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Executive Summary

2009 Fall Outlook

Stewart Hunt — Managing Director, Portfolio Advisory Group

As we move into the final quarter of the calendar year we have definitely witnessed the remarkable resilience of investors and the markets. After driving prices lower at the beginning of the year on fears of a global depression the equity and bond markets came off the mat to provide investors with positive returns. Currently, the global economy is beginning to show signs of growth aided by the fiscal actions taken by governments and central banks providing stability to the financial markets. Since the spring our Portfolio Strategist Vincent Delisle has been recommending being overweight equities and cash versus bonds. This strategy has paid off even though Delisle has noted that institutional and retail investors have still been sitting on significant amounts of cash. With only a quarter left in the calendar year institutional investors who have been sitting on cash earning sub market returns will be faced with having to invest to try and gain the market returns they have missed. As a result, we anticipate the market to continue to maintain positive returns into the year end. While Delisle does see the equity market overbought he does not see it overvalued based on potential earnings as the economy moves from recovery to growth. With the Bank of Canada committed to maintaining a low interest policy we would recommend investors mobilize their cash and take advantage of higher returns provided by equities and corporate bonds.

Here are some of the highlights of the Fall 2009 IPQ;

- Scotia Capital Portfolio Strategist Vincent Delisle, from an asset allocation perspective, continues to recommend being overweight equities and cash and underweight bonds; although in the bond sector Delisle would be overweight corporate bonds and underweight government issues. In the equity market Delisle expects the cyclical sectors to outperform defensive stocks as he believes the depression risk has gone and the economy is recovering from a very deep recession that will support cyclicals. In addition, Delisle notes the amount of cash sitting on the sidelines yet to be deployed would provide support to any significant correction as any market decline will be treated as a buying opportunity.
- Our Scotia Capital Economics Team Derek Holt, and Karen Cordes, highlight being overweight Canada within a global investment portfolio. They note some issues Canada may face in reduced domestic savings as the result of the Canadian dollar moving towards parity against the US, our largest trading partner. However, our resilient domestic economy, low interest rate environment, significant cash holdings and better corporate balance sheets all make Canada an attractive investment.
- Canadian Equity Advisor Gareth Watson sees Canada as a great place to invest. Watson notes the strengthening Canadian dollar and the global economic recovery driven by commodity hungry emerging market countries as providing underlying demand for cyclical stocks in Canada. As result, Financials, Energy, Materials, Technology, Consumer Discretionary and Industrials are all sectors that should benefit.
- Paul Danesi, our U.S. Equity Advisor, makes a case for U.S equities noting that with the U.S. government maintaining a stimulative low interest rate environment and loads of cash sitting on the sidelines the trend for the market remains up. Danesi notes that if economic growth and corporate profitability rise in 2010 the current valuations are neither cheap nor expensive but fairly valued. Danesi sees cyclical stocks leading the way with some of his top picks being McDonald's (MCD), Nike (NKE), Apple (AAPL) and Fluor (FLR).
- In our feature article Joey Mack, Director, Portfolio Advisory Group Fixed Income Trading and Sales, provides an introduction to high yield bonds as an asset class. With the conversion of the income trusts into corporations in 2011 we anticipate an increased demand from investors for higher yielding securities and thus the potential growth for high yield bonds. Mack highlights the key characteristics, reasons to buy, key risk factors and investment strategies when considering an investment in high yield bonds.

- Tara Quinn, Portfolio Advisory Group Preferred Share Analyst, provides her thoughts on whether Canadian investors are ready to buy more straight perpetual preferred shares. Quinn takes the time to review the structures and considerations investors should make when looking at adding perpetual preferred shares to an investment portfolio.
- Carolyn Tsai, Senior Analyst, Portfolio Advisory Group Fund Research, has created an educational piece to assist investors in selecting the right mutual fund. With over 5,000 mutual funds to choose from in Canada finding the right fund can be daunting and difficult. Tsai provides the methods she and the fund research team use to select funds for their market leading mutual fund recommended list.
- Adam Salahudeen, Senior Manager, Taxation Advisory Services, provides an update on the Home Renovation Tax Credit (HRTC). Salahudeen provides guidance on eligible dwellings for the purpose of the HRTC, allowable and eligible expenditures, how to claim HRTC and what the Canada Revenue Agency (CRA) will consider as acceptable documentation for claiming the HRTC.
- In conclusion, Steve Uzielli and Chris Kennedy provide their quarterly review and commentary on the performance of the Equity and Fixed Income Guided Portfolios.

Our Fall 2009 edition of Investment Portfolio Quarterly (IPQ) is designed to provide you with ideas to activate your cash or diversify your portfolio. This is a great time to be contacting your advisor to determine what investments best suit your financial needs.

Stewart Hunt

Portfolio Strategy

Strategy View Unchanged: Stick With Equities and Corporate Bonds

Vincent Delisle — Portfolio Strategist, Scotia Capital

We believe the worst of the global recession is behind us and expect global growth to pick up in the latter half of 2009. Under this scenario, equities, cyclical sectors, and corporate bonds should extend their year-to-date leadership. The U.S. leading indicator (LEI) is up 8.9% on a six-month annualized basis and the OECD leading indicator is posting a 9.3% jump, both pointing towards a dynamic rebound in economic activity over the next six to nine months.

The first three months of the year represented the worst phase of this recession, and most indicators bottomed out in the second quarter. Identifying when the worst is over, not when the recession is over, has been key in establishing our optimistic and successful 2009 Portfolio Strategy thesis. Admittedly, the macroenvironment remains filled with structural challenges that will have implications on the potential and durability of the recovery. Nonetheless, we believe current perceptions – not to mention defensively positioned portfolios – may still be underestimating the 2010 potential for profit growth. The economic recovery may be sub-par, but the leverage on corporate profits may still positively surprise. In our opinion, improving news will translate into funds flows being reallocated into equities, thus sustaining additional gains.

Risks of a double-dip recession (the W-scenario, i.e., another recession in late 2010/early 2011) will intensify if companies and consumers do not sustain the recovery past Q1/10. What these post-2010 recovery risks imply, however, is how investors will need to adopt a more tactical approach to their strategy, rather than sticking to one longer-term/buy-and-hold view. Leadership phases between cyclicals and defensives will be shorter and swing back and forth until monetary and fiscal policies are normalized. This could take a decade. Consequently, the S&P 500 will likely evolve in a wide trading range over the next five years with the 1,200/1,300 levels potentially representing the top of the range. Hence, when markets start pricing a normal environment again, a more cautious bias will become warranted.

Normalization Phase Not Over

Last year's spike in risk premiums and the substantial decline in equity indices were based on fears of depression-like scenarios. Since March, the depression discount has been taken out, and risk has been repriced favourably for equities and corporate bonds. In our opinion, the normalization phase is not over yet. With the S&P 500 hovering near the 1,050 level, we still see earnings upside even under the "muted" recovery scenario. When markets start pricing in US\$80+ earnings and monetary/fiscal policies reverse course, we will grow more sceptical.

Migrating Fair Values

The S&P 500 is up 18% since the Golden Cross (50-day moving average crossing the 200-day moving average on the upside) was confirmed on June 23. History shows that returns post-Golden Cross (GC) are superior to returns pre-GC. From March 9 to June 23, the S&P 500 advance was 32%. More importantly, achieving GC status typically implies equity markets are back in a higher-high/higher-low environment where investors want to buy the dips.

Based on our valuation models, both the S&P 500 (1,010) and U.S. 10-Year Treasury yields (3.3%) currently appear fairly valued. Looking at the trend in leading indicators (U.S. LEI +8.9% on a six-month annualized basis), we believe upcoming changes in the 2010 macro landscape (rising earnings, declining jobless claims, core CPI rebounding) could take the S&P 500 fair value above 1,200 versus 4%+ 10-year bond yields. Hence, migrating fair values should favour the S&P 500 as 2010 improvements are priced in.

We will likely go through a “show-me” period in Q4/09 where any delay in the U.S. economic rebound will hurt equity sentiment. The S&P 500 has been in euphoric/overbought territory since mid-July and pullback risks remain if the string of better-than-expected macroeconomic data takes a pause. The ‘USD down/CRB up’ trade was probably the most extended one. Near term, investors could be disappointed by the intensity of the economic rebound and the sell-off could continue. Any pullback should remain muted, however, much like the one encountered in late June (S&P 500 was off 7% from June 12 to July 10). We would expect indices to find support closer to their 50-day MA (1,017/S&P 500; 10,950/TSX).

Still Lots of Cash

Cash sitting on the sidelines, both at the investor and company level, continues to be an important factor behind our positive 2009 equity view. Assets have been shifting back towards riskier assets since the spring, but we believe the intensity will accelerate as positive coincident data hits headline news over the next six months. Companies will also look to redeploy their cash, either through M&A or buybacks, as management teams go from deep-recession-contingency plans to grow-and-gain-market-share objectives.

Our 2009 strategy theme of overweighting cyclical assets remains unchanged. In our opinion, the risk-reward profile for equities remains appealing and we expect improving data to provide support in coming months. Equity indices could post 10%-15% total returns over the next 12 months versus low single-digit returns for government bonds and Cash. Corporate bond performance should hover in the 6%-8% range as spreads continue to improve (Exhibit 1).

On the equity side, our global bias remains unchanged: overweight America (North and South) and Emerging markets, underweight Europe and Japan. From a sector standpoint, earnings momentum has materially shifted away from defensive sectors since March and has been favouring cyclical segments of the market. U.S. Energy, Materials, Discretionary, Financials, and Technology are posting superior relative earnings momentum. Our Sector Strategy continues to be geared towards Cyclical sectors.

Exhibit 1: Equities, Bonds and Cash: Year-To-Date Performance & Projected Returns			
Asset	Performance (TR; %)		
	YTD	Last 12-M%	Expected Next 12-M
Cash	0.5%	1.3%	0.5%
Bonds	5.6%	10.3%	0-5%
<i>Government</i>	2.2%	8.8%	0%
<i>Corporate</i>	15.1%	14.8%	6-8%
Equities			
<i>S&P/TSX</i>	30.0%	0.5%	10-15%
<i>S&P 500</i>	19.3%	-6.9%	10-15%

Source: Scotia Capital Estimates

Exhibit 2: Scotia Capital Recommended Asset Mix – Fall 2009				
	Asset Mix		Change from Last Quarter	Performance YTD (TR) %
	Benchmark	Recommended		
Equities (TSX)	60%	68%	0%	30.0%
Bonds	38%	28%	0%	5.6%
<i>Government</i>	28%	15%		2.2%
<i>Corporate</i>	10%	13%		15.1%
Cash (91-D Tbills)	2%	4%	0%	0.5%

Source: Scotia Capital

Exhibit 3: Scotia Capital Equity Mix – Fall 2009

	Equity Mix		Change from Last Quarter	Performance* YTD (%)
	Benchmark	Recommended		
TSX	20%	24%	0%	27%
S&P 500	30%	30%	0%	17%
Int'l (Europe+Japan)	30%	23%	0%	26%
Emerging Markets	20%	23%	0%	61%

Source: Scotia Capital Estimates

*ex-dividend performance is in USD, except for the TSX. International performance based on the MSCI EAFE index.

Exhibit 4: Scotia Capital Sector Allocation – Fall 2009

	Global		U.S.		Canada	
	MSCI World	Scotia	S&P 500	Scotia	S&P/TSX	Scotia
Energy	12%	14%	12%	13%	27%	29%
Materials	8%	8%	4%	3%	18%	15%
Industrials	10%	12%	10%	12%	5%	7%
Consumer Discretionary	9%	11%	9%	11%	4%	5%
Consumer Staples	9%	7%	12%	9%	3%	2%
Health Care	8%	6%	13%	12%	0%	0%
Financials	23%	25%	15%	17%	32%	35%
Technology	10%	11%	19%	21%	4%	4%
Telecom	6%	6%	3%	3%	4%	3%
Utilities	5%	3%	4%	2%	1%	1%

Source: Scotia Capital

*TSX Materials recommendation reflects underweight gold stance. TSX Gold represents 55% of TSX Materials Index.

