

A Test of Fortitude & Discipline: 2011 in Review

Monthly Strategy Report December 2011

BMO EXCHANGE TRADED FUNDS

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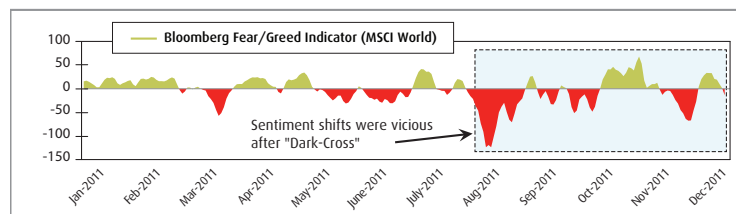
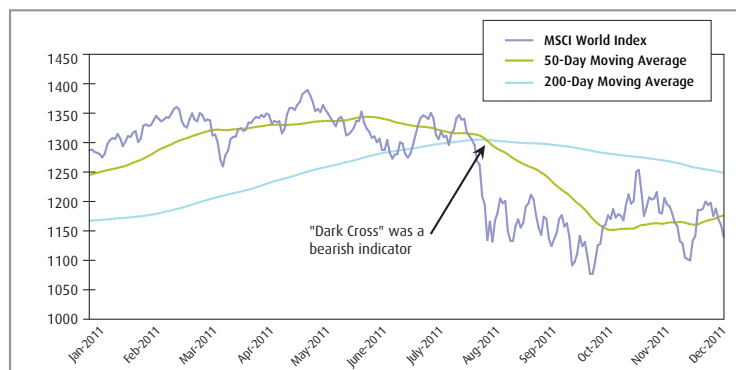
All prices or returns as of market
close on December 20, 2011
unless otherwise indicated.

Just when you thought financial markets couldn't get any more extreme, they suddenly prove otherwise. Such was the theme over the course of 2011, a year where market volatility caused constant changes in sentiment and significantly frustrated many investors. Global equities fell 6.5% on the year, as indicated by the *MSCI World Index (Total Return)*, which should actually be viewed as a positive given the macro-economic backdrop. As the year progressed, the market was hit with an increasing number of negative headlines including: the unfortunate Japanese earthquake/tsunami; the downgrade of U.S. Treasuries by *Standard & Poor's*; deteriorating sovereign debt issues in Europe; and growing concerns of a hard landing in China. As a result, most of the gains experienced in broad market equity indices during the first quarter of the year rapidly reversed course as sentiment became increasingly bearish from these news items during the last six months of the year. Moreover, since August, both realized and implied volatility have remained elevated, providing a serious test of discipline for investors.

We started the year with a more bullish tone as markets continued to enjoy the effects of "QE2" (the second instalment of quantitative easing by the U.S. Federal Reserve). However, as the year progressed and market sentiment soured, our *Global Inter-Market Model* showed developing trends in defensive-oriented assets. Consequently, and also considering the worsening macro-economic data, we

issued a report on August 15, titled "*Navigating Market Volatility*" where we recommended a more defensive-oriented portfolio strategy. Given the rapidly changing market environment, our recommendations in 2011 were significantly more tactical than the previous year. Below, we highlight some of the recommended themes throughout the year.

Sentiment Shifts in Global Equities Were Rapid in the Second Half of Year

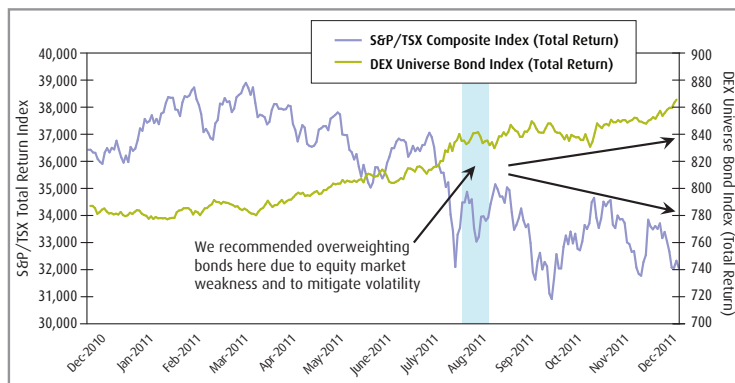


Source: BMO Asset Management Inc., Bloomberg

Asset Allocation Themes:

