Institutional Quarterly

This Issue

BMO Global Asset Management

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BMO Global Asset Management

Hedging inflation with fixed income ETFs

Alfred Lee, Portfolio Manager at BMO Global Asset Management, outlines his views on inflation and explains why institutional investors should look to ETFs as a means to hedge inflationary pressures and their associated risks.

Winter 2022

Alfred Lee

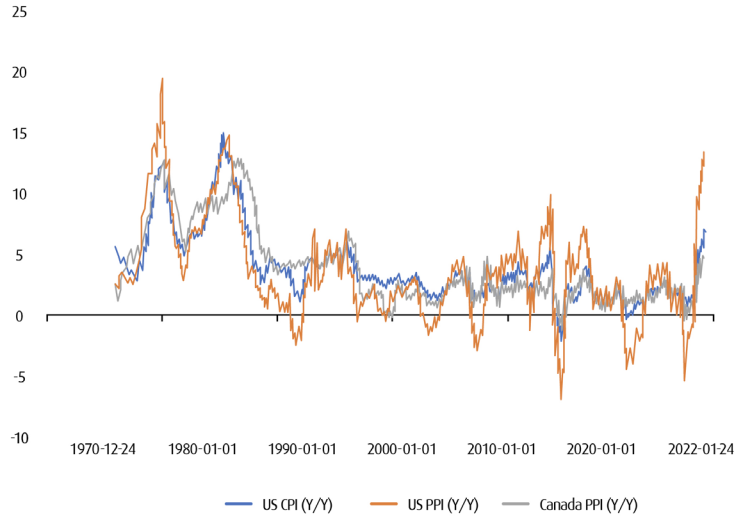
PORTFOLIO MANAGER AT BMO GLOBAL ASSET MANAGEMENT

Root cause of today's inflationary environment

There are a number of factors that account for the current bout of inflation affecting global markets. Monetary policy, fiscal stimulus and supply chain issues have been implicated as the reasons for these inflationary pressures, and rightly so.

Central banks have driven prices higher, largely due to the US Federal Reserve keeping their foot on the gas for too long with easing strategies. At the same time, stimulus measures by governments – that put money in the hands of people and into an economy without high unemployment – have led to heightened consumer spending. Lastly, current broad based supply chain issues have resulted in significant supply-demand imbalances, leading to today's higher prices in many sectors around the globe.

Inflation has not been this high since the 1980s



Source: Bloomberg, December 24, 1970 to January 24, 2022.

Inflation impacts consumers for the long term

Among the core drivers, shipping delays will likely be the main element that will be most persistent and long-lasting. Some companies have struggled to pass on the associated costs to consumers, which has only exacerbated this phenomenon. However, the pricing imbalance can't persist indefinitely, and as firms become capable of transferring their increased production costs, it will only fuel the flames of inflation further.

Companies having a tough time passing on higher costs may find relief as the economy opens and demand starts to pick up.

What's important to note in the case of inflation and price increases is that while year-over-year price increases and the CPI will eventually dissipate over time, the absolute cost of these goods will not decrease. The actual cost of goods and services won't diminish as inflation subsides, so consumers are ultimately left with paying more for these items over the long term.

Hedging inflation with fixed income assets

In a period of inflation, it's more important than ever that your portfolio works harder – and smarter – for you. Nowhere is this more impactful than when looking at fixed income investments. With interest rates at all-time lows, institutional investors need to seek innovative and creative solutions to derive the higher yields needed from this asset class to keep pace with inflation.

However, one aspect investors need to be cautious of when researching inflation-protected products is the duration of the underlying assets. While longer duration assets generally compensate the investor with higher coupon payments that offset the effects of inflation, they also have greater interest rate sensitivity, which can erode real returns in a rising rate environment.

Our suite of fixed income ETF products provides a low-cost and targeted solution, providing you with the enhanced yield you're looking for.

US TIPS ETFs

Last year we launched a suite of ETFs focused on the real return bond market invested in short duration US TIPS (US Treasury Inflation-Protected Securities).

