The New Fixed Income Environment

BMO Mutual Funds: Fixed Income Platform

BMO Mutual Funds

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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.

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.

FIXED INCOME PLATFORM

STRATEGICALLY DESIGNED TO FILL YOUR INVESTMENT NEEDS

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

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.

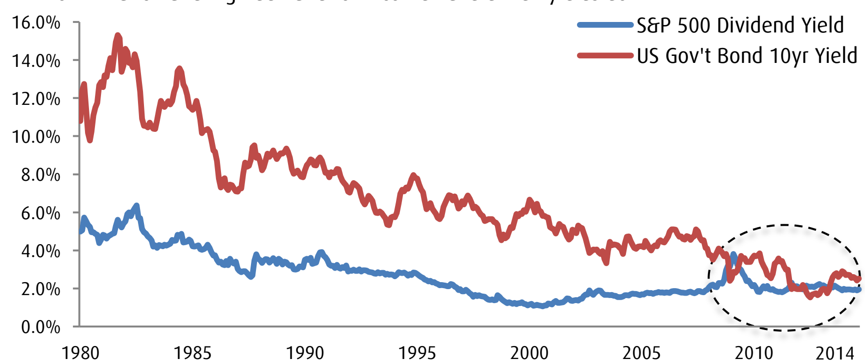
Historically, low bond yields have driven investors to seek income from other asset classes such as dividend paying equities, but dividend yields have also fallen.

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 manoeuver within a proper asset allocation strategy combined with diligent investment management will be key to coming out ahead.

Declining yields are not a new phenomena

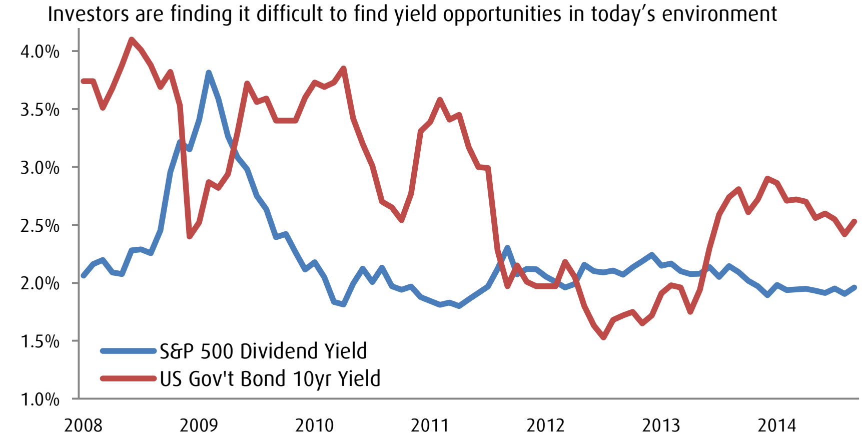
Low inflation and high demand for income have driven yields down



Source: BMO GAM, Bloomberg, September 30th 2014.

Yields are low for both bonds and dividends

Investors are finding it difficult to find yield opportunities in today's environment



Source: BMO GAM, Bloomberg, September 30th 2014.

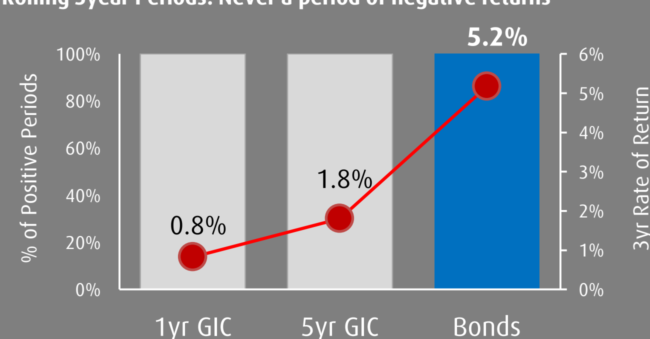
Did You Know?

