BMO Laddered Preferred Share Index ETF Strategy

- **BMO Laddered Preferred Share Index ETF** (ZPR)

Preferred share ETFs provide an effective exposure by diversifying across issues and issuers while minimizing trading costs. It can be difficult to maintain consistency in a successful active strategy of direct holdings in a small asset class with limited liquidity. ZPR holds approximately 60% of the issues on the market, and secondary market liquidity allows ZPR to trade at tight bid-offer spreads.

Understanding Preferred Shares

Preferred shares ("preferreds") are hybrid securities with both equity and fixed income characteristics. Similar to an equity security, a preferred share represents an ownership interest, and generally does not have a maturity date. Like a bond, however, a preferred share generally carries no voting rights, has a par value, and tends to pay a fixed distribution rate.

Capital Structure Hierarchy	
Secured Debt	Higher
Unsecured Debt	
Unsecured Subordinated Debt	
Preferred Shares	
Common Shares	Lower

Why Invest in Preferred Shares?

- **Portfolio diversification:** Preferred shares historically have had a low correlation to both equities and bonds.
- **Greater security than common shares:** Preferred shares are senior to common equities in a company's capital structure, as dividends on preferred shares must be paid before those of common shares.
- **Fixed dividend rate:** The distributions on a preferred share are a fixed rate. Some preferred shares also have a cumulative provision, where any omitted dividends must also be paid before common shareholders receive their payments.
- **Tax-efficient yield:** Unlike a bond, which has distributions that are taxed as interest income, the distributions of preferred shares are considered dividends, which are taxed more favourably.
- **Lower volatility than equities:** Preferred Shares tend to trade around their par value which makes them more stable than common equities.

The Canadian Preferred Share Market

Currently, the size of the preferred share market in Canada is approximately $64.7 billion.[1] Preferred shares are typically more cost effective to issue than common shares, so companies have used them to raise capital without diluting their common share base. Some companies may also issue preferred shares over debt or debentures because they are more favourable to the company's debt to equity ratio.

There are four types of preferred shares in Canada:

1) **Perpetuals:** This type of preferred share has no maturity date and pays a fixed dividend for as long as it remains outstanding. Due to its long duration, a perpetual preferred share can be very sensitive to credit spreads and interest rates. This type of preferred share can be redeemed by the issuer, but the holder has no retraction rights, which limits price appreciation.
2) **Floating Rate:** A floating rate preferred share pays a quarterly (sometimes monthly) dividend that "floats" in relation to a reference rate, typically the prime rate. Some issues of these shares have a minimum dividend or "floor".
3) **Rate Resets:** This kind of preferred share pays a fixed dividend rate until its reset date. Upon its reset date, if the preferred share is not called by the issuer, the holder has

[1] Source BMO Capital Markets, November 30, 2020.

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two options. A new fixed dividend rate reflecting the current interest rate environment can be locked-in until the next reset date. The reset rate is predetermined and typically a spread above a Government of Canada bond with a similar term. The holder's other option at reset date is to exchange the issue for a floating rate preferred share.

4) **Retractables:** A retractable preferred share allows the holder to redeem the share at par value on a specified date. For hard retractables, the issuer can only pay cash upon retraction, whereas for soft retractables the issuer can pay either cash or common shares.

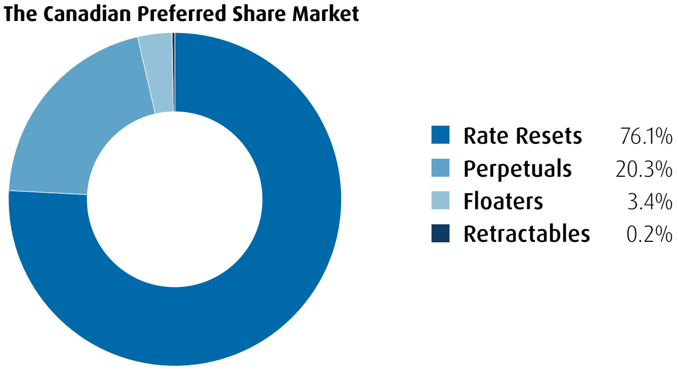
Interest Rate Risk	Credit Risk
Perpetuals	Perpetuals
Retractables	Floating Rate
Rate Resets	Rate Resets
Floating Rate	Retractables

Higher ↕ Lower

Source: BMO Asset Management Inc.

