

BMO ETF Portfolio Strategy Report

Third Quarter 2012

BMO EXCHANGE TRADED FUNDS

The Addiction to Intervention

Alfred Lee, CFA, CMT, DMS
Vice President & Investment Strategist
BMO ETFs & Global Structured Investments
BMO Asset Management Inc.
alfred.lee@bmo.com

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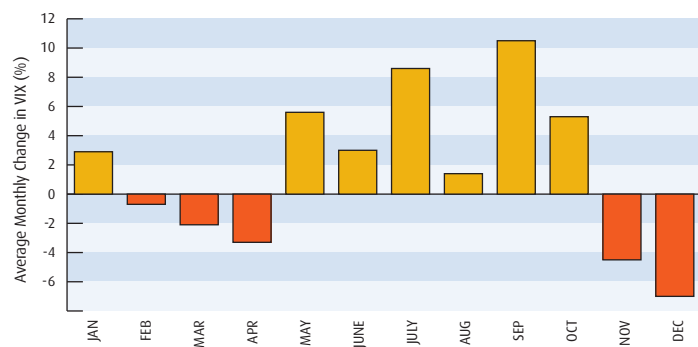
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All prices or returns as of market
close on June 25, 2012, unless
otherwise indicated.

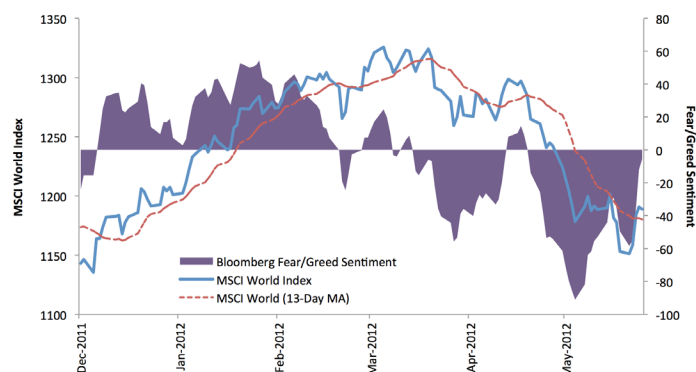
- **Seemingly set to auto-pilot**, following the “Sell in May and Go Away” market folklore, equity market volatility saw a substantial increase over the last two months. After seeing a massive compression in both the *CBOE/S&P Implied Volatility Index (VIX)*¹ and the *S&P/TSX 60 VIX Index (VIXC)*² over the first quarter, implied volatility levels are back on the rise, with each index gaining as much as 55.5% and 49.0% respectively since the end of April. Over the last ten years, implied volatility has shown a tendency to exhibit a large degree of seasonality.
- **However, we would never make investment decisions based on seasonality alone.** The major source of market uncertainty continues to be real macro-economic risk factors, most notably out of the Eurozone. Risk indicators, such as credit default swaps (CDS)³ on the sovereign debt of Spain and Italy in particular, are back on the rise, suggesting a greater concern over insolvency in these countries.
- **Recent data has also shown that the effects of the ECB’s Long-term Refinancing Operation (LTRO)**⁴ **have been exaggerated by the market.** While the program was successful in preventing a liquidity crisis in late 2011, corporate and personal lending are both down significantly, as a lack of business confidence has provided very little incentive to demand loans in the Eurozone.
- **A coalition in Greece has finally been formed.** Pro-bailout party New Democracy will join forces with Pasok and Democratic Left and together they will hold 179 of the 300 seats of member parliament. Their focus will now shift to renegotiating austerity terms, which creditors are looking increasingly willing to do.
- **A number of Purchasing Managers’ Indices (PMI)**⁵ for individual European countries and the Eurozone as a whole remain below 50, signifying economic contraction. The recently released Euro Area Composite PMI came in at 46.0 and has been on a five month downward trend. China’s HSBC Manufacturing PMI was last reported at 50.4, taking a very sharp fall between April and May. Closer to home, things look more promising with the U.S.’s ISM Manufacturing PMI at 53.5 and steadily trending upwards since last July.
- **Equity market valuations have become increasingly attractive** as a result of the global macro-economic and geo-political landscape. Currently the *S&P/TSX Composite Index (S&P/TSX)* has a price-to-earnings (P/E) ratio of 13.2x, while the *Dow Jones Industrial Average* is even lower at 12.7x. These numbers are well below their 15 year average of 20.2x and 17.8x respectively. As we have stated throughout the year, this is not a fundamentally based market, but the negative sentiment has made for a good opportunity to pick-up high quality, long-term core positions inexpensively.