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

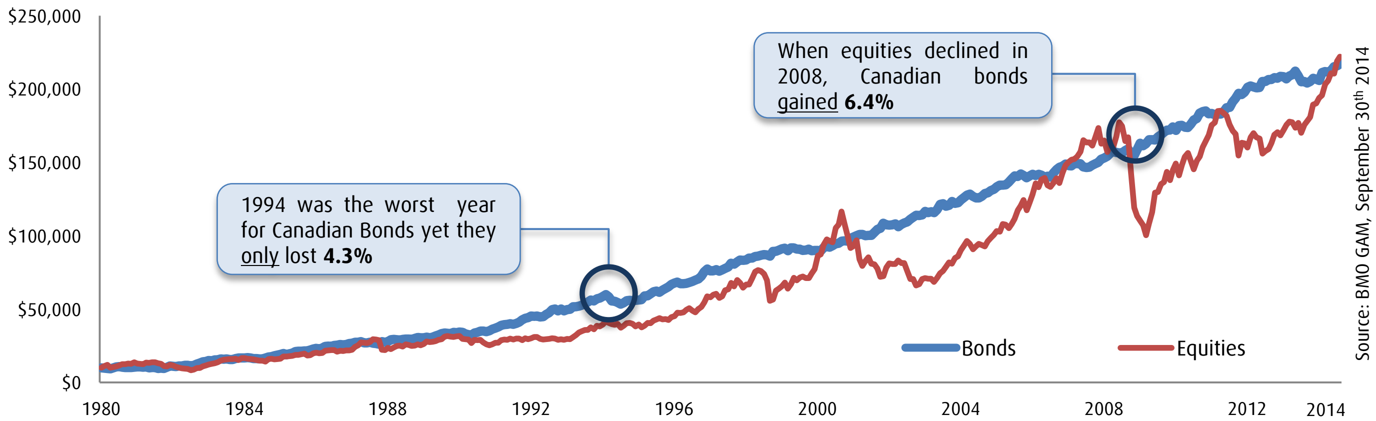
Rolling 3year Periods: Never a period of negative returns



Source: BMO GAM, September 30th 2014

BMO Mutual Funds

Fixed Income Provides Safety & Income



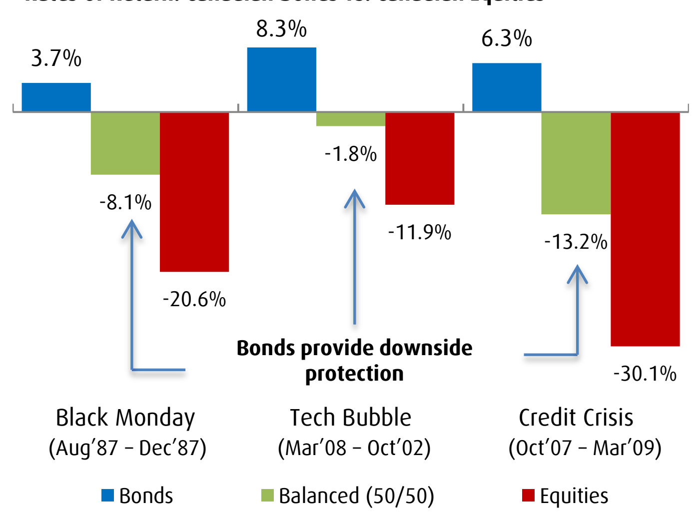
Get stability from Fixed Income...

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.

Rates of Return: Canadian Bonds vs. Canadian Equities



Source: BMO GAM, September 30th 2014. Bonds: FTSE TMX Canada Universe Bond Index; Equities: S&P/TSX Composite Index; Balanced: 50% FTSE TMX Canada Universe Bond Index & 50% S&P/TSX Composite Index

