The New Fixed Income Environment
BMO Mutual Funds: Fixed Income Platform
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For more information on BMO Mutual Funds products, please visit us at: http://www.bmo.com/mutualfunds
A Whole **New World**

Actively managed fixed income strategies have become even more important today as a result of the changing Canadian fixed income landscape.

A low yielding environment combined with limited price appreciation has meant opportunities in the Canadian bond market are shrinking. Investors who have succeeded with broad bond market exposure (‘beta’) alone may find it difficult to generate the same risk-adjusted returns going forward.

In today’s new world, active fixed income strategies are needed to exploit all of the opportunities that exist within the fixed income universe.

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**FIXED INCOME PLATFORM**

**SHORT TERM FIXED INCOME**
- BMO Money Market Fund
- BMO U.S. Dollar Money Market Fund
- BMO Short-Term Income Class
- BMO Mortgage & S/T Income Fund
  - Monthly | Variable
  - YTM: 1.79% | Duration: 2.41 yrs
- BMO Laddered Corporate Bond Fund
  - Monthly | Variable
  - YTM: 1.96% | Duration: 2.53 yrs

**HIGH YIELD FIXED INCOME**
- BMO High Yield Bond Fund
  - Monthly | 4.5¢
  - YTM: 7.00% | Duration: 2.90 yrs
- BMO U.S. High Yield Bond Fund
  - Monthly | 4¢
  - YTM: 6.31% | Duration: 4.45 yrs
- BMO Floating Rate Income Fund
  - Monthly | Variable
  - YTM: 5.21% | Duration: 0.93 yrs

**CORE FIXED INCOME**
- BMO Bond Fund
  - Monthly | Variable
  - YTM: 2.53% | Duration: 7.06 yrs
- BMO Core Bond Fund
  - Monthly | Variable
  - YTM: n/a | Duration: n/a
- BMO Core Plus Bond Fund
  - Monthly | Variable
  - YTM: n/a | Duration: n/a
- BMO Target Yield ETF Portfolio
  - Monthly | 2.5¢
  - YTM: 3.00% | Duration: 4.40 yrs

**GLOBAL FIXED INCOME**
- BMO World Bond Fund
  - Annual
  - YTM: 1.97% | Duration: 6.07 yrs
- BMO Emerging Markets Bond Fund
  - Monthly | Variable
  - YTM: 5.19% | Duration: 6.50 yrs
- BMO Global Strategic Bond Fund
  - Monthly | 3.5¢
  - YTM: 6.40% | Duration: 5.10 yrs

**BROAD RANGE OF FIXED INCOME SOLUTIONS**

The BMO Mutual Funds Fixed Income product suite is designed to allow investors to optimally build a fixed income portfolio.

The bond map illustrates the bond market across the full spectrum of our fixed income fund lineup.

Our funds invest in a wide range of asset classes including government bonds and foreign bonds from both developed and emerging economies, as well as investment grade and high yield corporate bonds.

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Source: BMO GAM, September 30th 2014
The **Current** Yield Environment

**Yield Crisis?**

With bond and dividend yields falling to historic lows, many investors are left wondering what to do. These secular trends have been driven by central bank policies, low inflation, and a growing demand for income-producing solutions.

This has been accelerated further by central banks around the world cutting interest rates to near zero in the wake of the Financial Crisis and the subsequent recession that followed.

Historically, low bond yields have driven investors to seek income from other asset classes such as dividend paying equities, but dividend yields have also fallen.

As investors continue to hunt for yield, non-traditional fixed income instruments such as global fixed income, high yield bonds, and emerging market debt have become more attractive.

While increasing exposures to these asset classes give the opportunity for added yield, it also comes with the potential for increased risk. Being able to actively maneuver within a proper asset allocation strategy combined with diligent investment management will be key to coming out ahead.

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**Did You Know?**

While many investors are aware of the tradeoff you get when buying a GIC (limited return potential for guaranteed protection of capital), most investors are surprised that historically, Canadian bonds\(^1\) have offered similar protection but with far superior returns.

