BMO ETF Portfolio Strategy Report

Second Quarter 2014 | BMO EXCHANGE TRADED FUNDS

The Interest Rate Tug-of-War

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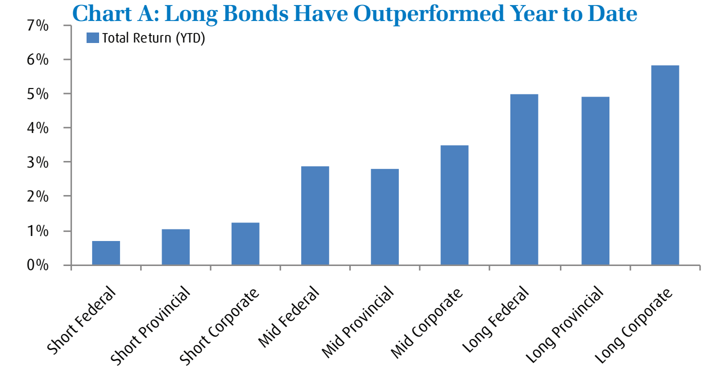
In this report:

All prices or returns as of market close on March 31, 2014, unless otherwise indicated.

In this report, we highlight our strategic and tactical portfolio positioning strategies for the second quarter using various BMO Exchange Traded Funds. Our key strategy changes are outlined throughout the report and in our quarterly outlook on page six.

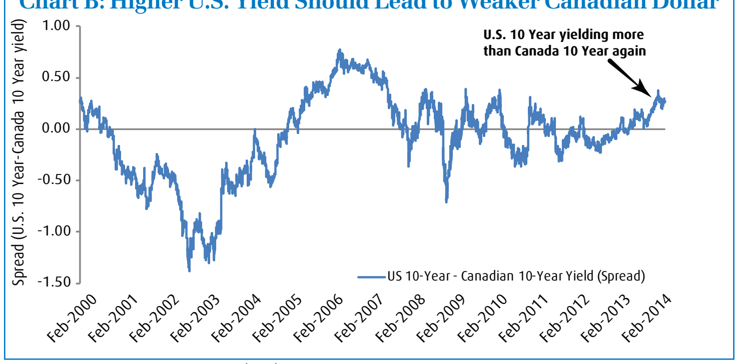
- **Surprising to many, the bond market has performed well year to date, with the *FTSE/TMX Canada Universe Bond Index* (formerly the *DEX Universe*), gaining 2.9% over the quarter. Longer maturity bonds, have outperformed year to date based on increased geopolitical risk and weaker economic data. (Chart A)** Many investors, (ourselves included) had reduced duration risk on concerns of higher interest rates which has not yet come to fruition. Over the long-term however, our greater concern of higher interest rate volatility remains, particularly on the long-end of the yield curve.
- **Geopolitical risk is back on the forefront, as turmoil has broken out in the Ukraine.** The upheaval has led to a tense dispute between Russia and the West, causing equity market volatility to briefly return in March. The *CBOE/S&P Implied Volatility Index*[1], often used as a fear gauge, had increased to 17.9, but still below its long-term average of 20. The geopolitical risk coupled with weaker economic data have counteracted the rise in long-term rates caused by the U.S. Federal Reserve's (Fed) indication of tighter monetary policy in the near-future.
- **Investors have also become concerned about China, as data points have indicated a slowdown in retail sales, factory output and investment growth. This prompted China's premier to warn that its economy could face "severe challenges" in 2014.**
- **New Fed Chair, Janet Yellen outlined the central bank's stimulus exit, leading mid-term rates of U.S. bonds to rise.** The difference between the U.S. and Canadian 10-year bond yield continues to widen. Amongst other reasons, we believe this is a positive for the U.S. dollar (Chart B) and is supportive of our stance on having U.S. dollar assets non-currency hedged.
- **Recent economic data out of the U.S. has also been weaker than expected. Consumer spending and job growth for example have waned, causing some concern in the markets.** After severe weather conditions in much of North American over winter, we believe this played a significant factor in dampening recent economic numbers. We continue to believe the U.S. recovery is gathering momentum, with items such as manufacturing back on the rise. The recent underwhelming data may actually cause expectations to move lower, potentially making upward surprises easier to materialize in the summer months.
- **Credit spreads between both U.S. high yield bonds and investment grade bonds continue to narrow.** Cyclical based sectors also continue to outperform more defensive oriented sectors. We believe these underlying market characteristics are supportive of an economic recovery and bullish for equities.