... alongside a reliable income stream

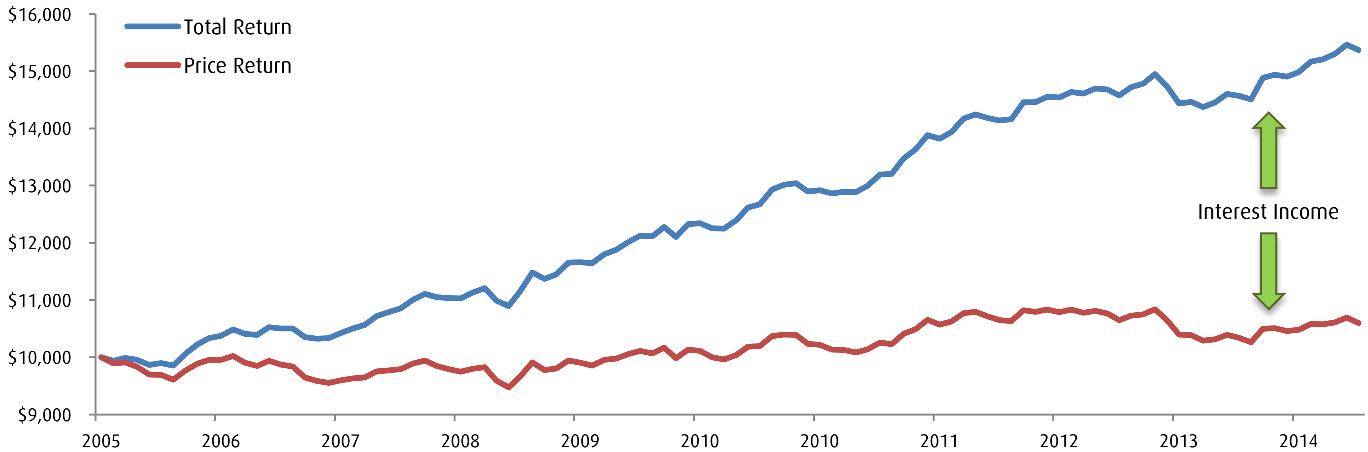
As fixed income investors, we all know what happens to traditional bond investments when interest rates rise. Basic math tells us that there's an inverse relationship between bond prices and interest rates – when one goes up, the other goes down. And the longer the duration, the more severe the decline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

Fixed Income Provides Safety & Income

Bond returns come from 2 sources: Price and Interest Income
Canadian Bond Index: FTSE TMX Canada Universe Bond Index



Source: BMO GAM, Bloomberg, September 30th 2014

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 has 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.

Coupon returns have helped offset price declines
Canadian Bond Index: FTSE TMX Canada Universe Bond Index

Year	Price Return	Income Return	Total Return
2014 YTD	3.24%	2.61%	5.93%
2013	-4.65%	3.61%	-1.19%
2012	-0.10%	3.70%	3.60%
2011	5.46%	4.02%	9.67%
2010	2.35%	4.30%	6.74%
2009	0.75%	4.63%	5.41%
2008	1.39%	4.97%	6.42%
2007	-1.34%	5.08%	3.68%
2006	-0.95%	5.05%	4.06%

Source: BMO GAM, Bloomberg, September 30th 2014.

Hypothetical Example: BMO Target Yield ETF Portfolio
Changes in yield can cushion changes in bond prices

Interest Rate Change	Bond Price Change	Current Yield
0	0	3.9%
+ 50bps	-2.2%	4.4%
- 50 bps	+2.2%	3.4%

Source: BMO GAM, Morningstar, September 2014. The above scenario is based on BMO Target Yield ETF Portfolio which had a duration of 4.4 years and a current yield of 3.9%

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.

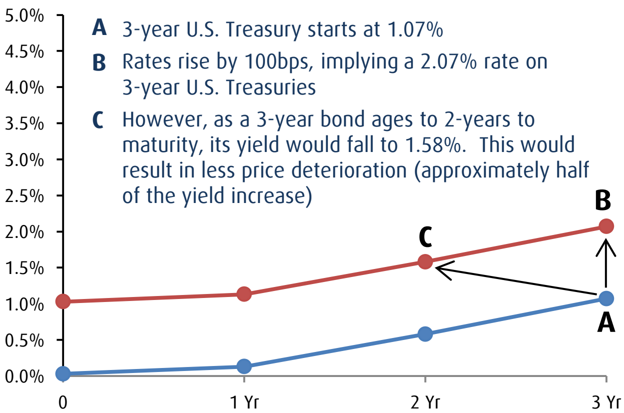
Faith, Trust, and Pixie Dust... Take advantage of market inefficiencies:

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



Source: BMO GAM, September 30 2014

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.

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.

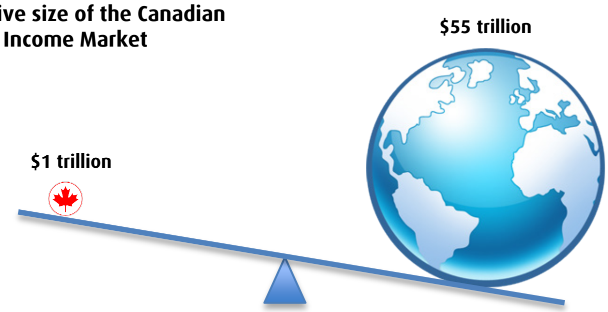
Active managers can exploit the difference in yields between the two bonds by buying the higher yielding off-the-run bonds resulting in excess yield with the same credit quality at the cost of non-material liquidity.

