The Return to an Era of Income Investing

Monthly Strategy Report November 2011

BMO EXCHANGE TRADED FUNDS

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BMO ETFs win Morningstar Best ETF Initiative at 2010 Canadian Investment Awards

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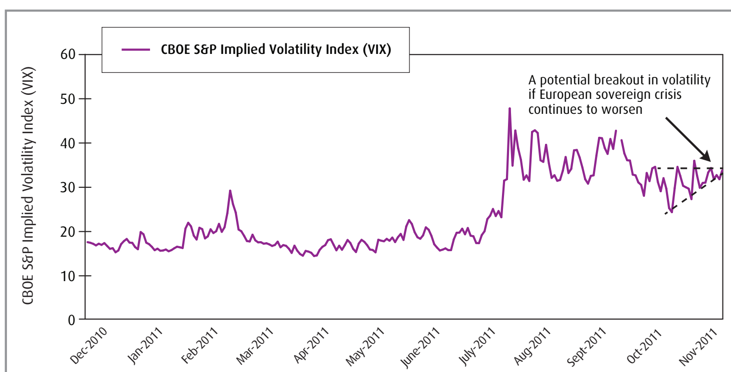
All prices as of market close on November 23, 2011 unless otherwise indicated.

With the ongoing European sovereign debt saga dragging on and critical decisions being postponed, its impact continues to weigh on global equity markets. The earnings story at the company level, particularly in the U.S, that we've been bullish on throughout the year continues to keep stock markets moderately buoyant. Over the last several months, a tough battle between macro- and micro-economics has compounded volatility. The *CBOE S&P Implied Volatility Index (VIX)* and the *S&P/ TSX 60 Implied Volatility Index (VIXC)* currently sit at 33.98 and 28.89, respectively, well above their normalized ranges, indicating continued fear in the market place. From a global macro perspective, credit default swaps (CDS) or the cost of insuring a default on the sovereign debt of Greece and Italy recently hit new records. The positive developments over the month have been the stepping down of prime ministers from both Greece and Italy. With Mario Monti now the prime minister of Italy and Lucas Papademos the new prime minister of Greece, this changing of the guard as well as their deep economic experience may help restore some confidence with investors. As a result, the performance of global equities for the remainder of the year depends on whether this deadweight on investor optimism from Europe can be lifted. If so, the focus of the market can quickly shift to the earnings of companies, which continue to come in better than expected. If confidence is not restored however, markets may potentially fall below their October lows, leaving the possibility of the much desired year-end Santa Claus rally extremely binary.

VIX Breaks Upwards as European Conditions Deteriorate



Country	CDS Mid Spread	Cumulative Probability of Default (CPD)[1]
Greece	9499.96	95.31%
Portugal	1099.51	60.27%
Ireland	762.05	47.58%
Italy	556.24	37.93%
Spain	485	34.11%

Source: BMO Asset Management Inc., Bloomberg, Credit Market Analysis Ltd. (CMA).
Cumulative Probability of Default based off of 5-year credit default swap prices.

Despite the uncertainty, which we feel will unfortunately continue to weigh on the markets, one of the few things that remains quite certain for the next two years is that we will continue to see a low interest rate environment. As U.S. Federal Reserve Board (Fed) chairman Ben Bernanke pledged

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to keep interest rates near or at historic lows until at least 2013, other central banks around the world will likely be forced to follow suit. Otherwise they risk causing their currency to rise with a higher relative interest rate, thus negatively impacting the country's exporting industry. Dividend paying or income producing strategies are one of the themes we have recommended throughout the year, and one that we continue to recommend. As we pointed out last year, a 10-year Bank of Canada note now yields less than the dividend yield of the *S&P/TSX Composite Index*. Similarly, the yield on a 10-year U.S. Treasury note is less than that of the dividend yield of the *S&P 500 Composite Index*. Although this condition will likely not hold as the appetite for risk returns, the spread between the yield of government bonds and equities will likely remain well below historical averages. This is a recent key development which should lead investors to continue chasing yield oriented investments, causing these areas to likely outperform.