Economic Outlook

Over-weight Canada – Or at least some of it

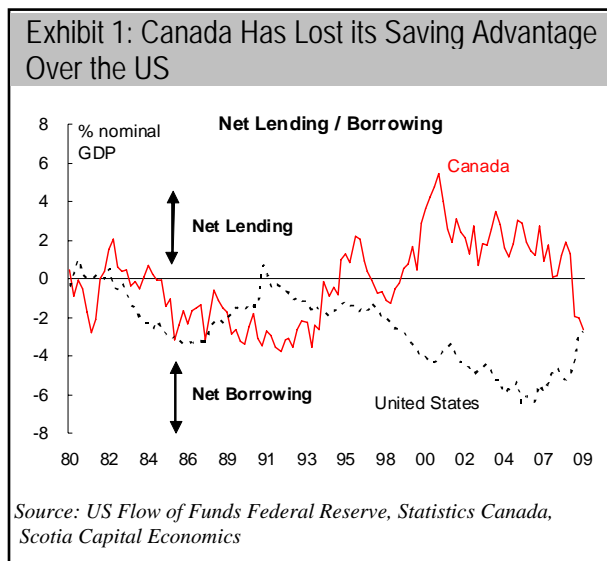
Derek Holt, M.B.A., CFA - Vice-President, Scotia Capital Economics

Karen Cordes, M.A. – Financial Markets Analyst, Scotia Capital Economics

All the world is blindly in love with Canada, but investors need to be choosy in deciding which among the gifts of courtship to embrace as the forces of recovery will work their way unevenly through the economy and markets. Indeed, the investing advice that falls out of our macroeconomic views is heavily shaped by the fact that Canada is a nation of twin economies, each subject to divergent prospects. Massive liquidity stockpiles, prospects for commodity price gains on lean commodity inventories and recovering demand, and the offsetting disinflationary effects of a strong Canadian dollar translate into powerful developing forces that are guiding the Canadian consumer and interest-sensitive sectors as we continue to recommend over-weighting Canada in global portfolios. But the fact that structural imbalances in the US economy are being painfully exported to become Canada’s twin fiscal and trade deficits cautions against exposure to manufactured exports, tourism and hospitality-related sectors.

Canada is Importing the U.S. Saving Disease

The macroeconomic trend illustrated in Exhibit 1 is one of the most important in shaping the outlook of Canada and the US relative to one another. In a very broad macroeconomic sense, the US is solving its structural imbalances on the backs of its trading partners such as Canada. As the US position of being a net borrower diminishes back toward balance and away from the peak degree of reliance upon foreign

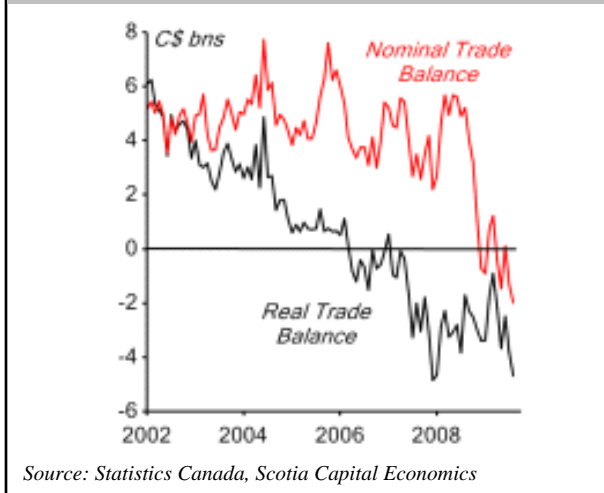


borrowing that had occurred over the 2003-07 period of leveraged excesses, Canada’s status as a net lender to the world during that period has now been lost. Large fiscal deficits in the US are being funded by higher personal saving, a recovery in corporate profits that is motivating corporate saving through retained earnings, and through a dramatic reduction in demand for funds as the US unwinds its leveraged investment bubble. Thus, despite huge fiscal deficits that will peak over the next year, the holistically-defined, economy-wide US reliance upon foreign funding is rapidly diminishing.

What this chart pointedly demonstrates is that Canada’s twin surpluses of yesteryear owed themselves less to Canadian frugality and more to the dissaving of the US economy that created strength in Canadian exports and government

finances that rode the revenue wave of economic strength tied to the US economy. In essence, Canadian saving looked good because of vast sums of US dissaving. As the US economy now transitions from a very advanced state of supply-side deleveraging through still-early demand-side deleveraging, the effects are likely to be a sustained period of twin deficits in Canada through less demand for our exports and structurally weakened government finances. Canada’s inability to grow adequate domestic saving means that this net shortfall of funds to finance Canada’s trade and fiscal deficits will have to be provided by foreigners. The country’s net foreign debt ratio is therefore about as good as it gets.

Exhibit 2: Canada Trade Weakness



Challenged Exporters

One part of this broad national shift is reflected in Canada's weakened export picture. Canada's strong trade ties to the United States and an elevated CAD are hammering its export competitiveness. Going forward, our forecast for sustained CAD parity in 2010 will continue to exert downward pressure upon the country's export competitiveness.

Indeed, the latest readings confirm ongoing trade sector weakness. Canada's trade deficit in volume terms sank back to its end of 2008 depths (Exhibit 2). The dollar value of the trade deficit that also takes prices into account was the worst on record. A whopping 5% decline in export volumes after controlling for price effects drove the deterioration, as

import volumes only fell by 0.3%. Going forward, it is hard to see this picture materially improving. A strong Canadian dollar will motivate more imports that are a leakage of economic activity from the country. Further, even a bullish commodity price forecast will not solve the fact that at the heart of Canada's trade woes is a structural volume-based shortfall in US demand. As evidence of this, the latest export figures fell 5% entirely through lower volumes as prices were unchanged. In dollar terms, the drop in exports was focused on machinery and equipment (-10.4%), agricultural and fishing (-10.3%), automotive (-5.5%), other consumer goods (-4.2%), industrial goods and materials (-3.3%) and forestry (-3.4%).

Of added complexity to Canada's trade sector is that it is so, very, undiversified. Other commodity-dependent nations like Australia are far less exposed to a fragile US economic recovery. Australia's trade exposure is mostly pointed towards Asia, with only a tiny fraction of its exports going to the US (Exhibit 3), whereas Canada sends 75% of its exports to the US, the epicentre of global deleveraging (Exhibit 4). Furthermore, the share of Australian exports headed to China has jumped markedly over just the past year.

This means that Canada is more heavily exposed to our double-dip fears for the US economy. That's true whether double dip means outright GDP declines, or double dip like the Scotia Economics base case that sees a temporary growth spurt to the 3-4% range for a couple of quarters then followed by 2-2.5% growth. Lastly, whereas the strong Australian dollar is of little concern to the RBA's decision to recently hike interest rates, Canadian dollar strength is front and centre on the minds of the Bank of Canada as a drag effect on growth.

Exhibit 3: July 2009 Australian Exports, % Share

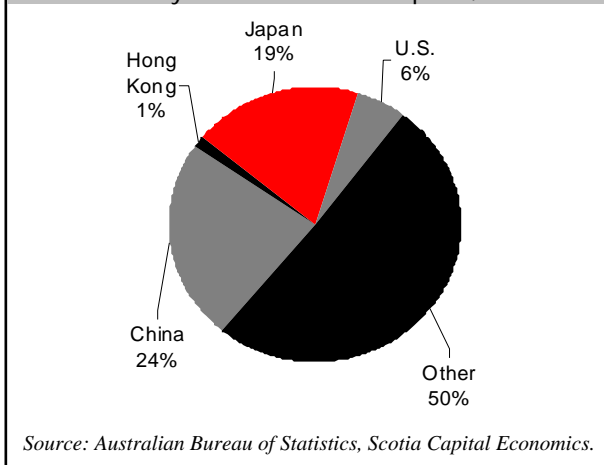


Exhibit 4: July 2009 Canadian Exports, % Share

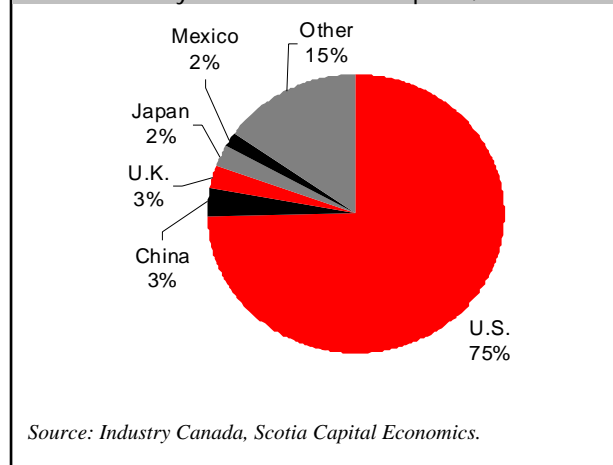
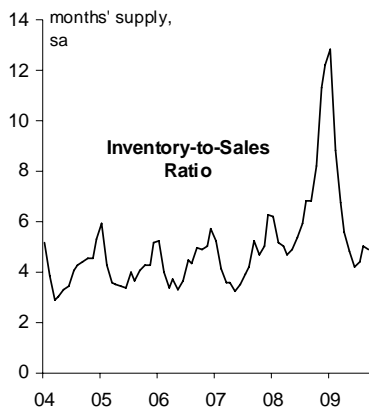


Exhibit 5: Canadian Resale Housing Market Has Rapidly Cleared



Source: Conference Board of Canada, Scotia Capital Economics

Resilient Domestic Economy

But Canada’s domestic economy remains fairly resilient. Nowhere is the resilience in the domestic economy more evident than in the recent performance of the housing and job markets. The nation’s housing market has rapidly swung toward balanced inventories after the huge overhang of unsold homes at the start of the past year (Exhibit 5). Two consecutive months of solid job growth have been much stronger than expected, and hours worked are growing even more rapidly as the recent gains have been in full-time jobs.

Low Interest Rates for a Long Time is the CAD Silver Lining

This dilemma of a decent domestic economy versus ongoing trade weakness is what will keep the Bank of Canada sidelined without materially altering short-term interest rates for a long time yet. The Canadian dollar’s elevated value reinforces this observation since it will continue to put downward pressure on inflation via the effect of lower import prices being passed through to consumers. As Exhibit 6 demonstrates, imported goods play a greater role in Canada’s consumer spending and investment spending than in many other industrialized nations and the majority of these goods come from the United States. A strong CAD is thus broadly disinflationary. The inflation-targeting BoC is not likely to hike on job or housing reports versus further emphasizing its CAD worries. This will push off the point at which interest-sensitive market sectors face the risk of rising interest rates, thereby enabling financials to remain focused upon revenue growth prospects.

Exhibit 6: C\$ Appreciation is Broadly Disinflationary

Components of final demand	Import Propensity (%)
Personal expenditures on:	
-food, beverages, and tobacco	31.9
-electricity, natural gas, and other fuels	20.3
-other non-durable goods	24.5
-semi-durable goods	40.5
-motor vehicles, repairs, and parts	55.6
-other durable goods	47.2
-services other than rent	17.8
-paid and imputed rent	8.7
Investment in:	
-residential structures	21.0
-non-residential structures	23.9
-machinery and equipment	71.7
Government expenditures on goods and services	10.9
Government gross fixed-capital formation	36.9
Exports of goods and services	34.3
Investment in inventories (year-over-year difference)	35.0
Total demand	29.3

Source: Bank of Canada, 2005.