Each of the funds has been designed to replicate the performance of the Bloomberg US Government Inflation-Linked 0-5 Year Bond Index, which means they are comprised of short duration (0-5 years) US TIPS and are generally issued or guaranteed by the US Treasury. The principal and interest of the underlying assets are inflation-linked to provide the protection investors are seeking.

We also offer a currency-hedged version of this ETF, which adds an additional layer of risk mitigation for investors concerned with CAD-USD currency risk. As an added benefit for multi-family offices, these solutions enable ultra-high-net-worth Canadian investors to gain exposure to these assets while avoiding the related estate taxes.

We believe that investing in TIPS can always be a core and strategic allocation in an investor's portfolio, not only during inflationary times. Given you can never predict if and when inflation may hit, and to what extent, having assets in place that can protect against it is a strategic way to manage risk.

Moving up the yield curve to enhance returns

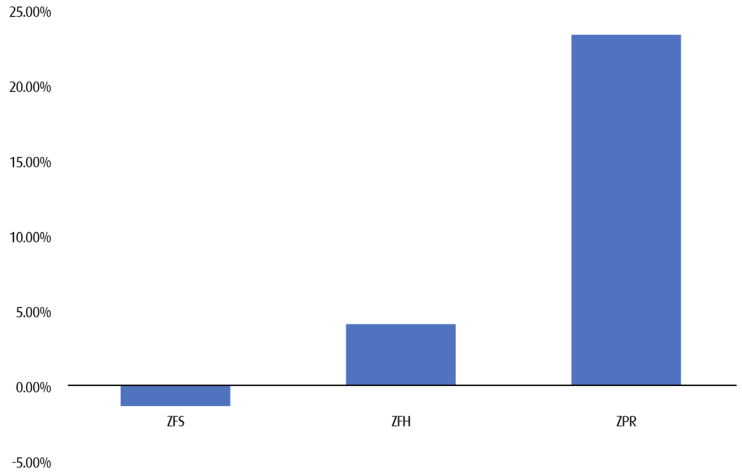
Hybrid assets, which fall somewhere in the middle between equities and fixed income assets, have become increasingly common investing strategies for investors seeking to move up the yield curve and who are willing to take on more risk to enhance portfolio performance. Two ETFs in particular deserve consideration as an alternative to the traditional 60/40 portfolio: the **BMO Floating Rate High Yield ETF (Ticker: ZFH)** is one, with the other being the **BMO Laddered Preferred Share Index ETF (Ticker: ZPR)**.

In this rate environment, it can make sense to move up the risk spectrum to generate higher yields for your bond portfolio.

In the case of ZFH, we invest in Canadian T-bills to minimize currency and interest rate risk. We then enhance returns for this low-to-medium risk strategy by investing in a diversified basket of US high yield (non-investment grade) issuers through the use of credit default swaps (CDX), adding yield to this solution.

ZPR takes on a completely different approach to enhancing yields by investing in preferred shares where the dividend paid are tied directly to the five-year Government of Canada bond rate. Therefore, as interest rates move higher, the dividends received will reset to a more attractive rate. This Fund has been designed to replicate the performance of the **Solactive Laddered Canadian Preferred Share Index**, and includes Canadian preferred shares that meet size, liquidity, listing and quality criteria.

Total returns: ZFS, ZFH and ZPR



Source: Bloomberg, January 1, 2021 to December 31, 2021. Annualized performance: ZFS (BMO Short Federal Bond Index ETF) – 1 year: -1.36%, 3-year: 1.64%, 5-year: 1.16%, 10-year: 1.23% and since inception (October 20, 2009): 1.63%; ZFH: 1-year: 4.14%, 3-year: 3.72%, 5-year: 3.50% and since inception (February 10, 2014): 4.18%; ZPR: 1-year: 23.50%, 3-year: 10.05%, 5-year: 6.69% and since inception (November 14, 2012): 1.99%.

