

Combining U.S. Preferred Shares with Canadian Rate Reset Preferred Shares

Preferred shares have many attributes that make them an attractive asset class and an efficient building block in the portfolio construction process. In addition to higher dividends, preferred shares reside higher in the capital structure of companies, which allows them to have low correlation to traditional asset classes such as bonds, equities and cash.

As a result, preferred shares have become an important tool to the portfolio of many Canadian investors. Over the last decade, the composition of the preferred share market in Canada has changed with the rate reset structure now making up the majority of the market. Given rate resets have dividends that reset based on the five-year Government of Canada yield, it is an asset class that can help provide protection in a rising interest rate environment.

U.S. preferred shares also have desirable portfolio construction characteristics. However, the majority of Canadian investors tend to be unfamiliar with this asset class. As illustrated in the correlation matrix below, U.S. preferred shares not only have a low correlation with traditional assets, but also with Canadian rate reset preferred shares.

Correlation of Asset Classes

| | Canadian Equities | U.S. Equities | Global Equities | Canadian Bonds | U.S. High Yield Bonds | Emerging Market Bonds | Gold Bullion | Canadian Rate Reset Preferred Shares | U.S. Preferred Shares |
|--------------------------------------|-------------------|---------------|-----------------|----------------|-----------------------|-----------------------|--------------|--------------------------------------|-----------------------|
| Canadian Equities | 1.000 | 0.758 | 0.771 | -0.238 | 0.556 | 0.346 | 0.015 | 0.335 | 0.363 |
| U.S. Equities | 0.758 | 1.000 | 0.913 | -0.289 | 0.532 | 0.334 | -0.180 | 0.288 | 0.401 |
| Global Equities | 0.771 | 0.913 | 1.000 | -0.274 | 0.538 | 0.366 | -0.147 | 0.345 | 0.296 |
| Canadian Bonds | -0.238 | -0.289 | -0.274 | 1.000 | -0.128 | 0.120 | 0.283 | -0.152 | 0.066 |
| U.S. High Yield Bonds | 0.556 | 0.532 | 0.538 | -0.128 | 1.000 | 0.341 | -0.052 | 0.252 | 0.299 |
| Emerging Market Bonds | 0.346 | 0.334 | 0.366 | 0.120 | 0.341 | 1.000 | 0.099 | 0.104 | 0.319 |
| Gold Bullion | 0.015 | -0.180 | -0.147 | 0.283 | -0.052 | 0.099 | 1.000 | -0.135 | 0.009 |
| Canadian Rate Reset Preferred Shares | 0.335 | 0.288 | 0.345 | -0.152 | 0.252 | 0.104 | -0.135 | 1.000 | 0.152 |
| U.S. Preferred Shares | 0.363 | 0.401 | 0.296 | 0.066 | 0.299 | 0.319 | 0.009 | 0.152 | 1.000 |

Source: Bloomberg (Using Period between February 14, 2015 and February 14, 2017).

As such, U.S. preferred shares are not only a standalone diversifier to an overall portfolio, but can also be combined, specifically, with Canadian rate resets preferred shares. By doing so, investors can create an even more efficient income sleeve that offers beneficial characteristics in both rising and falling interest rate environments. In addition to interest rates, issuers in the U.S. tend to have less exposure to the cyclical nature of commodities and provide exposure to a different and more diverse economic backdrop.

The listed U.S. preferred share market is made up of predominantly fixed-rate preferred shares, which provide protection in a falling interest rate environment, as their dividends do not change. While preferred shares have no fixed maturity

date, which could make them vulnerable to rising interest rates from a duration perspective, it should be noted that they are predominantly credit products. In most cases, when interest rates rise it is due to a general improvement in economic conditions, which leads credit spreads to contract. The tightening of credit spreads in a rising interest rate environment tends to mitigate some of the duration risk and provide protection.