Chart A: Long Bonds Have Outperformed Year to Date



Source: BMO Asset Management Inc., Bloomberg

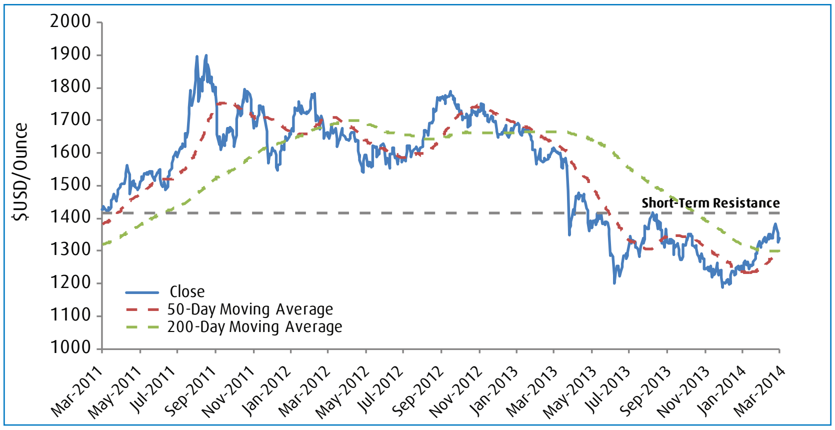
Chart B: Higher U.S. Yield Should Lead to Weaker Canadian Dollar



Source: BMO Asset Management Inc., Bloomberg

BMO Exchange Traded Funds

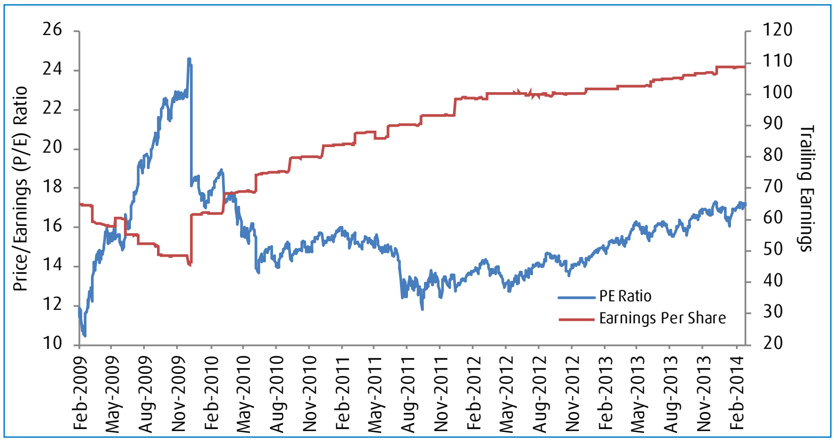
Things to Keep an Eye on...



Source: BMO Asset Management Inc., Bloomberg

After registering its first annual loss in 13 years, gold has made a noteworthy comeback to date this year. At the end of March, spot gold has gained 6.6% in U.S. dollars. In our opinion, there are three primary reasons for owning gold in a portfolio: a hedge against inflation; a weakening U.S. dollar; and global macro-economic or political risk. While the rise in gold could partially be attributable to political risk out of Russia and the Ukraine, it may also be due to short-covering, as there was much negativity priced into precious metals coming into the year. Whether prices continue to gain could depend on technical momentum.

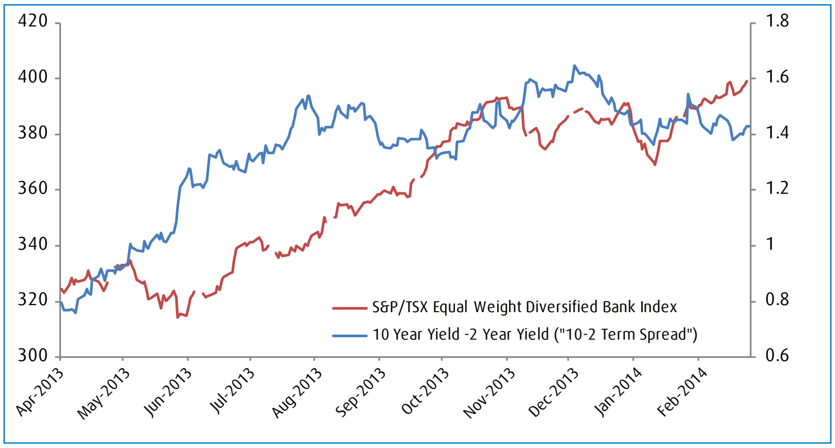
Recommendation: While the precious metal looks to be overbought in the short-term, its longer term performance may depend on whether it breaks above USD$1400/ounce, which looks to be the next resistance level. Large and small cap gold stocks may be areas investors want to consider. Investors can access these areas with the ***BMO Equal Weight Gold Index ETF (ZEG)*** or the ***BMO Junior Gold Index ETF (ZJG)*** for larger and small-cap exposure respectively.



