BMO ETF Portfolio Strategy Report

Second Quarter 2016

BMO EXCHANGE TRADED FUNDS

Don't Wake the Bear

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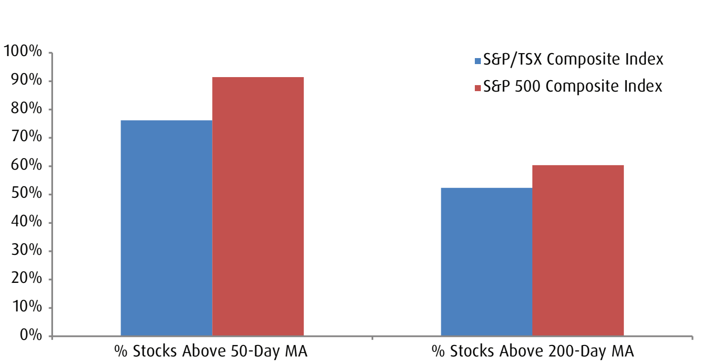
In this report:

All prices or returns as of market close on April 4, 2016, 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.

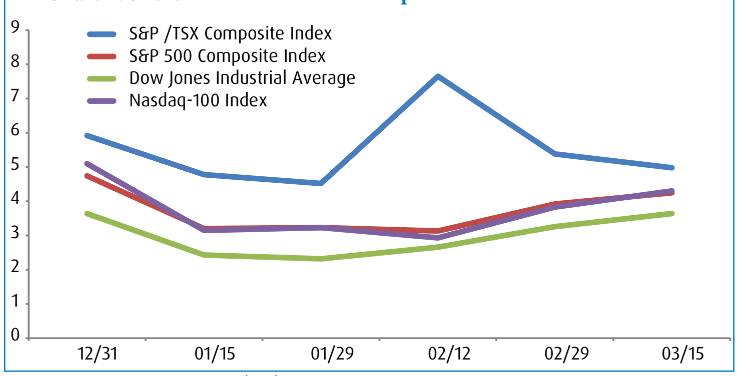
- **Although still fragile, economic data has shown that global economic conditions have thus far been less negative than anticipated.** Equity markets bounced back in the first quarter, with both the *S&P/TSX Composite Index ("TSX")* and the *S&P 500 Composite Index ("SPX")* now in positive territory, up 4.2% and 2.0%, respectively, on a total return basis year-to-date. Furthermore, the recent market recovery has come with breadth, as 76.2% of the TSX and 91.5% of the SPX stocks are now trading above their 50-day moving averages (Chart A).
- **Over the next several quarters a continued recovery will likely need to be met with real signs of economic improvement as market expectations have revised upwards over the last several months.** In addition, market shorts (with TSX stocks) have likely been covered, suggesting easy gains have already been realized (Chart B). In addition to improving economic data, a continued market recovery will need potential tail risks to remain out of the headlines. For one, the Chinese economy will need to stabilize, preventing another deleveraging event similar to the one experienced last August. The European and Japanese economies will also need to exhibit real improvements beyond what is driven by quantitative easing in those jurisdictions. Finally, concerns of Brexit need to remain subdued.
- **We hypothesized in our last report that the U.S. Federal Reserve (Fed) would be more dovish than market expectations.** However, the Bank of Canada's (BoC) statement at its January meeting implied that the federal government's fiscal policy should do the heavy lifting in stimulating the economy was a surprise to many. Consequently, the Canadian dollar firmed up more swiftly than anticipated. A weaker U.S. dollar is one less headwind for commodities. However, both supply and demand are still the main concerns that keep commodity prices supressed. While the sentiment to commodity related areas, particularly energy, is less bearish now, we do need a supply disruption or the Organization of Petroleum Exporting Countries (OPEC) agreeing to freeze production levels for crude prices to return to early 2014 levels.
- **As oil prices have steadied since last quarter, they have remained, for the most part, in the trading range we outlined in our last quarterly report (US$25-40/barrel).** In the absence of any resolution from OPEC, we anticipate that oil prices will remain in a similar range, but with a slightly higher resistance (~US$50/barrel) as the U.S. dollar has faded. Should a decline in OPEC production transpire, we anticipate that crude prices would reprice quickly and aggressively as shorting activity would be forced to cover.
- **Despite the improvement in sentiment over the last quarter, we believe investors should stay defensive.** With the recent market recovery, the market now has higher expectations, leaving it vulnerable to disappointments and negative headlines. Investors should stay cautiously optimistic but managing downside risks should be their major objective.

