Your Guide to **Investments**

BMO Private Investment Counsel Inc.

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Introduction

Your personal BMO Private Investment Counsel Investment Counsellor is dedicated to understanding you and your goals. To help you understand the fundamentals behind our investment approach, this Guide provides an overview of two broad asset classes – Capital Preservation and Capital Appreciation – along with examples of qualitative and quantitative measures of their associated risks.

Positioning your investment portfolio to minimize the risk of not meeting your investment goals is of utmost importance. In order achieve your goals, we work with you to implement an investment strategy that takes into account your specific risk tolerances; allowing us to build a diversified portfolio of securities across various asset classes.

Our ultimate benchmark is your financial success. We pursue this goal through consistent and principled actions that are integrated into every aspect of your Wealth Plan.

This Guide is not meant to be an exhaustive list of all types of investments and their associated risks. Please speak with your Investment Counsellor should you have any questions about investment characteristics, their risks, or your investment portfolio.

Understanding Asset Classes

We group investments into two broad asset classes: Capital Preservation and Capital Appreciation. Each of these broad asset classes have sub-asset classes that can be differentiated by investment characteristics and/or geographic exposure.

Capital Preservation Investments are characterized by relatively low volatility, as exhibited by price swings, and higher capital protection that reduces risk in order to "preserve capital." Investors accept lower expected returns for Capital Preservation investments in exchange for a higher probability of generating positive returns over a short-to-medium time horizon.

In addition, these investments may provide a buffer to portfolio drawdowns in times of significant uncertainty. Capital Preservation investments include, but are not limited to:

- **Cash and Cash Equivalents**: These investments include shorter term, individual fixed income securities such as Treasury Bills, Certificates of Deposit, Guaranteed Investment Certificates, Commercial Paper and other similar securities. These investments typically mature in one year or less.
- **Fixed Income Securities**: These investments include government and corporate bonds, preferred shares, mutual funds, investment funds and exchange-traded funds ("ETFs") exposed to fixed income market participation. These securities typically have a term to maturity of more than one year.
- **Non-Traditional Capital Preservation Assets**: These investments include structured notes, private placements, direct investments, limited partnerships and pooled investment vehicles exposed to fixed income market participation. Non-traditional investment vehicles may also employ more complex instruments, such as derivatives, in their strategies to achieve their investment objectives.

Capital Appreciation Investments are characterized by relatively higher volatility and lower capital protection in exchange for a higher probability of generating positive returns over the long term. Capital Appreciation assets tend to generate a meaningful portion of returns through capital gains/losses, which arise from selling at prices higher/lower than their purchase prices. Capital Appreciation investments include, but are not limited to:

- **Equities**: These investments include common stocks, income trusts, royalty trusts, convertible fixed-income securities, mutual funds, investment funds and exchange-traded funds exposed to stock market participation.
- **Non-Traditional Capital Appreciation Assets**: These investments include structured notes, private placements, direct investments, limited partnerships and pooled investment vehicles exposed to stock market participation. Non-traditional investment vehicles may also employ more complex instruments, such as derivatives, in their strategies to achieve their investment objectives.

A Closer Look at Traditional Investments: Bonds and Common Stocks

Bonds

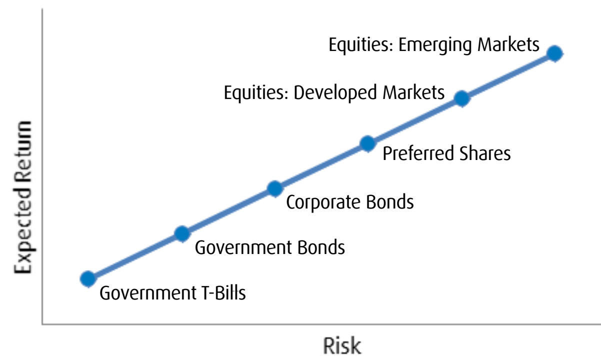
A common type of fixed income security, bonds are issued by entities such as governments and corporations to facilitate the borrowing of money. For example, when a government needs to borrow money it can do so through the capital markets by issuing bonds to investors at a prescribed rate of interest. At the time of issuance, investors will purchase a principal amount of bonds in exchange for repayment of the principal at maturity and interest earned over the life of the bond. Interest earned can come in the form of purchasing a bond at a discount or through regular coupon payments over the life of the bond. Bonds can be freely traded amongst investors at values determined by supply/demand and their underlying risks. While bonds are generally lower risk, compared to equities, they still present risks. If a corporate bond issuer, or less likely a government bond issuer, goes bankrupt the bondholders are paid from any remaining liquidated assets before payments are made to other types of investors due to their seniority. For a more detailed description of investment risks, please see "Investment Risks" below