Ever since Canadian bonds were first tracked by an index\(^2\), they have outperformed GICs, and more importantly, have never lost money over any 3yr, 5yr, or 10yr period.

\(^1\)Canadian Bonds represented by FTSE TMX Canada Universe Bond Index

\(^2\)Since January 1980
Fixed Income Provides Safety & Income

Get stability from Fixed Income...

In today’s low yielding environment coupled with limited total return upside, there have been some investors who have thought about abandoning core fixed income altogether. That would be a mistake.

While it’s true that traditional fixed income securities provide the potential for modest growth and interest income, investors should remember that the primary role of this asset class is to provide a safety net to portfolio volatility when combined with riskier asset classes, such as equities.

The diversification benefits can be substantial, regardless of the market environment, and becomes even more pronounced when equity markets have experienced sharp declines.

... alongside a reliable income stream

As fixed income investors, we all know what happens to traditional bond investments when interest rates rise. Basic math tells us that there’s an inverse relationship between bond prices and interest rates – when one goes up, the other goes down. And the longer the duration, the more severe the decline in bond prices.

While bond prices might drop when interest rates rise, there’s another source of potential returns that an investor can rely on to offset at least some of the price declines: income.

Income from bonds are a reliable source of cash flow, regardless of whether interest rates are rising or falling. This might surprise most investors, but since 2005 approximately 90% of the total returns of the FTSE TMX Canada Universe Bond Index have come from interest payments, not changes in bond prices.
Even when rates are rising, the interest payments from a bond help offset some of the price declines. Rising rates usually translate into higher interest payments over time. So while the price of a bond may drop in the immediate period that rates rise, over time, higher interest rates could actually help investors.

Refer to the table on the right for an example. It shows that interest payments for the FTSE TMX Canada Universe Bond Index have actually helped negate most of the negative price returns whenever they’ve occurred.

While price returns have been negative almost half of the time since 2006, there has actually been only one negative performing calendar year during this period, since interest income has been able to offset the majority of the losses due to price changes.

The key point for investors to remember is that changes in interest rates don’t impact prices only. There are two components to a bond’s structure, and the changes in yield cushion’s the price impact. Take for example BMO Target Yield ETF Portfolio. A 50bps point change in interest rates results in the current yield offsetting the change in bond price.

When the change in price and yield are netted together, investors should realize that the most important figure to pay attention to is a bond’s total return.
The Need For a More **Active** Approach

The general role of all active managers is to find ways to exploit market inefficiencies with an eye to lower volatility and enhance total returns. Not only are they attempting to add value in the process, but they’re also looking to reduce volatility and minimize specific risks associated with individual securities that can occur when following a benchmark.

Now more than ever has the need for active management in the fixed income world been more evident. With today’s near-zero rate environment, which has resulted in low yields across the curve, investors seeking to generate income from traditional Canadian bond holdings can find it difficult, especially with the limited opportunities for price appreciation in the markets.

**Yield Curve Roll Down**

Each year as a bond nears maturity it will start to ‘roll down’ the curve towards lower yields. Active managers can search for these bonds that are positioned at the steeper parts of the yield curve and benefit as a bond moves from a higher yielding term to a shorter term while still carrying its original coupon.

This can act as a partial buffer in a rising interest rate environment as the roll down effect offsets some of the negative impacts of rising yields on bond prices.

**Yield Curve Roll Down Example**

A 3-year U.S. Treasury starts at 1.07%
B Rates rise by 100bps, implying a 2.07% rate on 3-year U.S. Treasuries
C However, as a 3-year bond ages to 2-years to maturity, its yield would fall to 1.58%. This would result in less price deterioration (approximately half of the yield increase)

Source: BMO GAM, September 30 2014

**Off-the-run bonds**

Some of the most liquid bonds in the market are ‘benchmark’ bonds, which are securities with specific terms such as 2yr, 5yr, 10yr, and 30yr issues. However, when a specific bond no longer qualifies as a benchmark bond, and a new bond with the same term is issued, it becomes known as an ‘off-the-run’ bond. These bonds are generally issued with higher yields at the cost of slightly less liquidity.