Chart A: The Market Recovery Has Come With Good Breadth



Source: Bloomberg

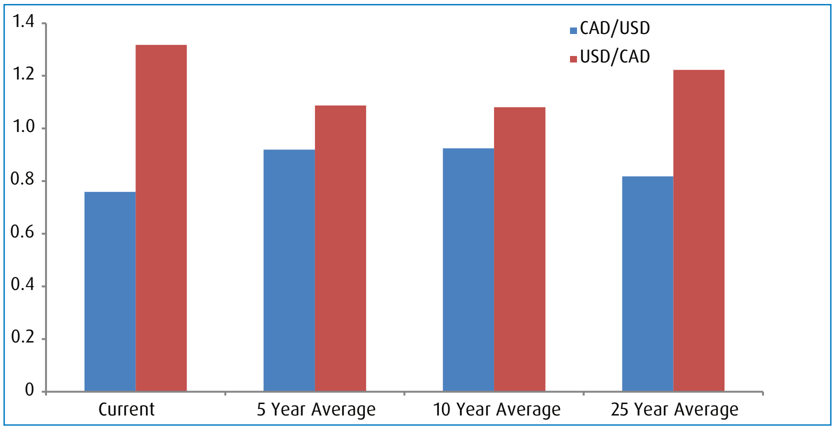
Chart B: Short Interest in Canadian Equities has Declined



Source: BMO Asset Management Inc., Bloomberg

BMO Exchange Traded Funds

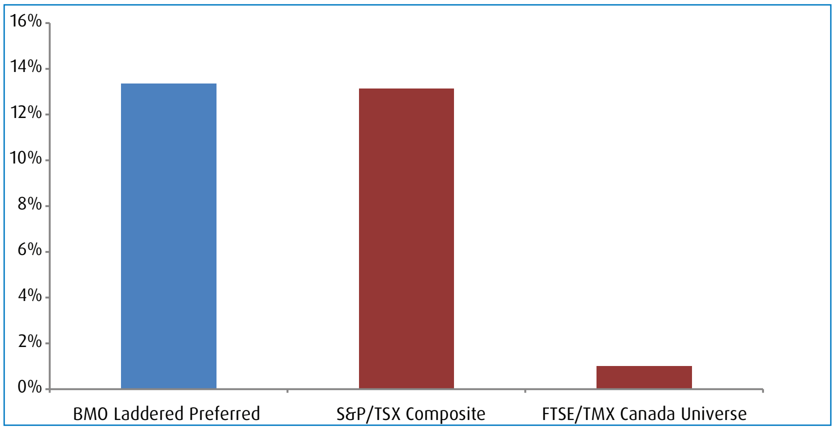
Things to Keep an Eye on...



Source: Bloomberg

Since January 19, 2016, the Canadian dollar has gained 11.4% relative to its U.S. counterpart. Although momentum indicators, such as the *Relative Strength Index (RSI)* suggest the greenback looks poised for a short-term rally, we believe the Canadian dollar has further room to strengthen over the longer-term. In terms of monetary policy, we continue to believe the market's expectation for the Fed to make two rate hikes in 2016 is aggressive. The BoC may also not make another rate cut as it has implied that the government's fiscal policy should do more of the heavy lifting.