Common Stocks

A common type of equity security, also known as common shares, are issued by corporations when they wish to raise money in exchange for ownership rights, or shares, in their company. Investors can purchase commons stocks either from the company directly in an "IPO," which is an Initial Public Offering (or a Secondary Public Offering), or from other investors through a stock exchange, sometimes called the open market. Owners of a corporation's common stock are their shareholders. They have the right to receive dividends should the company choose to distribute excess earnings and cash to them. If a company goes bankrupt, common shareholders are paid out with any of the company's funds that remain after all other types of creditors and investors, including bondholders have been paid.

Figure 1 shows the relationship between investment risk and expected return for various investments. Investors expect to be compensated with a higher rate of return when investing in securities that entail a higher level of risk.

Figure 1: **Risk-Return Scale**



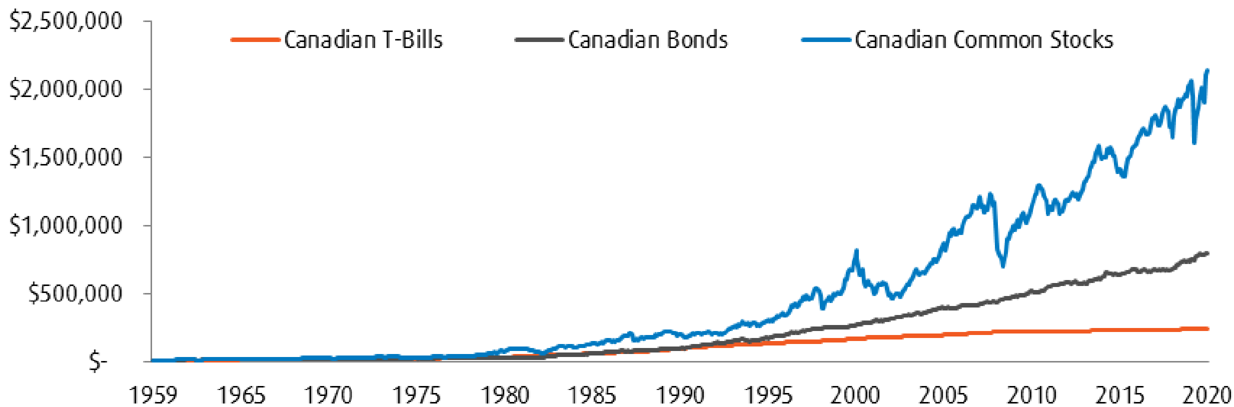
Source: BMO Private Investment Counsel Inc.

Investment Returns

Returns on an investment can be measured in many different ways. In its simplest form, holding period return is the rate of return of an asset over the entire period of time that it's held. This is measured by the sum of income received plus any capital gains/losses, divided by the initial value, or purchase price, of the investment. Capital Preservation investments, such as bonds, typically have a greater proportion of their investment return in the form of income while Capital Appreciation investments, such as common stocks, typically have a greater proportion of their investment return in the form of capital gains. The term "yield" or "current yield," which measures the sum of income divided by the investment's price, should not be confused with total returns. While yield is an important component of return, it is just one component and in most cases investors should focus on generating total returns.

In general, Capital Preservation investments generate lower long-term returns than Capital Appreciation investments. In **Figure 2** we see that over the long term Canadian common stocks have provided greater returns than Canadian bonds and Canadian Treasury Bills.

Figure 2: **Investment Growth of $10,000**



Source: BMO Private Investment Counsel Inc., S&P Dow Jones, FTSE Canada, Bank of Canada.

