BMO ETF Portfolio Strategy Report

Fourth Quarter 2013

BMO EXCHANGE TRADED FUNDS

Fed Fake-Outs and Debt Ceilings

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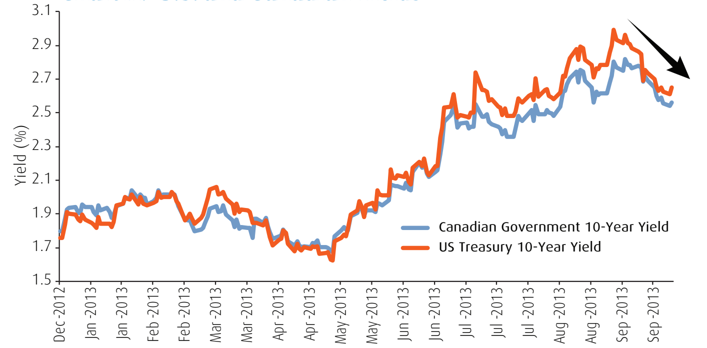
In this report:

All prices or returns as of market close on October 7, 2013, unless otherwise indicated.

In this report, we highlight our strategic and tactical portfolio positioning strategies for the fourth quarter using various BMO Exchange Traded Funds. Our key strategy changes are outlined throughout the report and in our quarterly outlook on page six.

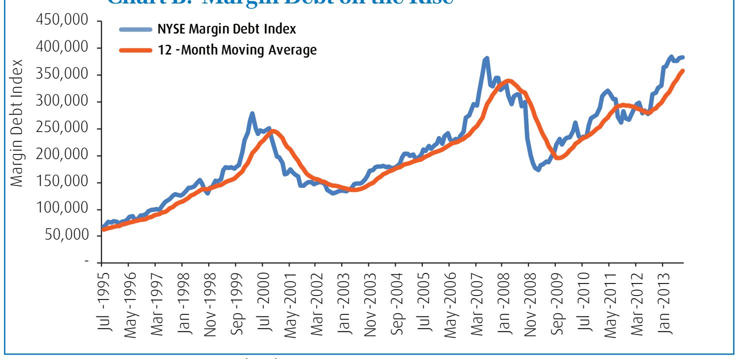
- **Once again, the U.S. debt ceiling has come to the forefront in terms of headline risk.** A failure to raise the limit on the ceiling by the October 17 deadline would likely lead to a significant rise in market volatility and a potential downgrade of U.S. Treasuries. As a percentage of gross domestic product (GDP), U.S. debt is expected to hit 75%, more than double the 36% in 2007.
- **Over the summer months, asset markets continued to drift lower on anticipation that the tapering would be announced at its September Federal Open Market Committee (FOMC) meeting.** In anticipation of a reduction in the Federal Reserve Board's (Fed) Large Scale Asset Purchase (LSAP) program, the rates market experienced a considerable uptick, especially on the long-end of the curve, putting significant pressure on bonds and yield oriented assets.
- **Come mid-September, however, Fed Chairman Ben Bernanke surprisingly announced that there would be "no tapering", citing the need for additional evidence of a lasting improvement in the economy.** While markets bounced back on the announcement, the rally faded as we headed into October. Although the tapering has been called off for the time being, we believe the Fed has created uncertainty and hurt its credibility in providing guidance.
- **Yields have stabilized since the last FOMC meeting, with the 10-year U.S. Treasury rate falling 23 bps to 2.62% since September 17. Canadian yields also experienced a similar alleviation, falling 22 bps to 2.55% over the same time period.** Additionally, we saw yield curves flatten in recent weeks, taking pressure off of fixed income, especially longer dated maturities (Chart A).
- **Assuming the debt ceiling gets raised, yield oriented assets look deeply oversold.** Consequently, we anticipate potential gains in areas such as real estate investment trusts (REITs), emerging market debt and longer dated government bonds, political risk notwithstanding. Over the longer term, however, we continue to believe the market is becoming more cyclical, with economically sensitive areas outperforming, especially for U.S. equities. Over the mid-term, the inter-market relationships also suggest a strengthening economy, with equities and even certain commodities gaining relative to bonds.
- **One concerning note is an indicator that we have addressed in the past. The *NYSE Margin Debt Index*, which measures the margin used to buy stocks on the New York Stock Exchange, recently reached an all-time high.** Lower borrowing cost is an obvious reason. The concern, however, is the impact of rising rates on borrowing costs and whether the velocity of the rise may lead to a deleveraging event. As a result, even though we favour equities over commodities and bonds, it is important not to over-stretch towards equities (Chart B).