Source: Bank of Canada

Canadian Households Sitting on \$1 Trillion in Cash

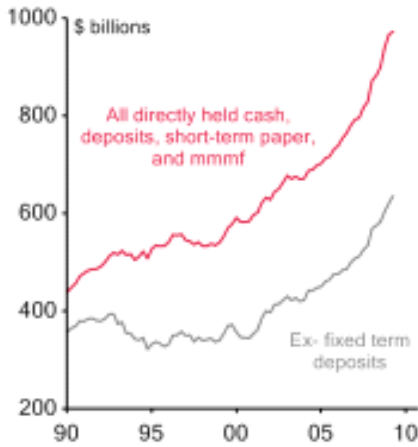
Now notwithstanding the broad macroeconomic trends in play, there is added reason to be bullish on some aspects of the Canadian economy and markets. What further amplifies the insulating factors in the

domestic economy is that sidelined Canadian liquidity is enormous. We’re not convinced that all comes rushing back into the markets, but some of it will while the remainder serves as a significant support to Canadian household and business finances.

Exhibit 7 depicts the direct cash holdings in the Canadian household sector. They are simply and astoundingly massive.

To get the total, we’ve added currency holdings, chequable and non-chequable deposits at all financial institutions in both C\$ and other currencies, direct holdings of short-term paper, and indirect holdings of cash through money market mutual fund assets. The top line in the chart is the grand total, and equals C\$972 billion as at 2009 Q2, or close to \$1 trillion and perhaps over that now.

Exhibit 7: Canadian Household Cash Holdings



Source: Statistics Canada, Bank of Canada, Scotia Capital Economics

Fixed term deposits, however, are not fully liquid and so we strip them out of the tally in the lower line on the chart. That still yields a figure equal to \$635 billion. The true, fully liquid cash holdings of the household sector are somewhere in the middle, but we cannot break down fixed term personal deposits into maturities of under one year, and over one year so as to include only those under one year. Since our aim is to consider the liquid cash holdings over which households have direct control, we have also excluded cash holdings at non-money-market mutual funds, and pension funds.

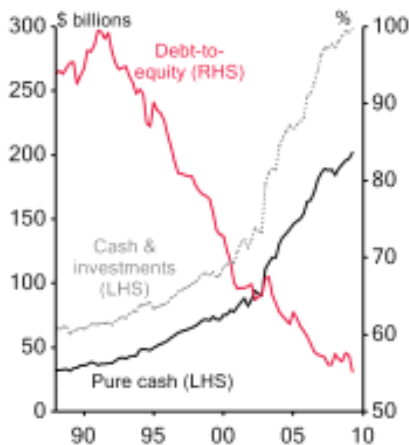
Regardless, the point is that after having been largely flat through the 1990s, cash and near-cash holdings have taken off this decade. Two particular slope shifts have occurred, one after Y2K, the dot-bomb bubble, and 9/11. The rate of cash accumulation then accelerated further after mid-

2007. Thus, this is not a new phenomenon owing to, say, direct or indirect effects of liquidity tools employed by monetary policymakers. There are multiple drivers, but we think the dominant one is excessive complacency and risk aversion on behalf of households when managing their finances. Large cash holdings at a particular point in time may make sense if one is bearish, but sustained over many years is difficult to justify. Some of the motive for increased cash holdings is understandable given all of the shocks of recent years, but regardless of what one thinks of the causes, the outcome is indisputable.

It's also useful to put such holdings in perspective by comparing them to appropriate benchmarks. The narrower measure of cash and near-cash holdings that excludes all fixed term deposits equals 40% of total Canadian equity market capitalization, 9% of total household sector assets, 46% of their total liabilities, two-thirds of their after-tax incomes, and nearly 70% of consumer spending.

Canadian Corporate Balance Sheets in Excellent Shape

Exhibit 8: Strong Canadian Corporate Balance Sheets



Source: Statistics Canada, Quarterly Survey of Financial Statements

The cash supports to the economy and markets go beyond just the household sector. Since the end of 2002, cash holdings at nonfinancial Canadian corporations have sharply improved (Exhibit 8). Direct cash holdings have more than doubled over this period to C\$200 billion, while holdings of cash and portfolio investments have also more than doubled to C\$300 billion. Some of this cash war chest may be a positive for M&A activities, but there are three caveats to this interpretation. First, borrowing and other current liabilities have risen significantly over this period. Cash holdings have risen faster, but not all of this is available for M&As. Second, cash holdings are likely to be partially preserved as a safety buffer given uncertainties over the near-term outlook. Finally, other uses could well include higher dividends, capital structure changes, or continued pay-down of relatively higher-cost business loans particularly given relatively tighter credit conditions.

More important, however, is that relatively high cash holdings combined with a much lower debt-to-equity ratio than during Canada's great leveraging period in the early 1990s mean that Canadian corporations are in much better financial health this time around as we've often argued.

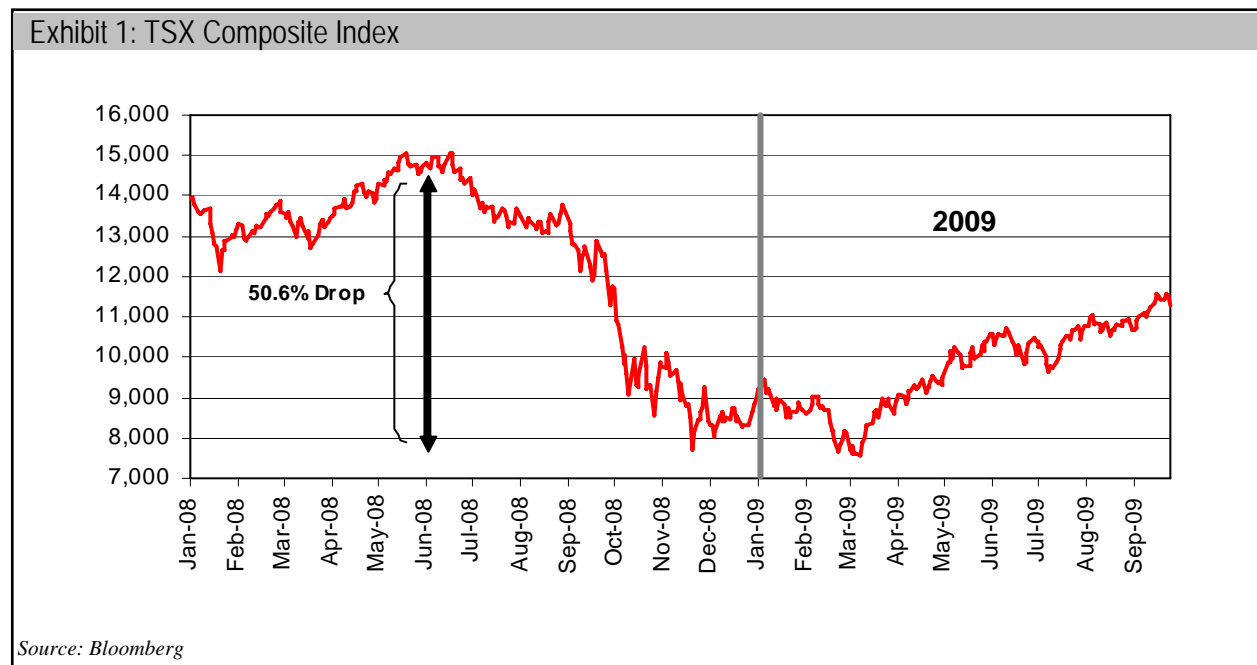
Thus, the broad forces in play in this recovery will unevenly move through both the Canadian economy and markets with vastly different growth prospects across various sectors of the economy.

Canadian Equity Strategy

Canada – Still a Great Place to Invest

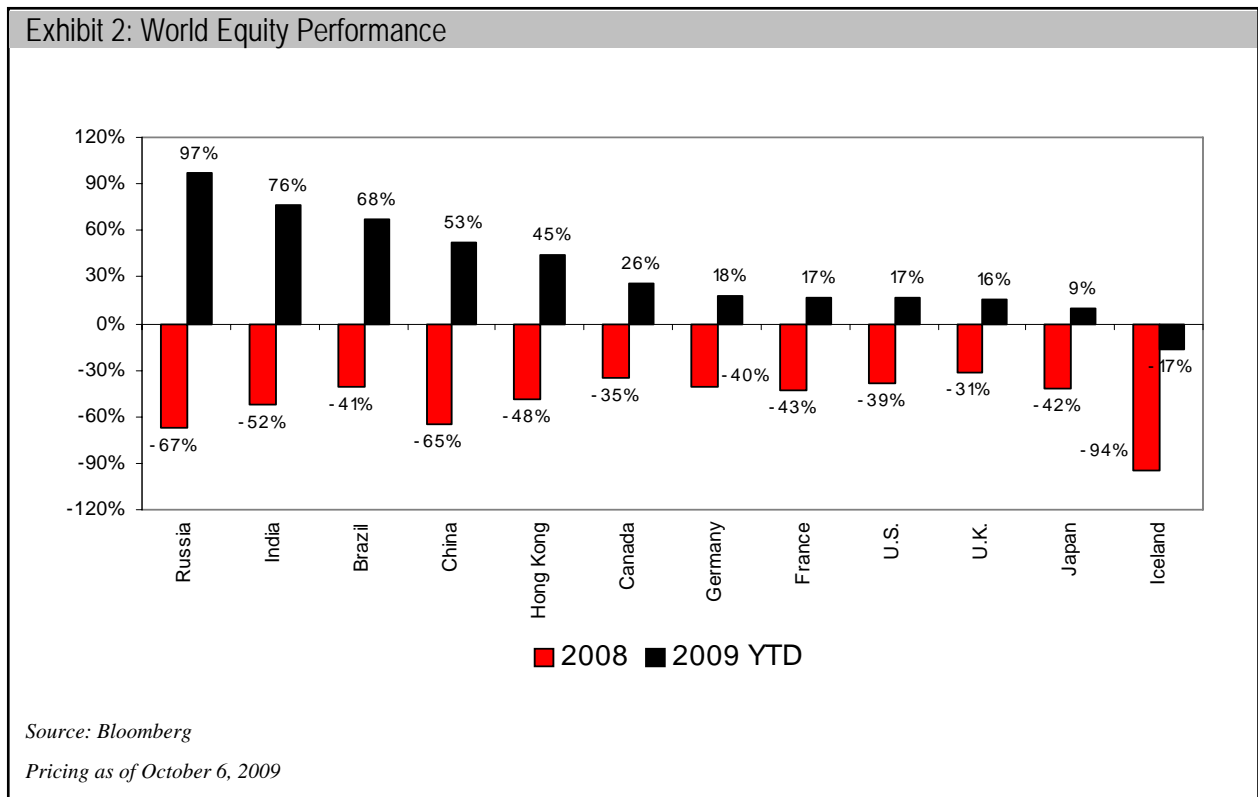
Gareth Watson, CFA — Director, Portfolio Advisory Group

After a rocky first quarter of 2009, Canadian equity markets appreciated by 19% in the second quarter and continued to post impressive returns in the third quarter by adding another 9.8% bringing year-to-date gains to the 26.8% level. Over 90% of these gains have come from the three highest weighted sectors in the TSX Index including Financials, Energy and Materials, thus indicating that investors expect signs of economic recovery already witnessed will only strengthen. While we had indicated in our last quarterly publication that it appeared as though the market was sprinting to start a marathon, it would appear as though the economy and investor confidence are much stronger than we thought. Stock markets are always forward looking, so if we're posting solid gains today it can only be a reflection that the economy will encounter fewer obstacles on the road to recovery than some skeptics might have believed. Below we show the performance of the TSX Index going back to the beginning of 2008 where we illustrate both the recent highs and lows of the market over the past 21 months. While we are certainly nowhere near the 15,000+ peak reached in June of 2008, it is clear that investors are no longer as risk averse as they once were at the beginning of the year as approximately 50% of the peak to trough drop has been recovered.