Investment Risks

While Figure 2 shows that historical long-term returns for Canadian common stocks are superior compared to Canadian bonds and Canadian Treasury Bills, investors must also consider their different risk profiles. Investment risks can be viewed through a number of different lenses. For example, some may view risk as the variability of investment returns while others may view risk as the possibility of permanent loss of capital. Both kinds of risk should be accounted for by you and your Investment Counsellor when assessing your personal risk tolerance.

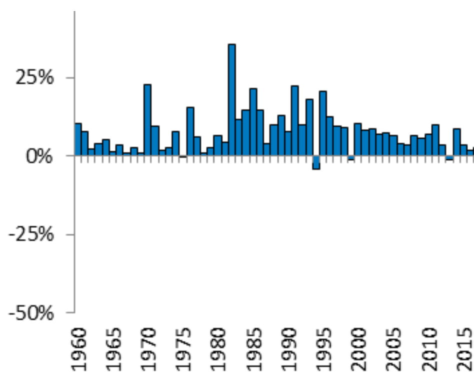
Typically, Capital Preservation investments are less risky than Capital Appreciation investments. As illustrated in Figure 2, the higher expected return of Capital Appreciation investments usually compensates investors for the greater potential risk implied by this asset class.

Capital Preservation investments often come in the form of fixed income securities, which typically represent debt to the security's issuer, while Capital Appreciation investments are more often in the form of equity, or partial ownership, in the issuer. Fixed income securities can generally be considered less risky than equity securities for a number of reasons, such as:

- Fixed income securities rank higher in the capital structure, meaning if an issuer was to go bankrupt, fixed income security holders would be paid before equity holders.
- Fixed income securities typically have lower return variability compared to equity securities.
- Fixed income securities have a fixed term to maturity as opposed to the perpetual nature of equities.

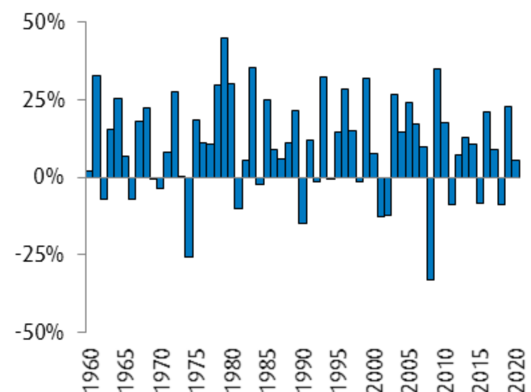
Figures 3 and 4 show the annual returns for Canadian bonds and Canadian common stocks. Although Canadian common stocks have had greater rates of return than Canadian bonds over the long term, their returns have been more volatile (greater ups and downs), in addition to having more years with losses or negative performance.

Figure 3: Canadian Bonds: Annual Returns



Source: FTSE Canada

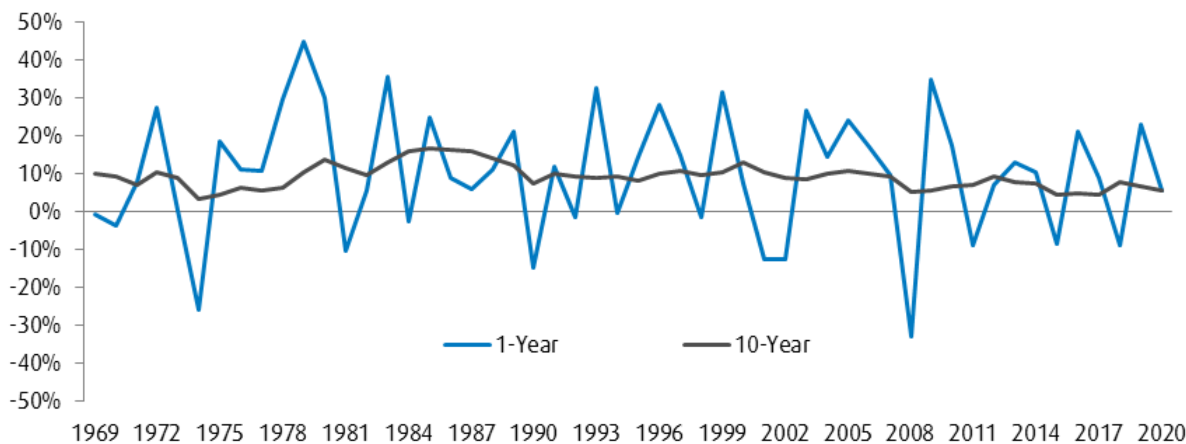
Figure 4: Canadian Common Stocks: Annual Returns