Source: BMO Asset Management Inc., Bloomberg

Much has been said about the run in U.S. equities over the last five years. Since March of 2009, the S&P 500 Composite Index has gained 208.1% on a total return basis, leaving some to question how much upside there is. However, the market looks reasonably valued with a current price to earnings (P/E) ratio of 17.1x, a slight 5.5% premium to its 10-year average. It should be noted that the average P/E ratio was skewed lower because of the lower equity market valuation during the recessionary markets between 2008 and 2010.

Recommendation: We have recommended an overweight to U.S. equities since early 2011 and it continues to be one of our most favoured regions for equity investing. The characteristics of the U.S. equity market also look encouraging with more cyclical areas beginning to outperform more defensive areas. Our concern, as mentioned in last quarter's report, is that markets look very reactive to negative headline risk. For greater risk control, investors may want to consider the ***BMO Low Volatility U.S. Equity ETF (ZLU)*** or the ***BMO U.S. Dividend ETF (ZDV)***, which provide broad U.S. equity exposure but both have a lower beta than the *S&P 500 Composite Index*.



Source: BMO Asset Management Inc., Bloomberg

Canadian banks saw a surge in share prices last year, as the yield curve experienced a significant steepening. While we anticipate longer term interest rates in Canada to appreciate, we don't expect the same pace of gains as in 2013. Inflation remains low at 1.5% in Canada and the Bank of Canada's new governor may favour a lower loonie given his background in export development.

Recommendation: We still believe the overall environment in Canada is constructive for Canadian banks. However, we don't envision the same pace in share price appreciation as we did in 2013, instead we anticipate a slower gain. Consequently, we favour a covered call overlay when investing in Canadian banks, as its higher yield will help offset the yield shortfall from our shorter duration position in fixed income. Investors can consider utilizing the ***BMO Covered Call Canadian Banks ETF (ZWB)*** for efficient implementation.

Changes to Portfolio Strategy

Asset Allocation:

- The strategy remains well balanced between equities, fixed income and hybrid assets. When constructing and rebalancing our portfolio strategy, we have started with the fixed income side of the portfolio, as higher recent interest rate volatility led us to shorten duration, resulting in less-yield generation from our bond exposure. As a result of the yield shortfall, the equity portion of our portfolio strategy has been more yield-oriented and our exposure to areas like U.S. high yield and preferred shares have helped bolster overall portfolio yield.
- Since its inception in late June of 2012, our portfolio strategy has kept pace with a portfolio invested 60% in the *S&P/TSX Composite Index* and 40% in the *FTSE/TMX Canada Universe Bond Index* (formerly called the *DEX Universe*). The portfolio strategy, however, has been much less volatile over the period, especially on the downside. From an asset allocation perspective, we are not making significant changes to our portfolio strategy this quarter, with the exception that we are reducing the 1% cash to 0%. Rather, we will focus on fine tuning the selection of the ETFs in the portfolio.

Fixed Income:

- Last quarter, we shortened duration by repositioning our exposure from the ***BMO Mid Corporate Bond Index ETF (ZCM)*** to the ***BMO Short Corporate Bond Index ETF (ZCS)***. With macro-economic risk surfacing over the quarter in the Ukraine and the weaker than expected economic data out of the U.S., longer-dated bonds have outperformed year to date. Over the long-term however we believe the bigger threat of rising rates on the long-end of the yield curve remains. Consequently, we believe our shorter duration stance and our overweighting in Canadian and U.S. corporate bonds are well positioned, as we expect the economy to continue to steadily strengthen, placing upward pressure on longer rates. Changes to our fixed income exposure are therefore not necessary.

