ETFs Q&A

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Can you explain your income smart BETA product?

The BMO Enhanced Income Equity ETFs launched in July and they are the first ever UCITS ETFs to employ an option overlay in order to gain extra income. What we identified was that people looking for dividends were quite challenged: not only were they often buying lower quality stocks, but many have been ploughing into overpriced bond proxies that could be vulnerable to a downturn.

The UCITS ETFs are based on our eight options-based products in Canada, which have been running for six years now and have over $3.8 billion in assets*. They are not complex, and aim to tap into a volatility risk premium that exists due to more people looking to hedge their equity positions compared to a lower number of people who want to provide that hedge to them. That usually means that volatility is lower in reality than on an implied basis, and we're looking to exploit that.

So for this European range we are tracking three major benchmarks – the FTSE 100[1], Eurostoxx 50[2] and S&P 500[3] – and selling index options on top of that. We find that we can generally generate an extra 2-4% on top of the dividend yield for those benchmarks. That means on average we expect the net portfolio yields to be around 4.6% in the US, 6% for Europe and 6.8% for the FTSE 100, which could be very appealing for clients looking for a higher and more stable income.

In what sort of environment is it most likely to succeed? Will it struggle if short-term volatility picks up?

At the moment we are in a low volatility regime. So, if anything, volatility is likely to increase from here, and if that occurs, we should be able to collect more premium with this type of solution. However, when you consider different scenarios, we have identified that the best conditions are sideways, choppy markets with not much direction.

Over the last three months, the three benchmarks we track have been lacking momentum, so it has been quite a favourable environment for this strategy. We also expect this strategy to outperform in falling equity markets as the premium collected mitigates the downside.

The only kind of market condition that generally would not suit this particular solution is a rapidly rising equity environment, such as a big rally in the stock market, because the strategy may miss out on some of the upside participation. You do still get a lot of the participation, but you typically would not get 100%. So the best environment is sideways or falling markets – then we expect it to outperform the underlying index with lower volatility.

Does this mean the strategy has performed better in the US than Europe and the UK?

Interestingly, the US has been the most challenging environment so far as it has the least implied volatility, but we are still above the lower end of the premium range targeted with option yields of 2%. Not surprisingly, the strongest outperformance has been BMO Enhanced Income UK Equity ETF**, because the FTSE 100 has lost direction and has actually fallen moderately in the month of September. Over the long-term, as evidenced through our simulated back-tests, these strategies are expected to provide higher Sharpe ratios, as they experience less risk than the underlying benchmark.

Do you see this outperformance continuing as central banks look for the exit doors?

We do, as we have launched these products at a time when stock market performance has slowed, markets are moving sideways, people are afraid of allocating too much to bonds and volatility should pick up with the gradual removal of monetary stimulus.

What sort of investors may be interested in the strategy?

I find it appeals to various types of investors. For bespoke wealth managers, many may have their own clients that require a higher yield, who are in retirement for instance. They are using this type of product as an alternative to low-paying corporate bonds, expensive or risky dividend paying stocks, or property. There is upside potential through the equity participation but you are still cushioned from the downside with the additional income.

On the other hand, discretionary fund managers who are constructing risk-targeted models may say it is more appropriate in the cautious or moderate ranges.

Finally, we are finding some clients that are converting their regular index holdings and switching into this type of solution because of their view on the current macro environment. They still want to participate in the market, as they do not know when the current positive run will end since this has been an extremely long business cycle, and they also want to reduce their downside risk at the same time.

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* Source: BMO Global Asset Management as at 30.6.17. **Source: Bloomberg, BMO Global Asset Management as at 29.9.17. For professional investors only. Past performance should not be seen as an indication of future performance. Investing in ETFs involves risk, including risks associate with market volatility, currency rate fluctuations, replication strategies, and changes in composition of the underlying index and assets. The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

BMO Global Asset Management