VIX Seasonality in Last Decade

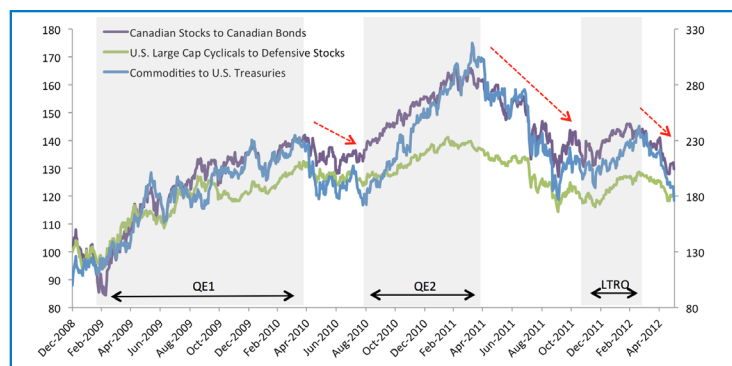


Source: BMO Asset Management Inc., Chicago Board Options Exchange (CBOE), Bloomberg

Global Equity Sentiment Has Been Bearish



Things to Keep an Eye on...

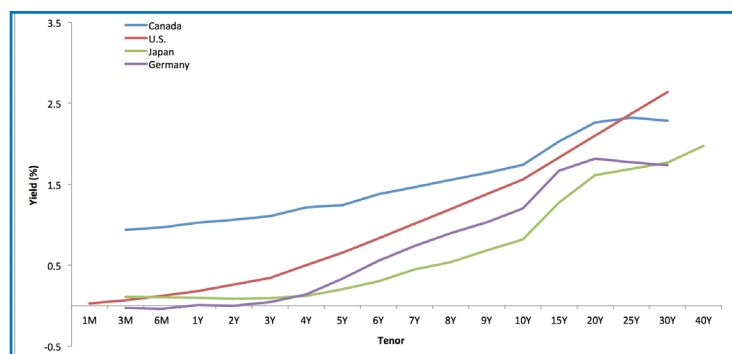


Source: BMO Asset Management Inc., Bloomberg

markets experience considerable set-backs. As a result, the market has become far more dynamic, with frequent bouts of volatility and more changes in investor sentiment. This supports our view that investors should be tactical in their allocation amongst asset classes in this environment.

Though the ride has been a turbulent one, equities and commodities have seen an enormous rally since the market bottomed “post-Lehman.” Since March 9, 2009, the *MSCI World Index* is up 92.5% on a total return basis, whereas the *S&P/GSCI Commodity Index* is up 64.9%. A closer look shows that risk-assets have been largely propped up by central bank stimulus and monetary policy. Here we show two inter-market ratios (commodities vs. U.S. treasuries and Canadian equities vs. Canadian bonds) and one intra-market ratio (U.S. large-cap cyclical stocks vs. U.S. large-cap defensive stocks). Clearly, risk assets have not yet shown an ability to stand on their own two feet.

Recommendation: For lack of a better term, the “Risk-on, Risk-Off” behaviour of the market will likely continue, especially with central banks standing ready to inject additional stimulus into the system should