Equities:

- From a valuation perspective, emerging market equities currently look extremely attractive. However, their fundamental appeal is a result of a decline in price, rather than a pick-up in the momentum of earnings growth. With the recent turmoil between Russia and the Ukraine and the past tendencies for headline risk to spread quickly with emerging markets, we are eliminating our position in the ***BMO Emerging Market Equities Index ETF (ZEM)***.
- Last quarter, we made mention of the strengthening technical underpinnings in European equities. We also noted, the higher earnings multiple given the weaker economic backdrop in the Eurozone leading to a reduced bottom lines for European companies. We, therefore noted in the same report that investors would need to be more selective when investing in the area, focusing on companies with sound balance sheets and avoiding lower quality, higher leveraged companies. The ***BMO MSCI Europe High Quality Hedged to CAD Index ETF (ZEQ)*** focuses on European stocks with a high return on equity (ROE), stable year over year earnings growth and low financial leverage. We are now initiating a 4.0% positioning in this ETF, as we believe this to be a more effective way than traditional market-capitalization weighted indices to obtain exposure to Europe.
- We continue to favour U.S. banks, believing there are a number of tailwinds in the space including a wider differential between short and long-term interest rates, which tends to be a positive for lenders. In addition, the housing market and business confidence in the U.S. continues to improve, which also is a positive for banks. As we started mentioning in January of 2013, we prefer having currency exposure in U.S. assets, with long-term rates likely to rise more in the U.S. than in Canada, meaning the U.S. dollar is likely to outperform. We are thus switching our 4.0% allocation in the ***BMO Equal Weight U.S. Banks Hedged to CAD Index ETF (ZUB)*** for the non-currency hedged ***BMO Equal Weight U.S Banks Index ETF (ZBK)***.

Alternative/Hybrids:

- Our exposure to U.S. high yield bonds and preferred shares have been complementary to the equity and fixed income portions of our portfolio strategy. We remain favourable in both areas which provide diversification beyond traditional bonds and the equities help bolster yield in the overall portfolio strategy. For this quarter we are making no changes to our exposure to this asset class.

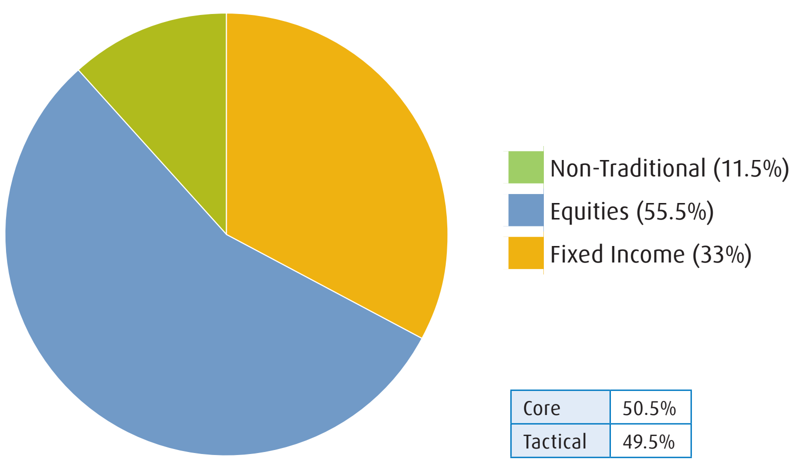
Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Emerging Market Equities Index ETF	ZEM	3.0%	BMO MSCI Europe High Quality Hedged to CAD ETF	ZEQ	4.0%
BMO Equal Weight U.S. Banks Hedged to CAD Index ETF	ZUB	4.0%	BMO Equal Weight U.S. Banks Index ETF	ZBK	4.0%
Cash		1.0%			
Total		**8.0%**	**Total**		**8.0%**

Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange traded funds (ETFs).