Chart A: U.S. and Canadian Yields



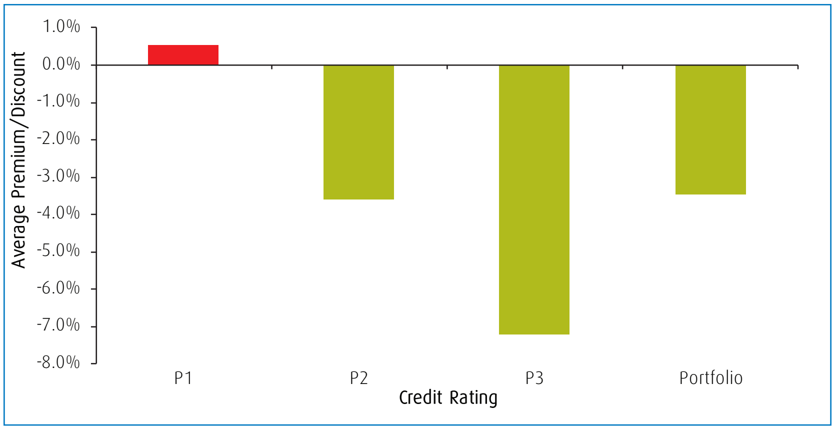
Source: BMO Asset Management Inc., Bloomberg

Chart B: Margin Debt on the Rise



Source: BMO Asset Management Inc., Bloomberg

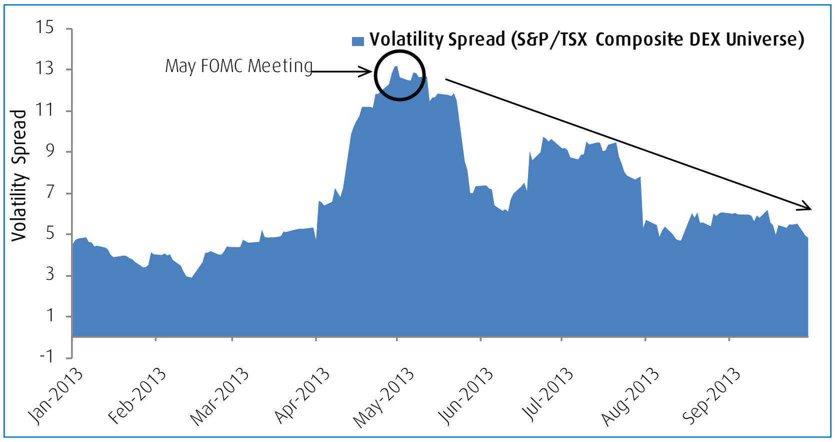
Things to Keep an Eye on...



Source: BMO Asset Management Inc., Bloomberg

Up until several months ago, preferred shares were one of the most desirable assets for Canadian investors. However, since the sell-off that began in May, investors have been less receptive to the hybrid asset class. While it is understandable given the interest rate sensitivity of preferred shares, particularly the fixed perpetuals, investors should keep in mind that the decline in prices in recent months is NOT solvency related, which was the case in 2008. The issuing companies, particularly investment grade issuers rated P3 and higher, have strong balance sheets as a whole. Given that the running yield of preferred shares has recently risen, the drop in prices presents a potential buying opportunity for yield oriented investors. Many of the non-bank issues rated P2 and P3 are still trading at discounts.

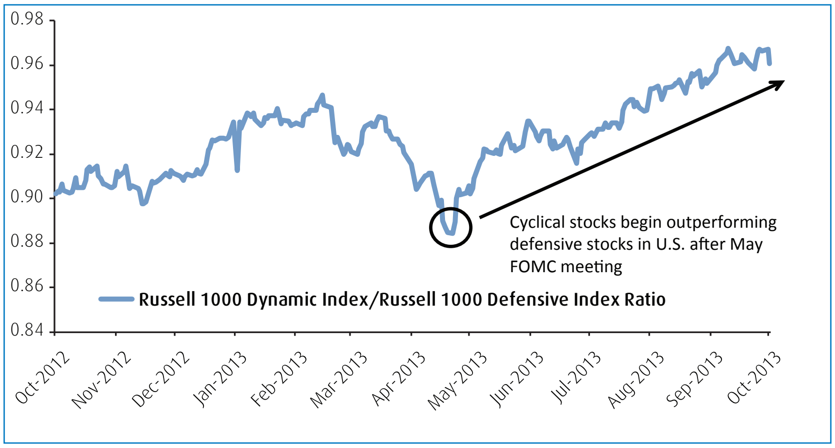
Recommendation: While perpetual issues of preferred shares are interest rate sensitive given their fixed dividends and long duration, rate reset preferred shares offer adjustable dividend rates providing, thereby better protection against rising rates. Furthermore, the potential for rate resets to be called every five years lessens duration risk. The ***BMO Laddered Preferred Share Index ETF (ZPR)*** is an efficient way for investors to get exposure to investment grade rate reset preferreds, with an equal portion of the ETF being redeemed or resetting to new rates, each calendar year. Our strategy continues to hold a 7.0% allocation to ZPR.



