Operation Twist:

Opportunities and realities for investors

Insight series
July 2012

The Federal Reserve Board, which recently reauthorized Operation Twist, is committed to flattening the yield curve in an attempt to keep long-term interest rates as low as possible. With global economic growth slowing and interest rates at historic lows, investors in search of total return face a challenging environment.

We believe selective fixed-income opportunities exist for maximizing total return at the long- and short- end of the yield curve even if interest rates increase sooner than expected.

Contributors
Taplin, Canida & Habacht, LLC (TCH)

Tere Alvarez Canida, CFA
President & Portfolio Manager

Alan M. Habacht
Principal & Portfolio Manager

William J. Canida, CFA
Principal & Portfolio Manager

Scott M. Kimball, CFA
Portfolio Manager

Taplin, Canida & Habacht, LLC, (TCH) is a fixed income specialist boutique located in Miami, FL. Founded in 1985, TCH is a part of BMO Global Asset Management and sub-adviser to the BMO TCH Corporate Income Fund and the BMO TCH Core Plus Bond Fund. All contributors are co-managers of those funds.

Separate Accounts | Mutual Funds | Collective Investment Trusts | Pooled Funds | UCITS | Alternative Investments

BMO Global Asset Management

Let's twist like we did last fall...

In September 2011, the Federal Reserve Board (Fed) launched Operation Twist, a program designed to bring down long-term interest rates. The Fed initially committed $400 billion that was spent through this June and plans to spend another $267 billion through the end of this year. The Fed had the opportunity to either extend or discontinue the program in June; with the U.S. economy, the Fed decided to continue the program in an effort to bolster the housing market, bring down unemployment and keep long-term rates low for an extended period of time.

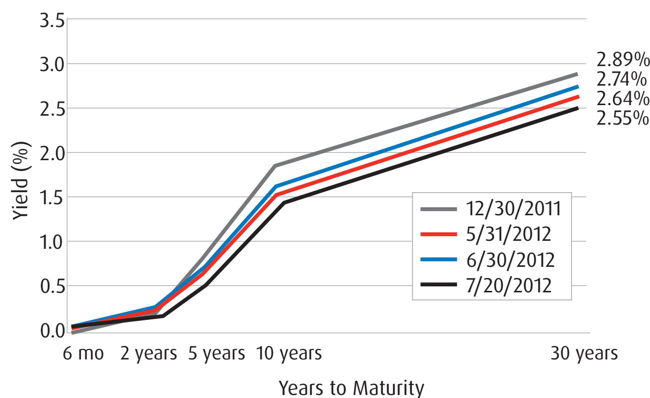
Despite the Fed's desire to stimulate the economy, it does not have the authority to appropriate funds to spur economic growth; those powers rest with Congress and the President. What the Fed can do is encourage consumers and businesses to spend by keeping interest rates low for as long as possible. Because borrowing costs are so low, corporations are incentivized to expand their businesses by investing in research and development and hiring employees. In addition, investors tend to respond to lower rates and a flattening of the yield curve by accepting additional credit risk and moving away from longer maturity Treasury bonds and into higher risk corporate bonds. As one of the tools in the Fed's toolbox designed to achieve these results, Operation Twist is likely to remain an ongoing part of the Fed's program into 2013.

The Fed's Operation Twist is designed to stimulate the U.S. economy, keeping long-term interest rates low for the foreseeable future.

Low rates continue

With both long-term and short-term yields projected to remain exceptionally low for the next several years, investors face a challenging environment in terms of capturing yield as seen in Chart 1. And as macro economic uncertainty remains constant with the ongoing sovereign debt crisis in Europe, the upcoming U.S. presidential election in November and the prospect of falling off of the fiscal cliff in January, equity markets are not particularly appealing.

Chart 1: treasury yield curve

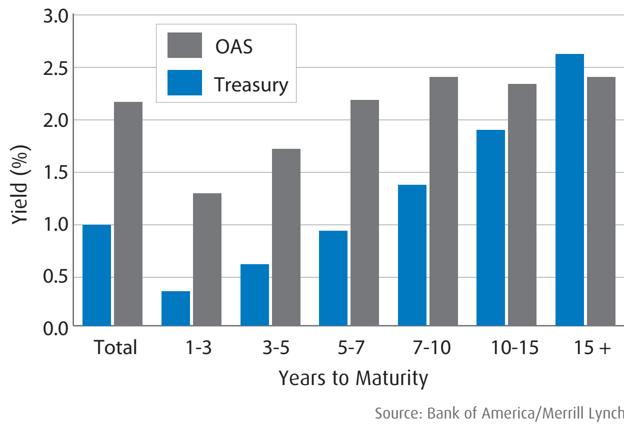


Source: Bloomberg L.P., BMO Asset Management US

The fiscal cliff is a confluence of economic circumstances that the U.S. economy faces in January 2013, which includes the potential of the Bush tax cuts expiring and other targeted spending cuts and tax increases going into effect. Together, these cuts and tax increases could trim from three to five percent from the U.S. gross domestic product, which could send the economy into another recession.