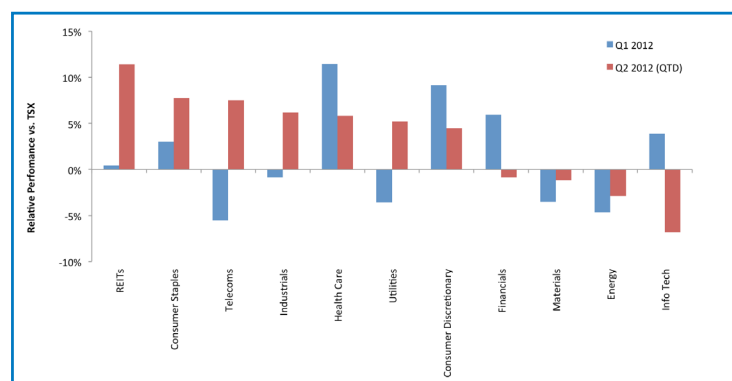


Source: BMO Asset Management Inc., Bloomberg

vulnerable. We recommend using a broad bond ETF as a core holding and supplementing that position with more tactically positioned mid-term federal and corporate bonds.

Over the last year much has been mentioned about the flattening U.S. yield curve looking eerily similar to that of Japan’s. A closer look at a number of other sovereign yield curves, such as Germany’s and Canada’s have also shown a convergence between its shorter- and longer-dated yields. Over the last-year, the spread between 30-year and 3-month yields have fallen 31 bps and 103 bps in Germany and Canada, respectively.

Recommendation: Although we are tactically overweight mid-term bonds, this does not suggest we are looking to completely avoid long-duration bonds. In 2011, long-term Canadian federal bonds returned 19.8% and the yield curve continues to flatten with the 30-year yield down 9.3% year-to-date. However, a rally of the equity markets could place upward pressure on 30-year yields, leaving longer dated bonds



Source: BMO Asset Management Inc., Bloomberg (Based off of S&P/TSX GICS Sectors)

rose above its more commonly quoted U.S. counterpart, the VIX. We are therefore, utilizing the **BMO Low Volatility Canadian Equity ETF (ZLB)** as a way to reduce volatility while staying invested in Canadian equities and also obtaining exposure to less economically sensitive areas.

Canadian equities were quick out of the gates this year, with the S&P/TSX gaining 6.1% in the first two months alone. Since March 1, however, the “broad-based” Canadian equity index declined 8.9%, as slower growth expectations out of Europe and China have become a drag on the economically sensitive, commodity related sectors. The high concentration of material and energy related stocks in the S&P/TSX have overshadowed the strong performance of other S&P/TSX sectors over the quarter, causing many investors to miss out on returns.

Recommendation: The high exposure to resources in the S&P/TSX has served investors well over the last decade during the commodity super-cycle. Given the lack of clarity in the Eurozone and increasing signs of economic contraction in China, commodity related stocks could potentially face increased volatility. Recently the *Canadian VIX (VIXC)*

Changes to the Portfolio Strategy:

Asset Allocation:

- We are establishing our strategy with a slight overweight in risk assets. Although the macro-economic backdrop remains bleak, fundamentals are rarely attractive without potential risks. To mitigate risk in the overall strategy, we are decreasing beta in our equity exposure, to off-set our higher weight in corporate bonds. Additionally, we are utilizing U.S. high yield bonds and emerging market debt as a less volatile substitute to U.S. corporate and emerging market exposure.

Fixed Income

- Our fixed income strategy is to implement a core-satellite approach. The **BMO Aggregate Bond Index ETF (ZAG)** will provide us with broad-based exposure to Canadian bonds, while we use more sector specific bond ETFs to fine tune our fixed income exposure. Although long-duration bonds offer higher potential returns, they do come with more volatility and interest rate sensitivity. As we see a low probability of the Bank of Canada (BoC) hiking interest rates this year, we recommend mid-term federal and corporate bonds in the Canadian fixed income space. Thus we are utilizing the **BMO Mid-Federal Bond Index ETF (ZFM)** and the **BMO Mid-Corporate Bond Index ETF (ZCM)** to gain exposure to these areas.

