ETFs, rules to ensure that, as a portfolio manager, you're adhering to your fiduciary duty to put client interests first.

First, avoid trading ETFs in the first half hour and last half hour of the day. Markets tend to be most volatile during these periods as buyers and sellers absorb news and try to settle on a price (there is no circuit breaker on Exchanges to allow the market to digest news). This is when ETF prices are most likely to deviate from NAV and these discrepancies can create sizeable gaps. Fills executed at such times fail to provide best execution for clients.

Second, use limit orders. Limit orders specify the maximum price you'll pay when buying, or the minimum you'll accept when selling. Limit orders are not filled until that price (or better) is available in the market and they are visible to all market participants. While a market order will get your trade filled immediately and in full, there is risk that you'll be filled at a price you didn't expect.

How could that happen? Maybe you ignored rule #1 and the ETF price moved on you before you were able to enter your order details. Maybe the ETF is thinly traded and the last quote was stale. Perhaps the overall market moved in the opposite direction of the sector ETF you intended to buy or sell, causing a disconnect. Clearly, under such circumstances, Market orders would not classify as 'best execution.'

Third, try to trade an ETF when the underlying stocks are trading. Market makers are the intermediary in the ETF market, buying and selling ETFs and their underlying securities, setting the bids and offers based on the risk of the underlying. When the underlying securities of an ETF aren't trading, the market maker faces uncertainty as to the true value of the underlying NAV. As a result, they will protect themselves by widening out the bid and offer spread.

The increase in portfolio managers in Canada's wealth management industry is a good trend. It means more advisors have a fiduciary duty, the duty to put your client's interests first, and this benefits Canadian investors. Following these three simple rules of ETF trading will ensure that you have a good experience and meet your fiduciary obligations to clients.

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Erika Toth
Director, Institutional ETFs, Eastern Canada

Fixed Income ETFs

Fixed income is the fastest growing segment of the ETF market in Canada, and it is large institutional investors leading this shift. There are three main reasons behind this long-term trend:

1. Trading efficiencies
2. Cost efficiencies
3. Diversification and market access

Trading efficiencies

The bond market is an opaque, over-the-counter market which affords very little pricing information to investors. Thanks to the ETF structure, market participants can see the bid and the ask prices, as well as the depth of the order book (how much quantity is available at each price point).

As the COVID-19 shock hit the markets in the month of March 2020, one of the biggest advantages of fixed income ETFs was underscored: enhanced liquidity through Fixed Income ETFs, which is often better than the underlying market, especially for harder to trade asset classes such as bonds.

The underlying bond market seized up, with much of the corporate bond market and even some of the provincial bond market in Canada going “no bid”. Yet aggregate, provincial and corporate bond ETFs continued to trade – providing price discovery in a highly stressed market.

Some critics pointed out that bond ETFs traded at a discount to NAV. In a stressed market like we saw, those NAVs were stale due to the fact that many of those underlying bonds had not traded for several sessions. On any given day, only 20% of Corporate bonds trade in material volume, so NAV, even in good times, is merely notional and is not indicative of the price at which a basket may be traded. In March’s dislocated market, the ETF price was a more reliable indicator of the true clearing price of those bonds.

In 2008 and 2009 in the US, we witnessed similar price discovery as high-yield bond ETFs continued to trade (indeed, with even higher trading volume than normal) while the underlying bonds did not.

Another ETF trading-related advantage for large Investment Counsellors or family offices is trade anonymity.

Cost efficiencies

With rock-bottom interest rates, every basis point in cost savings counts. Not only do portfolio managers have to consider MERs, but they also have to do their due diligence on bid-ask spreads. In order to fulfill their fiduciary duties, it is of utmost importance for family offices and investment counsellors to work with an ETF provider that offers both low fees and liquid products.

