For professional investors only

BMO Global Asset Management Monthly ETF Update
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Contact us

UK Sales - ETFs

+44(0) 20 7011 5247

www.bmogam.com/etfs

christine.cantrell@bmogam.com

Quality Counts in Emerging Markets

The increased likeliness of a rate hike at the Fed meeting mid-March has led to a strengthening of the US dollar. It is expected that emerging markets (EM) will benefit from an increase in exports as their weakened currencies make their goods more attractive to US consumers. Investors looking to allocate to emerging markets should consider ETFs as an efficient and low cost access vehicle.

A number of emerging market ETFs track indices that weight companies on the basis of their market capitalisation alone. In recent times, ETF issuers have worked with index providers to develop indices that deliver precise exposure to factors proven to positively contribute to a portfolio's risk and return. One approach is to select companies based on their quality and ability to pay sustainable dividends. This has been proven to deliver enhanced risk adjusted returns over standard market capitalisation indices.

The **MSCI Emerging Markets Select Quality Yield Index** developed with BMO ETFs has been constructed to select companies that exhibit positive fundamentals (return on equity, low financial leverage, stability in earnings growth) and are therefore well placed to deliver sustainable income over time.

The rationale for 'quality' screens in a dividend targeting solution could be attributed to three main points:

Avoid Yield Traps

- Dividends paid by companies depend on two variables: willingness to pay and ability to pay. Some indices adopt methodologies that take into account rising historical payments, but ignore the deteriorating ability of lower quality companies to pay.
- For companies, one of the most dramatic ways to impact a stock price is to miss dividend payment expectations. A dividend paying company will typically hold off cutting a dividend or even holding it flat until they are deep in trouble.
- A screen based on comprehensive 'quality' factors, captures the ability to pay dividends, now and in the future. A methodology based on rising historical payments, regardless of tenure, does not capture current company operating conditions.
- 'Quality' screening avoids selecting deteriorating stocks masquerading as bargains instead capturing those that can sustain their dividends over the long run.

Example: Banco Do Brasil is a top holding in some of the traditional dividend targeting strategies. A 'quality' screen would filter out this company based on its level of leverage and earnings growth; its debt to equity is higher than peers (827% vs 203%*) and it has shown inconsistent earnings growth over the last 5 years. A symptom of this low quality is borne out in its historical volatility, at 45% compared to 12% for the MSCI EM Index using a 6 month daily measure.

(Source -Bloomberg 28 February 2017). *Average Debt:Equity ratio for the financial sector within the MSCI Emerging Markets Index.

Ability to capture market evolution

- Successful investment strategies aim to capture new investment opportunities. To achieve this, strategies must include a forward looking component.
- Dividends have traditionally come from sectors such as consumer staples, utilities and financials.
- Technology has emerged as one of the largest dividend contributors more recently – a sector that includes excellent opportunities for growth from innovation.
- Traditional dividend targeting methodologies consider rising historical dividend payments over a period of time while ignoring firms that are relatively new, hence missing out on possible growth opportunities.
- **Example:** China Mobile is a top holding in the index, one which is excluded from some of the more traditional dividend growth strategies as it is a newer entrant to the market. 90% of analysts rank it as a buy, P/E is 13.79, Return on Equity 12.09% and Debt to Equity 1.33. The quality factor identifies this relatively new stock, locking in growth opportunities. (Source Bloomberg 28 February 2017).

Enhanced risk adjusted returns

- A methodology that selects dividend paying companies based on their quality and weights on a market capitalisation basis strikes a balance between capital growth and yield delivering enhanced returns with reduced volatility.
- Weighting factor based indices on a market capitalisation basis ensures the largest holdings have sufficient liquidity to be traded efficiently and at a lower cost.
- Having a large weight in shares of companies based entirely on their dividend payments is likely to make a portfolio vulnerable to big price swings if those companies change their dividend policies.
- A number of income focused indices select companies based on historical dividend yield alone and face the challenges in the point above. This issue is then compounded by apportioning a weight in the index based on that yield, as opposed to the market capitalisation.

	MSCI EM Index	MSCI EM Select Quality Yield Index
Total Return (annualised)	9.16%	12.13%
Standard Deviation	23.51	21.55
Sharpe Ratio	0.43	0.58
P/B	1.58	1.77
P/E	15.11	12.73
Dividend Yield	2.50%	4.20%

Source MSCI. Data as at 28 February 2017.
Returns, Sharpe Ratio (based on ICE LIBOR 1 month) since 29 December 2000. P/E – Price to Equity; P/B – Price to Book ratio.

BMO Income Leaders Emerging Markets UCITS ETF (ticker: ZIEM LN) tracks the MSCI Emerging Markets Select Quality Index and provides your clients with an effective solution to position portfolios to capture both income and future market growth by combining high dividend yield and quality factors.

For further details of the MSCI Select Quality Yield Index methodology, you might find it useful to read the latest BMO Income Leaders brochure.

Read more

BMO MSCI Emerging Markets Income Leaders UCITS ETF – Key Facts

Fund Ticker	Net Assets (MM) 08 March, 2017*	Base Currency	Trading Currency	Index Yield*	OCF**	Inception Date	Index	ISIN
ZIEM	US$10.75	USD	GBP	4.22%	0.38%	Dec 06, 2016	MSCI Emerging Markets Select Quality Yield Index	IE00BZ053T90

*Source: BMO Global Asset Management. Information as at 28 February 2017. **OCF – Ongoing charges figure

Regulatory Disclosure

F&C Management Limited is the investment manager of BMO UCITS ETF ICAV which is authorised by the Central Bank of Ireland as a UCITS.

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