By bypassing yields – which are depressed and likely to remain so – and capitalizing on the total returns offered on the short and long ends of the yield curve, investors may realize significant returns that have the potential to sustain investment portfolios in a low yield and low economic growth environment. Chart 2 illustrates the potential offered by a total return focused approach.

Chart 2: credit option adjusted spread (oas) vs. Treasury yields



Source: Bank of America/Merrill Lynch

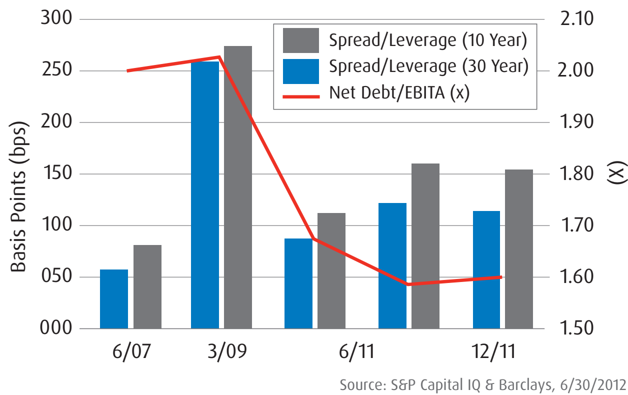
What the Fed's policies mean

This short-term mindset constrains many investors from potentially profiting from the Fed's moves, which are aimed at not only keeping both short and long-term rates low, but also at flattening the yield curve. Here is why investors are so nervous: when interest rates go up, existing bonds lose value. That is the definition of interest rate risk. Another concern is duration risk. Duration measures a bond's sensitivity to changes in interest rates. Duration is expressed in years; typically, when interest rates increase, the value of existing bonds decreases at a rate linked to that bond's duration. So the value of longer duration bonds will fall more than the value of shorter duration bonds when interest rates rise.

As a result, the fear that increases in interest rates will lead to losses in investment portfolios leads to an avoidance of the long end of the yield curve which, all else equal, may carry a higher sensitivity to changes in interest rates; however, the opposite is also true. In a declining interest rate environment, this sensitivity will benefit investors as longer-term securities produce larger gains. While the short end of the yield curve may carry less overall interest rate risk, it has its own challenges. Rates are the lowest here, which leads many investors to shun this sector because there is so little yield potential. But it is precisely at the beginning and end of the yield curve where total return investment opportunities often abound for investors willing to look beyond the headline interest rates.

For many investors, it may seem prudent to avoid the extreme ends of the yield curve due to perceived interest rate risk and the fact that the Fed plans to keep interest rates near zero for at least the next 18 months. Actually, though, that avoidance may be misguided. That is because when interest rates have risen in the past, they have not done so in tandem. So even if rates go up — which is not likely according to Fed guidance — not all bonds will be impacted equally. Historically, parallel or equal changes in yield are extremely rare because spreads are increasing while balance sheets are improving as illustrated in Chart 3 on the next page.

Chart 3: industrial spread trends



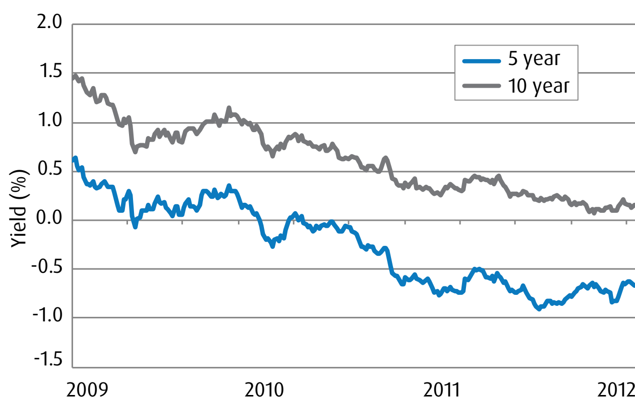
Source: S&P Capital IQ & Barclays, 6/30/2012

Even if interest rates increase sooner than anticipated, investment managers who are positioned in the part of the yield curve that ends up outperforming the market have the potential to deliver higher returns. This is far more significant in terms of the results a bond portfolio may ultimately deliver than any one number such as the maturity or duration of that portfolio. For example, from 2004 to 2006, the last time interest rates began to rise from an extremely low point, the long end of the yield curve benefited, with long-term bonds gaining 10 percent in total return, according to the Barclays Capital U.S. Treasury Index.