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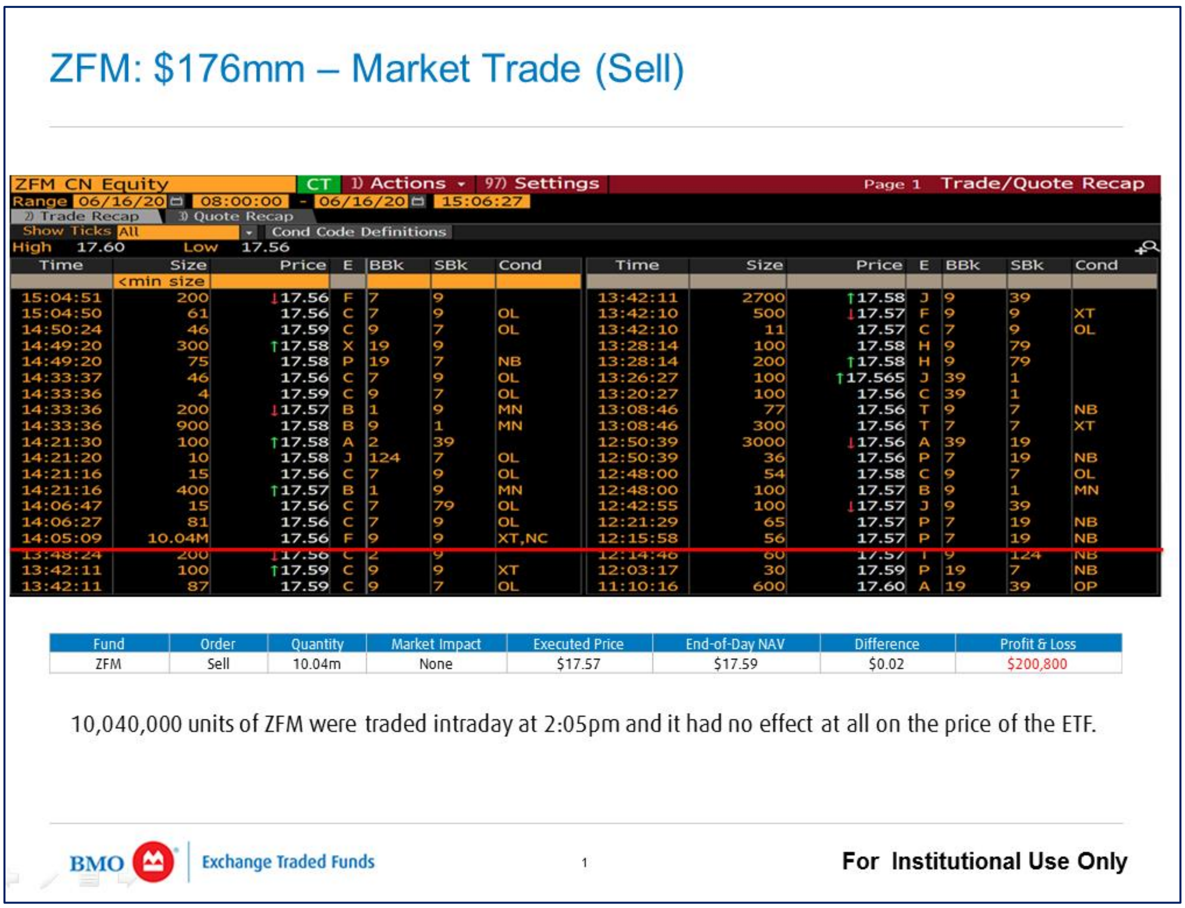
A couple of quick tips regarding bid-ask spreads:

- The bid-ask spread is an important indicator of the liquidity of an ETF, more so than traded volume.
- When evaluating bid-ask spreads, it is best to calculate them as a percentage of the ETF's price per share to ensure an apples-to-apples comparison when looking at ETFs with vastly different unit prices.
- Bid-ask spreads will vary with the overall level of volatility in the market and are also a reflection of risk premium specific to that area of the market. In other words, when markets are more volatile, spreads will be wider – and may expand commensurately as credit quality declines.
- ETFs spread costs, while a factor, are often lower than spreads on individual bonds, particularly with harder to trade provincial and corporate bonds. More mature fixed income ETFs that are larger in AUM and have been around for longer may even trade at tighter spreads than their underlying market.

From an execution perspective, we can work with the market makers to execute custom creations, and in some cases may be able to get the trade done inside the bid-ask spread. Below are two examples of large trades, one for $176 million (a sell) and one for $48 million (a buy) – both trades had zero impact on the price of the ETF.