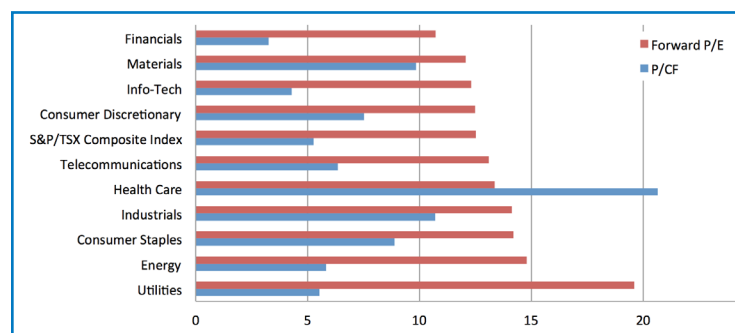
Equities:

- For core Canadian equity exposure we are utilizing the **BMO Low Volatility Canadian Equity ETF (ZLB)** and **BMO Canadian Dividend ETF (ZDV)** to gain exposure to lower beta and dividend paying equities, respectively. According to our *Global Index Trend-Spotter Model*, low beta and dividends are two factors that have been effective in the last two quarters. Given the heightened volatility over the last two months and less upward pressure on interest rates, we believe these two factors will continue to fare well in the third quarter.
- Over the last 18 months we have favoured U.S. equities, which has been a call that has paid off. Despite a number of unnerving data points recently, we continue to recommend a significant allocation to U.S. stocks, particularly in the multinational space. As implied volatility levels have risen, we recommend using the **BMO Covered Call Dow Jones Industrial Average Hedged to CAD ETF (ZWU)** as a way to enhance yield and reduce volatility while maintaining exposure to U.S. blue-chip companies.

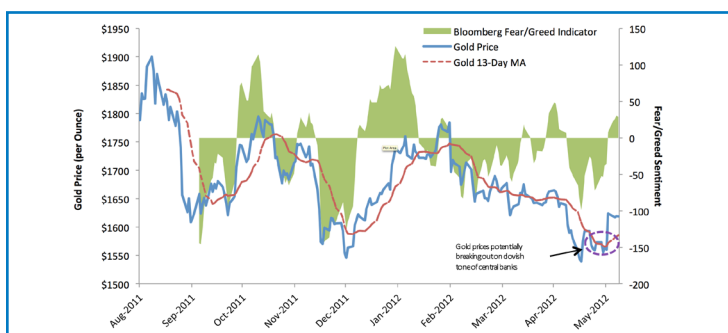
- One concern we have for multinationals is a higher U.S. dollar. Thus, we are also tactically positioning some of our U.S. equity exposure in the **BMO U.S. Equity Index ETF (ZUE)** in order to get exposure to some mid-cap U.S. companies. These more locally based companies should benefit from a higher U.S. dollar more so than multinationals. Additionally, we have established a small position in the **BMO Nasdaq-100 Hedged to CAD Index ETF (ZQQ)** to gain exposure to U.S. technology and consumer discretionary companies, based on their sensitivity to U.S. consumer confidence which has been on the rise.
- Other notable positions include Canadian banks and large-cap energy companies. We believe the recent sell-off has led to attractive valuations in those areas. Though macro-related issues could lead those sectors to become increasingly more inexpensive, we believe positions in these high quality areas can be established as long-term positions on the low. The **BMO Covered Call Banks ETF (ZWB)** allows us to get exposure to the big-six Canadian banks, while enhancing yield and lowering volatility, and the **BMO Equal Weight Oil and Gas Index ETF (ZEO)** provides exposure to larger cap energy related names.
- Additionally, we continue to believe the current low interest rate and sufficiently strong business environment in Canada will be favourable for real estate investment trusts (REITs). We are therefore establishing a tactical position in the **BMO Equal Weight REITs Index ETF (ZRE)** to attain exposure to Canadian REITs.

Alternatives:

- Central banks look increasingly willing to take a dovish stance in monetary policy and provide further stimulus if needed. The Euro/USD cross continues to break-down technically and there are talks that the central banks of emerging markets are now selling their Euro reserves. Increased macro-economic uncertainty and continued currency wars will also be a positive for gold. Momentum indicators also show gold bullion recently turning up consistent with the trend that gold tends to strengthen in the mid-summer. We are utilizing our **BMO Precious Metals Commodity Index ETF (ZCP)** to gain exposure to gold and silver prices.



