Brompton North American Financials Dividend ETF (TSX:BFIN; BFIN.U)

BROMPTON FUNDS

Portfolio Manager Commentary - March 31, 2023

Global Markets Review

Global equity markets registered positive returns during the first quarter of 2023, despite the global banking crisis in March that fueled a sell-off in the Financials sector. Decelerating inflation, potentially peak interest rates, and China's reopening, sent major stock indices higher. The MSCI World Index gained 7.9%. Information Technology rallied 21.2% and was the top performer, while Energy was the bottom-performing sector (-3.1%). In North America, the S&P 500 rose by 7.5%, buoyed by Information Technology and Communication Services. The S&P/TSX Composite added 4.6%, also boosted by Information Technology (+26.5%). In Europe, the STOXX 600 returned 8.6% for the quarter. Major European indices also finished the quarter in positive territory. Italy FTSE MIB and France CAC 40 gained 15.1% and 13.4%, respectively. Spain, Germany, Switzerland, and the U.K. were up 12.8%, 12.2%, 5.1% and 3.6%, respectively.

Global economic data was mixed during the quarter. Inflation has materially come off the peak since June 2022 (9.1%) to 6.0% for the February 2023 reading, supporting the market expectations that the monetary tightening cycle may end soon. Labour markets remain resilient, with unemployment rates still well below 4% and hourly wage growth decelerating. However, other major economic indicators in the U.S. warn that economic growth remains weak. Manufacturing PMI largely retreated in Q4 2022 and entered March 2023 at 46.3, an indication of contraction if readings are below 50. Global bond markets also finished up in the first quarter of 2023, even though rate volatility remained elevated. The U.S. 10-year Treasury yield broke above 4% on stickier-than-expected core inflation measures in early March 2023, but quickly dropped following the market fear of a banking crisis due to the collapse of Silicon Valley Bank. The U.S. dollar was largely weak against most G10 currencies on the Federal Reserve's more dovish tilt. Following a robust gain in Q4 2022, most equity markets continued the upward trend in Q1 2023, with investors factoring in the end of central bank tightening, deceleration of inflation, and China's reopening. Information Technology, Communication Services, and Consumer Discretionary, the three bottom-performing sectors in 2022, have recovered and gained strong momentum in Q1 2023. From a factor perspective, the decline in bond yield supported growth stocks' outperformance against value during the quarter.

Central banks in developed economies started to deliver more dovish stances of their monetary policy as inflationary pressure abated. The Federal Reserve raised interest rates by 25 basis points at both 2023 February and March Federal Open Market Committee ("FOMC") meetings, sending the target rate to the 4.75%-5.00% range. As the Fed has slowed its pace of hikes, investors expect that cooler inflation data and the turmoil surrounding regional banks should end the tightening cycle soon. The Fed funds futures market is pricing in the terminal rate at 5%, followed by around 60 basis points of cut in the second half of the year. Given that inflation readings remain well above the Fed's 2% target and additional hikes add to the banking system stress, we believe the expectations of a dovish Fed pivot will continue helping market sentiment, but a discussion on the trajectory of rate cuts is premature.

The Bank of Canada (BoC) maintained its overnight policy rate at 4.5% in March 2023. This is the first meeting that hasn't resulted in a rate increase since January 2022. Since that time, the BoC hiked at eight consecutive meetings for a cumulative tightening of 425 basis points. However, the central bank does not rule out the option to increase the policy rate further if needed to return inflation to the 2% target. With the easing of inflation, there is a higher chance that this conditional pause should be sustained, translating to a temporary relief on household debt.