Implications for bond fund total return strategy

So as the yield curve flattens in response to Operation Twist, we believe there is significant opportunity to profit from the longer end of the curve, where real yields are remaining positive. By purchasing longer maturity Treasury bonds in the 20- and 30-year range, significant total return gains may be possible as seen in Chart 4.

Chart 4: forward implied real treasury yield (%)



Source: Bloomberg L.P.

Recessionary fears result in many investors avoiding higher yielding bonds and missing out on the opportunity to strategically add these bonds with shorter maturities—where there may actually be less risk.

In addition, as the economy continues to soften and uncertainty reigns in Europe and the United States, investors are maintaining a strategic flight to high-quality bonds, which are mostly short- and intermediate-term treasurys. Investors view those bonds as "safe" alternatives, although rates are so low as to produce a negative inflation-adjusted return.

Because they are spooked by the possibility of weaker corporations going under if the global economy continues to flounder, this myopic mindset lumps all high-yield issues together, when, in fact, shorter maturity high-yield bonds in the BBB credit quality range are worth considering. That is because they typically offer more yield and total return potential above the treasury yield curve making them potentially worthwhile investment opportunities.

By avoiding high-yield bonds as an asset class, investors may be missing out on the opportunity to strategically add these bonds with shorter maturities, where there is actually less risk. Here is another area where concerns about risk in terms of duration and interest rates are misjudged as illustrated in Chart 5. There may be less interest rate risk in high yield, especially in shorter maturity high yield, than there is in other areas of the fixed-income market.

Chart 5: real yield comparison

Years	Total	1-3	3-5	5-7	7-10	10-15	15+
Credit YTW (%)	3.08	1.48	2.11	2.98	3.47	4.54	4.75
Treasury YTW (%)	0.92	0.34	0.62	0.94	1.39	2.06	2.68
B/E Inflation (%)	2.00	1.00	1.58	1.77	1.95	2.15	2.20
Real Yield-Credit	1.08	0.48	0.53	1.21	1.52	2.35	2.55
Real Yield-Treas.	-1.08	-0.67	-0.96	-0.83	-0.56	-0.09	0.48

Source: Barclays Capital, BMO Asset Management US

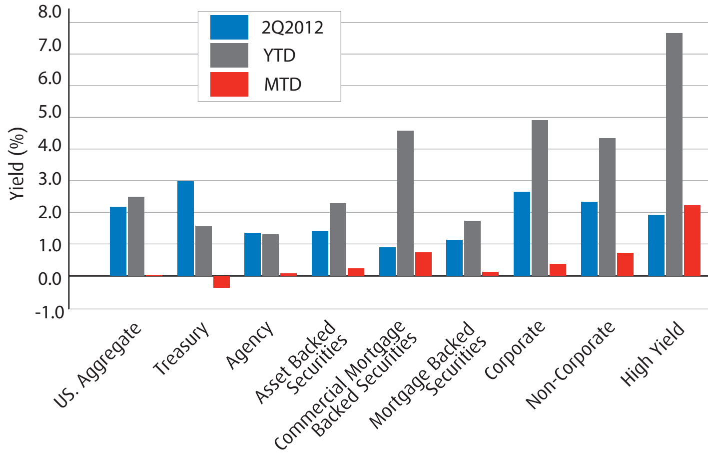
Combining these two approaches results in a strategy that appears like a barbell. By leveraging the Fed's stated intention to keep interest rates low and seeking total return on the short and long ends of the yield curve, it is possible to both maximize bond total returns to outperform index benchmarks and avoid risk. The major risk to investors in the current fixed-income environment is realized interest rate risk, which this strategy strives to sidestep by taking a tactical approach that focuses on the short and long portions of the yield curve.