Source: BMO Asset Management Inc., Bloomberg

Several quarters ago, we began recommending a higher allocation to equities relative to fixed income. This decision was made on the premise that a steepening yield curve would place downward pressure on bonds. As bonds have sold-off in the last six-months, we continue to hold that view. Furthermore, as a multi-decade interest rate cycle draws to a close and as stimulus is eventually removed from the financial system, we anticipate bond market volatility to rise. Below is a differential between the 30-day realized volatility of the *S&P/TSX Composite Index* and the *DEX Bond Universe Index*. A greater positive spread indicates equities to be more volatile, while a more narrow spread suggests a lesser differential.

Recommendation: Up to one year ago, our strategy placed a higher allocation to bonds, but as the economic recovery has since progressed, the steeper yield curve we envisioned six months ago has come to fruition. Given the market and particularly that the yield curve is forward looking, we believe bonds remain vulnerable as even the Fed's consideration of tapering, ultimately represents a directional change in its monetary policy. We continue to reduce our weighting to fixed income and within the asset class, we look to increase our allocation to credit. Given both macro-economic and geo-political risk (which could lead equity market volatility to unexpectedly return) remain, it would be unwise for investors to be entirely devoid of fixed income in their portfolio.



Source: BMO Asset Management Inc., Bloomberg

Within the equity portion of a portfolio, we have mentioned the importance of increasing exposure to cyclical oriented areas. As the economy, particularly the U.S., continues to recover, those sectors more sensitive to the business cycle will begin to outperform the more defensive, stable areas. The dynamic-to-defensive ratio, which compares the *Russell 1000 Dynamic Index* to the *Russell 1000 Defensive Index*, continues to trend higher. An increasing ratio indicates out-performance of economically sensitive companies, whereas a declining ratio suggests defensive areas are outperforming.

Recommendation: The increase and gathering momentum of the dynamic-to-defensive ratio in recent months is further indication of expansive economic conditions. Though we have increased our weighting to cyclical oriented equities in recent quarters, our strategy has been defensive, which has weighed on performance in recent months. We continue to shift to more growth oriented areas, but keep in mind not to get overly aggressive, as a macro-economic shock could be a significant detriment to economically sensitive assets.

Changes to Portfolio Strategy

Asset Allocation:

- Our strategy in past quarters to overweight yield oriented areas of the market has worked exceptionally well in generating alpha. Over the last quarter, however, these income based areas have faced headwinds given the market's concern over the Fed tapering its bond-buying program, leading to a giveback on some of the outperformance. The stimulative measures put forward by the Fed such as quantitative easing (QE) have been beneficial for higher income oriented areas as a whole. Although Bernanke backtracked on his intentions of tapering, we believe this has created uncertainty in the markets. Consequently, investors need to be more selective in yield oriented areas going forward, as certain assets will have better risk/return characteristics and represent better buying opportunities. While rates have stabilized since the last FOMC meeting, over the long-term, we anticipate an increase in realized volatility for fixed income, keeping dividend paying equities appealing. Not to mention, aging demographics of the developed world will make dividends a critical component of portfolio construction. Additionally, we continue to shift more of our bond allocation toward equities and increase the cyclicality of our strategy as the economic recovery continues.

Fixed Income:

- With fixed income, our strategy continues to decrease weighting to interest rate sensitive government bonds and increase our credit related weighting. The macro-economic backdrop, particularly in the U.S, has improved despite the Fed's back-peddling in relation to its bond buying program. Credit spreads may potentially narrow further and default rates will decline as the business environment looks poised to improve, albeit slowly. In addition to increasing our exposure to corporate bonds, we continue to bring in the duration risk of our strategy, as rates have picked up considerably more on the long-end of the yield curve. Furthermore, the Fed's pledge to keep rates low until 2015, should keep the short-end relatively flat, meaning less volatility for those bonds closer to maturity. We are thus reducing our weighting of the ***BMO Aggregate Bond Index ETF (ZAG)*** by 1.0% to 17.0% and replacing our 10.0% position in the ***BMO Mid Corporate Bond Index ETF (ZCM)*** with a 9.0% position in the ***BMO Short Corporate Bond Index ETF (ZCS)***.