Source: S&P Dow Jones

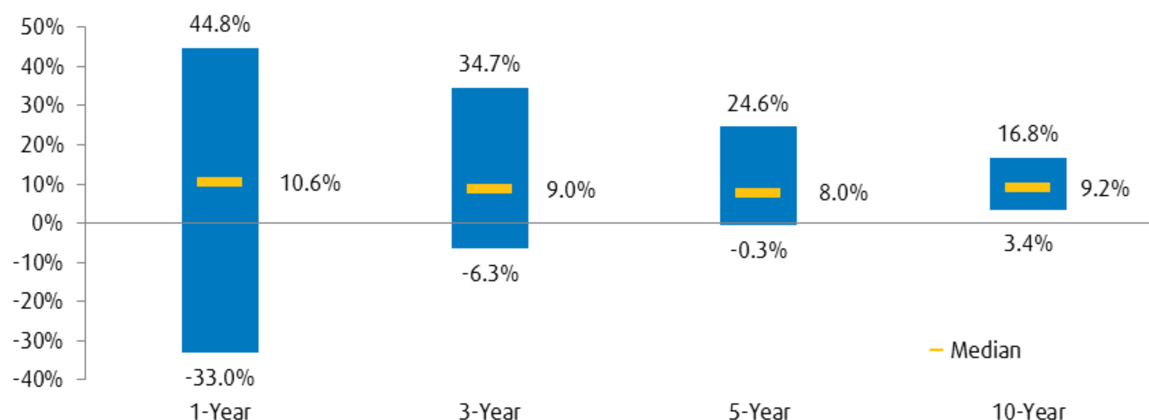
Risks can also be highly influenced by an investor's time horizon, which is the amount of time before the investor projects the need to cash in on their investments. **Figures 5 and 6** show that risk, as measured by both variability of returns and the risk of negative returns, decreases as an investor's time horizon lengthens.

Figure 5: Canadian Common Stocks: Rolling Returns, 12-month Moving Window



Source: S&P Dow Jones

Figure 6: **Canadian Common Stocks: Range of Annualized Returns (1969 to 2020)**



Source: S&P Dow Jones

Table 1 highlights some common investment risks that apply to both Capital Preservation and Capital Appreciation investments.

Table 1: **Investment Risks**

Investment Risk	Description
Default Risk, Credit Risk and Company-Specific Risk	Default risk is the risk that a borrower will fail to meet its interest and/or principal repayment obligations to a lender, while credit risk is the risk that a borrower's willingness or ability to make future interest and/or principal repayments will diminish. A borrower with a higher credit rating, such as the Canadian government, will typically have lower default and credit risk compared to an entity with a lower credit rating, such as corporations that issue bonds in the high yield market. Company-specific risk is tied to an individual company and affects its ability to meet debt obligations or generate future profits. Examples include loss of competitive advantage, poor use of capital and diminishing corporate governance. Such risks could cause both bond and common share prices to fall.
Reinvestment Risk	The risk that future investments will have to be reinvested at lower rates of return. This risk is of primary concern to fixed income security holders in a falling interest rate environment, where interest earned must be reinvested at lower interest rates.
Interest Rate Risk	Interest rate risk is faced by fixed income security holders when interest rates move higher, and the price of such securities fall. Equity investors may also face this risk as some common stocks that pay a higher dividend (such as those issued by utilities, telecommunications companies and REITs) may become less attractive relative to fixed income securities as interest rates rise.
Market Risk	The risk that a security's price falls due to adverse circumstances that influence the overall performance of financial markets. These factors are numerous and include economic and geo-political factors, as well as securities' supply/demand dynamics.
Currency Risk	The risk of negative investment returns due to an adverse fluctuation in the exchange rate of the investment's currency and the investor's local currency.
Liquidity Risk	The risk of being unable to sell an investment in a reasonable amount of time at a fair price.