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.

Relative size of the Canadian Fixed Income Market



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

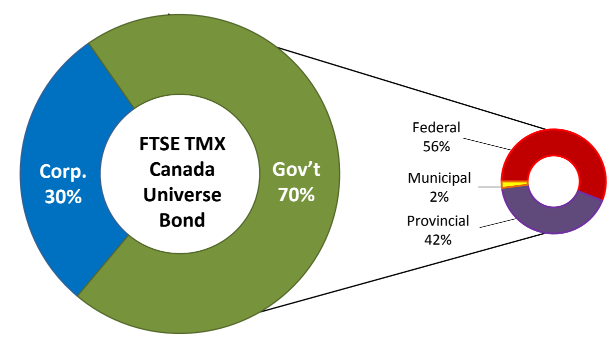
The composition of any bond market is based on the sum of all the issuances in the market. In Canada, the fixed income allocation that results from this phenomena is eerily similar to our equity market, as it's very concentrated in a few select sectors.

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.

	Growth (15% probability)	Sluggish (70% probability)	Recession (15% probability)
Canadian Federal Bonds	**-0.9%**	**2.3%**	**7.0%**
Canadian Corporate Bonds	**1.6%**	**3.9%**	**2.6%**

Source: CIBC Capital Markets

Credit Breakdown of the Canadian Bond Index



Source: BMO GAM, June 30th 2014

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.

Calendar Year Returns of various Fixed Income Sectors

2007	2008	2009	2010	2011	2012	2013	2014 YTD
CDN Govt Bonds 4.4%	Global Bonds 31.1%	High Yield 33.8%	High Yield 9.2%	CDN Govt Bonds 10.2%	EM Bonds 14.8%	High Yield 14.6%	EM Bonds 18.6%
CDN ST Bonds 4.1%	EM Bonds 10.0%	CDN IG Corps 16.3%	CDN IG Corps 7.3%	EM Bonds 10.0%	High Yield 13.0%	Global Bonds 3.9%	High Yield 12.1%
CDN Bonds 3.7%	CDN Govt Bonds 9.0%	EM Bonds 10.2%	CDN Bonds 6.7%	CDN Bonds 9.7%	CDN IG Corps 6.2%	CDN ST Bonds 1.7%	Global Bonds 9.3%
CDN IG Corps 1.8%	CDN ST Bonds 8.6%	CDN Bonds 5.4%	CDN Govt Bonds 6.5%	Global Bonds 8.3%	CDN Bonds 3.6%	EM Bonds 1.1%	CDN Govt Bonds 8.2%
Global Bonds -7.1%	CDN Bonds 6.4%	CDN ST Bonds 4.5%	EM Bonds 6.4%	CDN IG Corps 8.2%	CDN Govt Bonds 2.6%	CDN IG Corps 0.8%	CDN Bonds 8.0%
EM Bonds -10.0%	CDN IG Corps 0.2%	CDN Govt Bonds 1.6%	CDN ST Bonds 3.6%	High Yield 7.0%	Global Bonds 2.0%	CDN Bonds -1.2%	CDN IG Corps 7.6%
High Yield -13.3%	High Yield -7.9%	Global Bonds -9.2%	Global Bonds 0.0%	CDN ST Bonds 4.7%	CDN ST Bonds 2.0%	CDN Govt Bonds -2.0%	CDN ST Bonds 2.8%

Source: BMO GAM, Morningstar, September 2014. CDN Govt Bonds: FTSE TMX Canada Government Bond Index; CDN ST Bonds: FTSE TMX Canada Short-Term Bond Index; CDN LT Bonds: FTSE TMX Canada Long Term Bond Index; CDN Bonds: FTSE TMX Canada Universe Bond Index; CDN IG Corps: FTSE TMX Canada All Corp Bond Index; Global Bonds: Barclays Capital Global Aggregate Bond Index; EM Bonds: JPM EMBI Global Diversified Bond Index; High Yield: BofA ML Master II Index. All returns in $CAD

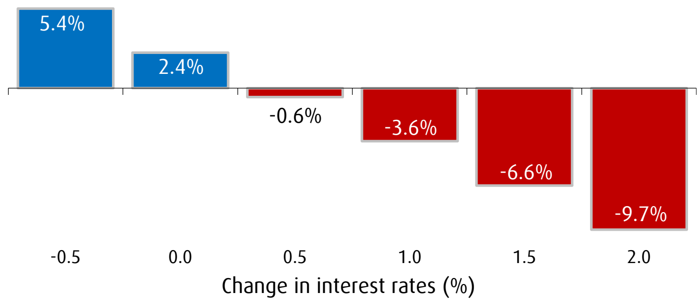
The Need For a More Active Approach

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.