Active managers can exploit the difference in yields between the two bonds by buying the higher yielding off-the-run bonds resulting in excess yield with the same credit quality at the cost of non-material liquidity.

**Foreign Bonds**

The Canadian fixed income market makes up only a small fraction of the opportunities available around the world.

By expanding the investable universe to include international sovereign bonds, foreign investment grade and high yield bonds, emerging market debt, and the ability to gain exposure through a variety of derivatives, active managers have an even wider variety of sources to generate strong performance and to diversify a portfolio.

**Reliance on Credit Agencies**

The pricing of individual bonds are heavily influenced by its assigned credit rating. While credit rating agencies are used by all managers, most only use these ratings as a starting point, or an input into their own proprietary credit research.

While this additional analysis is done in the hope of uncovering mispriced fixed income securities, it can also identify securities that are deteriorating and have not been downgraded by rating agencies.

**Relative size of the Canadian Fixed Income Market**

$55 trillion

$1 trillion

Source: Bloomberg, March 2014 in $C. Includes government & investment grade corporate bonds, inflation linked bonds, high yield bonds, and EM local debt)
The Need For a More Active Approach

Benchmark Weightings
The composition of any bond market is based on the sum of all the issuances in the market. In Canada, the fixed income allocation that results from this phenomena is eerily similar to our equity market, as it’s very concentrated in a few select sectors.

Government bonds make up over 70% of the Canadian bond market, but given the context of the low yielding environment we’re in, this might not necessarily be the optimal allocation for the end investor.

<table>
<thead>
<tr>
<th></th>
<th>Growth (15% probability)</th>
<th>Sluggish (70% probability)</th>
<th>Recession (15% probability)</th>
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</thead>
<tbody>
<tr>
<td>Canadian Federal Bonds</td>
<td>-0.9%</td>
<td>2.3%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Canadian Corporate Bonds</td>
<td>1.6%</td>
<td>3.9%</td>
<td>2.6%</td>
</tr>
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</table>

Source: CIBC Capital Markets

Furthermore, as illustrated by the table above, the return possibilities across the spectrum of Canadian fixed income sectors, especially for Canadian Federal Bonds, run fairly wide. Ultimately, this allows an active manager to exploit and opportunistically allocate across sectors to reduce the concentration risk that exists within the benchmark.

Sector Allocation
Identifying opportunistic sectors can in most cases produce superior returns over the long term. And while investors normally associate this with equities, the same thinking applies with fixed income. And much like equities, what’s doing well one year in the fixed income markets doesn’t necessarily mean success in the following year.

The ability for a manager to actively overweight an undervalued area of the market and completely remove exposure to more risky sectors increases the chances to outperform the broad market.

Security Selection
Within the fixed income market, there exists a wide variety of securities with different characteristics (coupons, quality, duration, etc...). This is especially true given the context of the current fixed income environment - since the Credit Crisis in 2008, there has been a material increase in the level of risk in the market (particularly with bank capital, corporate bonds, and within the European government bond markets).

Identifying individual fixed income securities that are expected to generate optimal risk-adjusted returns are just another tool that can add value to a portfolio.
The Need For a More Active Approach

Duration Management
Active fixed income managers can change the overall duration of their portfolios relative to a benchmark to increase yield and to reduce volatility. Increasing the duration of the portfolio has the effect of increasing the yield of a portfolio (assuming a normal upward-sloping yield curve).

Furthermore, when interest rates are expected to rise, managers have the ability to reduce the interest rate exposure of their portfolio by shortening duration, which has the effect of offsetting the price declines of the underlying bonds.

Yield Curve Positioning
The yield curve at any given time reflects the range of yields that investors of a particular bond can expect over various terms of maturity. Over the term of a bond, changes in interest rate outlook, due to fundamental or technical factors, can change the yield curve in a number of ways:

- If interest rates change by the same amount for all terms of bonds (very rare), the yield curve is said to have had a parallel shift.
- When the difference between short and long term interest rates increases, the yield curve is said to steepen.
- When the difference between short and long term rates decreases, the yield curve is said to flatten.