The role for ETFs with institutional investors

For institutional investors, ETFs can be viewed as an important tool in your investment toolkit. In essence, they are resources you should be looking at on a regular basis as a means to augment and enhance the assets in your portfolios.

Remember, ETFs allow investors to integrate more broadly based and diversified investment solutions than would typically be possible through more traditional asset management practices. In many ways, they should be viewed as "access vehicles" – providing investors with a means to buying unique, cost-effective investment products when and where they need to.

Without them, many asset managers would be limited by the types of investment decisions they could make internally, and the speed with which they could make them. As we strive to optimize alpha – while effectively managing risk in a rapidly growing investment universe – having access to the strategies will continue to be a critical component in the investment process.

How ETFs benefit active managers

Active management plays a critical role in portfolio management, and most importantly in maximizing returns at a given level of risk. That said, active managers by definition tend to specialize in one specific asset class, where they leverage their in-depth knowledge and experience in this area.

Where ETFs can benefit active managers is in those other asset classes beyond their core strength. They can provide great value for these portfolio managers is by enabling them to gain access to unique sectors and styles, and hence enable them to diversify their investment holdings that much more readily without having to hire another manager.

ETFs help active managers tap into different areas of the market that, in the past, would have been difficult to access. It would take time to go out and find a high yield bond manager, whereas an ETF can get that exposure up and running right away.

Ultimately, we believe ETFs are far more efficient, particularly from an operational perspective, but are also far more efficient when it comes to enabling a portfolio to be more holistic in nature. One term we often use in this regard is "surgical" – pinpointing areas outside your typical comfort zone where you normally focus your efforts from an investment management perspective.

Introducing Jeff Shell: BMO GAM's new innovation chief

Jeffrey Shell, our first Head of Alternatives, ESG and Innovation, discusses transformational change across the investment landscape and how BMO GAM plans to stay one step ahead

Winter 2022

Jeffrey Shell

HEAD OF ALTERNATIVES, ESG AND INNOVATION, BMO GLOBAL ASSET MANAGEMENT

"You can never plan the future by the past." – Edmund Burke

Frontiers of growth

How do you identify and capitalize on innovation? We believe it comes through commitment – and an expectation that ground-breaking advancements usually occur as leaps and bounds rather than cautious, incremental steps.

This type of "nonlinear innovation" requires experimentation, care and planning. In recognition of this, BMO Global Asset Management provided me with a mandate to deliver on novel experiences and keep our clients ahead of the curve on new technologies.

Coincidentally, my own professional journey to this point has been anything but straight. I have worked in technology research, at a startup, in strategy groups, and in various functions within capital markets. All of this has one common denominator: *change*.

Full circle on innovation

I arrived at my current role from BMO Capital Markets, where I headed a team that provides banking services globally. I was initially responsible for trade finance and correspondent banking, and soon after as a reflection of our global footprint, for corporate banking in Asia, as well as cash management in the U.S.

Years later, a restructuring led to the creation of two new organizations. One sold products and services to corporate and commercial clients. The other, which I was given to build, was a global practice that served banks, insurance companies, asset managers, wealth managers, specialty finance providers, broker dealers and credit unions across products and solutions. That opportunity gave me a chance to really understand how to serve each division of a bank as if they were an external client. It was a tremendous learning experience, and we grew faster than every other division for three years running. Then, a few

months ago, BMO GAM brought me over to this new and exciting opportunity.

Interestingly, the transition brings my career full circle. Two decades ago, I was a computer science researcher at Queen University's Human Media Lab, pushing the boundaries of how computers and people interact. My job was to design technologies that inspired people to think differently – now it is to invest in them.

An education in computer science is a great basis to tackle difficult problems.

Despite being fascinated by technologies of tomorrow, I found the distance from practical to be too great. So, I switched gears and moved into consulting where the stakes were real, even if the skills required were similar. Computer science is all about problem-solving, after all. You work hard until you crack the puzzle, whether that's figuring out how to optimize a computer algorithm or reduce waste on a shop floor. Finance is much the same, only the problem will contain different variables, such as cost drivers and cash flow. I've found the consistent challenge to be in identifying the system and getting to know how it works – from there, there are often ways to make it work better.