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



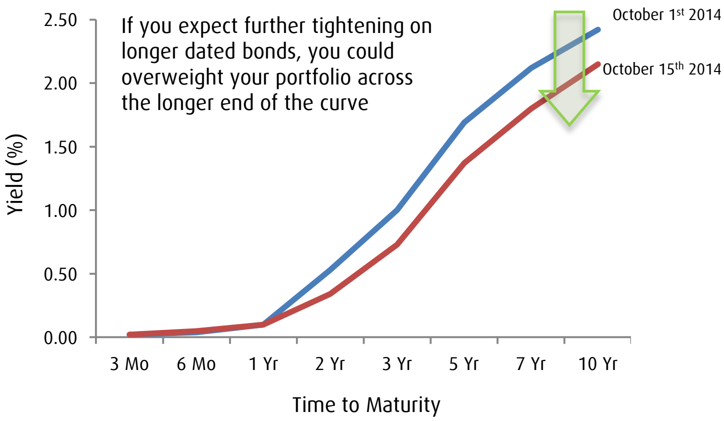
Source: BMO GAM, September 2014. The bond portfolio is represented by the FTSE TMX Canada Universe Bond Index.

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.

An example of a flattening yield curve



Source: BMO GAM

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

The Road Ahead

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

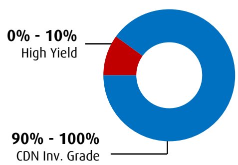
BMO gives you access to the fixed income world with fantastic choices, opportunities and expertise

Short-Term Fixed Income

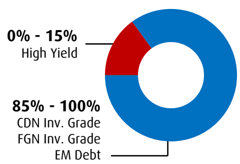
	BMO Money Market Fund	BMO U.S. Dollar Money Market Fund	BMO Short-Term Income Class	BMO Mortgage & S/T Income Fund	BMO Laddered Corporate Bond Fund
INCEPTION DATE	May 1988	October 1998	November 2000	July 1974	April 2012
PORTFOLIO MANAGER	Denis Senécal	Peter Arts	Denis Senécal	Denis Senécal	Rob Bechard
CATEGORY	Canadian Money Market	U.S. Money Market	Canadian S/T Fixed Income	Canadian S/T Fixed Income	Canadian S/T Fixed Income
RISK LEVEL	Low	Low	Low	Low	Low

Core Fixed Income

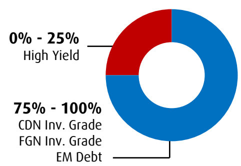
BMO Bond Fund



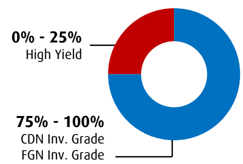
BMO Core Bond Fund



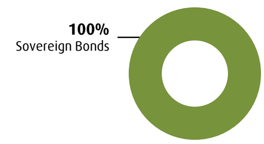
BMO Core Plus Bond Fund



BMO Target Yield ETF Portfolio



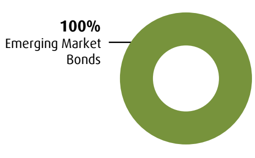
BMO World Bond Fund



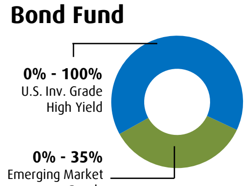
	BMO Bond Fund	BMO Core Bond Fund	BMO Core Plus Bond Fund	BMO Target Yield ETF Portfolio	BMO World Bond Fund
OBJECTIVE	A Canadian bond fund which has a primary objective of capital preservation	A core Canadian bond fund that blends the importance of capital preservation and maximizing total return	An unconstrained core Canadian bond fund with the ability to use a variety of tools to maximize total return	A core global bond fund that targets risk adjusted yields by using a variety of ETFs	A global bond fund that invests primarily in sovereign debt to generate total return
INCEPTION DATE	May 1988	November 2014	November 2014	April 2012	August 1993
PORTFOLIO MANAGER	Denis Senécal	Denis Senécal	Denis Senécal	Robert Bechard	Robert Bechard
CATEGORY	Canadian Fixed Income	Canadian Fixed Income	Canadian Fixed Income	Global Fixed Income	Global Fixed Income
RISK LEVEL	Low	Low	Low	Low	Low-to-Medium
DISTRIBUTION	Monthly | Variable	Monthly | Variable	Monthly | Variable	Monthly | 2.4¢	Annual