Source: BMO Global Asset Management, Bloomberg



Investment Objective and Strategy: The strategy involves tactically allocating to multiple asset-classes and geographical areas to achieve long-term capital appreciation and total return by investing primarily in exchange-traded funds (ETFs).

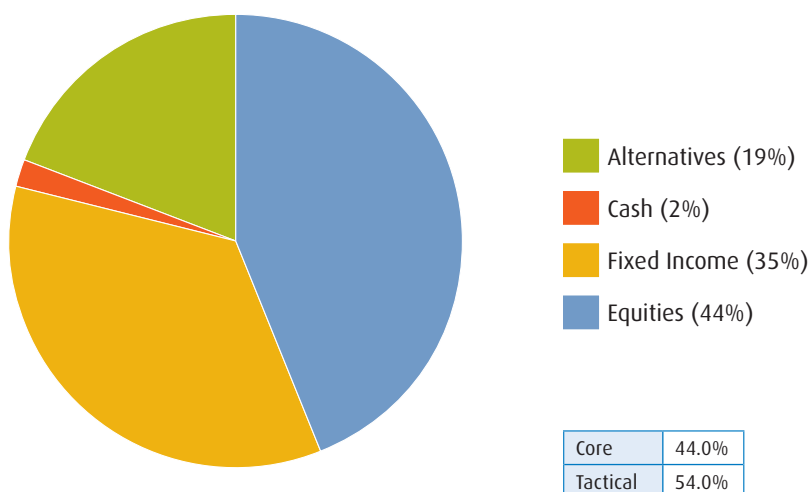
Stats and Portfolio Holdings

Ticker	ETF Name		Position	Price	MER	Weight (%)	90-Day Vol	Volatility Contribution	Yield (%)*	Yield/Vol
Fixed Income										
ZAG	BMO AGGREGATE BOND INDEX ETF	Debt	Core	\$15.98	0.28%	23.0%	4.1	10.2%	3.3%	0.806
ZFS	BMO SHORT FEDERAL BOND INDEX ETF	Debt	Tactical	\$15.03	0.20%	3.5%	2.4	0.9%	2.4%	1.017
ZCM	BMO MID CORPORATE BOND INDEX ETF	Debt	Tactical	\$15.92	0.30%	8.5%	4.8	4.4%	4.5%	0.946
Total Fixed Income						35.0%		15.4%		
Equities										
ZLB	BMO LOW VOLATILITY CANADIAN ETF	Equity	Core	\$15.83	0.35%	9.0%	8.9	8.6%	2.5%	0.284
ZDV	BMO CANADIAN DIVIDEND ETF	Equity	Core	\$14.94	0.35%	8.0%	10.7	9.3%	4.4%	0.411
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE ETF	Equity	Tactical	\$15.86	0.65%	9.0%	12.1	11.7%	6.4%	0.531
ZUE	BMO US EQUITY HEDGED TO CAD INDEX ETF	Equity	Core	\$20.24	0.22%	4.0%	13.8	5.9%	1.9%	0.138
ZQQ	BMO NASDAQ 100 EQUITY HEDGED TO C\$ INDEX ETF	Equity	Tactical	\$19.52	0.35%	3.0%	17.2	5.5%	0.6%	0.034
ZWB	BMO COVERED CALL CANADIAN BANKS ETF	Equity	Tactical	\$13.48	0.65%	4.0%	11.8	5.1%	7.8%	0.664
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	Equity	Tactical	\$19.72	0.55%	4.0%	9.6	4.1%	5.1%	0.525
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	Equity	Tactical	\$12.37	0.55%	3.0%	21.7	7.0%	3.3%	0.152
Total Equity						44.0%		57.3%		
Alternatives										
ZHY	BMO HIGH YIELD US CORP BOND HEDGED TO C\$ INDEX ETF	Debt	Tactical	\$15.37	0.55%	7.5%	7.7	6.2%	7.5%	0.971
ZEF	BMO EMERGING MARKETS BOND HEDGED TO C\$ INDEX ETF	Debt	Tactical	\$16.63	0.50%	5.5%	7.6	4.5%	5.1%	0.660
ZCP	BMO PRECIOUS METALS COMMODITIES INDEX ETF	Commodity	Tactical	\$16.57	0.65%	6.0%	24.2	15.6%	0.0%	0.000
Total Alternatives						19.0%		26.4%		
Total Cash**						2.0%	3.9	0.9%	1.30%	
Portfolio					0.41%	100.0%	9.3	100.00%	4.0%	0.427

*Note: Bond yields are based off of yield to maturity.