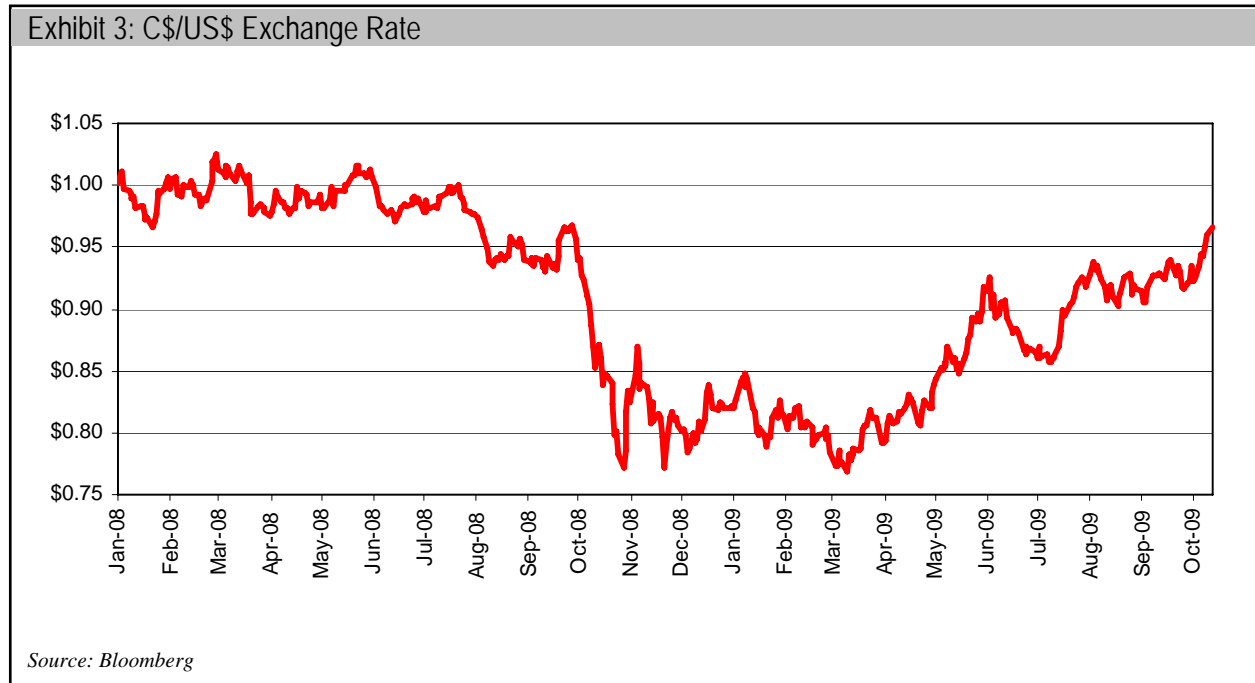
In the past we have provided you with some larger macroeconomic arguments in the opening of this quarterly article; however, since those arguments really haven't changed much we will instead provide you with some observations as to what we are currently witnessing from an economic and market perspective:

- Equity markets worldwide have rebounded nicely off their lows. Canada is not alone as the emerging BRIC (Brazil, Russia, India and China) markets have lead major market returns in 2009. While lagging these markets considerably, the TSX Index has provided the best equity market returns this year amongst the G7 Industrialized nations.



- The worst of the credit crisis is likely behind us, but problems will persist for years. A real estate crisis ballooned into a corporate credit crisis and is now a consumer credit crisis south of the border. While the absolute worst of the credit crisis is likely over, we will feel remnants of it for years to come and especially as governments and central banks continue to provide life support to the global financial system.
- Government intervention/rescue/stimulus appear to have averted a depression. We can argue about the policies that were used or the dollar amounts involved, but simply put, intervention saved us. Now we just need to see the global economy get back to a self sustaining level without the need for intervention.
- Canadian interest rates are at all time lows and will remain there for months. While this is good news for individuals that want to borrow and can get access to such credit, it is also remarkably clear that over the next few years interest rates have nowhere to go but up. Variable costs of borrowing will eventually increase.
- Emerging markets are recovering more quickly as producers replenish inventories. Before the western world can consume goods and services, the emerging markets have to produce them in the first place. Therefore, it is only logical to see the emerging markets improve economically before the western world follows.
- The western world consumer appears to be saving rather than spending – unemployment is still high and U.S. housing prices are still low. These factors do not create an environment ripe for consumption; therefore the global recovery is not without its challenges.
- The recession may technically end in the third quarter for North America, but the recovery could be sluggish if the consumer does not pick up his/her rate of consumption. The specific time the recession ends is irrelevant, how we position ourselves for the recovery is what’s important.
- U.S. dollar weakness has pushed commodity prices higher and speculators have returned to markets they briefly abandoned. Fundamental analysis of commodity prices can become meaningless when commodities are used for investment rather than consumption.

- As long as commodity prices rise and Canadian consumers maintain their wealth/equity, the Canadian economy has the potential to outperform the United States over the next year and the Loonie will be a “go to” currency for global traders.
- Canada emerged as a winner during a difficult time. Not only has our financial system withstood the blows of the credit crisis, our federal and provincial governments are holding in much better than our counterparts in the United States. While deficits are certainly a reality this year, those deficits in relative terms to our debt are still manageable.



With those broader macroeconomic observations in consideration, let's take a look at the Canadian stock market.

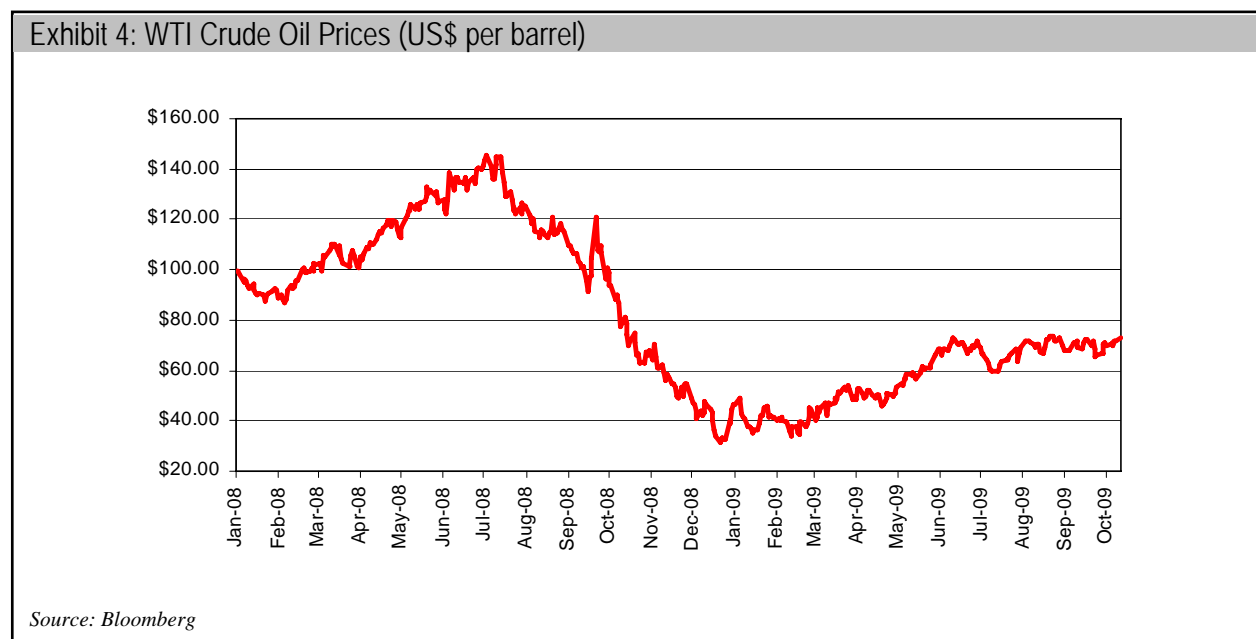
Financials

In our last quarterly publication we noted that earnings out of the Canadian banks provided further evidence that they were in better financial position than their international peers, that dividend policies were not in jeopardy, that risk was managed more appropriately in Canada, and that Canadian banks were profitable in a difficult economic and financial environment. Yet another earning season has come and gone and our comments from last quarter can only be echoed. The Canadian banks continue to execute well and their financial strength has only improved. In fact, one could easily argue that capital levels at the Canadian banks are too high and that shareholders are not earning enough return for the extra capital that has been raised over the past 10 months. It is for this reason that we believe the banks may make acquisitions over the coming year or return some of that capital to shareholders in the form of share buybacks or even dividend increases. Yes, that's correct, I said dividend increases. While some investors fretted at the prospect of dividend cuts last February, we cannot rule out the possibility that shareholders could see a return to dividend increases over the next year if the banks can't find a more efficient use for their capital. While the operating environment for the banks still remains challenging as the world tries to emerge from a recession and while credit concerns still linger, their diversified revenue streams have provided stability and should continue to do so for the foreseeable future. In addition, Scotia Capital bank analyst Kevin Choquette believes that we may have seen the peak in loan loss provisions for the current cycle and if this is true then Canadian banks can only benefit as earnings leverage will increase. While it is conceivable that the Canadian banks could fluctuate in price over the coming weeks leading into their next reporting season, we are bullish on the Canadian banks and encourage investors to maintain their banks holdings as long as their weightings within their portfolio are appropriate.

On the other side of the financial equation are life insurance companies such as Manulife Financial (MFC), Sun Life Financial (SLF) and Great-West Lifeco (GWO). These companies have not been treated as well as the Canadian banks over the past year as depressed equity and credit markets resulted in many writedowns. Furthermore, investors were not amused by the surprising dividend cut out of Manulife. However, following such a difficult year for this industry, are these companies bad investments? We would say no and would actually conclude that their recent weakness is a long-term buying opportunity. The market is so distracted by offsetting credit losses and recent equity gains that it may be losing sight of the underlying insurance business which is holding up reasonably well in a difficult financial environment. Eventually the credit losses will come back down to normal levels and investors will once again focus on the ongoing operations. When they do that, we believe they'll like what they see, especially as companies such as Manulife and Sun Life look to grow in emerging markets in Asia. Such transformational growth will take time to achieve, but it would appear as though the seeds for growth are being sown as these companies try to diversify away from the more mature North American market. We are bullish on the Canadian life insurance industry and while we recognize that we may see a few more bumps in the road in this cycle, we believe long-term investors will benefit from purchases in this sector today.

Energy

It is no secret that in our last quarterly publication we expressed some reservation about oil prices around US\$70.00 per barrel from a fundamental perspective. While prices have not pulled back to a great extent, they haven't appreciated much either even with further U.S. dollar weakness. In fact we basically find oil prices right where they were at the end of the second quarter. Perhaps this is a recognition that oil prices were too high, but investors were too reluctant to sell in case the rally was to continue. What is obvious is that speculators have returned to the market and that financial investing is possibly outweighing physical purchases. We won't repeat our argument yet again when it comes to the short-term outlook on oil. We still believe that inventory levels are too high and that demand is not strong enough yet to justify where oil prices trade today; however, as I've mentioned, markets are forward looking so perhaps speculators are telling us we have some good economic times to look forward to over the next six months. In the short term, barring any unexpected major supply disruptions, economic uncertainty and high inventory levels will likely limit near-term gains in the price of oil. However, over the long term there is a good possibility that consumption will outpace production growth which will put upward pressure on oil prices and there will be a greater reliance on unconventional resources going forward. With increasing wealth and accelerating energy use in high population countries, oil demand will likely remain concentrated in developing countries as the global economy improves.