The European Central Bank (ECB) continued raising the benchmark interest rate by 50 basis points at both February and March 2023 meetings to 3.5%. The Governing Council will likely keep hiking interest rates to tame inflation, as core measures reached a new record high during the quarter. The concern over financial stability (i.e. collapse of Credit Suisse) would put ECB's rate hike in a complicated position, where delaying the tightening may have a negative impact on inflation expectations, resulting in more hikes necessary at a later stage. On the positive side, energy prices should continue to moderate due to falling wholesale energy prices and government support measures. Meanwhile, the Bank of England (BoE) also stepped down its pace of tightening by a 50-basis- point increase in February 2023 and a 25-basis-point increase in March 2023 to 4.25%. The communication suggests that the Monetary Policy Committee would not maintain a bias towards tighter policy, while the upcoming decision will be fully data dependent.

The first quarter of 2023 started with a recovery rally in some of the worse performing sectors in 2022, such as Information Technology. Most central banks have slowed their paces of monetary tightening. However, the global banking industry has once again been thrown into turmoil in March with the failures of Silicon Valley Bank, Silvergate Capital, and Signature Bank in the U.S., as well as the takeover of Credit Suisse by UBS Group at the behest of regulators in Switzerland. While there were specific issues impacting each of these entities, these recent failures have highlighted the risks associated with the rapid move higher in interest rates over the past year as central banks around the world have moved swiftly to tighten policy in response to high inflation.

We continue to believe that a volatile market should persist for the rest of 2023. Inflationary pressure remains high, especially the core measures. The labour market is still tight. Share buyback black out window, Q1 earnings and subsequent economic data releases could act as a catalyst for volatility expansion. Even though many investors conclude that the systemic risk is minimal in the financial sector, any near-term development in U.S. regional banks' failure and the acquisition of Credit Suisse could still add turbulence to the market. As the timing of ending monetary tightening remains unclear among global central banks, value and growth could change leadership frequently in the rest of the year. Regardless, this inflationary environment should keep favouring companies that demonstrate resilient balance sheets, generate inflation-resistant cash, and maintain strong margin levels. Furthermore, in high volatility market regimes, strategies that lower portfolio correlations, such as investing in low volatility styles and preferred shares, should enhance risk-adjusted returns. Additionally, Brompton's ability to lean on its covered call writing program to harvest volatility risk premia augments risk-adjusted returns, lowers portfolio volatility, and aids in funding distributions.

Financial Sector Review & Outlook

During Q1 the global banking industry was thrown into turmoil with the recent US regional bank failures of as well as the takeover of Credit Suisse by UBS Group at the behest of regulators in Switzerland. These recent failures have highlighted the risks associated with the rapid increase in overnight interest rates over the past year as central banks around the world have moved swiftly to tighten policy in response to high inflation. These risks include declining asset values (i.e. bond investments) as a result of higher rates across the yield curve, particularly for banks that run a duration mismatch on their balance sheets as well as the potential for banks to quickly lose deposits as depositors search for higher yields in investment products. Actions taken by the Federal Reserve, Federal Deposit Insurance and US Treasury provided an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell those securities in times of stress. While all depositors were made whole during recent bank failures, signalling deposit insurance is not limited, we believe deposit flows will ebb and flow from regional banks to larger banks.

We are biased towards Canadian banks as they are more profitable than US and European peers. We believe high profitability is the first line of defense in a crisis, as core profits can be used to absorb losses and/or rebuild capital in times of stress. In our view, this is the key differentiating factor for Canadian Banks and a key reason for why they have been able to weather past crises so well. In addition, we favour financial institutions that have more diversified business models and have better deposit franchises than the US regional banks. As such, they are better prepared to deal with challenges as they arise, and deposits tend to be stickier.

We believe loan growth will likely moderate in 2023 after a solid pace last year. This is attributed to slower growth in consumer and deceleration in commercial activity given recessionary pressures. Banks' credit quality continues to be strong given the industry's high underwriting standards. However, we must expect some normalization of this historically high credit quality under a recession. We note that the Current Expected Credit Loss (CECL) accounting standard will make loan loss reserving comparisons to prior cycles more difficult due to the different methodology used. Banks have already started to build up loan loss reserves using CECL and we expect this to stabilize in the back half of 2023.

