Investment Perspectives
April 2014

Municipal Insights

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Market commentary

More bull than bear – so far

> "Curve exposure will also be a critical decision for investors and may mean the difference between a positive or negative return for the year. We expect yields to rise in a bear-flattening manner beyond the two-year maturity range, with rates shifting higher but to a lesser degree as you extend along the curve."

That was taken from our *2014 Municipal Insights Annual Outlook*. We obviously expected that yield curve positioning would be important this year and first quarter returns illustrate just how important. According to Barclays, the 3-, 10- and 30-year segments of the municipal curve have returned 0.33%, 2.02% and 5.83%, respectively — a 550 basis point (bps) difference between short and long maturities. So the flattening we expected is underway, but not in the manner we anticipated. We expected a bear-flattening trend in which rates across the curve would rise, with more upward pressure on short rates than long. However, until March, essentially all of the flattening had come from falling intermediate and long-term rates, primarily due to weaker economic data and tame inflation. Finally, last month we saw the beginning of a bear-flattening trend as short rates rose sharply (5-year AAA municipal bonds rose 31 bps), while long rates fell only modestly. Being directionally correct paid off as all of the BMO tax-free fixed income strategies outperformed both their respective benchmarks and Lipper peer group averages in the first quarter.

The predominant market tone for the quarter, however, was clearly more bull than bear with the municipal market off to its best start in five years. Several factors contributed, but an important one was the positive flows into the market. Nine of the 12 weeks of 2014 have had inflows to tax-exempt funds. While we don't expect every week to be positive, compared to the persistent outflows through much of last year, it is welcome news. Although April is typically a month in which redemptions occur to meet tax payments, recognition of higher tax rates and less-attractive alternatives in other fixed income sectors suggests investor demand is likely to continue.

> Once through the tax season, we foresee significant reinvestment demand ahead

The lack of supply continues to frustrate dealers and investors alike. Although new supply in March was nearly double February levels, it was still below long-term averages. As expected with the increase in rates last year, refunding supply is way down in 2014: off 40% compared to year-ago levels and total supply is off approximately 26%. The light new supply leads to lower secondary market trading activity as well. While we have been pleased with our ability to source bonds, we hear the frustration daily from dealers about less trading activity and larger institutional investors pleading for greater allotments on new issues and the desire for larger block sizes in the secondary market. Once through the tax season, we foresee significant reinvestment demand ahead, particularly in the seasonally strong June/July time frame. This year's roll-off from bond calls and maturities is expected to be heavier than usual. Reinvestment demand combined with still-high cash levels provides a favorable technical outlook for the market.

Rookie mistake?

Rookies make mistakes. It happens. Hopefully they learn from them and move on, avoiding the same error in the future. Baseball season is now underway and last year's World Series offers a perfect example, painful as it might be for St. Louis Cardinal fans to recall. Rookie second baseman Kolton Wong of the Cardinals was picked off at first base to abruptly end the fourth game of the Series. That win brought the Boston Red Sox back into a tie with St. Louis at two games apiece. More importantly, it helped swing the psychological momentum in favor of the Red Sox. The Cardinals never recovered as they went on to lose the next two games and the Red Sox were crowned 2013 MLB champions.

some believe that new Fed Chair Janet Yellen made a rookie mistake in her first post-Federal Open Market Committee (FOMC) press conference

Rookie mistakes happen in the world of finance as well. Although a veteran of the Federal Reserve (Fed), serving for a time as Vice-Chair behind Ben Bernanke, some believe that new Fed Chair Janet Yellen made a rookie mistake in her first post-Federal Open Market Committee (FOMC) press conference on March 19.

Her reply when asked what the Fed meant by "considerable period," referring to the time between when bond purchases end and the first rate hike begins, was at least one of the catalysts for the sharp rise in short-term rates last month. She said, "...It probably means something on the order of around six months or that type of thing," signaling to investors that rates could begin to rise as early as next April, sooner than most had expected.