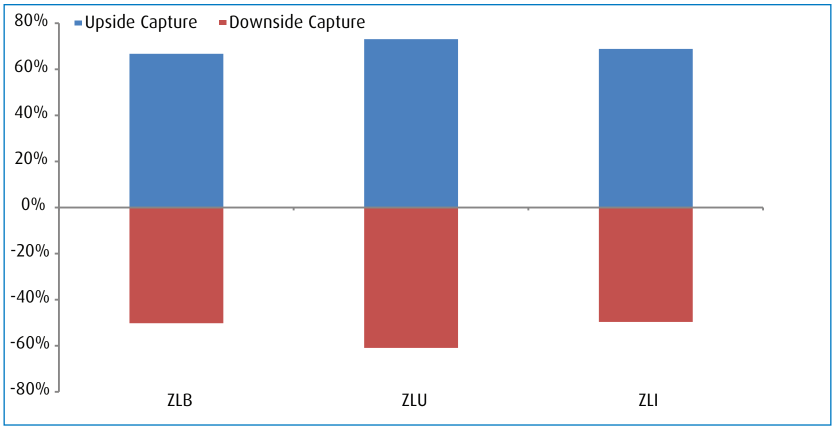
Recommendation: In our March Trade Opportunity report, "*Half In, Half Out*," we outlined investors may want to consider hedging part of their USD/CAD exposure. In terms of these two currencies, we believe there are three likely scenarios. The most bullish outcome for the Canadian dollar would be for signs of a global economic recovery or data showing conditions that are less negative than market expectations. Another possibility is for the economy and equity markets to continue facing headwinds, which would prevent the Fed from raising rates. This would also be positive for the Canadian dollar. The last scenario, would be for a market meltdown, leading to a flight to quality. This would be the one outcome that would benefit the U.S. dollar. Investors have a number of alternatives providing different currency exposures though BMO ETFs.



Source: Bloomberg

Coming into the new year, we expected preferred shares to have a difficult first half as issues scheduled to reset in 2016 had much tighter reset spreads than the market average. In addition, with oil prices weak at the time, we believed credit spreads with Canadian issuers would remain wide. With crude prices recently firming up and sentiment on the broader economy being less bearish, preferred shares have recently found some stability. In fact, since January 20, 2016 of this year, the ***BMO Laddered Preferred Share Index ETF (ZPR)*** has returned 13.3% on a total return basis.

Recommendation: In terms of preferred shares, we continue to believe the best opportunities remain in the rate reset market. Perpetual preferred shares, which pay a fixed dividend and have no maturity date, should have performed well with the 5-year Government of Canada yield falling 71 bps to 0.69% since January 1, 2015. Instead according the *BMO Capital Markets 50 Index Total Return-Straight Perpetual Sub-Index* perpetuals actually have been roughly flat on a total return basis between January 1, 2015 and March 31, 2016. Should oil prices rise and/or economic data improve, perpetuals may lag. Rate resets continue to look oversold, even at current interest rate levels. Investors looking for exposure to rate reset preferred shares with the addition of a laddered structure may want to consider ***ZPR***.



Source: Morningstar data as of March 31, 2016 based on daily returns. ZLB is compared to the S&P/TSX Composite TR, ZLU is compared to the S&P 500 Composite Index CAD and ZLI is compared to MSCI EAFE Index CAD.

Low volatility ETFs have been a central part of our BMO ETF Portfolio Strategy Report with our core holdings in the ***BMO Low Volatility Canadian Equity ETF (ZLB)*** and the ***BMO Low Volatility U.S. Equity ETF (ZLU)***. Often used as a defensive exposure, low volatility ETFs are often implemented to manage downside risk. However, the defensive characteristics are also the reason why these strategies tend to outperform over the long-term. By managing downside risks, a portfolio has a larger base to compound when markets recover.

Recommendation: International equity markets is where our low volatility ETFs have displayed the best upside and downside capture. This is a result of three potential levels in international markets where low volatility can add benefits beyond a traditional market cap weighted index. These are country, sector and security level. The ***BMO Low Volatility International Equity ETF (ZLI)*** and the ***BMO Low Volatility International Equity Hedged to CAD ETF (ZLD)*** may be used as a core holding or to complement an international fund or ETF.

Changes to Portfolio Strategy

Asset Allocation:

- Despite challenging market conditions year-to-date, our portfolio strategy continues to perform well as we maintain our diversification across asset classes and geographies. Our mix of various equity factors including low volatility, dividends and high quality exposures have also provided our portfolio strategy with additional stability. Given the strong performance of our strategy both on an absolute and relative basis, there are limited changes that we will make this quarter. Instead, we will take the opportunity to fine tune, rather than to implement wholesale changes to our portfolio strategy.
- As mentioned in our last quarterly report and on the previous page, we believe the Canadian dollar has some additional room to gain against the U.S. dollar. While we don't envision the loonie returning to parity, we believe the U.S. dollar could continue to drop to $1.20 CAD/USD, as sluggish economic growth could restrain the Fed from raising rates by more than two quarter points in 2016. As a result, we will currency hedge some of the positions in our strategy that have U.S. dollar exposure and closely monitor the two currencies and remove the hedge when it reaches our target level.