As the Fed continues to implement Operation Twist, the market should react by attempting to re-steepen the yield curve. Then it is likely the Fed will respond by buying more long-term bonds to flatten the yield curve again. It will be important for fixed income investment managers to continually adjust their strategies to take advantage of tactical opportunities and minimize risk that may occur if the long end of the yield curve steepens again. Investment managers who continually monitor the Fed's moves and investor reactions may be able to fine-tune their portfolios to reduce risk and to take advantage of the opportunities that most in the market are ignoring.

The opportunities for investors

Despite the Fed's commitment to low rates and monetary policy stimulus, neither is likely to have a major impact in terms of significantly boosting economic growth. As a result, the stock market is likely to continue to pose significant risks for investors into 2013 and why the unrealized total return potential in the bond market is potentially so appealing. As seen in Chart 6, bond total returns year-to-date are compelling in specific areas of the yield curve; investors are already capitalizing on those returns and should be able to continue to do so as Operation Twist is executed.

Chart 6: bond total returns



Source: Barclays Capital, BMO Asset Management US, 6/30/2012

In a low rate and low growth environment, funds such as the BMO TCH Core Plus Bond Fund and the BMO TCH Corporate Income Bond Fund offer investors the opportunity to capture total return. Through a strategy of maximizing investment opportunities on the short and long end of the yield curve, we believe the funds are well positioned to help investors increase their total returns, while avoiding the risks posed by equity markets and mid- and long-term high-yield bonds.

To learn more about the BMO Funds, please contact your investment professional or visit bmofundsus.com.

You should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. For a prospectus and/or summary prospectus, which contain this and other information about the BMO Funds, call 1-800-580-3863. Please read it carefully before investing.

All investments involve risk, including the possible loss of principal.

Keep in mind that as interest rates rise, bond prices fall. This may have an adverse effect on the fund's portfolio.

High-yield bonds, also known as "junk" bonds, involve a greater risk of default and price volatility than other high quality bonds. High-yield bonds can experience sudden and sharp price swings which will affect net asset value.

BMO Global Asset Management comprises BMO Asset Management U.S., BMO Asset Management (Canada)®, and BMO's specialized investment boutiques: Monegy, Inc.®, Pyrford International Ltd, Lloyd George Management, and Taplin, Canida & Habacht, LLC. BMO Asset Management U.S. consists of BMO Asset Management Corp., BMO Asset Management Canada includes BMO Asset Management Inc. and Lloyd George Management consists of the subsidiaries of LGM (Bermuda) Limited. BMO Global Asset Management is part of the BMO Financial Group, a service mark of Bank of Montreal (BMO). M&I Investment Management Corp. merged into BMO Asset Management Corp. (formerly Harris Investment Management Inc.) on June 1, 2012. Certain companies within BMO Global Asset Management offer a number of products and services designed specifically for various categories of investors in a number of different countries and regions. These products or services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations.

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment on the date indicated and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

BMO Asset Management Corp. is the investment adviser to the BMO Funds. **M&I Distributors, LLC, is the distributor.** BMO Funds is the brand name for Marshall Funds, Inc.

For more information, visit us at www.bmofundsus.com.

Investment products are: **NOT FDIC INSURED – NO BANK GUARANTEE – MAY LOSE VALUE**.

©2012 BMO Financial Corp 12-326-034 (09/12)

BMO® Global Asset Management

QE3:

What bond investors need to know

Manager Q&A
October 2012

On Sept. 13, the Federal Reserve Board (Fed) announced a new round of quantitative easing (QE3), a policy designed to bring down interest rates and lower unemployment. This bond buying program is in its third iteration and is one of a number of tools the Fed has employed, along with Operation Twist, to stimulate the U.S. economy. In this Q&A, we discuss why we believe the Fed is undertaking this third round of bond buying, what it hopes to accomplish and the potential implications for bond fund investors.

Q: Recently, BMO commented on the Fed's extension of Operation Twist. Does this new move change your thoughts?

A: The key is that QE3 will occur in concert with Operation Twist, which is a program that was extended in June designed to bring down long-term interest rates by purchasing mortgage-backed securities. Both programs will work together. Our take-away is that the supply of long-term Treasuries may continue to be constrained by these programs. It's possible that Operation Twist could be extended again if the Fed still believes in the need to maintain downward pressure on the yield curve on the long end.

Q: What, if anything, was surprising about the Fed's announcement about QE 3?

A: What took us and nearly everyone else by surprise is the open-ended nature of the program. The Fed has declared it's intention to purchase $40 billion a month of bonds for as long as they believe it is necessary -- basically an open-ended expansion of the Fed's balance sheet until 2015. That is unprecedented.