Stats and Portfolio Holdings

Ticker	ETF Name		Position	Price	MER	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/ Vol
	Fixed Income									
ZAG	BMO AGGREGATE BOND INDEX ETF	Debt	Core	$15.40	0.20%	14.0%	3.5	6.1%	2.5%	0.72
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Debt	Tactical	$15.53	0.25%	7.0%	8.0	7.0%	3.4%	0.42
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	Debt	Tactical	$14.81	0.30%	9.0%	2.2	2.4%	2.0%	0.91
ZST	BMO ULTRA SHORT-TERM BOND INDEX ETF	Debt	Tactical	$56.99	0.15%	3.0%	2.0	0.7%	2.0%	1.01
	Total Fixed Income					33.0%		16.2%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$21.40	0.35%	8.5%	7.5	8.0%	2.9%	0.38
ZDV	BMO CANADIAN DIVIDEND ETF	Equity	Core	$17.79	0.35%	9.0%	7.9	8.8%	4.6%	0.59
ZSP	BMO S&P 500 INDEX ETF	Equity	Core	$22.81	0.15%	8.0%	11.2	11.2%	2.0%	0.18
ZDY	BMO U.S. DIVIDEND ETF	Equity	Core	$18.69	0.30%	11.0%	12.9	17.7%	3.8%	0.29
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	Equity	Tactical	$15.48	0.40%	4.0%	12.6	6.3%	3.3%	0.26
ZWB	BMO COVERED CALL BANKS ETF	Equity	Tactical	$16.35	0.65%	3.0%	8.5	3.2%	6.0%	0.71
ZIN	BMO S&P/TSX EQUAL WEIGHT INDUSTRIALS INDEX ETF	Equity	Tactical	$22.03	0.55%	5.0%	13.4	8.4%	2.3%	0.17
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	Equity	Tactical	$19.06	0.65%	3.0%	11.2	4.2%	6.2%	0.55
ZUB	BMO EQUAL WEIGHT U.S. BANKS HEDGED TO C$ ETF	Equity	Tactical	$20.90	0.35%	4.0%	17.5	8.7%	1.6%	0.09
	Total Equity					55.5%		76.5%		
	Non-Traditional/Hybrids									
ZHY	BMO HIGH YIELD U.S. CORP BOND HEDGED TO C$ INDEX ETF	Debt	Tactical	$16.16	0.55%	6.5%	6.9	5.6%	5.0%	0.73
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Equity	Tactical	$14.11	0.45%	5.0%	2.6	1.6%	4.8%	1.86
	Total Alternatives					11.5%		7.2%		
	Total Cash					0.0%	1.5	0.0%	1.3%	
	Portfolio				**0.34%**	**100.0%**	**8.0**	**100.0%**	**3.3%**	**0.41**

Ticker	Top Holdings	Weight
ZAG	BMO AGGREGATE BOND INDEX ETF	14.0%
ZDY	BMO U.S. DIVIDEND ETF	11.0%
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	9.0%
ZDV	BMO CANADIAN DIVIDEND ETF	9.0%
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	8.5%
ZSP	BMO S&P 500 INDEX ETF	8.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	7.0%
ZHY	BMO HIGH YIELD U.S. CORP BOND HEDGED TO C$ INDEX ETF	6.5%
ZIN	BMO S&P/TSX EQUAL WEIGHT INDUSTRIALS INDEX ETF	5.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	5.0%
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	4.0%
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	4.0%
ZST	BMO ULTRA SHORT-TERM BOND INDEX ETF	3.0%
ZWB	BMO COVERED CALL BANKS ETF	3.0%
ZWA	BMO Covered Call Dow Jones Industrial Average Hedged to C$ ETF	3.0%



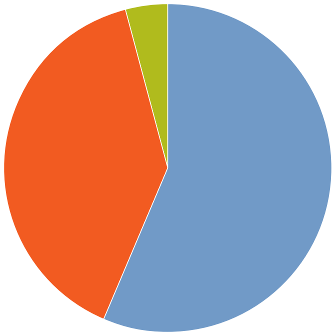
Core	50.5%
Tactical	49.5%

*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.

**Cash is based off the 3-quarter Canadian Dealer Offered Rate (CDOR).

Portfolio Characteristics

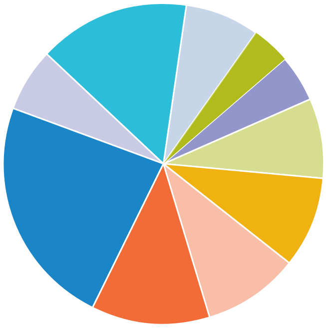
Regional Breakdown (Overall Portfolio)



Canada	56.5%
United States	39.5%
Emerging Markets	4.0%

*Regional Breakdown includes equities, fixed income and alternative sleeves.

