Income Leaders Strategy in Review

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Fund in focus: BMO MSCI USA Income Leaders UCITS ETF (ZILS)

Index: MSCI USA Select Quality Yield Index

U.S. equities have defied pundits and broken new highs year after year. Dividend equities have been a major participant in that growth. While forward price-to-earnings ratios for equities have increased to a level well above their median of the past three decades, further gains in equities will have to be sustained by growth in earnings. In our slow growth economic environment, coupled with market uncertainty from events such as the Trump election and Brexit, investors are looking for high quality companies that deliver increasing dividends and market growth.

The key considerations to capture include:

- Explicit quality screens
- Ability to capture market evolution
- Portfolio construction and weighting

BMO Income Leaders ETF Strategy is a multi-factor strategy focused on quality income and growth. We believe dividend strategies can avoid yield traps by adding a quality factor. Quality factors can also have additional benefits of reducing volatility, and enhancing risk adjusted returns across all market cycles. Our suite of ETFs are based on the MSCI Select Quality Yield Indices across geographies and available as both hedged and unhedged exposures.

MSCI USA Select Quality Yield Index

Universe: Constituents must be members of the MSCI USA Index.

Constituent Selection: Top 50% of securities with the highest quality scores, followed by top 50% by dividend yield

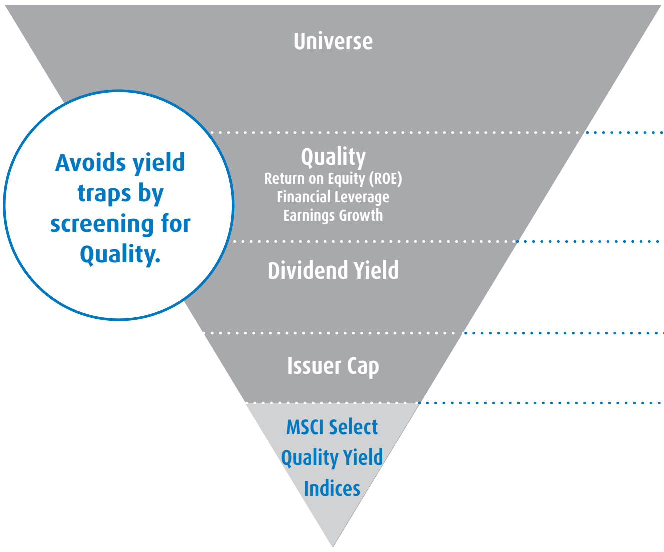
Minimum Market Cap: Constituents must be large and mid cap securities, currently defined at float-adjusted market cap of at least USD 5.8 billion as of the September 2016.

Diversification: Individual stocks are capped at 5%

Weighting: Market Cap

BMO Income Leaders ETFs go beyond traditional income. They focus on sustainable quality income.

Income Leaders Portfolio Construction



Parent Index (excluding REITs)
MSCI USA Index
MSCI United Kingdom index
MSCI Europe ex-UK Index

Quality screen – top 50% of securities with the highest quality scores

Dividend yield screen – top 50% of securities by dividend yield from previous screen

Individual securities are capped at 5%

The BMO Income Leaders ETFs track the MSCI Select Quality Yield Indices

Combining factor strategies to deliver sustainable and favourable risk adjusted returns.

Explicit Quality Screens

Dividends paid by companies depend on two variables, willingness to pay, and ability to pay. Outcome oriented screens, such as rising payments, which are used by other dividend targeting strategies address willingness to pay, but do not capture a deteriorating ability to pay. Looking under the hood, a screen based on comprehensive quality factors, captures the ability to pay dividends, now and in the future.

Quality investing identifies market leaders, companies that can grow their dividends over time, and deliver the market returns to fund portfolios.

For dividend payers, 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 into trouble. A screen based on rising payments, regardless of tenure, does not capture current company operating conditions.

Quality screening avoids deteriorating stocks masquerading as bargains and focuses on those who can sustain their dividend over the long run.

MSCI Quality Variables

- **High ROE** – Indicates a business with a sustainable competitive advantage, efficient operations and profitability.
- **Stable Earnings Growth** – Demonstrates durability and stability of a company's business model.
- **Low Financial Leverage** – Determines if returns are based on underlying operations and protects on the downside.

Each variable on its own is not necessarily an indicator of a quality company. For example, high ROE could be an abnormal spike at one point in time or a result of high leverage. The 3 variables in combination provide a more accurate assessment.

MSCI Screening

- The three variables are determined for all securities and ranked
- Once ranked, impact of extreme data outliers is removed for all 3 variables
- The three variables are then standardized: equal weights are used to calculate a composite score
- Composite scores are averaged into a single quality score

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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 with companies such as Microsoft and Apple leading the way. Microsoft started paying a dividend in 2006 and Apple in 2012 and are relatively new entrants to the dividend space. Backward looking dividend screens such as rising payments, regardless of the timeframe are likely to exclude these companies.

