For professional investors only

Precision engineering with BMO Enhanced Income Equity ETFs

Key facts

Structure
Exchange Traded Funds (ETFs)

Lead fund manager
Terry Wood
Fund manager
Alex Jones

Launch date
13 July 2017

On going charge p.a. (OCF)
0.30%

Distributions
Quarterly

BMO Enhanced Income Equity ETFs

- BMO Enhanced Income UK Equity UCITS ETF
- BMO Enhanced Income US Equity UCITS ETF
- BMO Enhanced Income Euro Equity UCITS ETF

Investors are looking for alternative ways to generate sustainable income without taking on additional risk. Enhanced Income strategies, also known as covered call strategies, are efficient solutions that can add income to a portfolio without increasing equity risk.

Building on our success and expertise in North America, where BMO Global Asset Management is the leader in covered call exchange traded funds (ETFs), with USD $4.8 billion* assets under management in this strategy, we also offer our European clients ETFs that incorporate this proprietary covered call strategy on established equity indices.

BMO Enhanced Income Equity ETFs provide equity exposure with a sustainable attractive yield and lower volatility than a traditional market capitalisation weighted index. This strategy is implemented by writing (selling) call options on the index, while owning the underlying stocks. The covered call option strategy allows the portfolio to generate income from the written call option premiums in addition to the dividend yield from the underlying stocks. Historically, covered call strategies have provided a similar long-term performance to the broad market with lower risk.

Risk factors

Past performance is not a guide to future performance. Stock market and currency movements mean the value of investments and the income from them can go down as well as up and investors may not get back the original amount invested. Shares purchased on the secondary market cannot usually be sold directly back to the Fund. Secondary market investors must buy and sell ETF Shares with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current Net Asset Value per Share when buying ETF Shares and may receive less than the current Net Asset Value per Share when selling them.

*Source: BMO Global Asset Management as at 31-Jan-19

BMO Enhanced Income Equity ETFs

BMO Enhanced Income ETFs appeal to investors who are looking for higher income.

Performance expectations

Generally, covered call strategies tend to outperform in slightly improving, flat or down markets, and underperform in periods of rapidly rising markets.

Down markets

The decline of the underlying stocks is partially offset by the call premium received. Generally covered calls will outperform their underlying portfolios.

Volatile markets

As markets become highly volatile, covered call strategies may underperform as the strike price becomes closer to the money and the options are more likely to be exercised. The covered call may outperform if the strike prices are further out of the money.

Rising markets

When stock prices rise significantly and exceed the strike price, the call option will move into the money. This caps the gain for the call writer based on the strike and premium received. Typically in rapidly rising markets, covered calls will underperform.

Key characteristics

40-60% target portfolio option overlay coverage

2 to 4% per annum target yield enhancement range

Target return of 80-100% of market returns over a 3-5 year period

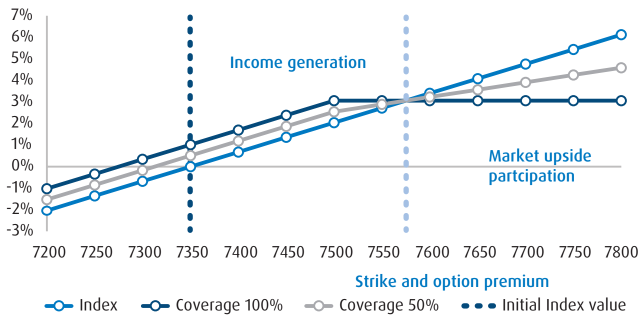
How do covered calls work?

Covered calls are implemented by selling a call option on the underlying portfolio. The ETF receives a premium, while the buyer has the option at a later date to purchase the underlying stocks at an agreed upon price (the "strike" price). The ETFs sell out-of-the-money (OTM) call options that cap the return of the portfolio at the option strike price until the option expires.

Example

A portfolio consists of 100 securities with a total value of £10 million matching the weights of the underlying index. Listed options based on an index level of 7350 points have an underlying spot value of £73,500 per contract. To implement a call strategy with 50% coverage, the portfolio sells call options on 68 contracts (£10m x 50% / 73500). Out of the money call options (strike price of 7500) that expire in two months are valued at a premium of £750 per contract, therefore the fund receives £51,000 in premium. This income is equivalent to 0.5% of the fund which equates to 3% on annualised basis. The buyer of those call options will only exercise their right to purchase at 7500 if the market price exceeds that level.

Payoff characteristics of call option with 7500 strike and underlying index price of 7350



BMO Global Asset Management offers Enhanced Income Equity UCITS ETFs to help investors generate a consistently high income without increasing volatility in their equity allocation. ETFs are an efficient way to access an enhanced income strategy combining passive equity portfolio management and a rules-based options overlay methodology, at a low cost.

BMO ETFs Enhanced Income Strategy

BMO Enhanced Income Equity UCITS ETFs provide passive exposure to established market cap weighted equity indices; FTSE 100, EuroStoxx 50 and S&P 500, with an additional index option overlay. Using index options allows for liquidity, transparency and cost efficiency in the portfolio.

Our enhanced income strategy looks to achieve index like returns over the long term, with reduced volatility and higher yield. We target a yield enhancement of 2 – 4% over the chosen equity benchmark across our suite.

Construct equity portfolio per index guidelines

Option liquidity assessment of index options

Select optimal strike(s) based on market environment in order to enhance yield

Implement option overlays utilising deep broker relationships and team expertise

Enhanced Income Equity ETF strategy implementation

Out-of-the-money (OTM) covered call options are sold on approximately 50% of the portfolio with a target range of 40-60%, as determined by market conditions. This dynamic approach provides investors with the right balance between enhanced income and participation in rising markets. The selection of the option's strike price will depend on the available option premiums and market volatility. Options are sold further OTM when volatility rises and closer to the money when volatility drops to maintain the target yield enhancement of between 2-4%.

This dynamic option selection process allows the ETF to benefit from upside participation in volatile markets. Conversely, if volatility decreases, options are selected closer to the market price, as there is less potential for significant short-term price appreciation. To take advantage of time decay, the strategy sells options at 1 to 3 months to expiry. This optimises the premium attainable while mitigating the risk of the option being exercised.

Key characteristics	
Stock selection	Passive. Full replication of stated benchmark
Target yield enhancement range	2 to 4% per annum
Target portfolio option overlay coverage	40%-60%
Options tenor	1 to 3 months
Option Moneyness	Minimum of 1.5%
Target return	80-100% of market returns over a 3-5 year period
Expected risk	90% of market risk* over a 3-5 year period

*Market risk as defined by annualised standard deviation of monthly returns.

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Terry joined the group in August 2007 as a Quantitative Portfolio Manager covering both passive and active funds. Previously Terry spent nine years at Deutsche Asset Management as a Quantitative Analyst for the Global Equity team. He holds a BA (Hons) in Accounting & Finance from the University of Kent and is a CFA Charterholder.

Terry Wood, Head of ETF Portfolio Management (EMEA)

A member of the ETF team since 2015, having joined the Group two years earlier as a researcher within the Multi-Asset Alternatives team. Alex moved from Goodhart Partners where he was one of the founding partners and an analyst on their range of multi-manager portfolios, having been involved in the development and launch of these portfolios whilst at WestLB Asset Management. Alex joined WestLB from Aon Consulting in 2006, where he spent seven years as a member of Aon's Investment Consulting practice. Alex has a BSC (Hons) in Mathematics from Sussex University.

Alex Jones, Portfolio Manager, Exchange Traded Funds

BMO Global Asset Management