Change on the horizon

Artificial intelligence techniques offer us the ability to solve all sorts of problems that extend human ability. We could, for instance, use natural language processing (NPL) to quickly scan the web and extract insights related to the companies we cover from hundreds of thousands of sources.

How would that help? Well, imagine you have an ESG impact story that will make its way to the cover of the *Wall Street Journal* at some point, but on its way, it is first reported in a tiny Brazilian newspaper. With an NPL algorithm scouring the web, that information would be seen quicker and we could act sooner – that action might help a fund invest within its mission faster (e.g., lower "values" tracking error) and at the same time reduce the chance that performance is reduced by unforeseen events. We want to continue to explore how AI automation can enhance the overall quality and efficiency of our investment decisions, particularly in use cases where pattern recognition is of paramount importance.

In addition to innovation, I also oversee Alternatives and ESG – two areas that are rife with opportunity. Alts, for example, should become an integral component of the modern investment portfolio amid low interest rates, high inflation and hefty forward earnings-based valuations. In this environment, the traditional 60/40 asset allocation portfolio may make it hard for income-reliant investors to reach their objectives. Further, shifting into riskier credit in an uncertain environment, or increasing the weighting of equity may not be good solutions for many investors for a variety of reasons.

A carefully selected portfolio that includes alternatives investments has the potential to both enhance total return and reduce risk. The magic is in accessing strategies that have low correlation to traditional investments and deliver a premium for the less liquid nature of many of these structures.

Finally, ESG continues to be an area of rapid growth. In 2021 alone, we saw net inflows of ~$1 billion per month to ESG funds in Canada.[1] The good news is that many institutional investors are already thinking about essential problems, from climate change to board diversity, Indigenous rights and social injustice, and proactively using their investment heft to influence positive change. When you combine the flexibility of private investments and the objective of influencing change, we expect there to be significant momentum in these two industry growth vectors.

My job was to design technologies that inspired people to think differently – now it is to invest in them.

What to expect from us

At BMO, we're incredibly proud of our stewardship and proxy voting record on ESG issues. We are focused on maintaining our tradition in this space. In the next year, we plan to scale our Responsible Investing team and build more ESG tools and experiences to guide portfolio choices.

Moving forward, you can also expect to see credit products that reflect BMO's history as an exceptional underwriter. Unfortunately, private debt has not always been an easy space to access. We are working to simplify with solutions that offer investors efficient exposure to illiquid parts of the investment universe.

As such, we will be sharing the opportunities that come to us by virtue of our scale, and packaging these solutions to suit different risk profiles and return objectives. The end goal will, of course, be to help solve the needs of investors who are seeking additional yield.

Perhaps the biggest lesson I've learned about innovation is that there shouldn't be any boundaries on what's considered possible. Optimization problems are important, to be sure, but we will strive to look beyond incrementalism and try to reach the opportunities that create terrific return and impact outcomes for our investor clients.

[1] BMO Global Asset Management, as of December 31, 2021.

BMO Global Asset Management

Canadian equities display strength, resilience in turbulent times

BMO Global Asset Management provides insights on the Canadian equity market, looking back at what transpired in 2021 while providing their projections for the year ahead, highlighting inflation, IPOs, the energy sector and more.

Winter 2022

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2021 Recap – Canadian equities

Many investors may have expected Canadian equity markets to stumble in 2021 in the midst of a global pandemic that showed no signs of slowing down, the ensuing supply chain and inflation issues that were worldwide plus the political fallout south of the border.

However, this was far from the reality. The TSX was up approximately 89% at year-end from its lows in March 2020, with performance for 2021 up around 25%,[1] led by financials and energy. Overall, the market's strength was widespread, with nine of 11 sectors in the positive along with two thirds of stocks, with only one pullback over 5%.