With the credit spreads of U.S. preferred shares issued at much wider spreads than their Canadian equivalent, this allows for more spread compression opportunities. Furthermore, when credit spreads tighten, issuers can look to refinance at lower rates, thus calling back existing issues at par value. Consequently, even though preferred shares have no fixed maturity date, favourable credit conditions could lead duration on an issue to significantly shorten in cases. The credit aspect potentially allows U.S. preferred shares to have protection in rising interest rate environments. The table below illustrates this by showing the average daily move in the Solactive U.S. Preferred Shares Select Hedged to CAD Index, when each of the 5-, 10- and 30-year U.S. treasury yields move up or down on a daily basis, respectively.

U.S. Preferred Shares in Rising and Declining Interest Rate Markets

| | 5-Year U.S. Treasury Yield | 10-year U.S. Treasury Yield | 30-Year U.S. Treasury Yield |
|--|----------------------------|-----------------------------|-----------------------------|
| Average Daily Move with Rising Rates | 0.0200% | 0.0285% | 0.0307% |
| Average Daily Move in Declining Interest Rates | 0.0584% | 0.0535% | 0.0497% |

Source: BMO Global Asset Management, Bloomberg, Solactive. (Solactive US Preferred Share Select Hedged to CAD Index - NTR used to represent U.S. preferred shares).

In the table below, we compare the portfolio yields of Canadian rate resets preferred shares, U.S. preferred shares and various blends between the two asset classes.

Blended Preferred Share Portfolio Characteristics

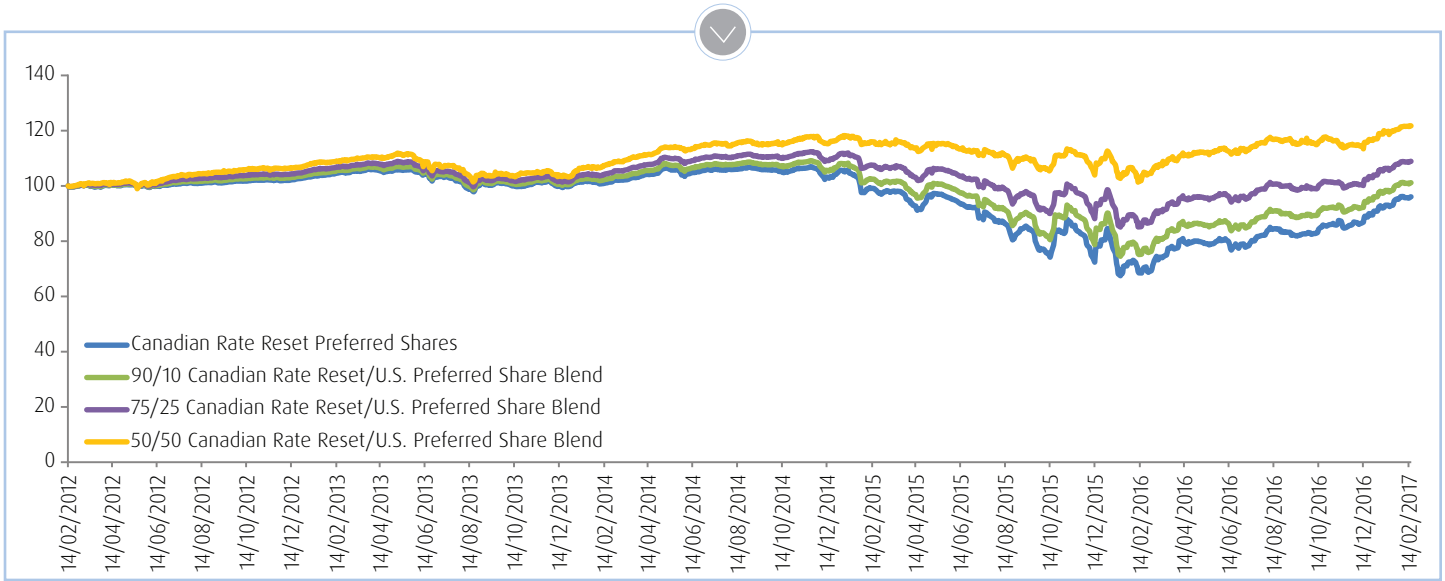
| | Canadian Rate Resets Preferred Shares | U.S. Preferred Shares | Canadian Rate Reset/U.S. Preferred Share Blend | | |
|-----------------------|---------------------------------------|-----------------------|--|-------|-------|
| | | | 90/10 | 75/25 | 50/50 |
| Gross Portfolio Yield | 4.75% | 6.34% | 4.91% | 5.15% | 5.62% |
| Net Portfolio Yield | 4.75% | 5.39% | 4.81% | 4.91% | 5.10% |