1) “Overweight Equities Relative to Bonds:” This asset allocation decision fared extremely well during the first quarter with the *S&P/TSX Composite Index to DEX Universe* ratio expanding until April 8, as Canadian equities outperformed bonds. Though we remained optimistic on equities through June, as the summer progressed, both macro-economic data and technical indicators suggested a greater emphasis to fixed income. We therefore recommended an overweighting in bonds in our previously mentioned August 15 report. That tactical shift to fixed income has served us well as our **BMO Aggregate Bond Index ETF (ZAG)** has gained 3.5% on a total return basis since that report, while the *S&P/TSX Composite Index* returned -6.7% on a total return basis from the same period. That tactical shift led to a difference of 10.2% in performance.

We Became Progressively Bearish as 2011 Progressed



Source: BMO Asset Management Inc., Bloomberg

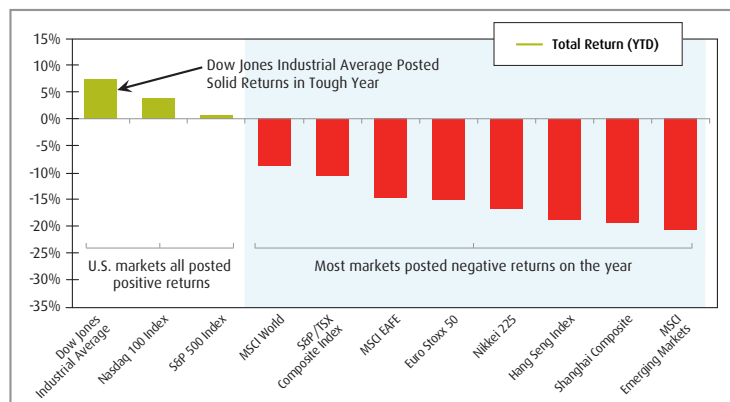
2) “Be Prepared for Sudden Upside Volatility:”

At the beginning of the year and a theme highlighted throughout 2011 was to prepare for constant shocks in volatility or what we noted as “volatility-squared,” as markets were becoming more behaviourally driven and increasingly reactive to negative headlines. A greater emphasis on cross-asset class diversification rather than simply diversification within an asset class was suggested as a means of mitigating some of these volatility shocks.

Equity Themes:

1) “U.S. Equities to Outperform:” Heading into the year, we expected U.S. equities to outperform, citing the fundamental strength of many U.S. large cap companies. Strong cash balances and a trend of increasing dividend hikes, share buy-backs and low market expectations led us to recommend an overweighting to U.S. equities. On January 20, we put out a report “*Dissecting the Dow*,” recommending investing in U.S. equities through the *Dow Jones Industrial Average (the Dow)* for its blue-chip, multi-national characteristics. The Dow was the top performing market index this year, assisted by many of its constituent companies such as McDonalds Corp., International Business Machines (IBM) Corp., and Coca Cola Co. recently making multi-year, if not all-time highs in 2011 despite significant equity market headwinds. Our **BMO Dow Jones Industrial Average Hedged to CAD Index ETF (ZDJ)** allows investors to access the Dow while mitigating currency risk.

The Dow Has Delivered Despite Macro-Economic Pressure



Source: BMO Asset Management Inc., Bloomberg

2) “Long-term Story for Emerging Markets Still Intact:”

Over the long-term, the jury is still out on this one, but as we previously noted, there are some concerned that China is headed toward a hard-landing, illustrated by its escalating credit default swap (CDS) prices. However, we suggested that over the short-term, emerging markets would likely face headwinds as they shifted their focus to tightening monetary policy and away from growth in 2011. As a result, we recommended allocating assets from emerging markets to Canadian