ZFM: $176mm – Market Trade (Sell)

ZFM CN Equity CT 1) Actions 97) Settings Page 1 Trade/Quote Recap
Range 06/16/20 08:00:00 - 06/16/20 15:06:27
2) Trade Recap 3) Quote Recap
Show Ticks All Cond Code Definitions
High 17.60 Low 17.56

Time	Size	Price	E	BBk	SBk	Cond
	<min size					
15:04:51	200	↓17.56	F	7	9	
15:04:50	61	17.56	C	7	9	OL
14:50:24	46	17.59	C	9	7	OL
14:49:20	300	↑17.58	X	19	9	
14:49:20	75	17.58	P	19	7	NB
14:33:37	46	17.56	C	7	9	OL
14:33:36	4	17.59	C	9	7	OL
14:33:36	200	↓17.57	B	1	9	MN
14:33:36	900	17.58	B	9	1	MN
14:21:30	100	↑17.58	A	2	39	
14:21:20	10	17.58	J	124	7	OL
14:21:16	15	17.56	C	7	9	OL
14:21:16	400	↑17.57	B	1	9	MN
14:06:47	15	17.56	C	7	79	OL
14:06:27	81	17.56	C	7	9	OL
14:05:09	10.04M	17.56	F	9	9	XT,NC
13:48:24	200	↓17.56	C	2	9	
13:42:11	100	↑17.59	C	9	9	XT
13:42:11	87	17.59	C	9	7	OL

Time	Size	Price	E	BBk	SBk	Cond
13:42:11	2700	↑17.58	J	9	39	
13:42:10	500	↓17.57	F	9	9	XT
13:42:10	11	17.57	C	7	9	OL
13:28:14	100	17.58	H	9	79	
13:28:14	200	↑17.58	H	9	79	
13:26:27	100	↑17.565	J	39	1	
13:20:27	100	17.56	C	39	1	
13:08:46	77	17.56	T	9	7	NB
13:08:46	300	17.56	T	7	7	XT
12:50:39	3000	↓17.56	A	39	19	
12:50:39	36	17.56	P	7	19	NB
12:48:00	54	17.58	C	9	7	OL
12:48:00	100	17.57	B	9	1	MN
12:42:55	100	↓17.57	J	9	39	
12:21:29	65	17.57	P	7	19	NB
12:15:58	56	17.57	P	7	19	NB
12:14:46	60	17.57	T	9	124	NB
12:03:17	30	17.59	P	19	7	NB
11:10:16	600	17.60	A	19	39	OP

Fund	Order	Quantity	Market Impact	Executed Price	End-of-Day NAV	Difference	Profit & Loss
ZFM	Sell	10.04m	None	$17.57	$17.59	$0.02	$200,800

10,040,000 units of ZFM were traded intraday at 2:05pm and it had no effect at all on the price of the ETF.

BMO Exchange Traded Funds 1 For Institutional Use Only

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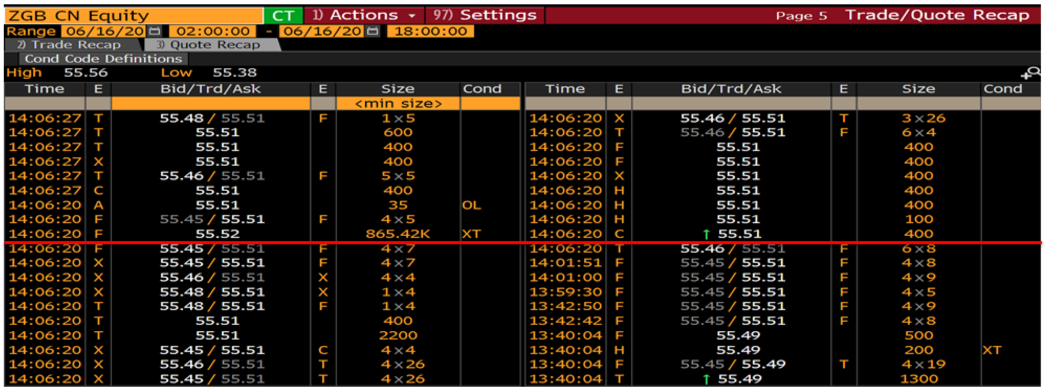
ZGB: $48mm – Market Trade (Buy)



