Building portfolios with Exchange Traded Funds

Whether you are building a portfolio on your own or with the assistance of a financial advisor, you must complete two basic but critical steps:

1. Identify your objectives, time horizon, risk tolerance, level of financial knowledge, and personal preferences.
2. Select a range of appropriate investments and decide how much to allocate to each asset class to maximize returns for a given level of risk.

Ideally, you want an optimal portfolio — one that provides maximum potential returns for a given level of risk. By using the efficient frontier (see illustration), investors can see the tradeoffs between risk and return offered by different portfolios. From this, they can then work to pinpoint the portfolio that may best achieve their objectives.

Portfolio building strategies using Exchange Traded Funds

Exchange Traded Funds (ETFs) are a valuable tool that can be used to build more optimal portfolios. An ETF tracks the performance of a specific index, such as an equity or bond index, mirroring its returns.

ETFs are ideally suited for use in portfolio building strategies because of their flexibility, low cost and wide range of investment options. The following are four examples of strategies that can be used on their own or in conjunction with one another and the benefits of using ETFs to implement them.

Blend index and actively managed funds

Indexed funds offer market performance which matches the beta[1], or returns of the overall market or of a specific segment of the market. Active management, meanwhile, provides the potential for alpha (outperformance relative to the market) through individual security selection, sector rotation or other active strategies. Get the benefits of each type of investment by incorporating both into your portfolio.

Benefits of using ETFs: ETFs provide diversified indexed exposure at a low cost; they are traded throughout the day, which provides added flexibility.

Mix core and satellite investments

The core is comprised of major asset classes combined to achieve a particular risk/reward profile. For example, these could include the Hong Kong and U.S. equities, and U.S. investment grade fixed income. Satellites have the potential to add value when combined with your core, but may be associated with additional risk. An example of a satellite position includes Asia high yield bonds. Investors who want exposure to this less correlated asset class with its higher income potential could invest in a HK-listed ETF that provides the performance of a diversified basket of these securities.

Benefits of using ETFs: Wide variety of equity and fixed income ETF options; easy and efficient access to various markets and market segments; suitable for both core and satellite portions of portfolio, depending on investor requirements.

Employ a tactical short-term strategy

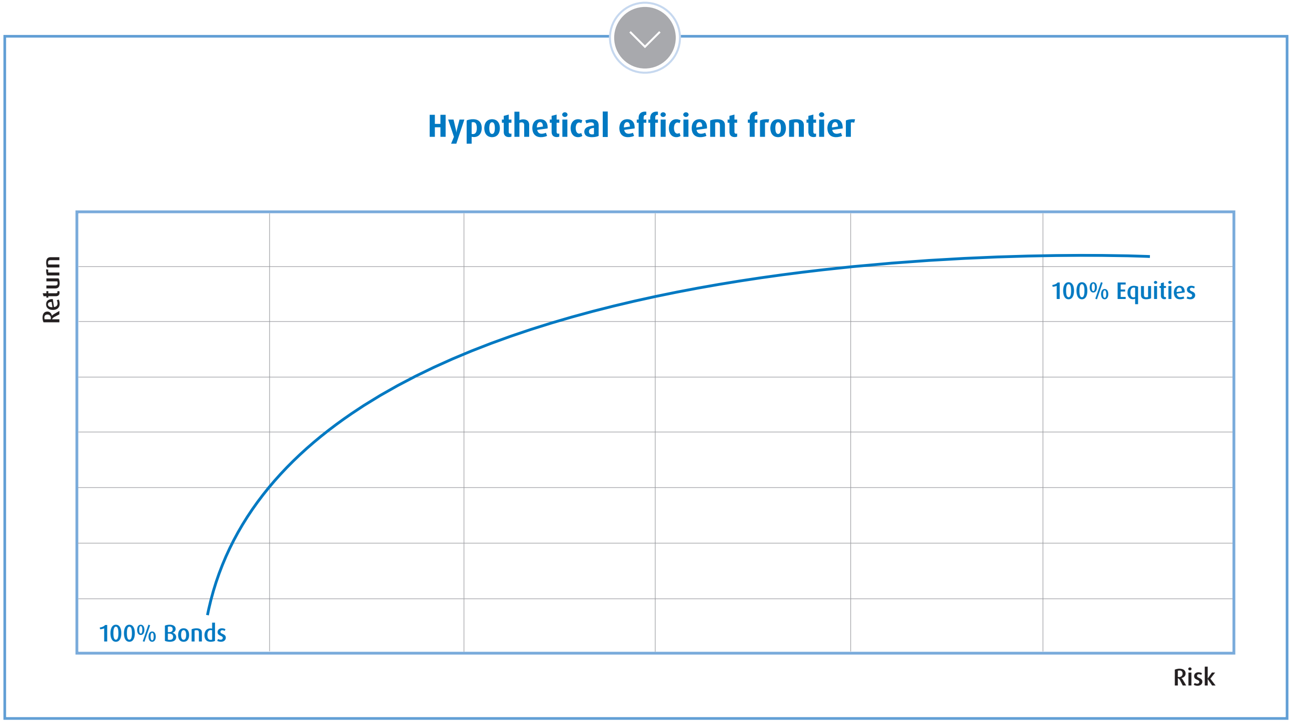
ETFs are an efficient means to adjust portfolio exposure through specific sector or segment investments. For example, if an investor wants tactical access to growth and dividend income provided by the Hong Kong banking industry, they could invest in a HK-listed ETF that holds most of the large Chinese and local banks in an appropriately diversified manner.

Benefits of using ETFs: Low entry and exit cost; easy and efficient access to segments and sectors that you want in your portfolio.

Diversify fixed income holdings

Many investors have built targeted equity portfolios to reflect their world view but have not applied that focus to their fixed income portfolio. A wide variety of fixed income choices are available, including government, agency and corporate bonds with different credit ratings and maturities. Depending on the market environment, their personal risk and return preferences, and time horizons, fixed income investors may want to choose specific fixed income sectors and maturities for their portfolios. For example, in the short maturity segment, they may prefer the combination of relatively higher credit quality and income that agency bonds provide. ETFs are available that would allow investors to get that precise investment exposure in their portfolios.

Benefits of using ETFs: Provide diversification by maturity, credit rating or type; enable investors to take targeted positions to best fit their macro economic expectations (for example, interest rate movements and inflation expectations).



This is a hypothetical illustration showing the risk return tradeoff as a portfolio's asset mix moves from 100% bonds to 100% equities. Portfolios that fall on the line offer the higher level of returns for a given level of risk.

[1] **Beta** is a historical measure of volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Beta measures how an asset (i.e. a stock, an ETF, or portfolio) moves versus a benchmark (i.e. an index). A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market.

BMO Exchange Traded Funds is a diversified family of ETFs that includes a broad range of domestic and global investment solutions. With BMO ETFs, investors can construct efficient multi-asset class portfolios using a risk allocation framework.

Contact us

+852 3716-0990

bmogamasiainfo@bmo.com

www.bmo.hk/etfs

BMO | Exchange Traded Funds 交易所買賣基金

07/16-1569