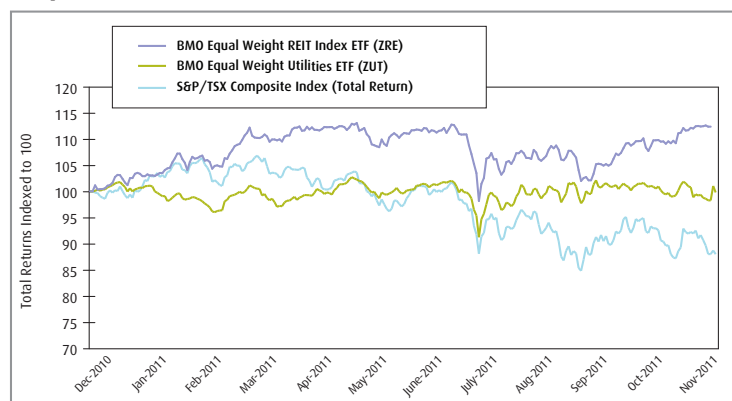
and particularly U.S. equities last January, which proved to be the correct call. Over the year, our **BMO Dow Jones Industrial Average Hedged to Cad Index ETF (ZDJ)** and our **BMO Dow Jones Canada Titans 60 Index ETF (ZCN)** outperformed our **BMO Emerging Markets Equity Index ETF (ZEM)** by 22.5% and 4.3% respectively on a total return basis.

3) *Canadian Banks Continue to Look for Acquisitions:*

A number of Canadian banks continued to acquire businesses in 2011, targeting asset managers to the retail brokerage units of foreign institutions. We anticipated this to be a good long-term business move but with the possibility that the stock prices of Canadian banks over the short-term would be depressed. On February 11, we issued a report “*Banking Income*,” recommending our **BMO Covered Call Banks ETF (ZWB)** as a way to enhance yield while maintaining exposure to the sub-sector that would likely face short-term headwinds.

4) *“Increase Dividends to Negate Volatility:”* As equity markets became increasingly volatile, investors gravitated toward dividend paying stocks. In addition, with the U.S. Federal Reserve launching “Operation Twist¹” in September and pledging low interest rates until 2013, investors were led to increase allocations to yield-oriented assets. The **BMO Equal Weight REITs (ZRE)** and **BMO Equal Weight Utilities ETF (ZUT)** delivered 12.6% and -0.8% year-to-date respectively on a total return basis, outperforming the -10.7% decline in the *S&P/TSX Composite Index*.

Higher Dividend Areas Such as Utilities and REITs Outperformed in 2011



Source: BMO Asset Management Inc., Bloomberg (All returns based on total returns)

5) *“Merger and Acquisition (M&A) Activity is Back:”*

At the onset of the new year, we believed rising M&A activity and slowly recovering U.S. housing market would lead U.S. banking stocks higher. This trade however did not work as many U.S. banks faced significant headwinds especially with the Fed flattening out the yield curve with ‘Operation Twist’ which impacts the profitability of the banks.

Fixed Income and Credit Themes:

1) *An Exposure to Non-Traditional Fixed Income:*

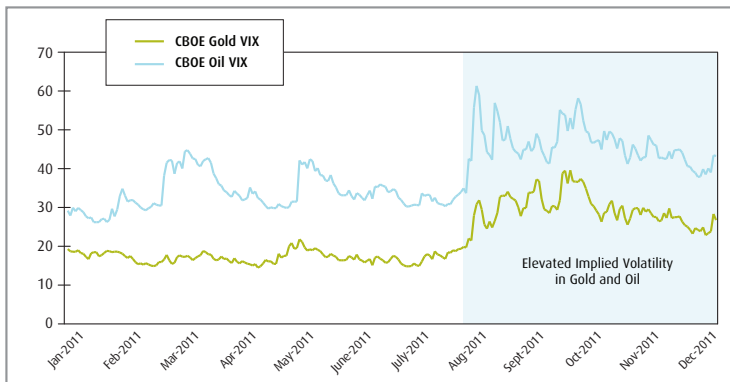
As we remain in a low interest rate environment, investors have had to look beyond government bonds to source higher yields. Non-traditional fixed income areas such as U.S. high yield bonds and emerging market debt have provided investors with higher yield. Although these areas offer more attractive yield, they are more volatile than Canadian federal and provincial fixed income and as such are more volatile. Given this, we have recommended exposure to these areas in moderation. Both of these areas in non-traditional fixed income can be accessed through our **BMO U.S. High Yield U.S. Corporate Bond Hedged to CAD Index ETF (ZHY)** and **BMO Emerging Market Bond Hedged to CAD Index ETF (ZEF)** respectively.