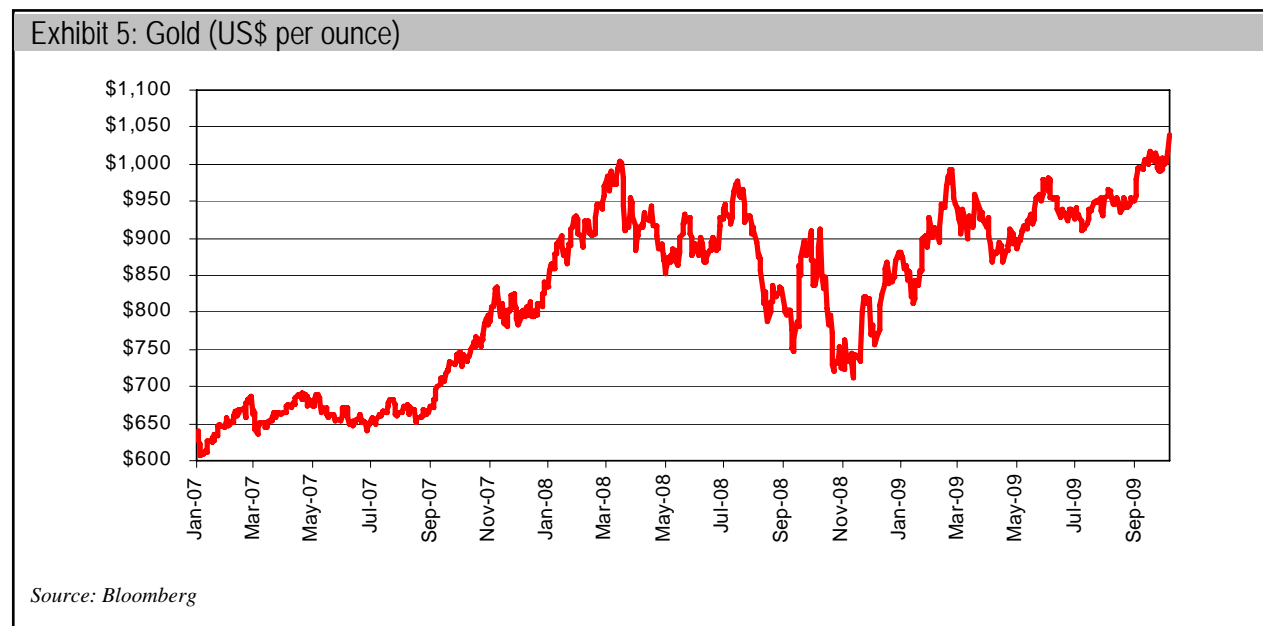


Natural gas prices look even worse on a near-term basis than oil prices as inventories continue to rise. Increasing supply will continue to be a dominating theme for the commodity. Aside from high inventory levels, the onslaught of liquid natural gas (LNG) supply and emergence of shale gas will prove to be major headwinds for natural gas prices going forward. However, at some point natural gas prices will revert back to their marginal cost of production which will help normalize them over the long term. With this in mind there may be an opportunity at current gas price levels for long-term investors; however, we think those long term opportunities are greater with investments in crude oil at this time.

Materials

Base metal equities have behaved in a similar fashion to energy equities in that they're both sensitive to the global economic recovery; therefore, most of what we've argued above for oil is similar to what we'll argue here for base metals. While base metal prices have appreciated over the past quarter thanks to U.S. dollar weakness and speculative premiums, fundamentally speaking we are not convinced that supply/demand fundamentals are strong enough to justify such increases in the short term until we see an increase in U.S. consumer spending which has yet to materialize. In fact it's interesting to note that as prices for aluminum, copper, nickel and zinc increased over the past three months so too did their inventory levels at the London Metals Exchange. Either prices will have to come down if inventory levels continue to rise or consumption will have to increase to draw down those inventories and justify current pricing. However, with our short-term caution we also recognize that it is possible to see additional strength in this sector over the next six months if the economic recovery is greater and faster than expected. The emerging markets are starting to show signs of life again and they will be the first to pick up their demand of raw materials, but the western world will eventually have to follow. Longer term, the supply concerns we raise above for oil could become prevalent for base metals as well. It is for this reason that our short-term concern becomes more constructive for longer-term investors.

Last quarter we noted that we were happy to see gold prices weaken in the second quarter as it would give investors another opportunity to buy in to the sector at cheaper prices. Considering that we've just hit an all time high for gold prices, we feel our comment from last quarter has now been vindicated. U.S. dollar weakness has been our justification for owning gold in 2009 and into 2010 and that view is unchanged. One day the U.S. dollar will eventually rebound more sustainably but we do not believe that time is now. In addition to U.S. dollar weakness acting as a driver for gold prices, we have now entered the seasonally stronger time of year for gold from a physical perspective. While we are not the gold bugs that believe prices are going to US\$4000 an ounce, we do believe that we have more upside in this current cycle and that a price between US\$1100 and US\$1200 in the next 6 to 12 months is not unreasonable.



When an investor puts money into fertilizer stocks, they must understand that there are many short-term factors that can impact grain prices and thus fertilizer equity prices. Weather is the most influential amongst them, so it's always wise to have a long-term investment horizon when purchasing stocks in this sector. Not much has changed in the past three months when it comes to our outlook for fertilizers as we continue to believe the supply/demand fundamentals for food on this planet help support fertilizer stocks over the long term even though many bumps in the road are likely along the way. Just like other commodity related stocks we've discussed thus far, the short-term performance for fertilizer equities remains uncertain; however, in the absence of a deep and prolonged global recession, we feel that fertilizer stock prices should be higher one year from now.

Defensives

In our last quarterly report we provided you with an explanation of "sector rotation" where, when the economy is closer to troughing, investors will start to sell defensive stocks such as Staples, Utilities and Telecommunications to raise money in order to purchase more cyclical or economically sensitive stocks such as Financials, Energy, Materials and Industrials. We saw a continuation of sector rotation in the third quarter and only expect it to continue going into 2010. Naturally such selling puts downward pressure on defensive equity prices and it is true that cyclical stocks have easily outperformed defensive stocks during the past quarter and on a year-to-date basis. However, we remind investors again that such selling is not taking place because these companies are bad investments, in fact some defensive companies in Canada are some of the best quality you can find in North America, if not the world. It's for this reason that we discouraged anyone from overweighting these sectors in our last report. However, it's also important to realize that even while investors may be flocking to cyclical areas of the economy, it is also unwise to eliminate your exposure to these sectors altogether if you're looking for a diversified portfolio and especially one that will provide you with dividend income. If you have a diversified portfolio you will always have both defensive and cyclical stocks as holdings, but as we progress through an economic cycle it's likely the weightings of these sectors will change to reflect the outlook for the economy.

The Rest

Technology: While most investors look south of the border for technology stocks as we have very little choice amongst large capitalization names in this country, we continue to recommend Canadian industry champion Research in Motion (RIM) for long-term shareholders. The company's recent earnings were not as strong as the market might have liked them to be as selling prices for the company's devices declined; however, we believe this concern is more cyclical in nature as no new devices were launched during the quarter. Aside from the average selling price disappointment, we still saw good earnings and solid subscriber additions. While competition is always going to remain fierce within the cell phone/smart phone market, we believe RIM is well positioned both strategically and financially for the long term.

Consumer Discretionary: This sector is made up primarily of retailing and consumer goods stocks with the exception of food stores and drug stores. It is only logical to assume that if the economy improves then consumption increases and the Consumer Discretionary sector benefits. And while we don't deny that the market has been pricing in these expectations, we still remain concerned about the outlook for the U.S. consumer. However, we also recognize that Canadian consumers have not been impacted to the same extent as Americans as we did not have a real estate crisis in this country to wipe away billions in consumer equity. As such, considering that the Canadian economy is likely to come out of recession in the current quarter we are no longer discouraging investors from looking at this sector. While the economic recovery could be sluggish, we feel the Canadian economy will have enough momentum over the next 12 months to get consumers spending more and profits rising for consumer discretionary equities.

Industrials: If we are no longer hesitant about consumer discretionary stocks then we are no longer hesitant about most Industrials as well. In fact, since most of the pick up in the global economy has come from developing nations it's only logical to feel more bullish on industrial stocks in Canada than Consumer Discretionary. If goods are being produced over seas and resource demand is increasing then the engineering services, railroad, and industrial equipment sectors are likely going to see an increase in business which should translate into increased profitability. We would certainly encourage investors in these sectors to maintain their exposure if not increase it over the course of the next year if they are underweight. If the Canadian economy is firmly back on track then it might even be time to start rethinking airline and auto part stocks; however, we recognize there is more risk in purchasing these stocks due to lower domestic demand.

Overall Conclusion

There is no denying the fact that the rebound for the TSX Index has been impressive. At the beginning of this year we predicted that the Canadian stock market would actually post positive returns, but they would be challenged to reach double-digits. Needless to say, our expectations have been exceeded likely due a weaker-than-expected U.S. dollar, a credit market that improved much faster than anticipated and emerging markets which literally refused to participate in the global recession. While any investors could be justified in predicting that the market is due for a pull back or maybe even a correction, it is evident from the past seven months that investors believe the market was oversold in March (it was) and that the economic recovery is going to pick up steam in the western world as the global recession will officially come to an end. While we can raise some near-term concerns when it comes to things such as resource prices and U.S. consumer equity, we are bullish for the Canadian stock market over the long term and believe this country will be a great place to invest as the global economy accelerates into 2010 and beyond.

U.S. Equity Strategy

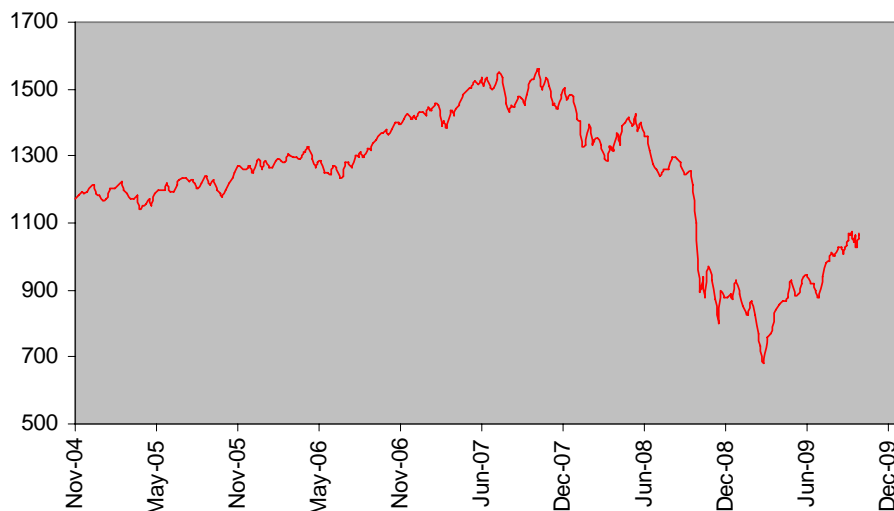
A Case for U.S. Equities

Paul Danesi, CIM – Director, Portfolio Advisory Group

The U.S. equity market is likely to remain in a “sweet spot” through the end of the year and possibly well into next spring, although buying power seems to be waning in the short term. Looking out into next year, the most obvious threat to the U.S. equity market and economy are higher interest rates however, the U.S. Federal Reserve and Treasury understand the risks of prematurely removing monetary and other stimulative measures. By the time clients receive this report, third quarter earnings season will be largely complete. Quarterly financial results will likely have proven supportive of equity prices.

