Covering your bases with enhanced income

BMO GAM's latest enhanced income fund, BMO Covered Call Canada High Dividend ETF Fund, provides a convenient way to access substantial portfolio yield, tax efficiency and risk protections not typically found in traditional dividend funds – all at low a cost

THIS MONTH, BMO Global Asset Management adds another option to its comprehensive enhanced income mutual fund lineup. The BMO Covered Call Canada High Dividend ETF Fund is a mutual fund that provides access to some of the country's top dividend-paying companies, while offering consistent income through its covered call strategy. The product has already proven popular in an ETF format – BMO Canadian High Dividend Covered Call ETF (ZWC), which launched in February 2017 – and now those who prefer to invest through a mutual fund can avail of the same strategy.

"It is the exact same price point as ZWC, and it is really about making the offering available to as many investors as possible," says Chris Heakes, the fund's portfolio manager. "Typically, they have a need for income and can take equity risk, although the risk profile of this fund tends to be less than broad market equities."

BMO GAM introduced its high-dividend covered call mutual funds with a US offering in 2014, followed by a European exposure the next year. In 2016, BMO offered the covered call strategy on a basket of Canadian bank stocks with the BMO Covered Call Canadian Banks ETF Fund. The latest fund allows Canadian investors to gain access to a diversified set of 30 blue-chip, dividend-growing companies, alongside a proven option strategy that provides enhanced yield while still participating in the market upside.

> "The dividend construction is straightforward, but the covered call overlay is what really differentiates this fund. We are able to generate, on average, between 3% and 4% in additional income, taxed as capital gains, so it is generating a new revenue stream tax-efficiently and adding that to the dividend yield of the portfolio"
>
> Chris Heakes, BMO Global Asset Management

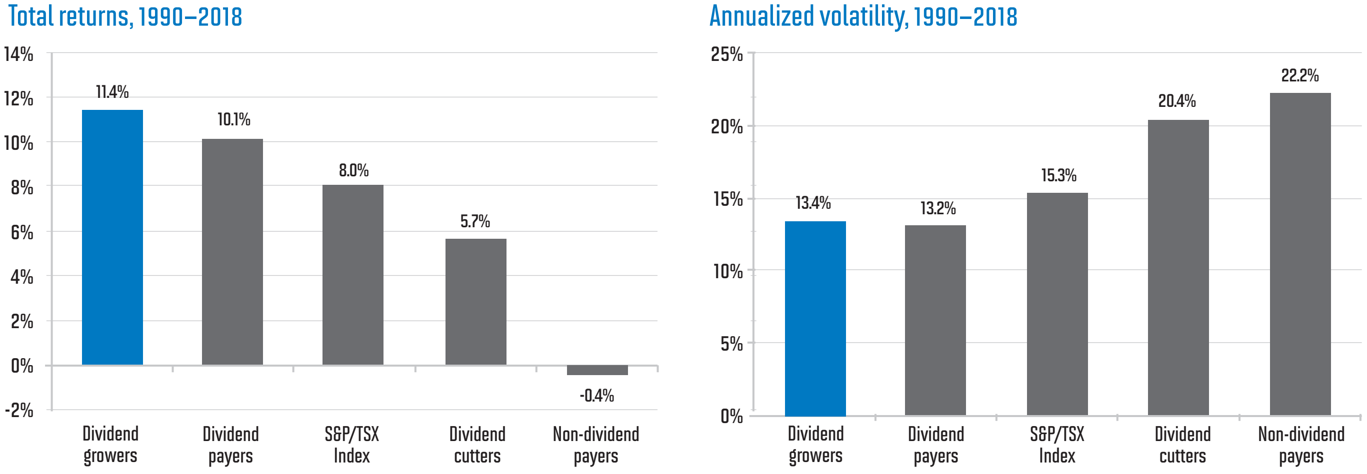
"It's a Canadian large-cap equity universe where we leverage our dividend methodology," Heakes says. "We look for stocks that have positive – or at worst flat – three-year dividend growth. That's the first screen, and then we look at the payout ratio to see the sustainability of those dividends."

He adds: "We are trying to avoid yield traps, so we have a metric where we look at four historical years of dividend payout ratios and one forward-looking year to come up with a measure of the sustainability of the dividends. That will potentially eliminate a company for consideration or penalize the weight of that company."

This process will identify approximately 30 of the highest-yielding candidates, whose yield then determines their weight in the

HAVING A DIVIDEND MATTERS

A better return profile at lower volatility is a winning proposition.



Source: BMO Investment Strategy Group, unweighted. Charts plot returns and annualized volatility of S&P/TSX Composite Index constituents, segmented by dividend characteristics. All data as of January 31st 2018. Analysis began in January 1990.

fund. Companies selected are also subject to a 40% sector cap, so the fund is balanced in such a way as to accurately represent corporate Canada. Financials lead the way with a 38% weighting, and energy is next at 23%.*

"I characterize the portfolio as having a quality bias with large-cap, blue-chip stocks," Heakes says. "There tends to be a positive size bias where we invest in the larger companies, as they tend to be more liquid from the options point of view."

But while the top two sectors in Canada's economy feature heavily, that isn't the case for materials – and for good reason, Heakes explains.

"It's a good way to get exposure to Canada, with less materials weights and less of the more volatile names in the Canadian index," he says. "We do have a healthy weight in energy; it is a sector where we are noticing a nice upward trend. What you don't tend to see in this fund is materials, where we just don't see the dividends and it doesn't fit our risk profile."

With a high yield, efficient taxation and a lower risk profile than many traditional dividend funds, all at a low cost, the fund differs from a host of other dividend offerings out there. With volatility returning to the marketplace this year, a covered call strategy can really prove its worth.

"The dividend construction is straightforward, but the covered call overlay is what really differentiates this fund," Heakes says. "We are able to generate, on average, between 3% and 4% in additional income, taxed as capital gains, so it is generating a new revenue stream tax-efficiently and adding that to the dividend yield of the portfolio."

This fund is therefore suited to an income-oriented investor who is searching for a steady stream of income over the long term. Such consistency means sacrificing blockbuster returns to a certain extent, but given the length of the current market cycle, it's a strategy sure to prove popular with many Canadian investors.

"Covered calls are a trade-off, so you can generate a lot of yield, but then you are potentially giving up on upside return," Heakes says. "We are not greedy for yield, so we only cover half of the portfolio, and if equities rally, half of the portfolio will rally, and we can generate 3% to 4% in yield in the covered half of the portfolio." **WP**

**Source: BMO Asset Management Inc. All data as of April 30, 2018*