Investment Risk	Description
Inflation Risk	The risk that an investor's purchasing power is diminished due to rising inflation, which is the general increase in the prices of goods and services over time. If inflation rises higher than expected, fixed income security holders will not be compensated accordingly. Equity securities may offer some inflation protection, as companies may be able to increase the prices they charge for their goods and services thereby increasing their revenues and potentially their profits.
Time Horizon Risk	The risk that an investor's time horizon is shortened compared to the time horizon initially anticipated when the investment was initially made. This could cause a situation in which an investor is forced to sell securities at a lower price than otherwise expected.

Source: BMO Private Investment Counsel Inc.

Investor Risk Tolerance

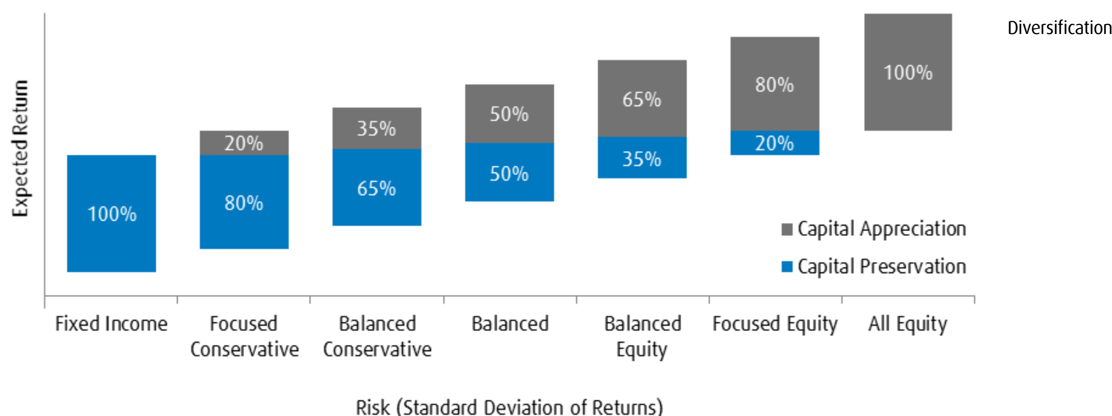
Up to this point, this Guide has discussed risks specific to individual investment vehicles. However, the most important risk to manage is the risk that your investment portfolio will not meet your needs as defined by your investment goals. In order to meet your investment goals, you Investment Counsellor will help you build a diversified portfolio aligned to your unique goals, while taking into account your risk tolerance.

Risk tolerance describes an investor's ability and willingness to tolerate risk. The ability to tolerate risk is a function of an investor's economic circumstances such as level of wealth, income, liquidity needs and time horizon. The willingness to tolerate risk is a function of an investor's psychology and emotions which may be influenced by past investment experiences or behavioural biases. Sometimes an investor's ability to tolerate risk is not reflected in their willingness to tolerate risk, or vice versa. Your Investment Counsellor will work with you to understand both dimensions of your risk tolerance prior to making any investment recommendations.

Portfolio Construction

Understanding your risk tolerance and investment goals is paramount to setting the parameters for your investment portfolio. It ensures that at any point in time, your portfolio is invested in the right mix of Capital Preservation and Capital Appreciation investments, aligned to your investment strategy. Your investment strategy will have a long-term Strategic Asset Allocation that may be adjusted from time to time, within defined ranges, with the objective of adding incremental value to the risk-adjusted returns of your portfolio. Such adjustments to the Strategic Asset Allocation[1] are referred to as Tactical Asset Allocation, also known as your portfolio's asset mix.

Figure 7: Risk and Return Profiles



Source: BMO Private Investment Counsel Inc.

[1] Long-term strategic targets and actual allocations may differ based on tactical asset allocation overlay.

Diversification

Once your asset mix is defined, risks can further be managed through effective portfolio construction. One of the most important principles to building a portfolio is diversification. Diversification can be achieved by investing in a variety of Capital Preservation and Capital Appreciation investments. Individually, each investment has a unique set of risk and return characteristics, however by combining all investments at different allocations into a portfolio, an investor can target a specific risk and return profile for the portfolio as a whole, which have be a different risk and return profile than the individual investments it holds. This happens because the returns of each individual investment do not necessarily move in the same direction, and to the same degree, over a given period of time and at different points within an economic cycle. The degree to which two or more investment returns fluctuate together is referred to as correlation. Positive correlation indicates investment returns are moving in the same direction, while negative correlation indicates investment returns are moving in the opposite direction.