**Cash is based off of 3-month Canadian Dealer Offered Rate (CDOR)

Ticker	Top Holdings	Weight
ZAG	BMO AGGREGATE BOND INDEX ETF	23.0%
ZLB	BMO LOW VOLATILITY CANADIAN ETF	9.0%
ZWA	BMO COVERED CALL DOW JONES INDUSTRIAL AVERAGE ETF	9.0%
ZCM	BMO MID CORPORATE BOND INDEX ETF	8.5%
ZDV	BMO CANADIAN DIVIDEND ETF	8.0%
ZHY	BMO HIGH YIELD US CORP BOND HEDGED TO C\$ INDEX ETF	7.5%
ZCP	BMO PRECIOUS METALS COMMODITIES INDEX ETF	6.0%
ZEF	BMO EMERGING MARKETS BOND HEDGED TO C\$ INDEX ETF	5.5%
ZUE	BMO US EQUITY HEDGED TO CAD INDEX ETF	4.0%
ZWB	BMO COVERED CALL CANADIAN BANKS ETF	4.0%
ZRE	BMO EQUAL WEIGHT REITS INDEX ETF	4.0%
ZFS	BMO SHORT FEDERAL BOND INDEX ETF	3.5%
ZQQ	BMO NASDAQ 100 EQUITY HEDGED TO C\$ INDEX ETF	3.0%
ZEO	BMO S&P/TSX EQUAL WEIGHT OIL & GAS INDEX ETF	3.0%
	Cash	2.0%



The Good, the Bad, and the Ugly

	Global-Macro/Political	Fundamental	Technical
Good	<ul style="list-style-type: none"> New coalition being formed in Greece will provide some short-term relief. The country's focus will shift towards renegotiating austerity terms with its creditors. China's year-over-year inflation has come down to 3.0%, suggesting they have inflation under control and providing room for further easing. <i>The Shanghai Composite Index</i> has reacted accordingly, up 4.5% year to date. Central banks look increasingly ready to intervene with quantitative easing or further unconventional measures, which can provide a lift to the markets. 	<ul style="list-style-type: none"> Equity market valuations in most major markets remain very attractive, with Hong Kong and Singapore equities being the best bargains. Overall, however, the Dow, which is also inexpensive, may offer better upside. Earnings continue to come in better than expected particularly in the U.S. with 59.9% of companies reporting a positive earnings surprise last quarter. Cash reserves of U.S. corporations remain exceptionally strong. This can be a positive for both U.S. high yield debt and U.S. equities. Canadian banks are trading at an average P/E ratio of 10.6x, a steep discount to their 14.1x 15-year average. 	<ul style="list-style-type: none"> Shorter-term momentum indicators such as Relative Strength Index (RSI) and Moving Average Convergence Divergence (MACD) suggest a possible relief rally in some risk assets. The S&P/TSX has also recently tested its 50-day MA, with its stochastic-oscillator trending higher. Two-year U.S. Treasury yields are also gaining positive momentum, suggesting a possible short-term risk-on rally. Low beta continues to be a market factor that continues to build positive momentum.
Bad	<ul style="list-style-type: none"> On the other hand, the need for further central bank intervention indicates the lack of a real economic recovery. Money velocity remains stubbornly low which limits the effectiveness of monetary policy. There are concerns that the so-called U.S. "fiscal cliff" is already delaying companies from hiring and spending. New French President Francois Hollande may have different policy views than German Chancellor Angela Merkel, which could lead to further political divide in the Eurozone and hurdles in establishing policy measures. 	<ul style="list-style-type: none"> We expect the long-term average of equity market valuations to be much lower this decade than the previous as we continue to be in a macro- and policy-driven market. There remains an excess supply of oil in the U.S. According to statistics from the U.S. Department of Energy (DOE), days of supply currently sits at 25 days, close to its 20-year high of 26.6 days. Though a negative for energy investors, this is a benefit for the general economy. 	<ul style="list-style-type: none"> Implied volatility measures including the VIX, VIXC and V2X indices have declined over the last week and half. However, their rapid rate of increase since mid-March shows an increase in market nervousness. The term structure for VIX futures has steepened in certain areas, which also indicates investor unease. Equity market breadth remains weak, only 42% of the TSX stocks are above their 200-day MA. Volume remains very low, showing a lack of conviction behind upside market moves.
Ugly	<ul style="list-style-type: none"> Lending rates for troubled Eurozone nations continue to rise. The yield for Spanish 10-year government bonds is now north of 7%, a Euro-era high. CDSs for Portugal, Ireland, Italy and Spain also remain elevated, as default risk for those countries remains high. Sovereign yield curves of key developed markets continue to flatten, suggesting a prolonged period of sluggish economic growth. 	<ul style="list-style-type: none"> Global small caps continue to trade at a heavy premium to the large caps. The current P/E ratio of the <i>MSCI ACWI Small Cap Index</i> sits at a 53.6% premium to the <i>MSCI ACWI Large Cap Index</i>. Fund flows have moved accordingly, with fund flows out of small caps and into large caps. 	<ul style="list-style-type: none"> The <i>NYSE Margin Debt Index</i> remains very close to its 12-month moving average. An unforeseen macro-event, can lead to massive margin covering and thus a deleveraging event. The <i>CBOE Implied Correlation Index</i> has slightly eased since the Greek elections, now at 70.2. However, intra-market correlation remains elevated and closely tied to equity market volatility. This indicates limited diversification of an all equity portfolio.

