An Alternative Way of Thinking About Portfolio Construction

What are alternatives?

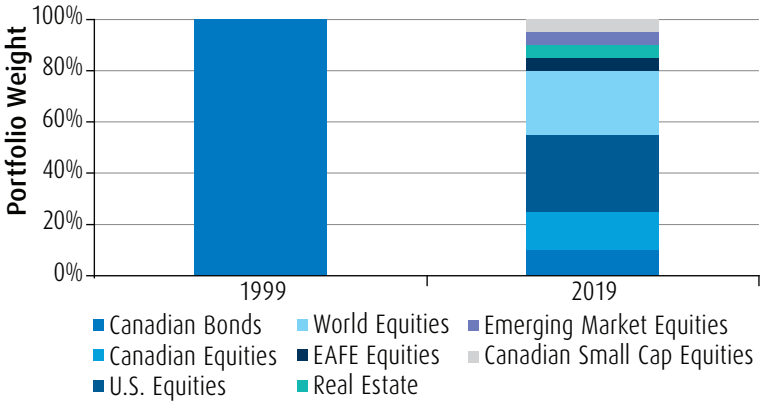
Alternatives are assets which have low correlation to equities and fixed income. Examples of alternatives include real estate, private equity, commodities, infrastructure assets, and some derivative strategies. Alternatives may use leverage to enhance returns. Historically, alternative investments have only been accessible to institutional and high net worth investors due to complexity and a lack of liquidity. At the start of 2019, liquid alternative mutual funds were permitted, adding interest and momentum to these strategies.

Why are alternatives important now?

A typical portfolio must take on more than double the amount of risk (defined by standard deviation) to achieve the same return today than it did 20 years ago. This means that portfolios are facing increased volatility, and the need for diversification and uncorrelated asset groups is an essential component of portfolio construction.

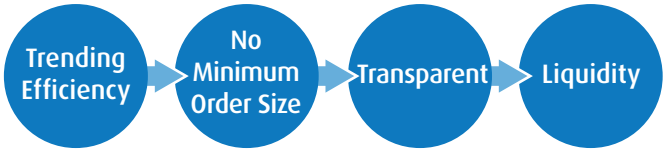
One of the greatest benefits of alternatives is that they offer increased portfolio diversification. Because of their low correlation to other portfolio holdings, they smooth returns, can lower overall portfolio volatility, and can offer alternative sources of return beyond broad-based equities and fixed income. Investors are looking for liquid strategies that differentiate from equity and fixed income markets, regardless of what they hold.

Historical Breakdown of Portfolio Holdings



5-year annualized, ending December*	1999	2019
Return	9.90%	10.03%
Standard Deviation	5.01	8.25

Why use an ETF for alternative exposure?



Traditional alternative asset classes are illiquid, require a large investment size, and are not transparent. Accessing an alternative asset or strategy using an ETF brings with it all the benefits of ETF investing: transparency of portfolio holdings, ability to buy and sell on the exchange, and enabling smaller transactions.

In Canada, there are over 30 Alternative ETF Strategies available (not including alternative asset classes), with over $1B in AUM[1]. The introduction of liquid alternatives has made it easier for alternative strategies to be used within ETFs, but investors must do their due diligence on each strategy to see if it is appropriate for them.

* Source: Morningstar Direct, as at December 31, 2019 in Canadian dollars. Canadian Small Cap Equities, Emerging Market Equities, Real Estate, EAFE Equities, U.S. Equities, Canadian Equities, Canadian Bonds represented by S&P/TSX Small Cap Index, MSCI EM Index, DJ Brookfield Global Infrastructure North American Index, MSCI EAFE Index, S&P 500 Index, S&P/TSX Composite Index and FTSE TMX Canada Universe Bond Index.

BMO ETF Alternative Solutions

Alternative Hard Assets

BMO Equal Weight Global Gold Index ETF: ZGD

- Exposure to the largest listed senior gold miners globally.
- Provides a leveraged exposure to the price of gold. As the gold price climbs, miners will grow at a greater multiple.
- Gold is currently witnessing enormous macro-economic tailwinds: historic amounts of monetary stimulus, increased market uncertainty, and the risk of inflation.
- Gold is a safe-haven asset for investors concerned about currency debasement or market corrections.

BMO Global Infrastructure ETF: ZGI

- Diversified exposure to global infrastructure sectors such as Utilities (gas, electric, water), Industrials (airports, toll roads), Real Estate (cell tower operators) and Energy (oil and gas storage and transportation).
- Infrastructure provides steady cash flows as these are generally long-term contracts with predictable cash flows.
- High barriers to entry in marketplace - high cost to setup does not encourage competition to come up easily – mostly monopolistic businesses.
- Benefits from large amounts of fiscal stimulus which will be directed at infrastructure projects.
- Accessing infrastructure through equities- better liquidity and pricing transparency.

Correlation Matrix

	1	2	3	4
1. BMO Equal Weight REITs ETF	1			
2. BMO Equal Weight Global Gold ETF	0.34	1		
3. BMO Global Infrastructure ETF	0.66	0.27	1	
4. MSCI World GR CAD	0.48	0.06	0.59	1

Source: Morning Star Direct, June 30, 2020.