Equities:

- We believe the continuation of the Fed's LSAP program will be beneficial for U.S. equities, despite a possible increase in near-term volatility in the equity market due to U.S. political risk. As we were debating whether or not to scale back our overweight in U.S. equities, the Fed's recent move led us instead to increase our weighting in the ***BMO U.S. Dividend ETF (ZDY)***. As previously mentioned, we believe low yielding fixed income and higher anticipated bond volatility will make dividend stocks attractive. We are increasing our position in ZDY by 3.0%, bringing our weighting in the ETF to 11.0%.

- Our position in the ***BMO Low Volatility Canadian Equity ETF (ZLB)*** has contributed to alpha since the inception of our strategy. In light of the slowly strengthening global economy, however, higher beta stocks have started to look increasingly attractive. In continuation of our strategy over the last several quarters to increase the cyclicality of the equity portion of our portfolio, we are reducing our position in ZLB by 3.0%, despite it being one of our most efficient positions in our strategy from a risk/reward perspective.

- To increase the cyclicality of the equity portion of our portfolio, we are increasing our weighting in the ***BMO Equal Weight Industrials Index ETF (ZIN)*** by 1.0%, bringing our weighting to 4.0%. Its holdings in railways, airlines and equipment related industries should benefit from stronger U.S. business demand. In addition, the industrial sector is less sensitive to interest rates and held steady during the summer months as investors were concerned about tapering by the Fed.

- During the last two months, U.S. banks have become oversold relative to their Canadian counterparts. This has been due to the recent strong earnings in Canadian banks and the higher long-term U.S. treasury rates affecting mortgage demand, especially with some of the regional U.S. banks. As long rates continue to stabilize and the U.S. economy slowly strengthens, we continue to be positive on U.S. banks, especially as their balance sheets further strengthen. We are thus increasing our position in the ***BMO Equal Weight U.S. Banks Hedged to Cad ETF (ZUB)*** by 1.0% to a 4.0% weighting in our strategy.

Sell/Trim	Ticker	(%)	Buy/Add	Ticker	(%)
BMO Aggregate Bond Index ETF	ZAG	1.0%	BMO Short Corporate Bond Index ETF	ZCS	9.0%
BMO Mid Corporate Bond Index ETF	ZCM	10.0%	BMO U.S. Dividend ETF	ZDY	3.0%
BMO Low Volatility Canadian Equity ETF	ZLB	3.0%	BMO Equal Weight Industrials Index ETF	ZIN	1.0%
			BMO Equal Weight U.S. Banks Hedged to C$ ETF	ZUB	1.0%
Total		14.0%	**Total**		14.0%

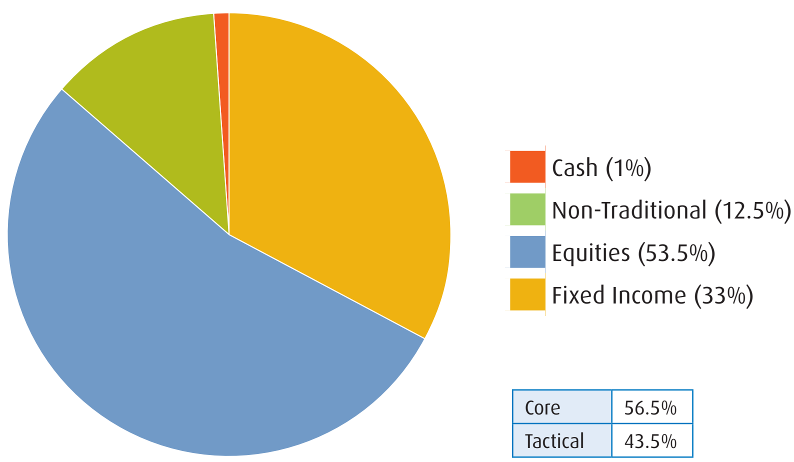
Stats and Portfolio Holdings

Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange traded funds (ETFs).