Tactical indicators suggest the market has temporarily moved into an overbought position. The S&P 500 has rallied nearly 60% from a panic-induced low established in March without as much as a 10% pullback. While ripe for a correction, periods of consolidation in the U.S. market will continue to be short lived and shallow. Persistent wholesale selling of U.S. equities just doesn’t seem likely in our opinion given improvements in the U.S. economy, low inflation expectations, and a rebound in corporate profitability.

Exhibit 1: S&P 500 – 5 Year Price Chart



Source: Bloomberg

It is very possible U.S. economic activity could slump again later in 2010. Signs of a rapid recovery in the U.S. economy could force central bankers to remove economic stimulus and raise interest rates prematurely. A low interest rate environment remains a key element supporting sustained economic growth. There is little doubt the highly leveraged consumer balance sheet has very little tolerance for higher rates. However, central bankers appear to be in no rush to remove economic stimulus creating a “sweet spot” for the economy and financial markets.

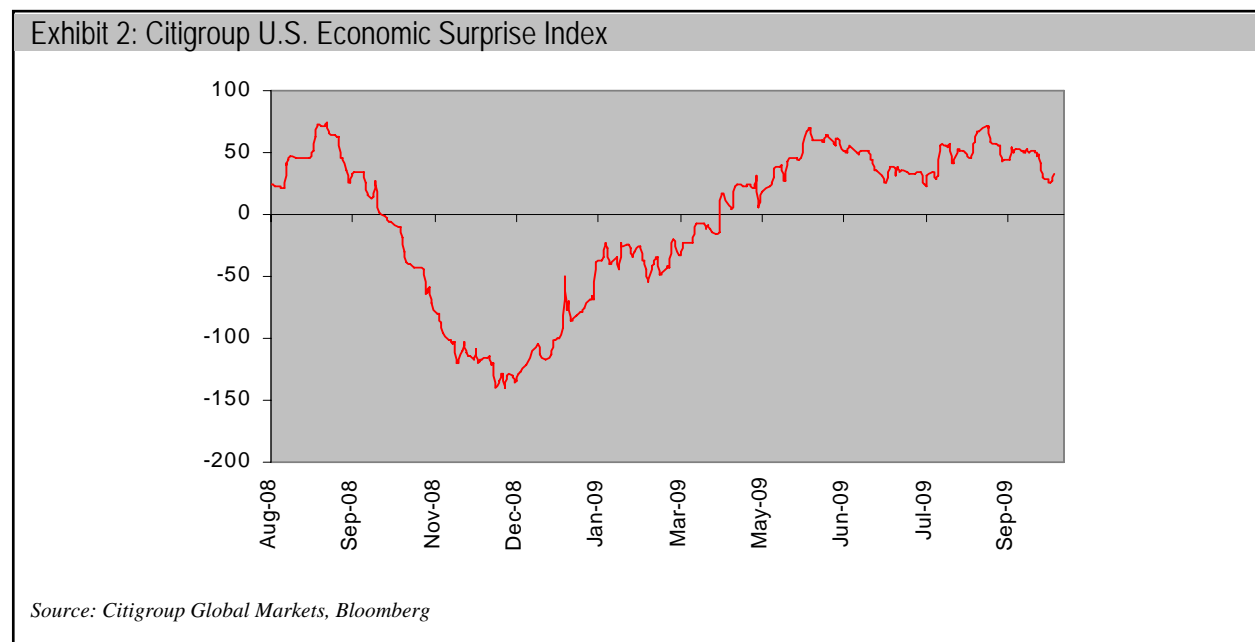
The Trend in the S&P 500 Remains Up

It is difficult for us to envision persistent wholesale selling of U.S. equities as the economy springs back and quarterly earnings reports show an ongoing rebound in corporate profitability. U.S. equities are under-owned at both the retail and institutional level. Cash in U.S. money market funds is currently 30% of U.S. market capitalization. Historically that level has averaged closer to 18%. Wyatt Watson, a global consulting firm, estimates U.S. pension funds are holding 51% of their assets in stocks versus a long-term average of 60%. Pension funds and other institutional money managers will find their defensive posturing will be challenged and difficult to defend in an environment where economic conditions are improving and corporate profits are rising.

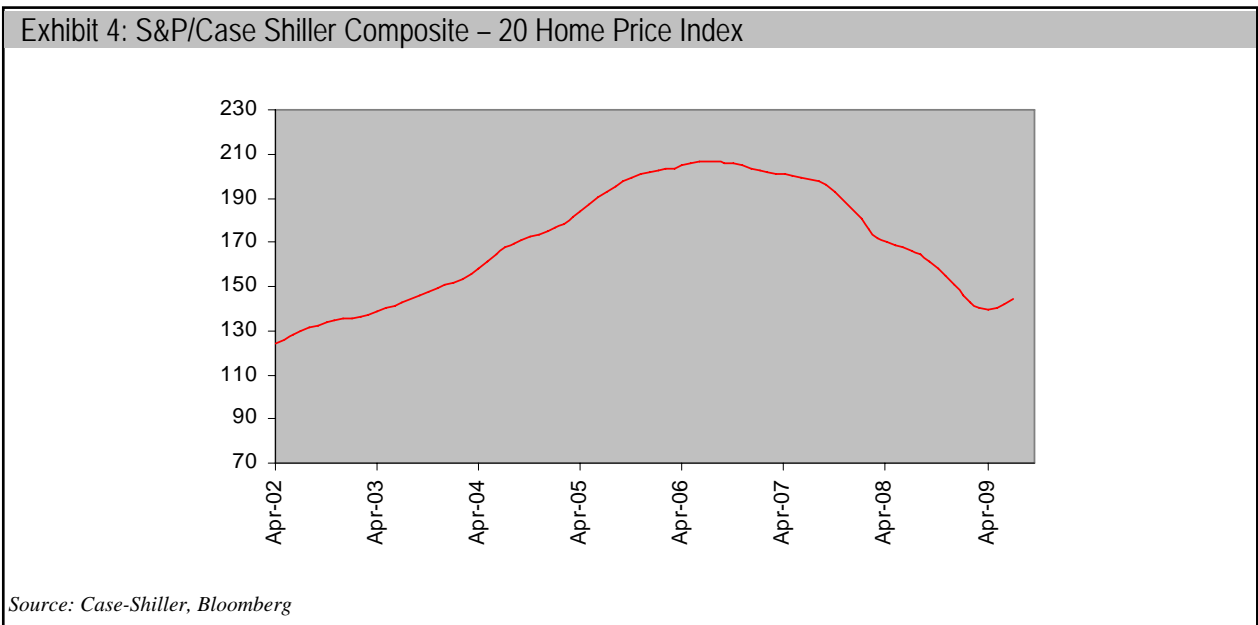
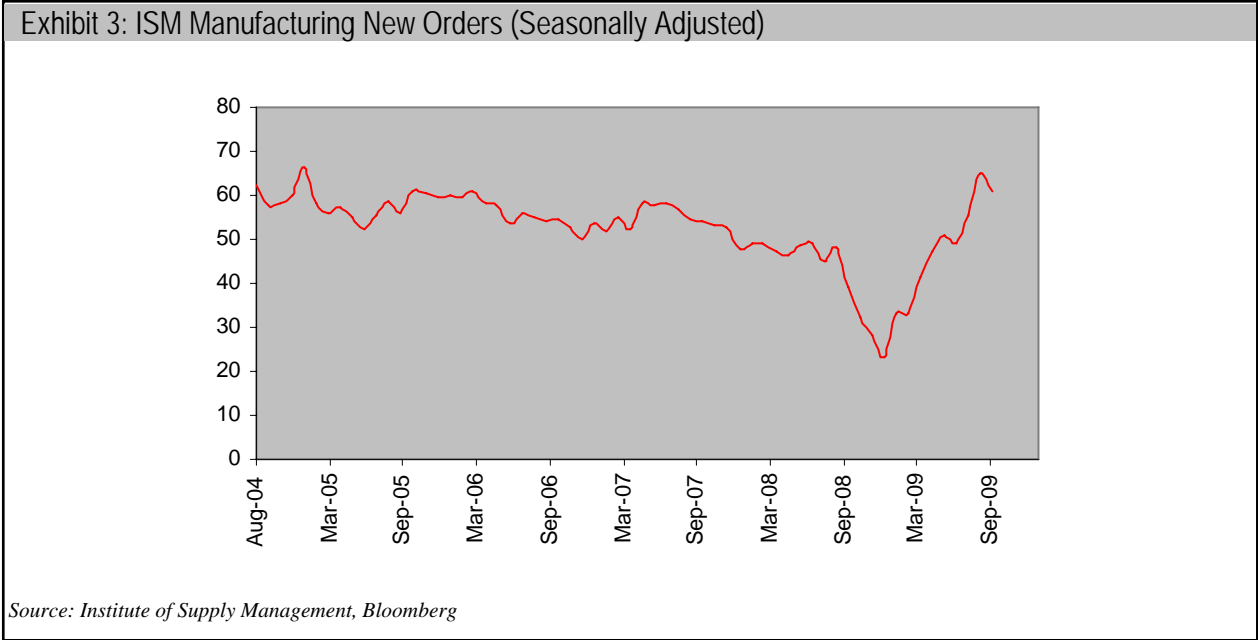
Investors are being paid very little to hold cash, and U.S. Treasury securities offer little appeal outside their defensiveness. Low interest rates drive investors back into risky assets and declining credit spreads reduce the cost of capital (cost of equity) supporting higher share prices.

Economic Growth is Likely to Surprise

In 2008 and the early part of 2009 we witnessed a synchronized global economic contraction, the worst downturn since the Great Depression. It now appears as if we are in the midst of a synchronized global economic recovery led by China, reinforced by highly stimulative monetary and fiscal policies, and improvements in financial markets. Industrial production collapsed in many countries last year, but has begun to rebound sharply. World trade volume is expanding again. Japan, Germany, France and many emerging market economies all grew in the second quarter. Others, including the U.S. and the U.K., will grow in the third quarter. Credit Suisse is forecasting U.S. GDP to contract **0.9%** in 2009 and rebound **3.9%** in 2010.



Forward looking gauges of economic activity, including the Index of Leading Indicators and the ISM New Orders Index, have accelerated in recent months and point to continued upward momentum in the near term. Job cuts have likely gone beyond what is warranted by the decline in output and sales. Employment is down 5.1% while hours worked declined 8.5% as GDP contracted 3.8%. Credit Suisse's global equity strategist believes nonfarm payrolls could turn positive in this first quarter of 2010 as job cuts overshoot what was warranted. Furthermore, recent housing data including the S&P/Case Shiller Home Price Index suggests the housing market may be bottoming after a three-year long collapse in pricing. Housing affordability is near record levels given the sharp decline in home prices and historically low mortgage rates.



As a caveat, home foreclosure activity remains at record levels and a back up in mortgage rates could derail the nascent recovery in housing. There are also ongoing concerns about the consumer and their newfound affinity for frugality. It is worth pointing out the U.S. consumer has a penchant for spending and the recession is creating significant pent-up demand. If Credit Suisse is correct about employment trends, consumer spending may not prove as large a drag as is being discounted. Consumers are also beginning to feel a little wealthier as their stock portfolios rebound and home prices in some regions are actually rising.