Conclusion: News of the New Democracy party leading a coalition in Greece likely shifts the country's focus to renegotiating its austerity terms. Although Greece's creditors look willing, the situation is far from over. On a global basis, there is still chance for disappointment if further central bank intervention does not occur or falls short of current investor expectations. Some shorter term indicators look slightly more positive, with some emerging markets starting to ease monetary policy again. Attractive valuations should also bring bargain hunters back into the market. However, volume levels remain low, showing a lack of investor conviction. Over the secular period, the macro-economic story continues to dominate and the outlook lacks clarity. We continue to believe we are in a multi-period holding pattern, which leads us to conclude that investors should dedicate a significant portion of their portfolio to tactical positions.

Footnotes

¹CBOE/S&P 500 Implied Volatility Index (VIX): shows the market's expectation of 30-day volatility, annualized. It is constructed using the implied volatilities of a wide range of S&P 500 index constituent options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge".

²S&P/TSX 60 VIX Index (VIXC): the Canadian equity market equivalent of the VIX to show the market's expectation of 30-day volatility, annualized. This index is used as a gauge for investor sentiment on Canadian large-cap stocks.

³Credit Default Swaps (CDS): A swap agreement where the seller of the CDS will compensate the buyer in the event of a loan default or other credit event. The buyer of a credit default swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the debt security. In doing so, the risk of default is transferred from the holder of the fixed income security to the seller of the swap. As such, a rising CDS price indicates an

increasing probability of a default on a fixed income issue, while a declining price indicates a lower probability.

⁴Long-Term Refinancing Operations (LTRO): a major financing method used by the European Central Bank to provide liquidity to its member banks. Although the operation has been in existence for well over a decade, its rules were recently revised to make it considerably easier for banks to obtain funding. First, through LTRO banks can now post collateral to borrow funds for three years rather than several months. Second, the eligible collateral to obtain funding has been relaxed significantly.

⁵Purchasing Managers' Index (PMI) is an economic indicator on the financial activity reflecting purchasing managers' acquisition of goods and services. Data for the PMI are compiled by monthly surveys polling businesses that represent the make up of the respective sector. The surveys cover private sector companies, but not the public sector. A number above 50 indicates economic expansion, whereas a number below 50 suggests economic contraction.

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