Fixed Income:

- For Canadian bond exposure, we continue to utilize a core-satellite strategy with the ***BMO Discount Bond Index ETF (ZDB)*** to gain broad exposure to the Canadian bond market. This ETF aims to provide similar characteristics as the *FTSE/TMX Canada Universe* (formerly called the "*DEX Universe*"), but with greater tax efficiency since it only holds bonds with a similar coupon and yield-to-maturity. As a more tactical position, we also hold the ***BMO Mid Corporate Bond Index ETF (ZCM)*** to tilt our exposure to overweight investment grade credit and mid-duration bonds. In our view, the BoC is still at least a year from sounding more hawkish. As such, we believe taking a little bit of duration risk in Canada to pick up additional yield will add value to a diversified portfolio strategy.
- A central part of our strategy has always been looking south of the border to add additional diversification to our strategy mix. The ***BMO Mid-Term U.S. IG Corporate Bond Index ETF (ZIC)*** has been one of the largest positions over the last year. We believe investment grade credit spreads have potential to tighten in the U.S., given the economic data suggest its economy continues to show signs of improvement. Based on our view that the Canadian dollar could continue to appreciate relative to the greenback, we are moving part of our position to the currency hedged version, the ***BMO Mid-Term U.S. IG Corporate Bond Hedged to CAD Index ETF (ZMU)***. We are thus moving 5.0% of our portfolio from ***ZIC*** to ***ZMU***, to protect some of the gains we made from the appreciation of the U.S. dollar over the last several years.

Equities:

- Similarly, we are moving part of our position from the ***BMO Low Volatility U.S. Equity ETF (ZLU)*** to the ***BMO Low Volatility U.S. Equity Hedged to CAD ETF (ZLH)***. Low volatility has been a central part of our U.S. equity strategy, as lower beta stocks tend to have better risk/return characteristics. With our slight negative outlook on the U.S. dollar over the mid-term, we are moving 4.0% of our portfolio from ***ZLU*** to ***ZLH***.
- Low volatility strategies tend to fare well in any market over the long-term given their propensity to protect on the downside. By capturing less of the downward moves in the market, the base of the portfolio is better preserved and has more to compound when markets rise again. Thus, its long-term outperformance is mathematical. As outlined on the previous page, international markets are where our low volatility strategies potentially offer the most value-add. This quarter we are removing the ***BMO International Dividend ETF (ZDI)*** from our portfolio and replacing it with 12.0% in the ***BMO Low Volatility International Equity Hedged to CAD ETF (ZLD)***.

Non-Traditional:

- Preferred shares have been an area that has experienced a setback over the last year and half. As mentioned on the previous page, we believe some recent developments are supportive of this asset class. While another rate-cut by the BoC would take rate-reset preferred shares down again, we believe the potential upside is far greater than the downside at this point. In addition, with a 5.7% distribution yield on the ***BMO Laddered Preferred Share Index ETF (ZPR)***, the tax efficient yield will partially mitigate downside moves. This quarter, we are adding 2.0% to our ***ZPR*** position.

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Mid-Term US IG Corporate Bond Index ETF	ZIC	5.0%	BMO Mid-Term US IG Corporate Bond Hedged to CAD Index ETF	ZMU	5.0%
BMO Low Volatility U.S. Equity ETF	ZLU	4.0%	BMO Low Volatility US Equity Hedged to CAD ETF	ZLH	4.0%
BMO International Dividend ETF	ZDI	14.0%	BMO Low Volatility International Hedged to CAD ETF	ZLD	12.0%
			BMO Laddered Preferred Share Index ETF	ZPR	2.0%
Total		**23.0%**	**Total**		**23.0%**

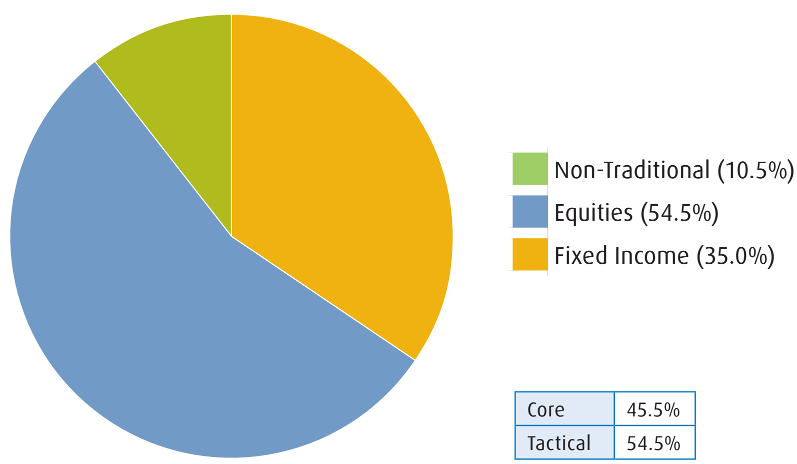
Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange traded funds (ETFs).