Ticker	ETF Name		Position	Price	MER	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/ Vol
	Fixed Income									
ZAG	BMO AGGREGATE BOND INDEX ETF	Debt	Core	$15.17	0.20%	17.0%	4.2	9.8%	2.1%	0.51
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	Debt	Tactical	$14.29	0.25%	7.0%	3.7	3.6%	2.8%	0.75
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	Debt	Tactical	$14.72	0.30%	9.0%	2.5	3.2%	2.9%	1.14
	Total Fixed Income					33.0%		16.5%		
	Equities									
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	Equity	Core	$19.25	0.35%	8.5%	7.1	8.3%	2.8%	0.40
ZDV	BMO CANADIAN DIVIDEND ETF	Equity	Core	$16.35	0.35%	9.0%	7.9	9.8%	5.6%	0.71
ZSP	BMO S&P 500 INDEX ETF	Equity	Core	$19.05	0.15%	8.0%	11.2	12.4%	2.2%	0.19
ZDY	BMO U.S. DIVIDEND ETF	Equity	Core	$15.95	0.30%	11.0%	9.6	14.6%	2.3%	0.24
ZEM	BMO MSCI EMERGING MARKET INDEX ETF	Equity	Core	$15.30	0.45%	3.0%	20.2	8.4%	2.1%	0.10
ZWB	BMO COVERED CALL BANKS ETF	Equity	Tactical	$15.37	0.65%	3.0%	7.3	3.0%	6.4%	0.87
ZIN	BMO S&P/TSX EQUAL WEIGHT INDUSTRIALS INDEX ETF	Equity	Tactical	$19.20	0.55%	4.0%	12.1	6.7%	2.9%	0.24
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	Equity	Tactical	$18.32	0.55%	3.0%	10.8	4.5%	5.4%	0.50
ZUB	BMO EQUAL WEIGHT U.S. BANKS HEDGED TO C$ ETF	Equity	Tactical	$17.33	0.35%	4.0%	13.8	7.6%	4.3%	0.31
	Total Equity					53.5%		75.4%		
	Non-Traditional/Hybrids									
ZHY	BMO HIGH YIELD U.S. CORP BOND HEDGED TO C$ INDEX ETF	Debt	Tactical	$15.62	0.55%	5.5%	7.3	5.5%	5.4%	0.74
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	Equity	Tactical	$14.11	0.45%	7.0%	2.6	2.5%	4.4%	1.70
	Total Alternatives					12.5%		8.1%		
	Total Cash		Tactical			1.0%	0.0	0.0%	1.3%	
	Portfolio				**0.33%**	**100.0%**	**7.2**	**100.0%**	**3.3%**	**0.46**

*Note: Bond yields are based off of yield to maturity.
**Cash is based off of 3-month Canadian Dealer Offered Rate (CDOR).

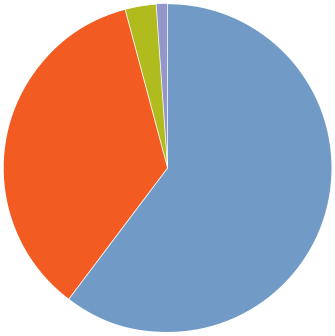
Ticker	Top Holdings	Weight
ZAG	BMO AGGREGATE BOND INDEX ETF	17.0%
ZDY	BMO U.S. DIVIDEND ETF	11.0%
ZCS	BMO SHORT CORPORATE BOND INDEX ETF	9.0%
ZDV	BMO CANADIAN DIVIDEND ETF	9.0%
ZLB	BMO LOW VOLATILITY CANADIAN EQUITY ETF	8.5%
ZSP	BMO S&P 500 INDEX ETF	8.0%
ZIC	BMO MID-TERM U.S. IG CORPORATE BOND INDEX ETF	7.0%
ZPR	BMO S&P/TSX LADDERED PREFERRED INDEX ETF	7.0%
ZHY	BMO HIGH YIELD U.S. CORP BOND HEDGED TO C$ INDEX ETF	5.5%
ZIN	BMO S&P/TSX EQUAL WEIGHT INDUSTRIALS INDEX ETF	4.0%
ZUB	BMO EQUAL WEIGHT U.S. BANKS HEDGED TO C$ ETF	4.0%
ZEM	BMO MSCI EMERGING MARKET INDEX ETF	3.0%
ZWB	BMO COVERED CALL BANKS ETF	3.0%
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	3.0%
	Cash	1.0%



Core	56.5%
Tactical	43.5%

Portfolio Characteristics

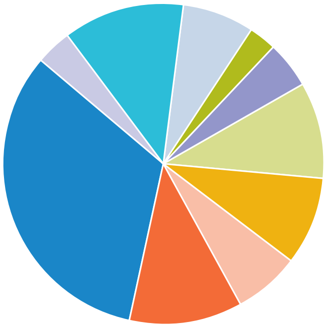
Regional Breakdown (Overall Portfolio)



Canada	60.5%
United States	35.5%
Emerging Markets	3.0%
Cash	1.0%

*Regional Breakdown includes equities, fixed income and alternative sleeves.