Back to the Old: Dividend Investing

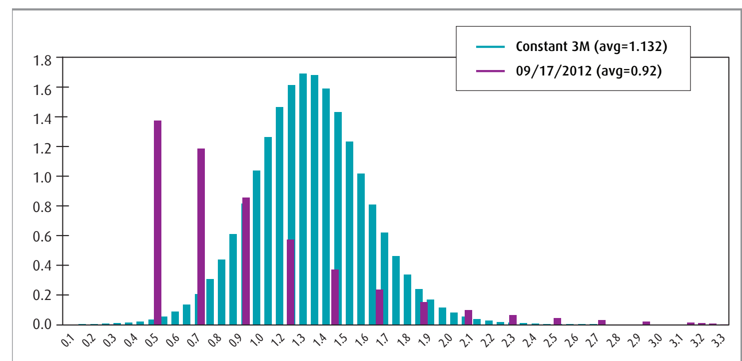
The returns from a stock are derived from two components: capital gains and dividends (or distributions). Since the 1990's chasing capital gains has been an effective strategy for investors – and for good reason. A perfect storm of rapidly evolving technology, baby-boomers entering their peak earnings age and deregulation were just a few of the factors which led a number of equity market indices around the world to see their most unprecedented rallies on record. Between 1980 and 2001, the *Dow Jones Industrial Average Index* and the *S&P/TSX Composite Index* gained 1186% and 393% respectively. Prior to this era, investing in solid companies that provided sustainable dividends was the key to a successful investment strategy, a key factor to the investment approach of investing legends such as Warren Buffet. In the current market environment where volatility has become (and will likely remain) more of a norm than an exception, the capital gains portion of a stock will become more unpredictable. The dividend portion of an equity investment, on the other hand, is more reliable.

In addition, dividend paying companies tend to be from more mature sectors, such as utilities, real estate investment trusts (REITs) and consumer staples, to name a few. These areas tend to be more stable, a desirable characteristic in this market climate. Though higher growth stocks will have their place in a portfolio, particularly in more tactical strategies, dividend paying stocks are better served for buy and hold investors. In choppy markets with strong moves both on the upside and downside, cyclical or high growth stocks will exhibit just as much, if not more downside then upside participation. As we highlighted last month, as one of our volatility mitigation strategies, dividend paying equities may help reduce the variability in an investor's overall portfolio. For this reason, we continue to recommend an overweight to dividend oriented areas for the equity portion of a portfolio.

Potential Investment Ideas:

- ***BMO Canadian Dividend ETF (ZDV)***
- ***BMO Equal Weight Utility Index ETF (ZUT)***
- ***BMO Equal Weight REIT Index ETF (ZRE)***

Futures Market Implies Probability of Lower Rates Next Year



Source: BMO Asset Management Inc., Bloomberg.
(Note: Based off of Three-Month Canadian Bankers' Acceptance Futures)

In with the New: Non-traditional Fixed Income

Another key investment theme we outlined in our 2011 strategy in January has been an exposure to investment grade corporate bonds and non-traditional fixed income. Again, with interest rates remaining low in the developed world, investors have been forced into areas outside of government bonds to source higher coupon paying credit. Emerging market debt and U.S. high yield bonds, which offer higher yields, have seen significant fund flows for this reason. While we are still recommending these areas, this does not suggest investors abandon traditional fixed income. Despite low rates, traditional government bonds continue to exhibit a negative correlation to equities, making them extremely useful in lowering portfolio volatility. Instead, an increase in allocation to emerging market debt and U.S. high yield bonds should be taken partially from equities. In addition, these areas should not be viewed as core investments in a portfolio as they tend to react to risk in similar fashion to equities at times.

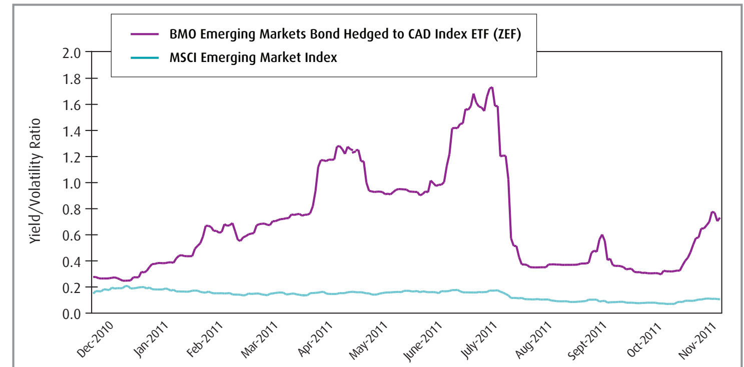
Another area in fixed income that we favour is Canadian investment grade corporate bonds. Although we preferred the shorter-term bonds in this area at the beginning of the year, we began recommending mid-term corporate bonds in August as the Bank of Canada is now looking they are likely to hold interest rates steady until at least the second quarter of 2012 as the economic recovery has lost some steam since last January. Another reason we continue to recommend mid-term corporate bonds is due to their attractive yield to volatility ratio (yield to 30 day volatility) suggesting they may help increase portfolio yield without adding significant volatility.