Source: Bloomberg, Solactive (Net portfolio yield is net of 15% withholding tax on U.S. dividends) – As of March 21, 2017. Canadian Rate Resets represented by the Solactive Laddered Canadian Preferred Share Index and U.S. Preferred Shares represented by the Solactive US Preferred Share Select Hedged to CAD Index - NTR used to represent U.S. preferred shares).

Canadian rate resets preferred shares and U.S. preferred shares can each be attractive standalone investments. Combining the two together, however, creates a highly effective income sleeve to a portfolio which could significantly stabilize returns over time. As shown in the table below, combining rate resets with U.S. preferred shares can significantly reduce volatility as shown by the lower standard deviation of the annualized returns in the blended portfolios. For income oriented investors, this results in a more stable portfolio that generates an attractive and steady dividend. Investors can create an income oriented sleeve utilizing Canadian rate resets and U.S. preferred shares in a static mix or tactically rebalancing between the two asset classes based on changing market conditions.

| | Canadian Rate Resets Preferred Shares | U.S. Preferred Shares | Canadian Rate Reset/U.S. Preferred Share Blend | | |
|---------------------------|---------------------------------------|-----------------------|--|--------------|--------------|
| | | | 90/10 | 75/25 | 50/50 |
| 2013 | -2.34% | -3.77% | -2.50% | -2.72% | -3.08% |
| 2014 | 2.72% | 15.81% | 4.12% | 6.19% | 9.53% |
| 2015 | -19.88% | 8.94% | -16.43% | -11.53% | -4.03% |
| 2016 | 7.35% | 1.77% | 6.48% | 5.36% | 3.86% |
| Average | -1.78% | 7.17% | -0.81% | 0.60% | 2.89% |
| Standard Deviation | 10.69% | 8.09% | 9.35% | 7.72% | 6.26% |

Source: Bloomberg, BMO Global Asset Management, Solactive (2012 returns is from index inception date of February 14, 2012). Canadian Rate Resets represented by the Solactive Laddered Canadian Preferred Share Index and U.S. Preferred Shares represented by the Solactive US Preferred Share Select Hedged to CAD Index - NTR used to represent U.S. preferred shares).



Source: Bloomberg, BMO Global Asset Management, Solactive (February 14, 2012 to February 14, 2017).

Exchange traded funds (ETFs) allow investors to efficiently access asset classes such as Canadian rate reset preferred shares and U.S. preferred shares. In addition, ETFs allow investors to allocate between the two areas according to investor needs or changing market conditions. The BMO Laddered Preferred Share Index ETF (ZPR), provides exposure to rate resets in a laddered structure with five term buckets. This unique structure equalizes reset, reinvestment and extension risk to 20% each year. For U.S. preferred shares, the BMO U.S. Preferred Share Index ETF (ZUP) utilizes a “smart beta” strategy that focuses on higher quality and higher dividend paying preferred shares listed in the U.S. This ETF is also available in U.S. dollar units, the BMO U.S. Preferred Share Index ETF U.S. dollar units (ZUP/u) and the BMO U.S. Preferred Share Index Hedged to CAD Index ETF (ZHP), which hedges U.S. dollar currency risk. These ETFs provide the necessary tools for both strategic and tactical investors to build portfolios and express their views on interest rates, credit and currency.

| | |
|---|--|
| <p>BMO Laddered Preferred Share Index ETF</p> <p>ZPR</p> <p>Mgmt. Fee: 0.45%</p> <p>Risk Rating: Low to Medium</p> | <p>BMO US Preferred Share Index ETF</p> <p>ZHP ZUP ZUP.U <small>hedged to CAD unhedged unhedged USD</small></p> <p>Mgmt. Fee: 0.45%</p> <p>Risk Rating: Medium</p> |
|---|--|

0 = Optionable ETFs

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