Equity Sector Breakdown



Financials	32.8%
Health Care	3.7%
Industrials	12.2%
Information Technology	7.0%
Materials	2.9%
Telecommunication Services	4.6%
Utilities	9.7%
Consumer Discretionary	8.9%
Consumer Staples	6.7%
Energy	11.5%

Fixed Income Breakdown

Federal	17.8%
Provincial	13.3%
Investment Grade Corporate	54.6%
Non-Investment Grade Corporate	14.3%

Weighted Average Term	7.2
Weighted Average Duration	5.4
Weighted Average Coupon	4.5%
Weighted Average Current Yield	4.2%
Weighted Average Yield to Maturity	3.2%

Weighted Average Current Yield: The market value weighted average coupon divided by the weighted average market price of bonds.

Weighted Average Yield to Maturity: The market value weighted average yield to maturity includes the coupon payments and any capital gain or loss that the investor will realize by holding the bonds to maturity.

Weighted Average Duration: The market value weighted average duration of underlying bonds divided by the weighted average market price of the underlying bonds. Duration is a measure of the sensitivity of the price of a fixed income investment to a change in interest rates.

The Good, the Bad, and the Ugly

Conclusion: With no change to the Fed's LSAP program, we anticipate a short-term relief rally in bonds, especially on the long-end. In addition, with the upcoming concerns of the U.S. debt ceiling, we anticipate some near-term concerns for risk averse investors who may look for safety in bonds. Looking further out, we continue to be more constructive on equities and expect economically sensitive sectors to outperform. Yield oriented areas will still play a critical part of portfolio construction, however, but increasing volatility in these areas means investors need to be more selective in their allocations to yield. The recovery in the economy needs to be gradual to avoid a sharp-rise in interest rates and a sudden withdrawal of accommodative monetary policy, which would unfortunately become a sudden headwind for most assets.

	Global-Macro/Geo-Political	Fundamental	Technical
Good	• The Fed calling off tapering has led sovereign yield curve to flatten out. This has taken pressure off of bonds with longer maturity dates. • Although the Fed needs to see more material data of an economic recovery, there are encouraging signs of improvement such as employment. • The months of supply in existing home sales in the U.S. has ticked up since January, but overall the housing market down south looks to be improving.	• North American and Asian Pacific stocks are inexpensive to the *MSCI World Index.* • Within North America, the 14.7x current price-to-earnings (P/E) of the *Dow Jones Industrial Average* is well below the 16.6x P/E of the *MSCI North American Index.*	• Chinese stocks have finally broken out. Though short-term overbought, they are slowly inching back up to their pre-taper levels. • Yield oriented areas are also bouncing back, giving investors better exit points if recharacterizing their portfolios.
Bad	• Backtracking on tapering could lead to uncertainty in the markets and may have hurt the credibility of the Fed's ability in giving forward guidance. • Debt ceiling concerns are again at the forefront. While it is likely that it will be raised, it may lead to short-term volatility. • The U.S. government shutdown will likely lead economic numbers to be lower in the coming quarter.	• Equity market valuations have steadily trended higher. However, any further price gains potentially could be offset by an improvement in earnings.	• The *CBOE/S&P Implied Volatility Index (VIX)* has been relatively low this year. Investors getting overly aggressive may get caught offside if volatility were to return.
Ugly	• Canadian consumer debt levels continue to rise to record highs • Money velocity continues to decline, reducing the effectiveness of the Fed's monetary and unconventional policies • Concerns about Syria remain, which could lead to market volatility and further spending by the U.S., potentially stalling the momentum in their economic recovery	• Inventory levels of copper at the London Metals Exchange (LME) remain at its highest levels in almost ten years.	• Margin debt continues to rise to historical levels. A rise in interest rates, leading to increased borrow costs could lead to deleveraging. • The 50-day moving average for the 30 year U.S. Treasury yields remains well above its 200-day moving average.

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