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

BROMPTON FUNDS

Portfolio Manager Commentary - March 31, 2022

Global Markets Review

First quarter of 2022 was a difficult start after a stellar 2021, with a majority of global equity markets experiencing turbulent performance. The Russia-Ukraine war, monetary uncertainty, and inflation concerns fueled a rise in market anxiety. For the three-month period ended March 31, 2022, the MSCI World Index fell by 5.0%. The index fell to the quarter-low in early March, followed by a sharp rebound through month-end. Energy was the best-performing sector, up 31.0%, while Consumer Discretionary was the bottom-performing sector, down 10.6%. In North America, the S&P 500 dropped 4.6%, while the S&P/TSX Composite gained 3.8%, well ahead of most global equity markets. The energy sector was the top performer in both the S&P 500 and S&P/TSX Composite. In Europe, the STOXX 600 was down 5.9%. The U.K. was the only developed European market that a registered positive return, with FTSE 100 up 2.9%. Spain and Switzerland fell by -2.6% and -4.3% respectively. France, Italy, and Germany also finished the period in negative territory with the CAC 40 down 6.7%, FTSE MIB down 8.1%, and DAX down 9.3%.

As the global economy was looking to emerge from the COVID-19 pandemic, the war between Russia and Ukraine became the top exogenous shock that escalated the existing concerns over inflation pressure and supply chain disruptions. Major economic indicators were mixed during the first quarter. U.S. Manufacturing PMI entered March at 57.1, the lowest reading since September 2020. On the positive side, we continued to see sequential decline in unemployment rates. However, inflation kept rising, as the March CPI data hit 8.5%, particularly through food and gasoline. Global yields rose sharply, with the U.S. Treasury market suffering from one of its worst selloffs on record. The 2-year and 10-year Treasury spread narrowed during Q1 and turned negative by the end of March for the first time since August 2019. The U.K. Gilt yield curves also flattened during the quarter, but not as pronounced as the U.S. Value stocks dominated in Q1 as rising rates weighed on growth names. Commodity-oriented stocks, such as crude oil, natural gas, and agricultural producers, led the rally amid the fear of tightening supply. This was also due to the Russia-Ukraine war and sanctions from the U.S. and its allies.

During the first quarter, central banks in developed economies delivered more hawkish stances of their monetary policy to combat inflationary risks. At the March Federal Open Market Committee ("FOMC") meeting, the Federal Reserve raised interest rates by 25 basis points, lifting its 0%-0.25% policy rate since March 2020. The policy rate change also marks the first rate hike since December 2018. As the Fed signaled further hikes at all six remaining meetings this year, the market is pricing in a 2.5%-2.75% target rate by year-end. The Committee also indicated in the recent Fed Minutes that they will begin to reduce the size of their balance sheet at a faster pace than was experienced in 2017-2019, reflecting more aggressive tightening and upward pressure on yields.

In Canada, the Bank of Canada (BoC) also commenced the tightening cycle to raise the overnight policy rate by 25 basis points to 0.5% at the March meeting. Even though Governor Macklem did not provide a detailed timeline on changing the reinvestment plan, he suggested that they will end purchases of government bonds, rather than slowly taper the reinvestment phase once the process of balance sheet reduction starts. The Bank is also open to 50-basis-point moves at individual meetings to tackle the rising inflation.

The European Central Bank (ECB) kept the benchmark interest rate unchanged at -0.50%. ECB President Christine Lagarde did not rule out the possibility of raising the policy rates this year. The Governing Council was clear on the necessity to reduce the asset purchases program (APP) over the coming months, while leaving it to the June meeting to decide on when to end the program. The decision is set to taper the APP from EUR40 billion in April to EUR30 billion in May, and EUR20 billion in June. Meanwhile, the pandemic emergency purchase program (PEPP) ended in March as stated in previous ECB meetings. In the U.K., the Bank of England (BoE) voted to lift the policy rate by two consecutive 25 basis points in its February and March meetings to 0.75%. The BoE also expected inflation to peak around 7.25% in April and dissipate over time. However, as the projections were published in February before the Russia Invasion of Ukraine, the upward pressure on inflationary risks could persist longer than projected.

The geopolitical tensions have been on the center stage in the first quarter, where Russia surprised the world with a full-scale military action on the Ukrainian border in late February, marking the first major military conflict in Europe in decades. Many developed countries have imposed economic sanctions on Russia, including banning Russian oil exports and its financial institutions from SWIFT. As a result, the conflict sent commodity prices such as crude oil, natural gas, and wheat sharply higher, which exacerbated the already-high inflation and supply chain bottlenecks, especially in Europe. In response, the U.S. announced to releasing 180 million barrels of crude oil over a six-month period from its Strategic Petroleum Reserve (SPR). The global oil supply had been tight even before the war. This has largely benefited commodity producers, resulting in Energy being the best-performing sector among most global equity indices. As market sentiment rose in response to the war, concerns over a global economic slowdown have been intensifying.