2) *Low volatility fixed income:* As mentioned, Bank of Canada bonds are yielding much lower rates than they have historically. However, we have recommended that investors maintain an allocation to government bonds, using them as a portfolio volatility mitigation tool. In addition, as non-traditional bonds at times react to macro-economic risk in the same way as equities, exposure to federal and provincial bonds would help offset some of that risk. Though we began the year preferring shorter-term federal bonds anticipating that the Bank of Canada would raise rates, as the year progressed, we extended our call on duration to mid-term federal bonds with a weakening economy even leading some economists to expect rate cuts in 2012.

Commodity Themes

1) “Higher Commodity Prices Would Come With Higher Volatility:” As we anticipated last January, gold and oil prices continued to move higher with an elevated level of realized volatility due to a growing number of push-pull factors in 2011. Gold and oil (Brent Crude) finished the year 13.7% and 12.6% higher respectively. Broad commodities as indicated by the *S&P/GSCI Commodity Index (Spot)* also finished the year higher gaining a slight 0.4% and also experiencing a higher volatility level than the previous two years.

Higher Gold and Oil Prices Came at Higher Levels of Volatility



Source: BMO Asset Management Inc., Bloomberg

2) “Exposure to Gold:” The price of Gold continues to climb, as bullion is headed for its 10th straight winning year. The yellow metal got a lift as investors flocked to the precious metal during the year as a hedge against fiat currencies. Given the strength of the U.S. dollar as of late however, the precious metal has been selling off aggressively in late December, plunging through its 200-day moving average. Nevertheless, the long-term trend in gold remains intact at the time of this report.

3) “Junior Gold:” Though we had much success with this trade last year, it was significantly more difficult in 2011. Gold stocks tend to under-perform bullion when markets fall significantly and as we experienced considerable equity market volatility, it made for a

difficult year for investors taking a buy-and-hold approach for small-cap gold companies. We did, however, find that for the majority of the year our **BMO Junior Gold Index ETF (ZJG)** followed a trading range where it would fall to roughly \$20 and trade up to \$24 forming what is technically called a “bullish spring pattern.” On July 5, when ZJG fell out of this range, we recommended investors buy the ETF and implement a stop-loss order and as ZJG moved towards our \$24 price target, we later recommended using a progressive stop-loss order, to protect profits.

Although it has been a challenging year for investors, many of the issues that weighed on the market remain today. As a result, investors should take a close look at their overall portfolio and ensure they are well diversified across asset classes. A lesson learned from 2011 is that investors need to focus on portfolio construction and implement a strategy that allows for discipline while being tactical enough to capitalize on short-term trends. Going forward, investors may want to consider dedicating the core of their portfolio to a long-term strategic asset mix and utilize the remaining portion for more tactical shifts. The tactical portion would allow for investors to better control risk and systematically provide potential alpha, while the core provides long-term discipline. Next month, in our **January BMO ETF Monthly Strategy Report**, we will highlight our new year outlook and the themes we favour in 2012. Until then, we wish you and your family a safe and happy holiday.

Footnotes

¹ “Operation Twist”: The name given to a Federal Reserve monetary policy operation that involves the purchase and sale of bonds. “Operation Twist” describes a monetary process where the Fed buys and sells short-term and long-term bonds depending on their objective. In the recent example in September of 2011, the Fed performed Operation Twist in an attempt to lower long-term interest rates. In this operation, the Fed sold short-term Treasury bonds and bought long-term Treasury bonds, which pressured the long-term bond yields downward and thus flattening the yield curve.

Rates of Return

ETF Name	Ticker	YTD Return	1-Yr Return	Since Inception	Inception Date
BMO Aggregate Bond Index ETF	ZAG	7.07%	7.00%	6.62%	January 19, 2010
BMO Dow Jones Industrial Average Hedged to CAD Index ETF	ZDJ	5.16%	10.26%	16.05%	May 29, 2009
BMO Emerging Markets Equity Index ETF	ZEM	-13.90%	-10.00%	-0.52%	October 20, 2009
BMO Dow Jones Canada Titans 60 Index ETF	ZCN	-8.75%	-5.35%	5.99%	May 29, 2009
BMO Equal Weight REITs Index ETF	ZRE	11.21%	12.58%	19.57%	May 19, 2010
BMO Equal Weight Utilities Index ETF	ZUT	0.44%	2.50%	8.24%	January 19, 2010

*Rates of return based on closing prices on TSX. Returns are as of November 30, 2011

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