The factors driving the returns in the market were more "value focused," with energy, banks and higher capital-intensity businesses leading the way. Areas of the market that represented higher risk saw returns driven primarily by quality factors that had lagged, such as ROE, profitability and growth.

Under this backdrop, the BMO Global Asset Management team has provided the following guidance on what transpired last year along with their prognosis for Canadian equities in 2022.

The resurgence of inflation

Inflation is one economic term that hasn't been mentioned in quite some time which has reared its ugly head in the latter stages of 2021. Its resurgence caught some off guard, though this should not be surprising given the macroeconomic conditions that have persisted over the past 22 months. That said, it's important to note that inflation does not dictate any of the decisions made around asset allocation within our Canadian funds.

There's been a massive supply and demand imbalance that occurred as a direct result of COVID-19. Many industries were forced to shutdown or scale back their operations in 2020 and 2021, which impacted supply globally and across many sectors. Couple this with uncertainty as to when demand would pick up again and the result is a complex ecosystem fraught with tremendous uncertainty and ambiguity.

Layer on the varied rates and degrees to which countries emerged out of the pandemic, and the result was a lot of logistical

challenges at ports and shipping terminals around the world. Combined with the labour shortages that ensued as many people failed or delayed returning to work, the result was upward pressure on labour costs to entice skilled workers to fill these vacant roles. The climate was ripe for inflation.

Managing inflation - Our portfolio management strategies

One element that's difficult to determine at this point is how persistent commodity inflation – such as energy, copper and lumber – will be in the coming months. For example, lumber prices spiked last spring from their historical range of $400-$500 per 1,000 board feet to $1,700. In the summer, they were back down to $500 and now are up again to $1,000. So clearly there is considerable volatility in the markets. The big question to be answered is how structural these price increases will be down the road.

Given inflation's unpredictable nature, it's important in this environment to find companies that have "pricing power" – those that are able to raise their prices more readily in an inflationary environment in order to avoid eroding margins. This will be incredibly important and something we will be focusing on.

When we think of companies with solid pricing power, we think of Storage Vault (Access Storage). This company operates traditional storage facilities across Canada. Its business model is operated by two people, one person who works out front while the other manages the facility, thus they have minimal labour costs. A strong storage operator can raise prices 6-8% every six to nine months since most people won't be backing up a U-Haul truck and moving their belongings elsewhere because their monthly rate increased from $100 to $106. That's a business with great pricing power that would be an attractive target for us.

IPOs fueled recent market successes in Canada

IPOs were another popular theme in 2021. Last year, we saw fifty-plus companies approach us looking to go public or have meetings to test the waters and see if there was a path forward to go public, so it was a busy year for this. As one would expect, they were primarily in the small cap space.

While there are many issues and concerns to contend with when it comes to investing in IPOs, including firms attempting to go public too early and for the wrong reasons, there are also many positives. For example, an allocation to a select number of names that meet our criteria can offer significant advantages in repopulating a portfolio with future Canadian leaders.

In many ways, it also provides us with the ability to own, at a very early stage, very strong business models that will have a long runway of growth, which can be future alpha for the portfolio. We have a good track record of sourcing new names from IPOs. For example, back in 2014-15 Shopify was a key holding in our small cap strategy at a $1.3 billion market cap, now it's over $200 billion.

Many IPOs fall short of our criteria, as they often lack proper internal systems, track record alignment and governance. Their management teams are often new to the business and there isn't a proper vision for the business and what it wants to be.

With the recent slowdown in IPOs over the past few months and a deterioration in their overall quality, the prognosis for this sector this year appears to be a little more muted relative to 2021. We will continue to monitor this segment as we look for ways to add value and alpha to our portfolios.

A few companies that stood out in 2021 would be Pet Valu, Magnet Forensics and Neighbourly Pharmacy. In the case of Neighbourly, it's the owner of rural pharmacies across Canada. They're operating in areas where they're not competing with Shoppers or Rexall. In small-town rural Canada, 70% of their business is prescriptions, where they play a very important role within Canadian society from a healthcare perspective. The CEO is an ex-Shoppers executive and the firm has a strong board.