Corporate Profitability Could Rise Sharply in 2010

Analysts tend to overestimate earnings in a down cycle and underestimate them when the economy is expanding. U.S. corporations have aggressively cut costs reducing headcount at a record pace, trimming SG&A, and mothballing production to maintain margins. Cost cutting has been the major driver of positive earnings surprises in both the first and second quarter of the year, typical of a normal earnings cycle. However, costs can only be reduced so far and sales must ultimately improve to sustain earnings growth. Sales should begin to improve as industrial production starts to rebound in the third quarter, and industrial production is turning. The ISM Manufacturing Index moved back above 50 in August and stayed there in September. Readings above 50 indicate manufacturing is expanding. Arguably more important, ISM non-manufacturing, which measures activity in the services sector of the economy, moved back up to 50 in September. Scotia Capital's portfolio strategist forecasts sales for the S&P 500 to be flat year-over-year in Q3 after plummeting 20% in Q2. With corporate cost structures as lean as they are, operating leverage is high, and any improvement in sales will have a very positive effect on margins and earnings. Plotting the year-over-year change in earnings for the S&P 500, it would appear that earnings momentum is turning the corner.

Valuation is Reasonable

The U.S. market is neither cheap nor expensive at current levels, rather fairly valued. Using the bottom's up consensus earnings estimate for 2010 of \$73.47 as compiled by Standard & Poor's, the S&P 500 trades at only 14.5 times earnings. A 10% pullback from its recent peak would leave the market trading at 13.1 times, far from expensive by historical standards. Looking at other valuation indicators such as U.S. market cap to GDP, the U.S. long-term equity-to-bond ratio, or Tobin's Q, a measure of market capitalization to replacement cost, all suggest there is no valuation problem yet. Conditions exist for a new bubble to develop if central bankers become complacent.

Cyclical Stocks Should Lead

While a correction would be an opportunity to add broad-based exposure to the U.S. market through mutual funds and ETFs, cyclical stocks should lead the market into year end. U.S. dollar weakness and stronger growth in developing markets support buying U.S. multinationals and exporters. Generally, we favour companies that provide exposure to the emerging market consumer and infrastructure development. Our favored names include McDonald's (MCD), Nike (NKE), and Apple Inc. (AAPL) for exposure to the global consumer. Attractive infrastructure plays include Fluor Corp. (FLR), one of the world's leading engineering and construction firms, and the SPDR Metals & Mining ETF (XME) for broad-based exposure to infrastructure materials including iron and steel. Broadly speaking, corporate balance sheets in the U.S. are in excellent shape. Free cash flow is likely to be spent on productivity enhancing software and technology hardware given the still high levels of excess productive capacity. Hewlett Packard (HPQ) with its PCs, servers, and printers, along with EMC Corp. (EMC) and their leading edge storage devices are well positioned to participate in a revival in corporate spending. Intel Corp. (INTC) should benefit as a component supplier. Among domestically oriented businesses we like AT&T Corp (T) and its hefty 6.0% dividend yield. We also find Comcast (CMCSA), the largest U.S. cable operator attractive. Rumours that Comcast is looking to buy a stake in NBC Universal from General Electric (GE) has led the share price lower, creating an attractive entry point for new investors.

Feature Article

Investing in High Yield Bonds as an Asset Class

Joey Mack, CFA — Director, Portfolio Advisory Group, Fixed Income

Introduction

The high yield debt market is comprised of securities issued by corporations whose credit ratings fall below the BBB(low)/BBB-/Baa3 category. Commonly referred to as junk, non-investment grade or speculative grade bonds, these issues typically have a higher risk of default (of not meeting interest and principal repayments in a timely fashion). As a result, these securities can be purchased in the marketplace or upon issuance with higher yield to maturity than stronger, investment grade credits, and hence offer higher potential total returns for investors.

The following table is a summary of each agency's bond ratings scale, and a general qualification of each category.

Exhibit 1: Agency Bond Rating Scale				
DBRS	S&P	Moody's	Fitch	Summary Definition of Credit Quality
Investment Grade				
AAA	AAA	Aaa	AAA	Highest/Excellent
AA	AA	Aa	AA	Superior
A	A	A	A	Satisfactory
BBB	BBB	Baa	BBB	Adequate
Non-Investment Grade				
BB	BB	Ba	BB	Speculative
B	B	B	B	Highly Speculative
CCC	CCC	Caa	CCC	Very Highly Speculative
CC	CC	Ca	CC	Very Highly Speculative
C	C	C	C	Very Highly Speculative
D	D	D	D	In Default

Note – Within each rating category (with the exception of the highest AAA category), Ratings Agencies also use a grade to indicate the relative standing of a particular credit. For example, DBRS applies high low grades, while S&P applies a "+" or "-" indicator.

High yield bonds have come to represent a significant portion of the U.S. bond market. In Canada, however, high yield bond issuance remains relative minor in comparison to the investment grade market, and continues to be primarily "fallen angels", or corporate bonds that were investment grade at the time of issuance, but have since been downgraded below the BBB category.

By example, the market capitalization of the DEX Universe Bond index is \$907.2 billion, and the market capitalization of the DEX Universe Corporate index is \$250.3 billion, but the market capitalization of the DEX High Yield Index is just \$2.6 billion. With a limited number of institutional investors in the Canadian high yield market, lower or unrated Canadian corporate borrowers have either turned to the U.S. market, or alternatively, to the Canadian convertible bond market. The market capitalization of the all convertible bonds listed on the Toronto Stock Exchange is currently \$11.0 billion.

However, the upcoming deadline for Income Trusts to convert to corporations in 2011, combined with rising investor demand for higher yielding securities, will likely lead to continued growth in high yield bonds as an asset class in Canada.

Characteristics

Valuation of high yield bonds in secondary markets is characterized by both the higher possibility of default, and limited liquidity.

During the recent economic and equity market downturn, the Bank of Canada lowered its target for short-term interest rates, and investors continued to look for safety of capital. The result was an increase in demand for fixed income securities, resulting in lower, longer-term yields. Government and strong investment grade corporate bond prices therefore rose, and hence we witnessed double-digit returns from (investment grade) fixed income as an asset class.

However, the economic downturn has increased the probability of default. This was not only due to the impact on corporate profitability, and hence ability to meet debt obligations out of cash flow, but also by the inability to refinance maturing debt, as the already limited investor base had little appetite for more product. This resulted in market pricing for high yield bonds dropping substantially, and the asset class produced sharply negative returns as a result.

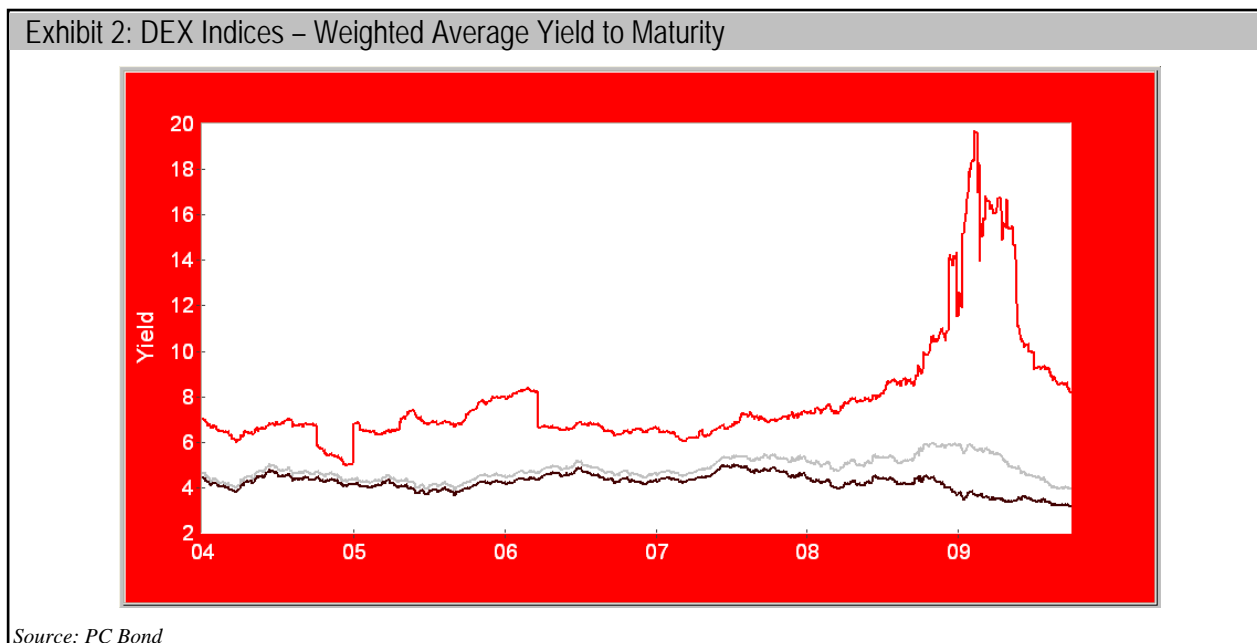
Returns on high yield bonds as an asset class therefore tend to have much higher price volatility than investment grade debt, and in addition, returns have a much higher correlation with equities than investment grade corporate and especially government bonds.

For these reasons, we view high yield bonds as a risky asset class, and asset allocation to the category should generally be a portion of the portfolio allocated to growth rather than safety or income. In other words, an investor's portfolio allocation to high yield bonds should reduce the allocation to equities, rather than the allocation to fixed income.

Why Invest in High Yield Bonds?

There are three primary reasons to consider an allocation to high yield: income, returns, and diversification.

Income – With the secular drop in interest rates over the past 30 years, individual investors have continued to seek high levels of income from their portfolios. Non-investment grade bonds can, and do, provide this high level of income. By example, the yield on the DEX High Yield index is currently 8.2%, versus 3.9% for the DEX Corporate Universe Index, and 3.2% for the DEX Universe Index, and on average over the past 5 years, has yielded 3.3% more than the corporate index and 3.8% more than the universe.



Returns – The total return from high yield bonds has continued to outpace investment grade bonds. For the past 10 years ended September 30, 2009, the DEX High Yield Index has posted an average annual return of 8.1%, versus 6.6% for the DEX Universe Bond Index and 7.3% for the S&P/TSX Composite. Returns on the DEX High Yield Index have also been less volatile than that for equities, with a standard deviation of annual returns of 4.9% versus 19.6% for the S&P/TSX Composite. On a risk adjusted basis, returns on high yield do therefore compare favourably with equities as an asset class.

Diversification – Although the returns from high yield are highly correlated with equities, they are not perfectly correlated, and hence offer diversification opportunities. For example, a portfolio invested in 25% high yield and 75% equities, rebalanced annually, would have posted stronger returns than an investment in equities alone, with a total return of 10.2% over the past 10 years ended September 30, 2009, versus 7.3% for the S&P/TSX Composite. In addition, these returns were realized with only 75% of the volatility of an equity only portfolio.

Key Risk Factors

Credit/Default – The timely payment of principal and interest are of utmost importance to the debt holder. Hence, issuer default is a key risk of investing in high yield bonds.

Credit ratings do provide an assessment of default risk, and there is a strong correlation between ratings and the probability of default. The following table highlights the results of a Moody’s study of the average cumulative default rates for corporate issuers over the period 1920 to 2008:

Rating	Year 1	Year 2	Year 3	Year 4	Year 5
Aaa	0.00%	0.01%	0.03%	0.08%	0.16%
Aa	0.07%	0.20%	0.31%	0.47%	0.73%
A	0.08%	0.25%	0.53%	0.85%	1.19%
Baa	0.28%	0.84%	1.54%	2.31%	3.10%
Ba	1.33%	3.18%	5.28%	7.45%	9.53%
B	3.89%	8.60%	13.32%	17.58%	21.29%
Caa – C	13.15%	21.90%	28.59%	33.57%	37.42%
All Investment Grade	0.14%	0.44%	0.81%	1.24%	1.71%
All Speculative Grade	3.56%	7.26%	10.83%	14.04%	16.87%
All Corporates	1.40%	2.89%	4.35%	5.67%	6.86%

Source: Moody’s Investors Service

The table highlights that the average default rate for investment grade corporate issuers has been 0.14% over a one-year horizon and 1.7% over a five-year horizon. Not surprisingly, speculative grade credits have a much higher default rate – 16.9% defaulted over a five year period. In addition, the lower the initial credit rating, the higher the likelihood of default.