Stats and Portfolio Holdings

Ticker	ETF Name		Position	Price	Management Fee[1]	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/ Vol
	Fixed Income									
ZDB	BMO DISCOUNT BOND INDEX ETF	Fixed Income	Core	$16.13	0.20%	11.0%	4.1	3.3%	1.9%	0.46
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$18.95	0.25%	10.0%	12.9	9.6%	3.4%	0.26
ZMU	BMO MID-TERM US IG CORPORATE BOND HEDGED TO CAD INDEX ETF	Fixed Income	Tactical	$15.13	0.25%	5.0%	5.3	2.0%	3.3%	0.62
ZCM	BMO MID CORPORATE BOND INDEX ETF	Fixed Income	Tactical	$16.38	0.12%	9.0%	5.8	3.9%	3.2%	0.54
	Total Fixed Income					35.0%		18.8%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$27.27	0.35%	11.5%	13.6	11.7%	2.3%	0.17
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	Equity	Core	$29.34	0.30%	7.0%	13.9	7.3%	1.9%	0.13
ZLH	BMO LOW VOLATILITY US EQUITY HEDGED TO CAD ETF	Equity	Core	$21.47	0.30%	4.0%	9.0	2.7%	1.9%	0.21
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	Equity	Core	$20.12	0.40%	12.0%	13.1	11.7%	1.9%	0.14
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	Equity	Tactical	$16.73	0.40%	10.0%	21.1	15.7%	2.1%	0.10
ZWB	BMO COVERED CALL BANKS ETF	Equity	Tactical	$15.87	0.65%	3.0%	20.1	4.5%	5.9%	0.29
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	Equity	Tactical	$18.59	0.65%	3.0%	16.7	3.7%	5.2%	0.31
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	Equity	Tactical	$15.77	0.35%	4.0%	27.9	8.3%	1.8%	0.06
	Total Equity					54.5%		65.6%		
	Non-Traditional/Hybrids									
ZFH	BMO FLOATING RATE HIGH YIELD ETF	Equity	Tactical	$14.62	0.40%	3.5%	10.9	2.8%	4.9%	0.45
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Fixed Income	Tactical	$9.57	0.45%	7.0%	24.4	12.7%	5.7%	0.23
	Total Alternatives					10.5%		15.6%		
	Total Cash					0.0%	0.1	0.0%	0.0%	
	Portfolio				**0.31%**	**100.0%**	**13.4**	**100.0%**	**2.9%**	**0.21**

[1] Management Fee as of January 11, 2016.

Ticker	Top Holdings	Weight
ZLD	BMO LOW VOLATILITY INTERNATIONAL EQUITY HEDGED TO CAD ETF	12.0%
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	11.5%
ZDB	BMO DISCOUNT BOND INDEX ETF	11.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	10.0%
ZEQ	BMO MSCI EUROPE HIGH QUALITY HEDGED TO CAD ETF	10.0%
ZCM	BMO MID CORPORATE BOND INDEX ETF	9.0%
ZLU	BMO LOW VOLATILITY U.S. EQUITY ETF	7.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	7.0%
ZMU	BMO MID-TERM US IG CORPORATE BOND HEDGED TO CAD INDEX ETF	5.0%
ZLH	BMO LOW VOLATILITY US EQUITY HEDGED TO CAD ETF	4.0%
ZBK	BMO EQUAL WEIGHT U.S. BANKS INDEX ETF	4.0%
ZFH	BMO FLOATING RATE HIGH YIELD ETF	3.5%
ZWB	BMO COVERED CALL BANKS ETF	3.0%
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE HEDGED TO C$ ETF	3.0%