What we like about companies like these is that, while you get low same-store sales growth of 2-4%, it's very sticky growth; they're a highly frequented store with their customers. They also offer an enticing M&A opportunity, one that involves small, single pharmacy transactions that carry lower risks.

There are significant succession planning challenges within this market, given the large pool of around 3,000 rural pharmacies. Neighbourly in some cases is the only interested buyer, and can therefore purchase businesses at attractive valuations. We think they have a long runway of growth, in the range of 10-15%.

Our take on the energy sector

One thing that needs to be emphasized on a more macro level is that when it comes to the energy sector, it's virtually impossible to make calls on commodity prices. Simply put, predicting and forecasting commodity prices is quite difficult.

That said, there are some positives in this sector. For example, demand is picking up as economies are reopening with more people and goods on the road. Energy producers are also more focused on capital returns as opposed to growth, which has helped to limit supply and thus keep prices stronger.

Unfortunately, many challenges remain within energy. With the big global push towards carbon neutrality and the reality that every day, another pension plan announces it will no longer invest in this sector, the future does appear to be bleak. There's also the question of what long-term demand will look like for electric vehicles (EVs), with the likelihood we may have underpriced their long-term market penetration. The business models in this sector are always challenged.

When it comes to our asset selection preferences in this sector, we're very much focused on the production side. In particular, we're most interested in those companies that deliver low costs of production combined with a management team that knows how to recycle capital in an efficient way. From our perspective, this is a compelling long-term approach that helps to lower risk by providing an added margin of safety, while still generating attractive returns.

Will financials have another record year?

For those that haven't been keeping tabs, the financial services sector in Canada had a very strong year in 2021 from a profitability and stock performance perspective, with the sector up 36%.[2] So, what's the prognosis for 2022?

It's clear to us that the stellar performance seen in 2021 is likely not going to be repeated this year, as what we saw in 2021 is something you normally experience after a recession. Given the current environment, it's quite probable that the banks and financials will continue to perform well over the coming years, but at a more normalized, high single-digit rate of return.

That's not to say there aren't companies that can't outperform in this sector. Intact Insurance is an example of one – a not so small Canadian financial able to generate 10-15% returns annually for more than 10 years.[3] Brookfield Asset Management is another real value creator in Canada that's achieved a CAGR of 19%[3] since the bottom of the market in March of 2008, compared to the banks at only 16%.[3] We're overweight in both these holdings.

When it comes to the financials sector, it's important to remember the sector is composed of quality companies, all big enough

and diversified enough that we see them as proxies for gross domestic product. They've produced excellent compounded returns over the past 20-30 years, offering great value to investors of all stripes and thus being an integral component of our funds.

Key takeaways

There are a number of key points investors can take from this review of the Canadian equities market. First, inflation is definitely a reality we all need to contend with for the foreseeable future and on a variety of fronts, investments included. In the case of the latter, while inflation won't influence industry or sector weightings, it will impact stock selection, particularly as it relates to a company's pricing power.

On the topic of IPOs, we will continue to take a cautious yet informed position when it comes to these investments. There are still opportunities in this segment, and we will seek those that can truly add value for investors by repopulating a portfolio with future industry leaders that can drive long-term growth.

Energy has often been a contentious sector in the markets for a variety of reasons, and now the ESG lens has added an entirely new level of scrutiny. While there are clearly many investment options in the Canadian market beyond the problematic fossil fuels segment, the question that needs to be asked now is: can you invest in this sector without including traditional energy stocks in your portfolio?

Finally, when it comes to the all-important financials sector, the returns from last year aren't sustainable in 2022, and we expect a return to more normalized, but still positive performance. This could be a benefit for the strategy, as the relatively high weighting in the benchmark along with our peer group provided a significant headwind for us last year, something that shouldn't be the case this year.

[1] Bloomberg, December 31, 2021.

[2] S&P/TSX Composite Index, GIC performance.

[3] Bloomberg.

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