Brompton Flaherty & Crumrine Investment Grade Preferred ETF

TSX:BPRF

Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF

TSX:BEPR

Portfolio Manager Commentary - September 30, 2022

Preferred Market Conditions

Third quarter returns were the least negative of the three quarters year-to-date ("YTD"). However, the past few months were, in some ways, the most volatile of the year. Market sentiment shifted wildly as investors debated scenarios from a pending recession to a possible Fed "pivot" (i.e., a slowdown in policy tightening). The preferred securities and contingent capital (CoCo) market experienced YTD lows in June only to be followed by a sharp rally in July, before slumping once again and reaching new YTD lows in September. The market's evolving views on the economic outlook and inflation, as well as related Fed monetary policy decisions have been the market's primary drivers all year.

Broad measures of inflation rose on a year-over-year basis and remain elevated. Consequently, the Federal Open Market Committee (FOMC) at its September meeting raised its median projection for the year-end 2022 fed funds rate to 4.4%, up from projections of 0.9% as of December 2021. For year-end 2023, the FOMC's median fed funds projections were 4.6% in September 2022 versus 1.6% as of December 2021. The evolution throughout 2022 of these projections reflects the FOMC's determination to bring down unexpectedly higher and broader inflation.

Higher rates have led to substantial price declines across fixed-income and equities, and the correlation across asset classes has been very high. While many investors assumed their investment-grade bond funds would be a safe place to hide from equity volatility or high-yield credit risk, these bond investments are generally down as much or more than sectors like preferreds and high-yield because of their longer interest-rate duration and lower spread in senior bonds at the beginning of this selloff.

Like other credit markets, preferred performance this year continued to be driven by higher interest rates and wider credit spreads—along with broad-market macro factors that accompany most market selloffs, including fund outflows (de-risking), thinner trading markets, and de-leveraging. The benchmark preferred index[1] YTD total return through September 30 was -14.3%. For comparison, over the same period the Bloomberg U.S. Corporate Bond Index[2] total return was -18.7%, the Bloomberg U.S. High Yield Index[3] total return was -14.7% and Bloomberg U.S. Aggregate Index[4] total return was -14.6%.

Outlook

Our credit outlook hasn't changed much, although the Fed's tone and actions certainly increase the probability of a recession. We continue to believe credit quality is a highlight of the preferred and CoCo market, and investors are now earning much higher yields for these credits. Banks remain very well capitalized, highly regulated, and most are asset-sensitive – which means earnings will increase with higher interest rates. Insurance companies have been longing for higher interest rates to boost portfolio yields, and they have finally have arrived. Higher interest rates should also reduce pressure on insurance liability calculations. Energy issuers, pipelines in the case of the Fund's portfolio, have been buoyed by higher commodity prices and potential increases in usage because of a shifting energy landscape. This all stands in contrast to securities of high-yield (junk) issuers, where higher interest rates are likely to be more concerning due to their weaker balance sheets and greater exposure to rising interest costs and slower economic growth.

Unfortunately, our view of credit quality and relative value in preferred securities and CoCo's won't determine the near-term path of markets, as much uncertainty remains for investors, and recent sentiment has shifted decidedly negatively. Investors (financial advisors) are moving to cash to de-risk portfolios, regardless of relative value assessments. For many, it is genuine concern about market direction, but for others they simply cannot stomach additional losses in their portfolios. Outflows across fixed income have led to follow-on effects such as de-leveraging, and in certain cases, bids moved materially lower with each transaction. If there is a silver lining in all this, it is that the market selloff has been mostly orderly and this dramatic shift to negative sentiment and cash likely means the eventual recovery in markets will be similarly dramatic. Of course, the exact timing of that shift is unknown, but it is unlikely to occur while the Fed is hiking short-term rates in 75 or 50 bp increments, which is what the FOMC has penciled in over the remainder of 2022.

Preferred and CoCo issuers, along with U.S. consumers broadly, are in a strong position to weather this storm — but time is the only remedy for macro issues outside the Fed's purview. We admit that holding or adding to investments when markets are lower and sentiment weak can be a difficult task. However, given the rise in rates and spreads that has already occurred this year, we think much of the adjustment is behind us and that today's yields of over 6% (with some issues much higher) offer a foundation for potentially better returns ahead. We believe long-term investors should focus on the benefits that preferred and contingent capital securities continue to offer: moderate interest rate risk, high income, and good credit quality.

Annual Compound Returns[5]	YTD	1-YR	3-YR	5-YR	10-YR	S.I. BPRF[6]	S.I. BPRF.U[7]
BPRF - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD-H)	(15.1%)	(15.1%)	(1.7%)	-	-	1.4%	-
BPRF.U - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD)	(15.2%)	(15.2%)	(0.7%)	-	-	-	0.2%
BEPR - Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (CAD-H)	(21.4%)	(21.6%)	(4.3%)	(0.2%)	4.9%	-	-
ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index	(14.3%)	(14.2%)	(0.7%)	-	-	2.3%	0.0%

(1)The benchmark preferred index is the ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index (P8JC).

(2)The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

(3) The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

(4)The Bloomberg US Aggregate Bond Index is a broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

(5) Returns are for the periods ended September 30, 2022 and are unaudited. The table shows the Fund's compound returns for each period indicated compared with the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index ("Preferred & Jr Subordinated Securities Index"), (the "Index"). The Preferred & Jr Subordinated Securities Index tracks the performance of US dollar denominated high grade and high yield preferred securities and deeply subordinated corporate debt issued in the US domestic market. Qualifying securities must be rated at least B3, based on an average of Moody's, Standard & Poor's and Fitch and have a country of risk of either the U.S. or a Western European country. The Index is 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. Past performance does not necessarily indicate how the Fund 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 Fund.

(6) BPRF inception date October 15, 2018.

(7) BPRF.U inception date August 8, 2019.

BROMPTON FUNDS

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