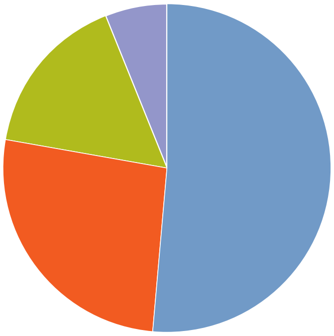
Core	45.5%
Tactical	54.5%

*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

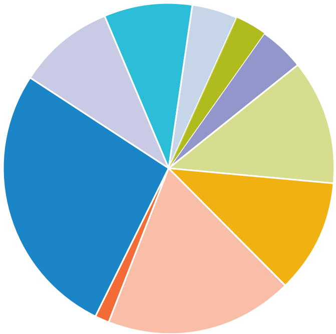
Regional Breakdown (Overall Portfolio)



Canada	51.5%
United States	26.5%
Europe	16.1%
Asia	5.9%

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

Equity Sector Breakdown



Financials	26.8%
Health Care	9.6%
Industrials	8.5%
Information Technology	4.4%
Materials	3.3%
Telecommunication Services	4.4%
Utilities	12.0%
Consumer Discretionary	11.2%
Consumer Staples	18.4%
Energy	1.4%

Fixed Income Breakdown

Federal	10.3%
Provincial	10.3%
Investment Grade Corporate	70.3%
Non-Investment Grade Corporate	9.1%

Weighted Average Term	7.88
Weighted Average Duration	6.14
Weighted Average Coupon	3.3%
Weighted Average Current Yield	3.2%
Weighted Average Yield to Maturity	2.8%

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: A steady gain in oil price has provided some stability to Canadian stocks and provided some relief to oil exporting countries such as ours. On an absolute level, however, oil prices still remain low which will benefit oil consuming nations, making a case for international diversification. As policy divergence remains a central theme, currency exposure is an important decision. With political and macro-economic risk lingering, we are cautiously optimistic preferring stocks with low volatility and quality characteristics. A mix of investment grade and high yield bonds, supplemented with preferred shares should provide income for investors as we remain in a low interest rate environment.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• U.S. unemployment continues to improve. Non-farm payrolls came in better than expectations than expectations while unemployment dropped to 4.9%. • Canadian federal government released its budget with a fiscal stimulus plan. • Unemployment in the Eurozone fell for the 15th straight month. • US Existing home sales have recovered to pre-2008 levels. • Eurozone composite PMI remains above 50. • Australia had its 98th quarter without a recession. • Saudi Arabia agrees to oil production freeze, conditional on others freezing as well.	• Oil demand has been steadily rising, partially offsetting some of the excess inventory. • Depressed earnings per share (EPS) of TSX stocks may seem like a negative, but now leaves ample room for earnings expansion.	• Canadian equities are among the best performing asset for the year. • Gold is up 21% since its December low. • After falling more than 10%, U.S. equities ended the quarter in positive territory (a feat that hasn't happened since Q4 1933). • Oil bottoms and breaks above US$40/barrel. • S&P 500 broke above its 200-day moving average. • MSCI Emerging Markets Index also broke above its 200-day, and had its best month since 2009. • Short interest in the US has reached its highest level since 2008.
Bad	• U.S. Fed sees risks to the downside, rate expectations are thus lowered. • Brexit risk increases with probability of Great Britain leaving the EU greater than staying. • BoJ sets rates negative to -0.1%. • China put on downgrade watch by both Moody's and S&P. • Iran opens its oil to the world after a long period of international sanctions.	• U.S. margins are elevated and are likely to fall. • Global earnings recession continues. • U.S. equities are beginning to look more expensive with its 18.5x current P/E ratio vs. its 10-year average of 16.6x. • Valuation on global stocks are also becoming slightly stretched with the 19.6x current P/E ratio of the MSCI World Index. This compares to its 10-year 17.3x P/E ratio.	• US TWI broke below its 200-day moving average. • German yields are negative out to 9 years. • Japan rates across the curve tumble to record low.
Ugly	• Greece returns to recession. • Deflation in Europe. • Trade balance in Canada swells as exports shrink. • U.S. net investments is still at recessionary levels. • Global PMI are turning over and heading lower towards 50.	• U.S. Price-to-sales is higher than any time in the sub-prime boom. • U.S. share buybacks-to-EBIT are at an all-time high.	• The USD has been the strongest G10 currency for the last 2 years, a trend that is unlikely to continue. • U.S. dollar remains way above its long term PPP.

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