Figure 8 shows the yearly performance of a select group of sub-asset classes. As you can see, in periods of strong equity markets, such as 2009 and 2010, as the markets recovered from the financial crisis, riskier Capital Appreciation investments (e.g., Emerging Markets stocks and small capitalization stocks) outperformed Capital Preservation investments (e.g., Canadian bonds and Canadian treasury bills). Their performance reversed in 2011 as lower-risk Capital Preservation investments provided downside protection to portfolios amidst European debt troubles.

Figure 8: **Sub-Asset Class Yearly Returns (Total Return, Canadian Dollars)**

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Canadian Stocks: Small Cap 62.4%	Canadian Stocks: Small Cap 35.1%	Canadian Bonds 9.7%	Emerging Markets Stocks 16.0%	US Stocks: Small Cap 48.4%	US Stocks 24.0%	US Stocks 21.0%	Canadian Stocks: Small Cap 38.5%	Emerging Markets Stocks 28.7%	US Stocks 4.0%	US Stocks 25.2%	US Stocks: Small Cap 17.6%
Emerging Markets Stocks 54.5%	US Stocks: Small Cap 20.0%	Canadian Preferred Shares 5.8%	International Stocks 15.3%	US Stocks 41.5%	US Stocks: Small Cap 14.4%	International Stocks 18.8%	Canadian Stocks 21.1%	International Stocks 17.4%	Canadian Bonds 1.4%	Canadian Stocks 22.9%	Emerging Markets Stocks 16.3%
Canadian Stocks 35.1%	Canadian Stocks 17.6%	US Stocks 4.4%	US Stocks: Small Cap 13.8%	International Stocks 31.8%	Canadian Stocks 10.6%	US Stocks: Small Cap 14.0%	US Stocks: Small Cap 17.7%	US Stocks 13.8%	Canadian T-Bills 1.4%	US Stocks: Small Cap 19.5%	US Stocks 16.1%
Canadian Preferred Shares 27.0%	Emerging Markets Stocks 12.8%	Canadian T-Bills 0.9%	US Stocks 13.5%	Canadian Stocks 13.0%	Canadian Bonds 8.8%	Canadian Bonds 3.5%	US Stocks 8.6%	Canadian Preferred Shares 13.6%	US Stocks: Small Cap -3.2%	International Stocks 16.8%	Canadian Stocks: Small Cap 12.9%
International Stocks 14.3%	US Stocks 8.9%	US Stocks: Small Cap -2.0%	Canadian Stocks 7.2%	Canadian Stocks: Small Cap 7.6%	Emerging Markets Stocks 7.1%	Emerging Markets Stocks 1.9%	Emerging Markets Stocks 8.3%	Canadian Stocks 9.1%	International Stocks -5.8%	Canadian Stocks: Small Cap 15.8%	Canadian Bonds 8.7%
US Stocks: Small Cap 9.7%	Canadian Preferred Shares 7.7%	Canadian Stocks -8.7%	Canadian Preferred Shares 5.5%	Emerging Markets Stocks 4.5%	Canadian Preferred Shares 6.8%	Canadian T-Bills 0.5%	Canadian Preferred Shares 7.0%	US Stocks: Small Cap 7.1%	Emerging Markets Stocks -6.7%	Emerging Markets Stocks 13.2%	Canadian Preferred Shares 6.2%
US Stocks 9.1%	Canadian Bonds 6.7%	International Stocks -9.7%	Canadian Bonds 3.6%	Canadian T-Bills 1.0%	International Stocks 4.2%	Canadian Stocks -8.3%	Canadian Bonds 1.7%	Canadian Stocks: Small Cap 2.8%	Canadian Preferred Shares -7.9%	Canadian Bonds 6.9%	International Stocks 6.1%
Canadian Bonds 5.4%	International Stocks 2.4%	Emerging Markets Stocks -16.3%	Canadian T-Bills 1.0%	Canadian Bonds -1.2%	Canadian T-Bills 0.9%	Canadian Stocks: Small Cap -13.3%	Canadian T-Bills 0.5%	Canadian Bonds 2.5%	Canadian Stocks -8.9%	Canadian Preferred Shares 3.5%	Canadian Stocks 5.6%
Canadian T-Bills 0.3%	Canadian T-Bills 0.6%	Canadian Stocks: Small Cap -16.4%	Canadian Stocks: Small Cap -2.2%	Canadian Preferred Shares -2.6%	Canadian Stocks: Small Cap -2.3%	Canadian Preferred Shares -14.9%	International Stocks -1.5%	Canadian T-Bills 0.7%	Canadian Stocks: Small Cap -18.2%	Canadian T-Bills 1.7%	Canadian T-Bills 0.4%