Whether her comments were made intentionally as a signal to investors, or a mistake, we believe the flattening trend will remain an ongoing theme for the yield curve in 2014 and beyond. If upcoming economic data is weaker than expected, the curve may re-steepen a bit in the near term. But just like the momentum shift in last year's World Series, investor psychology has likely now shifted regarding Fed policy. A flatter curve and, we believe, higher rates are likely in our future.

Credit updates — some old, some new

Detroit

In the "old news" category, the bankruptcy saga in Detroit continues. The City continues to push their Plan of Adjustment (the Plan) as a roadmap for exiting bankruptcy, most recently even reducing the expected payout to some bondholders further than originally offered. Also, Judge Rhodes has hired a group of experts to help him review the Plan, which will most likely reduce the risk of appeal for whatever the eventual solution looks like. There has been no reported progress in reaching settlement agreements with any of the creditors.

Even Detroit's water and sewer debt holders are being penalized more than originally expected, most recently by the rating agencies. The City proposed creating a regional water and sewer authority, with the goal of having the five outlying counties pay $47 million annually back to Detroit. That plan now seems all but dead as county representatives cited a lack of detail and trust of City negotiators. Meanwhile, S&P recently downgraded the water and sewer debt from BB- to CCC.

Even Detroit's water and sewer debt holders are being penalized more than originally expected

Even though all parties agree that the revenues from the system are secure and bondholders are expected to get paid in full, because the City is proposing to lower the coupon rate on some debt and to adjust call features, some bondholders may get a lesser valued security on swap than they currently hold. Further complications arise since the majority of the debt is insured. If the tax status of the interest payments is called in to jeopardy because the insurers, not Detroit, become the ultimate obligor, how are the insurers and the market going to react? As always, stay tuned for further developments.

Puerto Rico

Puerto Rico successfully issued $3.5 billion of debt, providing them with some necessary breathing room. Strong demand was evident for the deal, with an estimated $16 billion of orders and the yield of 8.73% coming in well below early fears of double-digit interest rate levels. Nonetheless, the outlook for the current administration remains quite challenging unless economic growth improves. A growing debt service burden against a shrinking economy and out-migration of residents presents a very difficult long-term challenge for Puerto Rico. It was no surprise that the majority of buyers of the new deal were hedge fund managers who have a different risk tolerance than most traditional municipal investors.

Insurance

The other big, and somewhat ironic, credit news last month was the rating upgrade of two municipal insurers. S&P raised the ratings of Assured Guaranty (from AA- to AA) and National Public Finance Guarantee (from A to AA-). National is the municipal bond subsidiary of MBIA and this upgrade is estimated to have lifted approximately $300 billion of outstanding debt into the AA category. Assured is the only insurer who has continued to guarantee new and outstanding debt before, during and after the financial crisis. While National has not yet returned to insuring new debt, with the rating upgrade in hand, they are expected to be back doing so soon. S&P cited the improvement in the taxable side of the business, which was the primary cause for the decline in the industry, as well as the small but once again growing share of the new issue municipal market which insured debt represents.

Overall, the insurer upgrades are a positive development for the market, particularly for retail investors

Overall, the insurer upgrades are a positive development for the market, particularly for retail investors. S&P expects insured debt to represent 7% - 8% of the new issue market by year-end, up from the 3% - 4% last year, and a long way from the more than 50% market share they once commanded.

Strategy and performance

Strategy

We implement the bear-flattening outlook in a number of ways across our tax-free income strategies. First, with the expectation that all rates, both short and long, will trend higher, we want to maintain our average duration at, or below, benchmark duration. Second, we believe an overweight in very short duration securities (zero to two years), including floating rate issues, combined with a weighting in appropriate longer-term exposure for each strategy should outperform a bullet curve structure as the curve flattens. A third way is to hold an overweight exposure in lower-rated credits, such as A and BBB rated debt. The excess yield these issues provide should enhance performance over the extended period of time that the gradual unwind of excessively easy monetary policy occurs. A higher fed funds rate will only occur if economic growth continues, strengthening municipal credits as tax and fee revenues rise.