Q: What is significant about the Fed's decision to potentially keep interest rates low until 2015?

A: Most analysts are missing the fact that the Fed is now committing to a policy of quantitative easing for a total of eight years. They implemented QE1 in 2008 and now have publicly committed to it until 2015. That's extraordinary and unprecedented. What we believe is the Fed is continuing to take these measures to avert what they see as much worse potential outcome for the U.S. economy. The economy isn't in great shape now, but without Fed intervention, it could be much worse.

Q: What does the Fed hope to accomplish?

A: The Fed's goals are to:

- Lower deflation expectations
- Stimulate and stabilize the markets for risk assets such as stocks and corporate bonds
- Increase employment
- Encourage fixed investments.

Contributor

Taplin, Canida & Habacht, LLC (TCH)

Scott M. Kimball, CFA
Portfolio Manager

Taplin, Canida & Habacht, LLC, (TCH) is a fixed income specialist boutique located in Miami, FL. Founded in 1985, TCH is a part of BMO Global Asset Management and sub-adviser to the BMO TCH Corporate Income Fund and the BMO TCH Core Plus Bond Fund.

By increasing their balance sheet, the Fed has stated that they are willing to risk higher inflation; the TIPS market has already reacted accordingly. Bond spreads have normalized and are less volatile. Equities have experienced a strong rally. The toughest part of the equation is unemployment – that's because the link between unemployment and this policy is very shaky at best. But the Fed believes the risks to the economy from a high unemployment are significant and that is worth trying to do whatever they can do to increase employment.

Q: Have the Fed's previous attempts to drive down interest rates worked?

A: There are many naysayers who believe that quantitative easing policies haven't been particularly effective in lowering interest rates. But actually, if you look at the interest rate landscape, the fact is that the Fed has reduced the supply of Treasuries and mortgage-backed securities. There is no question that they have had an impact and lowered rates. Actually, what the Fed is trying to do – and in our minds, what they have succeeded in doing – is maintaining downward pressure on rates. These policies have managed to achieve this outcome.

Q: How should bond fund investors position themselves to take maximum advantage of QE3?

A: To put it in the simplest terms, we'd say don't fight the Fed. If the Fed is willing to let inflation increase over the near term, look at the types of fixed income securities aligned with that mandate. One sector that we feel is as well positioned is the inflation-protected market. We believe that even though valuations may seem high from a portfolio positioning or defensive standpoint, these instruments still may offer value. Another area is mortgage-backed securities, where the Fed is applying a lot of pressure to that market in terms of taking away inventory where the inventory is already low.

Another area that we see an opportunity is in investment-grade fixed-income to take potential advantage of the Fed's move to stimulate and stabilize risk assets. In this market, the risk-return profile isn't as asymmetrical as with the high yield market, which we view at this point as pretty overvalued. We think the best way to align yourself with the Fed is to look at plain vanilla, credit type securities.

In terms of maturities, we believe that long maturities still offer the best value in positioning a bond portfolio for the long-term. It may make sense for investors to carry more exposure to long-dated assets in this environment while maintaining sensitivity to the potential for a surge in inflationary expectations beyond what we are factoring in right now.

If that occurs, the yield curve could steepen further, which would be a negative for long-term rates. We see it as a balancing act in that long term maturity issues are attractive, but investors, financial advisors and bond fund managers need to be alert to any signs of rising inflation and if that happens, take steps to rebalance the portfolio. Taking into account the structure and duration of QE3, we also believe that some shorter maturity issues may also be an attractive play on Fed policy.

You should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. For a prospectus and/or summary prospectus, which contain this and other information about the BMO Funds, call 1-800-580-3863. Please read it carefully before investing.

All investments involve risk, including the possible loss of principal.

Keep in mind that as interest rates rise, bond prices fall. This may have an adverse effect on the fund's portfolio.

High-yield bonds, also known as "junk" bonds, involve a greater risk of default and price volatility than other high quality bonds. High-yield bonds can experience sudden and sharp price swings which will affect net asset value.

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide trust, custody, securities lending, investment management, and retirement plan services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment on the date indicated and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

BMO Asset Management Corp. is the investment adviser to the BMO Funds. **M&I Distributors, LLC, is the distributor.**

For more information, visit us at www.bmofundsus.com.

Investment products are: **Not FDIC Insured – No Bank Guarantee – May Lose Value.**

©2012 BMO Financial Corp (10/12)