Source: S&P Dow Jones, MSCI, FTSE Russell, FTSE Canada, Bank of Canada

It is also important to diversify within each major asset class.

Bonds

Although a traditional asset class such as bonds is often meant to preserve capital, this outcome could be at risk if there is not ample diversification across bond sectors (such as government and corporate), issuers, and maturities amongst other factors. For example, in times of economic and financial stress, corporate bonds from lower-rated issuers tend to underperform bonds from highly-rated government issuers as these corporations' creditworthiness may deteriorate, which causes investors to demand greater returns through comparatively lower bond purchase prices.

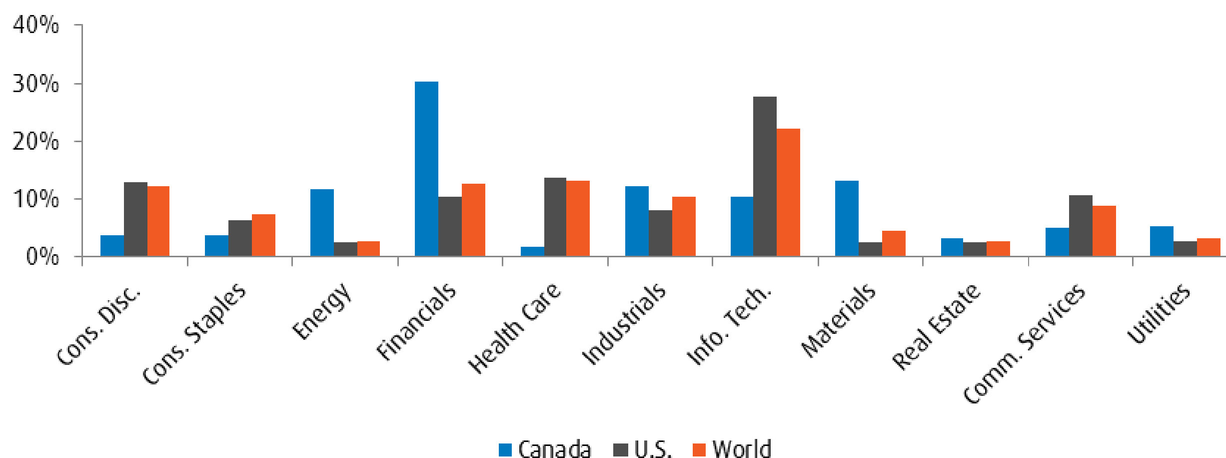
In Canada, different bond rating agencies, including Standard & Poor's ("S&P"), Dominion Bond Rating Service ("DBRS") and Moody's Investors Service, provide credit ratings for bond issuers. According to S&P, issuers with a credit rating of BBB- or higher are considered Investment Grade, while those with credit ratings of BB+ or lower are considered non-Investment Grade (or high yield). In addition, bonds with longer-term maturity dates experience greater price movements than those with shorter terms to maturity in response to any given change in interest rates and; therefore, it is important to invest in bonds with different maturities.

Common Stocks

Common stocks are often used to grow capital. However, investing in a small number of common stocks exposes investors to individual, company-specific risks. This risk is reduced by investing in a greater number of companies. More broadly, investing in the common stocks of companies in different sectors and different geographies reduces the impact of risks that are shared amongst companies in those respective sectors and geographies.