Normally the yield curve slopes upwards, where short-term rates are lower than long term rates, but there have been times when the yield curve “inverts” or flips due to drastic changes in market outlook. When this happens, long term interest rates can be lower than short-term rates.

The yield curve provides the market’s unbiased outlook. If the investors’ view differs, savvy investors can make calls in their bond portfolio to take advantage of the shape of the yield curve.

Hypothetical impact of changing rates on a bond portfolio’s total return

An example of a flattening yield curve

The Need For a More Active Approach

The need for income is still here and is something that likely wont change for the foreseeable future. However, we’re now more than five years removed from the Credit Crisis in 2008 and economic growth has been positive and monetary easing policies around the world have made money cheap. These are all factors that should have pushed interest rates higher, yet rates still remain low. Given the context of this new world, the overarching theme within fixed income going forward should be to tactically allocate portfolios to areas that have the best chance of producing superior results.

Sitting still in an aggregate bond strategy that’s fully exposed to today’s low yielding environment, along with the inherent duration risk that exists in the markets isn’t necessarily something that will yield a successful outcome. Instead, a good allocation of quality and credit, taking advantage of non-traditional tools not easily accessible in the physical market such as currencies, derivatives, and overlay strategies, all within tactically selected sectors is likely the more effective approach to portfolio management.
**BMO has Fixed Income Covered**

BMO gives you access to the fixed income world with fantastic choices, opportunities and expertise.

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**BMO Money Market Fund**
- **Objective**: A Canadian bond fund which has a primary objective of capital preservation
- **Inception Date**: May 1988
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian Money Market
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO U.S. Dollar Money Market Fund**
- **Objective**: A core Canadian bond fund that blends the importance of capital preservation and maximizing total return
- **Inception Date**: October 1998
- **Portfolio Manager**: Peter Arts
- **Category**: U.S. Money Market
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Short-Term Income Class**
- **Objective**: An unconstrained core Canadian bond fund with the ability to use a variety of tools to maximize total return
- **Inception Date**: November 2000
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian S/T Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Mortgage & S/T Income Fund**
- **Objective**: A global bond fund that targets risk adjusted yields by using a variety of ETFs
- **Inception Date**: July 1974
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian S/T Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Laddered Corporate Bond Fund**
- **Objective**: A global bond fund that invests primarily in sovereign debt to generate total return
- **Inception Date**: April 2012
- **Portfolio Manager**: Rob Bechard
- **Category**: Canadian S/T Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | 2.4¢

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**BMO Bond Fund**
- **Objective**: A Canadian bond fund which has a primary objective of capital preservation
- **Inception Date**: May 1988
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian Money Market
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Core Bond Fund**
- **Objective**: A core Canadian bond fund that blends the importance of capital preservation and maximizing total return
- **Inception Date**: November 2014
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Core Plus Bond Fund**
- **Objective**: An unconstrained core Canadian bond fund with the ability to use a variety of tools to maximize total return
- **Inception Date**: November 2014
- **Portfolio Manager**: Denis Senécal
- **Category**: Canadian Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | Variable

**BMO Target Yield ETF Portfolio**
- **Objective**: A core global bond fund that targets risk adjusted yields by using a variety of ETFs
- **Inception Date**: April 2012
- **Portfolio Manager**: Robert Bechard
- **Category**: Canadian Fixed Income
- **Risk Level**: Low
- **Distribution**: Monthly | 2.4¢

**BMO World Bond Fund**
- **Objective**: A global bond fund that invests primarily in sovereign debt to generate total return
- **Inception Date**: August 1993
- **Portfolio Manager**: Robert Bechard
- **Category**: Global Fixed Income
- **Risk Level**: Low-to-Medium
- **Distribution**: Annual