Strategy overview

Duration: Neutral-to-short

Curve: Maintain barbell structure with overweights in zero to two years and longer maturities appropriate for each strategy

Credit: Seek selective opportunities in the A and/or BBB rating category when adequately rewarded through additional yield

Sector: Maintain a revenue sector bias, and evaluate opportunities in the general obligation sector as trading inefficiencies emerge

Structure: Premium coupon structure to minimize market discount risk

Fund performance as of March 31, 2014

				As of March 31, 2014 (%)		Returns as of March 31, 2014 (%)					Expense ratios (%)[1]	
Fund / *Index*	Share class	Inception date	Ticker	1-month	YTD	1-year	3-year	5-year	10-year	Since inc.	Gross	Net
BMO Ultra Short Tax-Free Fund	Y	09/30/09	MUYSX	0.04	0.34	0.56	1.05	—	—	1.24	0.58	0.56
BMO Ultra Short Tax-Free Fund	I	09/30/09	MUISX	0.07	0.40	0.81	1.31	—	—	1.47	0.33	0.31
Blended Benchmark[2]				*0.02*	*0.12*	*0.39*	*0.50*	—	—	—		
BMO Short Tax-Free Fund[3]	Y	11/29/12	MTFYX	-0.11	0.91	1.09	—	—	—	2.04	1.07	0.56
BMO Short Tax-Free Fund[3]	I	11/29/12	MTFIX	-0.09	0.95	1.24	—	—	—	2.19	0.82	0.41
Barclays Short (1-5 Year) Municipal Index				*-0.34*	*0.38*	*0.97*	—	—	—			
BMO Intermediate Tax-Free Fund[4]	Y	02/02/94	MITFX	0.12	2.41	0.30	5.23	5.54	4.26	4.61	0.62	0.56
BMO Intermediate Tax-Free Fund	I	12/27/10	MIITX	0.04	2.46	0.41	5.34	5.61	4.30	4.62	0.37	0.37
Barclays U.S. 1-15 Year Blend Municipal Bond Index				*-0.16*	*2.26*	*0.84*	*4.59*	*4.63*	*4.16*			

Other benchmarks as of March 31, 2014

	As of March 31, 2014 (%)		Returns as of March 31, 2014 (%)			
	1-month	YTD	1-year	3-year	5-year	10-year
Barclays U.S. 1-10 Year Blend Municipal Bond Index	*-0.37*	*1.61*	*0.78*	*3.88*	*4.02*	*3.86*
Barclays U.S. Municipal Bond Index	*0.17*	*3.32*	*0.39*	*5.79*	*5.71*	*4.45*

Source: Barclays and BMO Global Asset Management

Performance data quoted represents past performance and past performance is not a guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To receive the most recent month-end performance, call 1-800-236-3863. Returns quoted are pre-tax. Investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision as the illustration above does not reflect these factors. For more information about performance, please contact your investment professional. Total returns for periods of less than one year are cumulative.

1 Net expense ratios reflect contractual fee waivers and/or expense reimbursements if applicable, made by BMO Asset Management Corp., the investment adviser (Adviser). The Adviser may not terminate these fee waivers and/or expense reimbursements prior to December 31, 2014 without the consent of the Board of Directors, unless the investment advisory agreement is terminated. Without these contractual waivers, the Fund's returns would have been lower.

2 The Blended Benchmark: 50% Barclays 1-Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index

3 The Gross Expense Ratios for this Fund are based on estimated expenses for the current fiscal year because it is a new Fund.

4 Performance data quoted prior to Inception of Class I of the Fund is the performance of the Fund's Investor Class (Class Y), not adjusted for any differences in the expenses of the classes.