BMO Equal Weight REITs ETF: ZRE

- REITs provide exposure to hard assets in real estate which provide inflation protection.
- Valuations are looking attractive in this sector right now, as some investors are concerned over the future of offices and malls.
- Because if its equal-weight methodology, ZRE has a diversified sub sector exposure with holdings in the retail, residential, office, industrial and health care spaces. Its exposure to office space is currently around 10% of the portfolio.
- Good alternative investment for a yield-focused investor: ZRE currently yielding 5.4%[2].

Alternative Strategies

BMO Premium Yield ETF: ZPAY

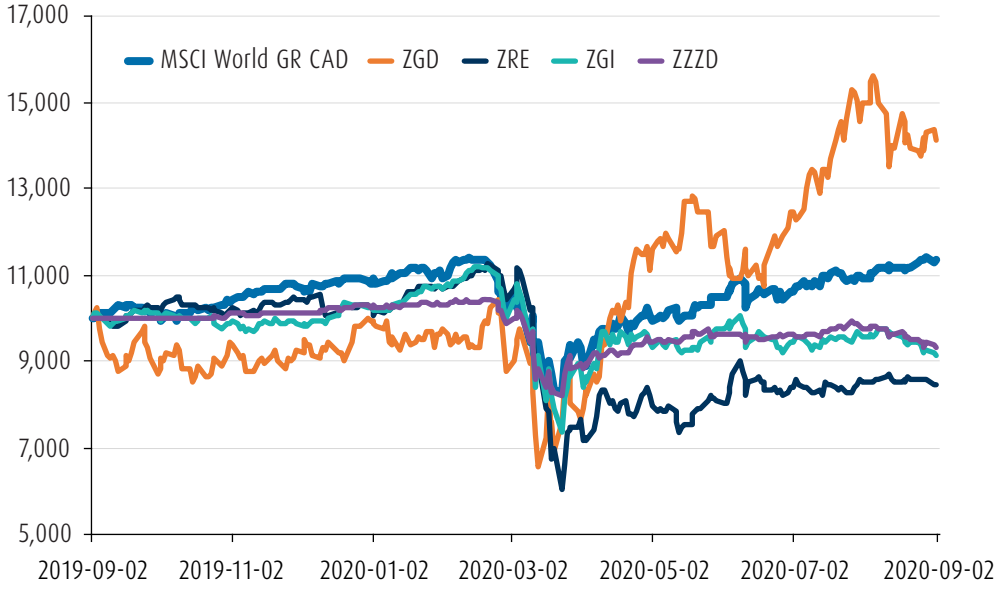
- ZPAY is a dynamic option-based strategy which uses put-writes and covered calls combined with some long stock exposure to provide an enhanced income product that has less volatility, more diversification, higher yield and partial market exposure.
- In normal market conditions, the fund targets 20-50% equity market exposure. The partial exposure gives the fund a lower beta, and lower correlation to the broad market.
- The strategy is built to "buy low, sell high" because of the calls and puts it writes. When puts go "in-the-money" the fund buys stocks at a discount, and when calls go "in-the-money" it sells the stocks away once they have rebounded. This proved to be very successful through March during the equity market sell off and through April and May when equities rebounded.
- ZPAY yields 5.9%[2], and because most of the yield is generated through selling options, this yield is tax efficient as option premiums are taxed as capital gains.

BMO Tactical Dividend ETF: ZZZD

- ZZZD can tactically shift to increase or decrease risk, and combines active management with passive, low-cost ETFs.
- This fund makes tactical calls on beta, increasing exposure when markets correct, and dialing back when markets rally.
- The strategy has proven successful and is uncorrelated with both equity and fixed income returns[2].
- ZZZD yields 4.1%[2].

Growth of $10,000

1 Year Returns, MSCI World vs BMO Alternative ETFs



Source: Morningstar Direct as of September 3, 2020. All returns in Canadian dollars.
Past performance is no guarantee of future results.

When looking to add alternative investments to your portfolio, investors should consider one of BMO ETFs' alternative options:

BMO Equal Weight Global Gold
ZGD
Distribution Yield: 0.0% | A
Mgmt. Fee: 0.55%
Risk Rating: High

BMO Global Infrastructure
ZGI
Distribution Yield: 3.5% | Q
Mgmt. Fee: 0.55%
Risk Rating: High

BMO Equal Weight REITs
ZRE
Distribution Yield: 5.4% | M
Mgmt. Fee: 0.55%
Risk Rating: Medium

BMO Premium Yield ETF
ZPAY.F hedged to CAD | **ZPAY** unhedged | **ZPAY.U** USD Units
Distribution Yield: 5.9% | M
Mgmt. Fee: 0.65%
Risk Rating: Low to Medium
new

BMO Tactical Dividend ETF Fund
ZZZD
Distribution Yield: 4.1% | Q
Mgmt. Fee: 0.70%
Risk Rating: Low to Medium

Articles & Podcasts Related to This Document:

- Podcast: Why "Alternatives" Enhance Portfolio Risk and Reward Listen
- A Golden Opportunity for Gold: BMO Equal Weight Global Gold ETF, ticker: ZGD Read
- An Alternative Income Strategy: BMO Premium Yield ETF, ticker ZPAY Read

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[1] Source: Morning Star Direct, June 2020.
[2] Annualized distribution yield as of August 31, 2020.

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