The following charts compare some yields to volatility ratios between some of our fixed income ETFs and some equity based indices. By switching from a security with a low yield to volatility ratio to one that exhibits a higher ratio, investors can potentially improve their overall portfolio yield and lower volatility. Although, these switches may reduce the opportunity for capital gains, yield and volatility reduction should be a paramount strategy in the current market environment.

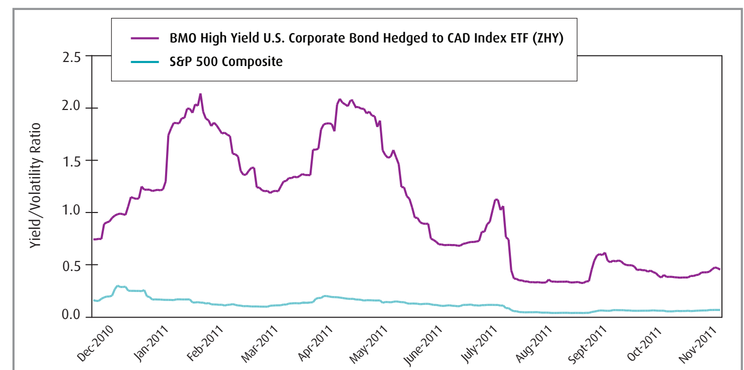
Potential Investment Ideas:

- *BMO Emerging Market Bond Hedged to CAD Index ETF (ZEF)*
- *BMO U.S. High Yield Corporate Bond Hedged to CAD Index ETF (ZHY)*
- *BMO Mid Corporate Bond Index ETF (ZCM)*

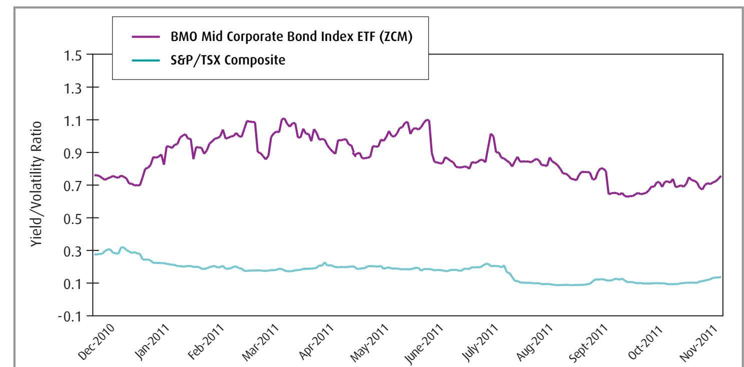
Yield to Volatility: Emerging Market Bonds vs. Emerging Market Equities



Yield to Volatility: U.S. High Yield Bonds vs. U.S. Equities



Yield to Volatility: Mid Corporate Bonds to S&P/TSX Composite



Source: BMO Asset Management Inc., Bloomberg (Note: 12 month yield is used to approximate yield, while 30-day realized volatility is used to characterize volatility)

Income focused investments will likely continue to show relative outperformance to the broad market as long as we remain in a low interest rate environment. The European Central Bank (ECB) which has had a tendency to take a more hawkish tone on monetary policy surprisingly recently dropped interest rates by 25 basis points, shortly after new ECB president Mario Draghi was inaugurated. Moreover, with many developed nations still struggling to kick-start their economies, interest rates will likely remain low in the absence of either higher inflation or growth in gross domestic product (GDP). In addition, several weeks ago, credit rating agency Fitch Ratings warned that the credit worthiness of U.S. banks would deteriorate if the European debt crisis worsens. This is a good depiction of how interconnected the global economy has become and how much hinges on the restoration of confidence in Europe. With the tug-of-war between the macro-economics in Europe and the improving micro-economics at the company level, market volatility is likely to remain, leading capital gains to show greater variability. Thus increasing exposure to income oriented areas should be an effective strategy for a market where expectations of economic growth is low and volatility is likely to remain high.

Footnotes

[1] Cumulative probability of default (CPD) quantifies the probability of a country being unable to honour its debt obligations over a given time period. For sovereign CDS, this typically includes the probability of a restructuring of debt. Unless otherwise stated, all values are for the five year CPD. CPD is calculated using an industry standard model and proprietary credit data from CMA Datavision™. Reference to 'risky' is purely in terms of the probability of default derived from the price of the CDS.

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