We are cautiously optimistic on the financial sector given macro economic risks and the fact that the market is factoring increasing probability of a recession. We believe banks are in a good position given high asset quality with fee revenue benefitting from higher interest rates. At this juncture investors who believe the economy will not enter a deep recession, should find banks stocks attractive as large banks are trading at 1.4x price to tangible book value and 7.6x 2023 EPS, below the recent peak levels (during 2017-2018) of 2.2x and 12.5x respectively. However, under a deep recession scenario valuation could compress to 0.9x based on historic trough. Overall, banks are attractively valued and remain well capitalized. We believe capital return for banks could be relatively muted with share repurchase activity slowing given the uncertain economic outlook. Stocks in our portfolio are well positioned to capture the idiosyncratic risk/reward opportunities across large cap banks, regional, consumer finance, investment banks, exchanges and fin tech.

Portfolio Review

Brompton North American Financials Dividend ETF (the "Fund") was down 4.2% versus the S&P/TSX Capped Financials Index, up 1.7% and the S&P 500 Financials down 5.6%. The Fund was slightly underweight Diversified Banks which negatively impacted performance but was ahead of the benchmark. Top holdings include Citigroup (up 4.7%), TD Bank (up 3.5%) and Royal Bank of Canada (up 2.7%). An overweight position in Investment Banks negatively impacted performance which was ahead of benchmark holdings. The only top performer was Morgan Stanley (up 4.1%). The Fund's overweight exposure in Asset Managers contributed to performance which was ahead of the benchmark. Top holdings include Blackstone (up 29.4%), Brookfield Asset Management (up 15.5%) and Brookfield Corp (up 3.8%). A market weight position in Regional Banks negatively impacted performance which was ahead of the benchmark. Our top performer was M&T Bank (up 7.6%). The Fund was overweight Property & Casualty Insurance which contributed to performance ahead of benchmark holdings. Our top performer was Progressive Corp (up 10.4%). The Fund's overweight exposure in Life Insurance contributed to performance which was ahead of the benchmark. Our top performer was IA Financial (up 9%) which was offset by Aflac (down 9.8%). An underweight exposure in Financial Exchanges detracted from performance which lagged the benchmark. Our top performer was Factset (up 2%).

Annual Compound Returns[1]	YTD	1-YR	3-YR	Since Inception[2]	Since Inception[3]
Brompton North American Financials Dividend ETF (CAD Hedged)	(4.2%)	(16.7%)	12.8%	2.9%	-
Brompton North American Financials Dividend ETF (USD)	(4.1%)	(17.8%)	14.3%	-	4.3%
S&P/TSX Capped Financials Index	1.7%	(9.8%)	17.5%	8.6%	9.3%
S&P 500 Financials Index	(5.6%)	(14.3%)	18.0%	6.5%	7.5%

(1) Returns are for the periods ended March 31, 2023 and are unaudited. The table shows the ETF's compound returns for each period indicated compared with the S&P/TSX Capped Financials Index ("Financials Index") and the S&P 500 Financials Index ("S&P Index") (together the "Indices"). The Financials Index is comprised of constituents of the S&P/TSX Composite Index that are classified as members of the financial sector with individual constituents capped at 25% weight. The S&P Index is comprised of constituents of the S&P 500 Index that are classified as members of the financial sector with individual constituents capped at 25% weight. The ETF invests in North American Financial Services companies with market capitalization of at least $5 billion. It is therefore not expected the ETF's performance will mirror that of the Indices which have more diversified portfolios. Further, the Indices are calculated without the deduction of management fees, fund expenses and trading commissions, whereas the performance of the ETF is calculated after deducting such fees and expenses. Past performance does not necessarily indicate how the ETF will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the ETF on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the ETF.

(2) Inception Date October 17, 2018

(3) Inception Date August 8, 2019.

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THE FOUNDATION FOR EXCELLENCE

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