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**BMO Emerging Markets Bond Fund**
- **Objective**: An emerging market bond fund with exposure to both hard & local currencies to generate absolute total return
- **Inception Date**: August 2013
- **Portfolio Manager**: Tere Alvares Canida
- **Category**: Emerging Market Bonds
- **Risk Level**: Low-to-Medium
- **Distribution**: Monthly | Variable

**BMO Global Strategic Bond Fund**
- **Objective**: A tactical global bond fund that invests in investment grade & high yield bonds and emerging market debt to generate income and total return
- **Inception Date**: November 2008
- **Portfolio Manager**: Curtis Mewbourne
- **Category**: Global High Yield
- **Risk Level**: Low-to-Medium
- **Distribution**: Monthly | Variable

**BMO High Yield Bond Fund**
- **Objective**: A broad high yield bond fund that invests in the U.S. & Canada to generate interest income and total return
- **Inception Date**: January 1999
- **Portfolio Manager**: Lori Marchildon
- **Category**: High Yield Fixed Income
- **Risk Level**: Low-to-Medium
- **Distribution**: Monthly | 3.5¢

**BMO U.S. High Yield Bond Fund**
- **Objective**: A U.S. high yield bond fund that seeks to generate a high level of interest income and absolute total return
- **Inception Date**: June 2008
- **Portfolio Manager**: Lori Marchildon
- **Category**: High Yield Fixed Income
- **Risk Level**: Low-to-Medium
- **Distribution**: Monthly | 4.0¢

**BMO Floating Rate Income Fund**
- **Objective**: A high yield fixed income fund with ultra low duration designed for rising interest rate environments
- **Inception Date**: July 2005
- **Portfolio Manager**: Lori Marchildon
- **Category**: High Yield Fixed Income
- **Risk Level**: Low-to-Medium
- **Distribution**: Monthly | Variable
The New Fixed Income Environment

ACTIVE FIXED INCOME

Multi-Strategy Philosophy:
• Bottom-up, value oriented buy-and-hold process
• Top-down views on the macroeconomic environment
• Extensive use of fundamental and technical credit analysis
• Emphasizes diversification of ‘layers’
• Diligent portfolio management

Additionally, there is a strong emphasis on risk management through the use of a proprietary risk management system which allows the team to identify, measure and manage risks that impact the value of the portfolio on a regular basis.

BMO Asset Management’s fixed income team actively employs a multi-strategy approach with the goal of minimizing volatility, enhancing portfolio yield and taking advantage of market opportunities.

SPOTLIGHT: BMO’S CORE FIXED INCOME SOLUTIONS

BMO Bond Fund
A core Canadian bond fund investing in traditional fixed income instruments.
Capital preservation and providing a stable level of interest income are the main objectives of this strategy.

BMO Core Bond Fund
A core Canadian bond fund that invests in both traditional and non-traditional fixed income instruments.
Capital preservation and providing a high level of interest income are the main objectives of this strategy.

BMO Core Plus Bond Fund
A flexible core Canadian bond fund with the ability to invest in foreign bonds, emerging market debt, and high yield bonds to enhance yield and provide diversification benefits.
Providing a high level of interest income and total return are the main objectives of this strategy.

The Fixed Income Continuum
The risk-return characteristics across fixed income

In an ever expanding fixed income world, the case for fixed income diversification has become an even more important tool for investors. When constructing a fixed income portfolio and analyzing the resulting risk-return characteristics over a meaningful period of time, it becomes clear how non-traditional fixed income asset classes can work in tandem to build better portfolios.

When analyzed independently, non-traditional fixed income asset classes, such as high yield bonds, emerging market debt, and floating rate loans, to name a few, can bring a sizeable amount of risk as stand-alone investments. Only when combined with more traditional and other non-traditional fixed income holdings can the benefits of diversification begin to take hold, resulting in lower overall volatility while maintaining much of the upside potential.

Diversification
Come in to your local BMO branch and speak to one of our trusted financial professionals to find out more.

For more information on BMO Mutual Funds products, please visit us at: http://www.bmo.com/mutualfunds

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