Portfolio construction and weighting

Based on the screening process, other smart beta dividend strategies will be biased to traditional dividend sectors, where ZILS will be comparatively overweight to evolving dividend sectors. The chart below ranks S&P500 sectors by dividend yield and compares ZILS weighting in those sectors. BMO Income Leaders quality screens will typically underweight financials due to high leverage in the sector; in addition this index excludes REITs. It will be overweight more evolving dividend sectors such as technology.

S&P sectors ranked by Dividend Yield

S&P sectors	Dividend Yield	ZILS Weighting
Telecom	5.05	
Real Estate	4.35	
Utilities	3.56	0.47%
Energy	2.82	7.85%
Consumer Staples	2.66	12.98%
Industrial	2.35	13.70%
Materials	2.24	4.20%
Financials	1.92	5.47%
Health Care	1.76	17.90%
Consumer Discretionary	1.62	11.96%
Information Tech	1.57	25.41%

Source: Bloomberg. Data as at 31.10.2016

Dividend weighting in comparison to market cap weighting can increase exposure to deteriorating companies, as a company with a market price that is declining faster than its dividend payout growth will have an increasing yield. A high dividend yield alone could therefore also mean investors no longer expect market growth from the stock. Market-cap weighting provides enhanced liquidity and exposure to growth areas of the market, in contrast to yield weighting which can over-weight less growth-oriented companies and can result in significant sector biases.

Example: Pitney Bowes

Another significant benefit of the quality screens is that it provides an important glance into the health of a company and can provide warning signs to indicate a company should be removed from the index well before many of the more traditional single factor (ie. Dividend growth) strategies are aware there's a problem. Taking Pitney Bowes as an example – PB is best known for being the largest manufacturer and supplier of postage meters globally – claiming 85 percent of the U.S. postage meter market but not without its fair share of challenges. This company was held in many dividend ETFs until 2013 when it was removed from many indices as a result of a dividend cut of 50%. In 2013 the stock was near its bottom when it was removed from many indices, but were there warning signs? Yes, in fact if we look at a number of the quality factors we screen for in our Income Leaders ETFs, we can quickly see the benefit to these screens, Pitney Bowes would have been eliminated much earlier, and investor's losses on this security would have been mitigated. In 2010, 2011, and 2012 the debt to equity ratios were 2,148%, 1,644%, and 987% respectively. ROE was negative across this period as well. Furthermore, price of this stock has fallen by more than 20% over the last 5 years.

BMO MSCI US Income Leaders UCITS ETF (ZILS) - Top 10 holdings

Below is a snapshot the top ten holdings for ZILS. We can see the strength and sustainability of each company in the chart based on the quality variables provided. Approximately 60% of analysts rate Microsoft as a buy and only 10% a sell. They forecast a return potential of 4.8% over the next year. Lastly, the 1, 3, and 5 year dividend growth rate are all just over 16%. (As of Oct 31 2016)

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Top 10 holdings	Weight	P/E Ratio	Return on Equity	Debt/Equity	Dividend Yield	Earnings Variability*
Microsoft	5.77%	28.15	22.41	74.57	2.46	0.29
Apple	5.68%	13.13	36.90	67.86	2.07	0.58
Johnson + Johnson	4.98%	19.28	21.86	27.91	2.61	0.41
Exxon Mobil	4.61%	39.95	5.24	21.88	3.49	0.75
Procter + Gamble	3.43%	22.56	17.51	52.77	3.19	0.28
Pfizer	2.87%	16.48	10.71	59.97	3.68	0.40
Coca Cola	2.70%	21.14	27.68	171.61	3.38	0.16
Merck + Co	2.57%	24.59	12.29	59.23	2.86	0.49
Intel Corp	2.50%	14.56	16.99	36.58	3.02	0.13
Pepsico	2.41%	21.84	51.11	276.67	2.81	0.30

*5 Year Standard Deviation of quarterly EPS Source: Bloomberg. Data as at 31.10.2016

To position portfolios to capture both income and future market growth, BMO MSCI US Income Leaders UCITS ETF (ZILS) has significant benefits relative to the other dividend approaches.

The key benefits include:

- Explicit quality screens – to measure dividend sustainability
- Ability to capture market evolution – inclusive of new dividend growers
- Portfolio Construction and weighting – market cap to capture growth

	BMO MSCI USA Income Leaders UCITS ETF (ZILS)
OCF (Ongoing charges figure)	0.35%/0.40% (GBP hedged)
Hedging	USD is hedged back to GPB in hedged version. Done so by notionally 'selling' each currency forward at the one-month forward rate at the end of each month
Standard Deviation	13.16*
Sharpe Ratio	0.56*
Dividend Yield	2.79%
Price/Earning Ratio	19.63
Average Price/Book	3.71
Average Market Cap	US$ 6,774.41 B

*10 Year, MSCI USA Select Quality Yield Index. Source: MSCI. Data as at 31.10.2016

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For professional investors only.

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Investing in ETFs involves risk, including risks associated with market volatility, currency rate fluctuations, replication strategies, and changes in composition of the underlying index and assets.

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