In addition to growing in size, the make-up of the Canadian preferred share market has evolved over the last several years. Where perpetual preferred shares historically made up a majority of the market, rate reset preferred shares have grown in popularity, and today have grown to three quarters of the marketplace. There have also been a growing number of non-financial issuers utilizing the preferred share market as a source of financing, providing the asset class with better sector diversification.

The Canadian Preferred Share Market



Source: BMO Capital Markets (As of November 30, 2020)

LRCNs and Their Impact on the Preferred Share Market

The introduction of Limited Resource Capital Notes (LRCN) to the Canadian marketplace occurred in July 2020, as regulators permitted LRCNs as a new way for banks to raise Tier 1 Capital. LRCNs are classified as debt and so for the issuer, they are a less expensive way to raise capital as interest incurred can be expensed. The capital raised by LRCNs may be used to redeem outstanding preferred shares and so many preferred shares have since pulled to par or even began trading at a premium (especially those with high reset spreads). This may reduce the overall supply of preferred shares.

Preferred Share Investing in the Current Market Environment

The BoC has set its policy rate at 0.25% and has indicated that rates will remain low for a long time. In this ultra low-rate environment, preferred shares are an asset class which offers tax efficient yield (yield is taxed as dividend income) and are less exposed to equity risk (preferred shares are above common shares in the capital structure hierarchy). Rate reset preferred shares are generally less sensitive to interest rates than straight perpetuals which have a much longer duration.

Benefits of Laddering

To further diversify a preferred share portfolio against a rising interest rate environment, an investor can structure rate-resets in a staggered manner. This can be done by organizing the portfolio in a ladder, similar to a bond or a guaranteed investment certificate (GIC) ladder. In this structure, the portfolio is evenly divided by calendar years, or term buckets. Within each term bucket, there will be a number of individual rate reset preferred share issues which have a reset date in the same year. Once the particular issue has reset, it will move to the back of the ladder, again grouped with other individual issues with a reset date of the same year. By doing this, each year a portion of the portfolio will be reset to reflect the current interest rate levels.

Should a particular issue of preferred shares be redeemed by its issuer upon its reset date, the capital would have to be reinvested in other securities. Rather than having a large portion of a portfolio called and a disproportionate amount to reinvest, a laddered process spreads the issues evenly across different terms.This reduces the chances that a large portion of the portfolio will be redeemed and have to be reinvested. Redemption risk is further mitigated by holding a number of preferred shares at each reset year.

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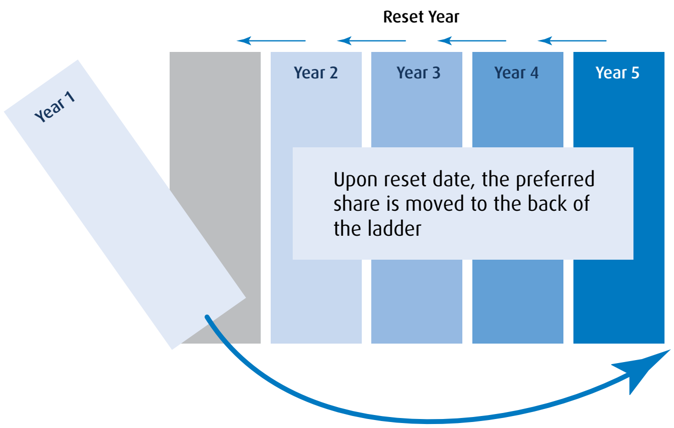

BMO Laddered Reset Preferred Share Index ETF (ZPR):

The BMO Laddered Preferred Share Index ETF is the largest preferred share ETF in Canada at $2 billion in assets. It is also the most actively traded preferred share ETF in Canada.* Secondary market liquidity allows ZPR to trade at tight bid-offer spreads. Historically preferred shares have been a hard to access asset class. The ETF structure enables investors to access preferred shares in a liquid and cost efficient way.

BMO Exchange Traded Funds

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1-800-361-1392 bmoetfs.com

*As of December 2020, Bloomberg