Equity Sector Breakdown



Financials	23.3%
Health Care	6.4%
Industrials	15.2%
Information Technology	7.7%
Materials	3.8%
Telecommunication Services	4.6%
Utilities	8.0%
Consumer Discretionary	9.3%
Consumer Staples	9.6%
Energy	12.1%

Fixed Income Breakdown

Federal	13.8%
Provincial	10.7%
Investment Grade Corporate	59.0%
Non-Investment Grade Corporate	16.5%

Weighted Average Term	6.5
Weighted Average Duration	4.8
Weighted Average Coupon	4.5%
Weighted Average Current Yield	4.1%
Weighted Average Yield to Maturity	2.9%

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.

The Good, the Bad, and the Ugly

Conclusion: In this section three months ago, we mentioned how weather could play a factor in weaker economic data over the first quarter. While it can be argued if the harsh winter hampered production in North America, we believe expectations of economic releases in the early spring and summer months, will likely be revised downwards as a result. This could lead to postive surprises over the summer months in our opinion, which can be bullish for equities in the absence of further political risk. Though higher long-term rates in the U.S. have transpired due to Janet Yellen's verbage, post FOMC (Federal Open Market Committee) meeting, this should be seen as encouraging that the economy continues to normalize. Based on our market expectations, it is our belief that our portfolio strategy is well positioned for the current environment.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• 29 out of 30 banks passed the Fed's recent stress tests, which were more stringent than years past. This should enable U.S. banks to further increase their dividends and buyback plans. • The U.S. unemployment rate has drifted lower over the quarter, now at 6.97%. This is the first time the measure has been below 7% since December of 2008. • Initial jobless claims in the U.S. is also lower and has continued to trend down since March of 2009. • As mentioned in last quarters report, we forecasted a colder winter to have a negative impact in Canada and northern parts of the U.S. We believe this has likely caused expectations to reviser lower for the early summer months, making positive surprises more likely.	• Valuations of North American stocks remain fairly valued from our perspective. The *MSCI North American Index* has a current PE ratio of 17.6x, slightly less than the 17.7x PE ratio of the *MSCI World Index*. • For investors willing to take on volatility, Asian Pacific stocks remain the best bargains in terms of valuations. The *MSCI Asia Pacific Index* has a current PE ratio of 13.4x.	• Asides from the rate shock last summer, correlations between asset classes have remained low. This is a positive for multi-asset strategies. • Canadian equities have exhibited relative strength relative to their U.S. counterparts year-to-date. Over the long-term however, we continue to favour U.S. equities.
Bad	• Labour force unemployment remains at 7.0% in Canada. However, the downward trend in Canadian unemployment over the last two years has been less prevalent compared to the U.S. • Economic data out of the U.S. and Canada have been weaker in recent months, but we believe weather played a big factor. • Unemployment in Germany is at 6.8%, but has remained around that level since the beginning of 2012.	• Earnings per share (EPS) in European stocks are still low, making valuation metrics rich in the European equities. Investors should be more selective in this area, focusing on higher quality stocks. • Canadian energy stocks continue to trade at a premium relative to their U.S. counterparts. The S&P/TSX Energy has a current PE ratio of 28.9x, compared to the 14.5x PE of the *S&P 500 Energy Index.*	• The term structure for VIX futures is now higher in the front end, suggesting more risk being priced into the market compared to three months ago. Should economic data weaken or we see a resolution in political risk, equities could gain in summer months. • Inter-market ratios all still favour equities, which could lead interest rates to move higher, faster than anticipated should investors continue allocating more to stocks.
Ugly	• Canadian household debt levels has now hit an all-time high of $1.4 trillion. While delinquencies area at an all-time low, higher debt levels, give the Bank of Canada less room to raise interest rates.		• We continue to stress that margin debt levels, continues to rise to all-time highs. While we keep mentioning it, it shows much of this rally has been built on leverage. A sharp rise in interest rates could potentially cause a de-leveraging event. • The 30-year yield in the U.S. has moved down year to date. It is important that longer-term yields not rise too quickly, which would potentially put a stop to the U.S. housing recovery.

Footnotes

[1] **CBOE/S&P Implied Volatility Index** is based on the options of the S&P 500 constituents. It is commonly used to gauge market sentiment. The term structure of VIX futures, shows the market's expectation for market volatility in the future.

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