ZGB CN Equity | CT | 1) Actions | 97) Settings | Page 5 Trade/Quote Recap

Range 06/16/20 02:00:00 - 06/16/20 18:00:00

2) Trade Recap | 3) Quote Recap

Cond Code Definitions

High 55.56 Low 55.38

Time	E	Bid/Trd/Ask	E	Size	Cond	Time	E	Bid/Trd/Ask	E	Size	Cond
				<min size>							
14:06:27	T	55.48 / 55.51	F	1x5		14:06:20	X	55.46 / 55.51	T	3x26	
14:06:27	T	55.51		600		14:06:20	T	55.46 / 55.51	F	6x4	
14:06:27	T	55.51		400		14:06:20	F	55.51		400	
14:06:27	X	55.51		400		14:06:20	F	55.51		400	
14:06:27	T	55.46 / 55.51	F	5x5		14:06:20	X	55.51		400	
14:06:27	C	55.51		400		14:06:20	H	55.51		400	
14:06:20	A	55.51		35	OL	14:06:20	H	55.51		400	
14:06:20	F	55.45 / 55.51	F	4x5		14:06:20	H	55.51		100	
14:06:20	F	55.52		865.42K	XT	14:06:20	C	↑ 55.51		400	
14:06:20	F	55.45 / 55.51	F	4x7		14:06:20	T	55.46 / 55.51	F	6x8	
14:06:20	X	55.45 / 55.51	F	4x7		14:01:51	F	55.45 / 55.51	F	4x8	
14:06:20	X	55.46 / 55.51	X	4x4		14:01:00	F	55.45 / 55.51	F	4x9	
14:06:20	X	55.48 / 55.51	X	1x4		13:59:30	F	55.45 / 55.51	F	4x5	
14:06:20	T	55.48 / 55.51	F	1x4		13:42:50	F	55.45 / 55.51	F	4x9	
14:06:20	T	55.51		400		13:42:42	F	55.45 / 55.51	F	4x8	
14:06:20	T	55.51		2200		13:40:04	F	55.49		500	
14:06:20	X	55.45 / 55.51	C	4x4		13:40:04	H	55.49		200	XT
14:06:20	X	55.46 / 55.51	T	4x26		13:40:04	F	55.45 / 55.49	T	4x19	
14:06:20	X	55.45 / 55.51	T	4x26		13:40:04	T	↑ 55.49		1300	

Fund	Order	Quantity	Market Impact	Executed Price	End-of-Day NAV	Difference	Profit & Loss
ZGB	Buy	865k	None	$55.51	$55.54	$0.03	$25,950

865,420 units of ZGB were traded intraday at 2:06pm and it did not affect the price of the ETF. The client was also able to buy at 3 cents lower than the End-of-Day NAV which resulted in a gain $25,950.

BMO Exchange Traded Funds 2 For Institutional Use Only

Diversification and market access

Another benefit of ETFs is the ability to reduce idiosyncratic risks in a portfolio through diversification - holding a basket of names. Typically, family fortunes are concentrated and industry-specific. So diversification is often a welcome benefit for these types of clients.

And with a wide selection of strategies available, institutions and family offices are able to opt for a broad or full-term exposure, or pinpoint exposure by duration or by credit quality.

Here are a few examples of how our clients are using ETFs for specific market access:

- Following the market turmoil in March 2020, several institutions opted to separate the bond universe (such as ZAG or XBB) into government and corporate exposure (eg, ZGB and ZCB) in order to improve liquidity and flexibility going forward
- Clients who like corporate credit but want only the highest quality corporate bonds (A and above) can opt for ZQB
- Conversely, those looking for a higher level of risk and yield pick-up may want to consider ZBBB (BBB universe) or high-yield exposures (ZHY/ZJK, ZFH)
- ESG screening is becoming an increasingly important consideration for family offices as the next generation takes over (consider ESGB and ESGF)

Did You Know?

- BMO GAM is the largest provider of fixed income ETFs in the Canadian marketplace, offering more ETFs over $500 million and more than $1 billion in AUM than any other provider on the street.
- BMO ETFs is the only provider to fully segment the yield curve by term and by credit, offering Short, Mid & Long Federal, Provincial & Corporate bond ETFs.
- ZAG – FTSE Russell Canadian Aggregate Bond Index, is the largest and lowest cost fixed income ETF in Canada;
- Due to our expertise in managing segmented bond exposures, the Bank of Canada appointed BMO GAM as the asset manager of choice to run the Provincial Bond Purchase Program in April 2020.

Please see links to BMO GAM's ETF Road Map and Fixed Income ETF Brochure for more information.

Laura Tase
Director,
Institutional
ETFs, Ontario

Tax Considerations with International Investing

As Canadian investors, we can benefit from investment opportunities in the US and other foreign markets. However, investing outside of Canada has its costs.

Withholding taxes can have a negative impact on portfolio returns and, in addition, the T1135 foreign income verification statement is a compliance burden when filing tax returns.

Form T1135 – Foreign Income Verification Statement

Form T1135 is a mandatory filing for any Canadian with certain foreign property with a total cost over $100,000 (CAD).