Non-Traditional Fixed Income

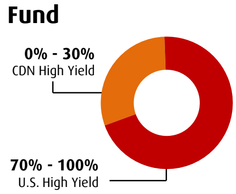
BMO Emerging Markets Bond Fund



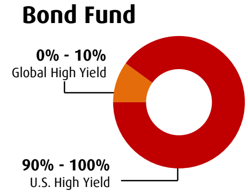
BMO Global Strategic Bond Fund



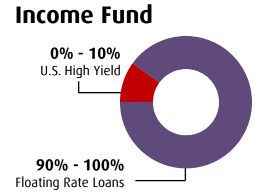
BMO High Yield Bond Fund



BMO U.S. High Yield Bond Fund

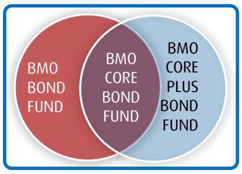


BMO Floating Rate Income Fund



	BMO Emerging Markets Bond Fund	BMO Global Strategic Bond Fund	BMO High Yield Bond Fund	BMO U.S. High Yield Bond Fund	BMO Floating Rate Income Fund
OBJECTIVE	An emerging market bond fund with exposure to both hard & local currencies to generate absolute total return	A tactical global bond fund that invests in investment grade & high yield bonds and emerging market debt to generate income and total return	A broad high yield bond fund that invests in the U.S. & Canada to generate interest income and total return	A U.S. high yield bond fund that seeks to generate a high level of interest income and absolute total return	A high yield fixed income fund with ultra low duration designed for rising interest rate environments
INCEPTION DATE	August 2013	November 2008	January 1999	June 2008	July 2005
PORTFOLIO MANAGER	Tere Alvares Canida	Curtis Mewbourne	Lori Marchildon	Lori Marchildon	Lori Marchildon
CATEGORY	High Yield Fixed Income	High Yield Fixed Income	High Yield Fixed Income	High Yield Fixed Income	High Yield Fixed Income
RISK LEVEL	Low-to-Medium	Low-to-Medium	Low-to-Medium	Low-to-Medium	Low-to-Medium
DISTRIBUTION	Monthly | Variable	Monthly | 3.5¢	Monthly | 4.5¢	Monthly | 4.0¢	Monthly | Variable

BMO Mutual Funds



SPOTLIGHT:
BMO'S CORE FIXED INCOME SOLUTIONS

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.

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.

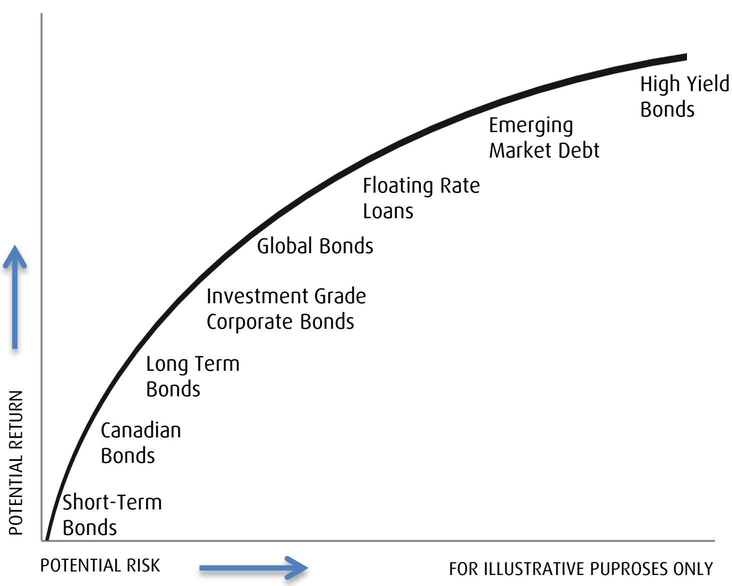
BMO Core Plus Bond Fund

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



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.

Diversification

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.

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