For example, the Canadian stock market is highly concentrated in the Financials, Energy and Materials sectors which make up approximately 55% of its total market value (or market capitalization). Therefore, investing in Canadian common stocks alone could lead to this portion of a portfolio being very sensitive to interest rate fluctuations, the state of the Canadian economy and commodity prices. Including investments in common stocks with a global presence into a portfolio allows investors to own companies that operate in sectors with limited exposure within in Canada, such as the Information Technology, Healthcare and Consumer sectors, and those exposed to different global economic environments (see **Figure 9**). Investing across geographies does introduce additional risks, such as geo-political and currency risks. Consequently, investors should be mindful of the trade-offs.

Figure 9: **Equity Market Sector Exposure by Geography (January 2021)**

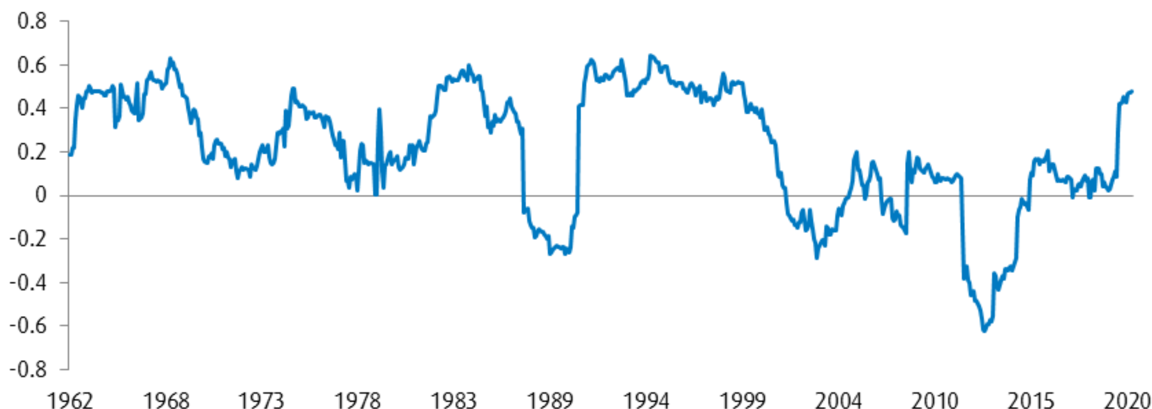


Source: S&P Dow Jones, MSCI

Diversification Beyond Traditional Investments

The relationship between investment returns and risks of different investments is not static, it's dynamic. For example, **Figure 10** shows that from the late 1990s to the recent past, Canadian common stock and bond returns often moved in an unrelated way, or opposite directions. As such, investing in a combination of common stocks and bonds added significant diversification to a portfolio. Interestingly, this was not the case from the early 1960s to the late 1990s, when common stock and bond returns frequently moved in the same direction.

Figure 10: Rolling 36-Month Correlation of Monthly Returns: Canadian Common Stocks and Canadian Bonds



Source: FTSE Canada, S&P Dow Jones

For this reason, it is important to think beyond traditional asset classes when constructing a portfolio. Non-traditional investments may come in a variety of forms. Examples include structured notes, hedge funds, private credit, private equity, real estate and infrastructure. Investment strategies in the non-traditional universe may offer lower liquidity, greater specialization in a sector or segment, use of derivative strategies or leveraged exposures, and provide less transparency. While these characteristics may introduce risks that differ from traditional investments, generally investors should expect to be compensated for these risks through enhanced portfolio return, reduced overall portfolio risk, or both.

Non-traditional investments can be structured to provide either Capital Preservation or Capital Appreciation and may offer return profiles that lead to a more efficient portfolio; one that provides greater return for an assumed level of risk. Given the unique features of non-traditional investments, investment due diligence must consider factors beyond those used to analyze traditional investments.

Conclusion

This Guide provides an overview of commonly used asset classes and investment securities along with descriptions of some, but not all, of their associated risks. While understanding the past return for specific asset classes provides historical perspective, the investment landscape continues to evolve and new risks emerge on a regular basis.

At BMO Private Investment Counsel, we get to know and understand you and your entire situation by going deeper, using our proven investment process. We are dedicated to understanding your goals, risk tolerance and unique circumstances, in order to partner with you so that, together, we can create an investment strategy and portfolio solution that is right for you, while ensuring that it evolves as your situation also changes.

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