- Impacted individuals include:
- Canadians that hold foreign assets
- Immigrants to Canada who hold foreign assets (not applicable to first year residents)
- Canadians abroad that acquire foreign assets

Examples of assets that must be reported:

- Shares of non-resident corporations and bonds issued by non-residents, even if held by a Canadian broker
- Domestic securities (such as Canadian stocks) held outside of Canada
- Life insurance policies issued by foreign issuers

Examples of foreign assets that are exempt from reporting:

- Foreign assets used primarily for personal use & enjoyment
- Foreign assets held in a RRSP or TFSA

What needs to be reported:	What does not need to be reported:
Stocks/ETFs traded on US exchanges	Canadian listed stocks and ETFs

Even if a Canadian listed ETF holds foreign securities, the units of the Canadian fund are not foreign property and are NOT subject to the T1135 reporting requirement.

The $100,000 threshold is triggered when the total cost amount of the assets (not the value) exceeds $100,000. The cost amount is generally the average cost base at the time of acquisition (so if the foreign property was initially purchased for $90,000, it does not need to be reported even if the property is now worth over $100,000).

Continued

The Impact of Foreign Withholding Taxes:

Dividends and interest (and potentially other sources of income), received from non-Canadian investments may be subject to withholding taxes, which are applied before the client receives the distribution (interest income from bonds is not withheld).

Type of Account

- Foreign tax credits can be claimed only for investments held in taxable (non-registered) accounts. Investors will receive a T3 or T5 slip after year end which indicates the amount of foreign taxes paid. Credits for these taxes can be claimed by completing T2209 forms.
- In an RRSP account there is no need to report anything for foreign taxes paid and there is no recovery of the tax either. Foreign taxes paid in an RRSP account will reduce the amount of money available for distribution at retirement

Type of Investment

- Investors are generally subject to withholding taxes imposed by foreign countries on sources of income in those foreign countries (for example, dividends paid to Canadian resident investors by U.S. resident corporations are generally subject to a withholding tax of 15%).
- In addition, whenever foreign securities (outside of North America) are held indirectly by a Canadian investment fund (i.e. Canadian listed ETF holding a US ETF), clients may be subject to a further 15% US withholding tax. This additional US withholding tax applies if the US listed ETF is treated as a corporation for US tax purposes.

Withholding Tax Example:

iShares MSCI EAFE ETF (EFA) – US listed ETF:

When held by a Canadian resident in a non-registered (taxable) account, two levels of withholding taxes apply:

- Withholding tax imposed by the US (recoverable)
- Withholding tax imposed by foreign countries (not recoverable)

Assuming a 12% withholding tax on foreign dividends, investors in EFA would lose approximately 48bps (EFA distribution yield as of March 31, 2020 is 4.01%).

A solution to this issue is holding a Canadian listed ETF such as ZEA (BMO MSCI EAFE unhedged) or ZDM (BMO MSCI EAFE hedged to CAD) – **ZEA/ZDM hold the underlying securities directly, so foreign tax credits can be claimed to offset the foreign withholding taxes.**

Continued

Breaking Down Withholding Taxes

	Scenario	Applicable Taxes
Non-Registered Account	❶ Canadian Mutual Funds or Canadian-listed ETFs that hold U.S. Stocks	**U.S. withholding taxes apply and are recoverable by claiming foreign tax credit.**
	❷ Canadian Mutual Funds or Canadian-listed ETFs that hold a U.S.-listed ETF that holds U.S. stocks	
	❸ U.S.-listed ETFs that hold U.S. Stocks	
	❹ Canadian Mutual Funds or Canadian-listed ETFs that hold Foreign Stocks[1]	**Foreign withholding taxes apply and are recoverable by claiming foreign tax credits.**
	❺ Canadian Mutual Funds or Canadian-listed ETFs that hold a U.S.-listed ETF that holds Foreign Stocks[1]	**Foreign withholding taxes apply and are not recoverable. U.S. withholding taxes may also apply and are recoverable by claiming foreign tax credit.**
	❻ U.S.-listed ETFs that hold Foreign Stocks[1]	

[1]Foreign stocks are defined as shares of corporations that are resident outside of North America

****In a registered account, foreign and US withholding taxes may apply and are NOT recoverable.****

Additional Tax Considerations:

In addition to withholding taxes, distributed capital gains resulting from portfolio rebalances of US listed ETFs may be taxed as foreign income.

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