Looking forward to the rest of 2022, the global economy and broad equity markets will continue to be driven by high inflation readings, normalized monetary policies, and the unknown war duration. In addition, the impact of COVID-19 cannot be ignored yet, as many countries have seen rising cases after loosening pandemic measures. China in particular has extended strict lockdowns on major cities to contain the outbreak. In this vein, it would be inevitable to see market turbulence persist in the near-term, which raises the importance of active portfolio strategies. The barbell approach (owning both cyclicals and defensive) remains our preferred strategy, while favoring dividend-paying quality companies, which generally demonstrate solid balance sheets, stable earnings growth, and reasonable valuations. In our stock selection process, we also carefully examine the candidate's Russian exposure and pricing power to deal with the uncertainties arising from geopolitical conflict and rising inflation.

Financial Sector Review & Outlook

The financial sector had a solid start to the beginning of the year. However, since its January peak the S&P 500 Financials Index sold off but performance is still ahead of the broader market down 1.5% vs S&P 500 down 4.6% in Q1. While rising interest rates is a tailwind for net interest income, banks receive substantially less benefit from incremental hikes later in the cycle than the benefit they receive from the first few hikes. At this stage in the cycle, we believe regional banks are favoured as they are expected to see higher levels on net interest income from a higher net interest margin and accelerated commercial loan growth. In addition, credit quality for domestic focused banks is more positive than global banks given increased geopolitical risk.

After coming off a record year for capital markets and investment banking, we continue to expect some normalization. During Q1, banks that were exposed to the capital markets businesses saw year-over-year declines in investment banking revenues led by the ECM business partially offset by strong Advisory revenues. Trading and Sales revenues generally were higher on a year-over-year basis. Mortgage banking revenues and originations were particularly weak due to the rise in mortgage rates and their impact on refinancing originations.

Banks continue to invest in digital transformation which was accelerated during the pandemic. As a result, we believe operating leverage will be limited as gains from rising rates and asset growth offset by reduced fee income and higher technology and discretionary expenses. Over time, investment in digital technologies is expected to lower banks' cost structure and improve efficiency gains. We note that larger banks have the ability to spend more on technology to support growth and market share gains at the expense of sub-scale competitors. To put this in perspective, the top 7 banks spend 10% of revenue on technology, however the top 4 spend up to seven times more dollars than the next 3 banks according to estimates from Goldman Sachs.

Banks stocks are trading at reasonable levels, 1.37x book value and 10.5x 2023 EPS. While these may appear above historic levels, they are below prior peaks of 1.6x book value and 12.5x forward P/E (during the 2011-2018 peak). We believe these valuation levels reflect the optimism in future economic expansion, the optionality of rising rates and the premium the market is placing on higher-returning franchises.

Portfolio Review

Brompton North American Financials Dividend ETF (the "Fund") was down 7% in Q1 2022 versus the S&P/TSX Capped Financials Index, which up 2.2% and the S&P 500 Financials down 1.5%.

The Fund benefitted from a market weight exposure to Diversified Banks, with performance ahead of the benchmark. Top holdings include National Bank of Canada (up 8%), Toronto Dominion (up 7%) and Royal Bank of Canada (up 4.6%).

The Fund was market weight Property & Casualty Insurance which contributed to performance relatively in-line with benchmark holdings. Top performing holdings include Cincinnati Financial (up 20%), Travelers (up 6.3%) and Chubb (up 2.8%).

The Fund's underweight exposure to multi-sector holdings contributed to performance which was in-line with the benchmark with our only holding, Berkshire Hathaway up 18%.

An overweight position in Investment Banks negatively impacted the Fund's performance which was in-line with benchmark holdings. Performance in Raymond James (up 10%) was more than offset by weakness in Morgan Stanley and Schwab, both of which were down over 10%.

The Fund's overweight exposure in Asset Management detracted from performance which was ahead of benchmark holdings. Flat performance in Blackstone was more than offset by weakness in Brookfield and Blackrock down 6% and 11% respectively.

The Fund's overweight exposure in Data Processing detracted from performance which lagged the benchmark. Performance in our holding in Paychex (up 0.55%) was more than offset by weakness in Automatic Data Processing (down 7.3%).

Laura Lau, SVP & CIO

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Annual Compound Returns[1]	YTD	1-YR	3-YR	Since Inception[2]	Since Inception[3]
Brompton North American Financials Dividend ETF (CAD Hedged)	(7.0%)	7.4%	12.3%	9.4%	-
Brompton North American Financials Dividend ETF (USD)	(6.3%)	8.6%	-	-	14.1%
S&P/TSX Capped Financials Index	2.2%	22.5%	15.9%	14.6%	17.5%
S&P 500 Financials Index	(1.5%)	14.6%	16.7%	13.4%	17.0%

(1) Returns are for the periods ended March 31, 2022 and are unaudited. The table shows the Fund'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 Fund invests in North American Financial Services companies with market capitalization of at least $5 billion. It is therefore not expected the Fund'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 Fund is calculated after deducting such fees and expenses.

(2) Inception Date October 17, 2018

(3) Inception Date August 8, 2019.

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INTEGRITY
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THE FOUNDATION FOR EXCELLENCE

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