Data for the journey

Valuation data as of March 31, 2014

AAA yields (%)

Year	Current	Change 1-month	Change 3-month	Change 1-year
2	0.39	*0.13*	*0.06*	*0.08*
5	1.31	*0.31*	*0.07*	*0.47*
10	2.49	*0.09*	*-0.28*	*0.58*
30	3.65	*-0.07*	*-0.54*	*0.56*

Source: InvestorTools® Perform

Cross-market values (%)

Year	Current (1-year averages) Muni/Treasury	Current (1-year averages) Muni/Corporate
2	93 (110)	76 (76)
5	76 (88)	73 (74)
10	92 (98)	84 (85)
30	103 (107)	96 (97)

Source: InvestorTools® Perform and Bloomberg

Yield curve data as of March 31, 2014

Slope changes (%)

	Current	Change 1-month	Change 3-month	Change 1-year
Wkly - 2's	0.36	*-0.03*	*0.00*	*0.06*
2 - 5's	0.89	*0.31*	*0.07*	*0.47*
2 - 10's	2.10	*-0.04*	*-0.34*	*0.50*
2 - 30's	3.26	*-0.20*	*-0.60*	*0.48*

Source: InvestorTools® Perform

Performance by duration (%)

Year	*1-month*	*3-month*	*1-year*
0–3	*0.13*	*1.08*	*0.00*
3–6	*-0.02*	*2.69*	*1.18*
6–10	*0.27*	*4.43*	*0.29*
10+	*1.10*	*10.13*	*-1.64*

Source: Barclays Point

Credit data as of March 31, 2014

Current rating spreads (%)

Year	Current (1-year averages) AAA–A	Current (1-year averages) AAA–BBB
2	0.16 (0.19)	0.65 (0.72)
5	0.44 (0.47)	1.04 (1.20)
10	0.68 (0.74)	1.32 (1.43)
30	0.73 (0.74)	1.26 (1.26)

Source: InvestorTools® Perform

Performance by quality (%)

Rating	*1-month*	*3-month*	*1-year*
AAA	*-0.11*	*2.20*	*0.00*
AA	*0.07*	*2.95*	*0.61*
A	*0.31*	*3.88*	*0.52*
BBB	*0.82*	*5.73*	*1.30*

Source: Barclays Point

BMO Funds Tax-Free Suite

Fund name	**Ticker (Class Y/Class I)**
BMO Tax-Free Money Market Fund	MTFXX / MFIXX
BMO Ultra Short Tax-Free Fund	MUYSX / MUISX
BMO Short Tax-Free Fund	MTFYX / MTFIX
BMO Intermediate Tax-Free Fund	MITFX / MIITX

All investments involve risk, including the possible loss of principal.

You should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. For a prospectus and/or summary prospectus, which contain this and other information about the BMO Funds, call 1-800-236-3863. Please read it carefully before investing.

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Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a Fund's portfolio.

Interest income from Tax-Free Fund investments may be subject to the federal alternative minimum tax (AMT) for individuals and corporations, and state and local taxes.

Barclays 1-10 Year Blend Municipal Bond Index is an unmanaged index of municipal bonds rated BBB or better with 1 to 12 years to maturity.

Barclays U.S. Municipal Bond Index is an unmanaged index of a broad range of investment-grade municipal bonds that measures the performance of the general municipal bond market.

Blended Benchmark consists of 50% Barclays 1 Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index. Money Fund Report Averages™ is an arithmetic average of performance for all money market mutual funds tracked within this category. Money Fund Report Averages™ is a service of iMoneyNet, Inc. (formerly IBC Financial Data). The Barclays Capital 1-Yr Municipal Bond Index is the 1-year component of the Barclays Capital Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

Barclays Short (1-5 Year) Municipal Index includes investment-grade tax-exempt bonds that are issued by state and local governments and have maturities of 1 to 5 years.

Barclays U.S. 1-15 Year Blend Municipal Bond Index is the 1-15 year Blend component of the Barclays Capital Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa and a range of maturities between 1 and 17 years.

Investments cannot be made in an index.

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4/14

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