Moody’s also notes that credit quality deterioration has historically been reflected in credit rating downgrades well in advance of default. Therefore, downgrades are a key indicator of impending difficulty, especially as ratings fall further below investment grade.

Liquidity – Given the typically smaller outstanding size of high yield debt issues, combined with a smaller investor base and fewer dealer participants, high yield debt instruments are less liquid than investment grade securities, even under normal market conditions. This is characterized by wider bid-offer spreads and limited product availability. Further, in economic downturns and other market events, the ability to trade in high yield debt can become even more challenging, as it can become very difficult to sell an instrument quickly and at a reasonable or efficient price.

Investment Strategies

Guidelines for Security Selection – Investors in high yield debt, like all fixed income investors, must consider the general credit worthiness of the borrower. Given the much higher risk of default in the high yield debt market, investors should consider what the issuers existing obligations are, what assets are available for protection, and analyze liquidity, borrowing, and cash flow needs. This credit analysis should also be forward looking, to take into account where the borrower is heading, in order to assess their ability to meet their obligations going forward.

Although the process of credit analysis should be performed by all investors, in public debt markets investors have a useful source in the Credit Ratings Agencies, who offer opinions over the general credit quality. A credit rating is not a recommendation to buy, sell, or hold an investment; rather, it represents the respective ratings agencies' opinion over the general credit worthiness of the borrower in regards to a debt security.

Diversification Principals – To properly diversify a portfolio, academic studies of the equity market have proven that holding 20 different securities provides a significant level of diversification, typically sufficient to reduce most unsystematic risk from a portfolio. Similarly, in the corporate bond market, a lower the credit quality of investments requires a greater level of diversification – in other words, to properly diversify a BBB rated portfolio, more securities should be held than if attempting to diversify a AA rated portfolio.

The following table highlights our recommended maximum allocation for broad investor risk categories in the corporate debt market:

Exhibit 4: Maximum Allocation for Broad Investor Risk Categories in the Corporate Debt Market					
	AAA	AA	A	BBB	<BBB
Conservative	20%	10%	5%	3%	0%
Moderate	30%	20%	10%	5%	3%
Aggressive	40%	30%	20%	10%	5%

High yield debt securities are by definition classified as high risk. Therefore, direct investing into these instruments would be considered unsuitable for conservative, income-oriented investors. Investors with a moderate to aggressive risk profile may consider direct exposure to these securities, but at a minimum, Aggressive investors, by example, should hold at least 20 different issuers in order to ensure an ample level of diversification.

In conclusion, for most individual investors, unless the allocation to high yield in a portfolio is in excess of \$100,000 and therefore allows for appropriate diversification, High Yield Mutual Funds and Exchange Traded Funds represent an optimal solution. Funds offer both professional management, as well as instant diversification, allowing a convenient way to participate in the asset class.

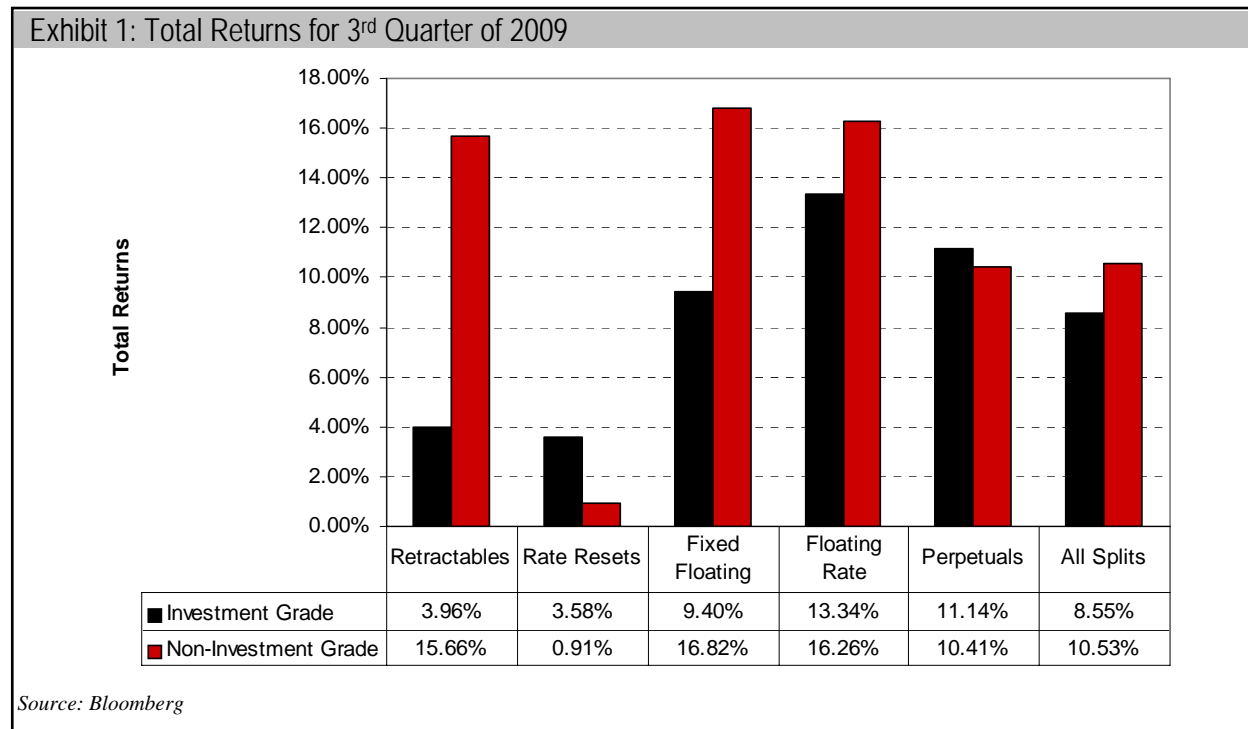
Preferred Share Market Update

Are Canadian Investors Ready for More Straight Perpetuals?

Tara Quinn, MBA — Associate, Portfolio Advisory Group

The Canadian preferred share market is on a roll as it has posted three quarters of positive returns thus far in 2009. Year to date, the S&P/TSX Preferred Share Index is up by 17.74% as of September 30th and during the third quarter of 2009 advanced by 4.53%. The S&P/TSX Preferred Share Index is designed to serve the investment community’s need for an investable benchmark representing the Canadian preferred stock market. This index is comprised of preferred stocks trading on the Toronto Stock Exchange that meet criteria relating to minimum size, liquidity, issuer rating, and exchange listing. This index is also rebalanced twice a year.

Focusing on the Investment Grade level of preferred shares it has been the fixed floating, floating rate, straight perpetuals and split shares which have impressively outperformed the general Canadian preferred share market this past quarter.



Although the fixed floating and floating rate preferred shares outperformed for the second consecutive quarter, the outperformance was on relatively low volumes. However, the performance of the straight perpetuals was on stronger volume and hence is a more substantial story to analyze.

At the beginning of the quarter, the straight perpetuals had an average current yield of 6.41% and by the end of the quarter these perpetuals were trading with a current yield of 5.86%. This equates to a yield decline of -0.24% and total returns of 11.14% over the quarter. In the same time period the yield on the 30-year Government of Canada bond was lower by only -0.02%. Therefore, the outperformance of the straight perpetuals can be attributed to the tightening of corporate credit spreads rather than a declining interest rate environment. Credit spreads can be defined as the yield pick-up over benchmark Government bonds, and are indicative of investors' risk tolerance. As confidence has returned to the market, investors have become less risk adverse and have purchased straight perpetuals which has improved the price and lowered the yield. Yet the question remains what direction will the straight perpetuals take from here? Before we anticipate that answer to the question, it is important to understand the structure of a straight perpetual preferred share.

Review of the Perpetual Structure

Straight perpetual preferred shares are issues which pay the holder a fixed dividend indefinitely. With this type of investment the holder has no retraction rights, yet the issuer (e.g. Royal Bank of Canada) can call the issue at certain prices on set dates, if it is in their best interest to do so. Due to the fact that perpetuals lack a maturity date they should be compared to corporate long bonds (maturity > 10 years) as both types of investments are affected by similar factors.

The risk in holding perpetual preferred shares is the price volatility as these structures are very sensitive to fluctuations in interest rates and credit spreads. Due to their long duration, prices will decline in value as interest rate rise or credit spreads widen. However, the opposite will happen in a declining interest rate, or credit spread tightening environment. In order to compensate investors for the risks associated with this type of investment, perpetual preferred shares generally offer a higher yield than other types of preferred shares.

Likelihood of Outstanding Perpetuals Being Called

Exhibit 2: TD Perpetuals		
TSX		
Symbol	Dividend Rate	Issue Date
TD.PR.O	4.85%	2005
TD.PR.P	5.25%	2007
TD.PR.R	5.50%	2008
TD.PR.Q	5.60%	2008

Perpetual preferred shares (perpetuals) will only be called by the issuer if the company decides it is in their best interest to do so. As seen in Exhibit 2, Toronto Dominion Bank (TD) currently has four perpetual preferred shares outstanding in the market, each offering the investor a different dividend rate. The dividend rate is reflective of the issue date, as this is the rate at which the issuer could come to market on a new issue basis at the time. Among the universe of Canadian perpetual preferred shares, the dividend rate ranges from 4.45% - 6.25%.

Similar to bonds, the perpetuals with the lowest dividend rates will experience the most price volatility based on changes in interest rates and credit spreads. Additionally, the perpetual with the lowest dividend rate will be the issue which the issuer is least likely to call. For example, if TD believes that they can refinance at a cheaper rate than 5.60%, they may call the TD.PR.Q issue and issue a new preferred share at the prevailing market rates, hopefully less than 5.60%. Therefore, when analyzing the potential call of a perpetual preferred share it is important to note the other issues the issuer has outstanding as well as determining the current market rate for that particular issuer to issue a new preferred share. However, it must be understood, that just because a company has the option of calling a preferred share at a set price does not mean that they will choose to do so.

New Issuance

Throughout 2009, we have seen an abundance of new issuance totalling \$9.2 billion compared to the \$6.4 billion of new issuance we saw last year. This new issuance has been dominated by the rate reset structure until recently (September 2009) when Great-West Lifeco came to market offering \$170 million of a straight perpetual with a fixed dividend rate of 5.65%. This was the first straight perpetual new issue the Canadian market has seen since April 2008 when Royal Bank of Canada offered \$213 million of a straight perpetual with a fixed dividend rate of 5.65%.

As an investor it is important to note that these new straight perpetual offerings are relatively small in size. For example, the latest Great-West Lifeco perpetual issue is \$170 million versus the TransCanada Corp Series 1 rate reset issue which is \$550 million. In addition, institutional investor placement at issue for the perpetuals has been very limited compared to the institutional participation for a rate reset issue. With these factors in mind it is likely that recently issued straight perpetuals will be less liquid than rate resets and therefore will trade with a wider bid/ask spread. So, are investors ready for more straight perpetuals?

Recommendations

We recommend investors reduce their exposure to straight perpetual preferred shares for the following reasons:

- **Interest Rate Forecast:** Bank of Canada overnight rate is forecast to hover near historical lows until the third quarter of 2010 yet Scotia Economics is expecting 30-year Government of Canada bond yields to increase by 0.94% up to 4.90% over the next 12 months. Rising interest rates will have a negative effect on perpetual prices.
- **Credit Spread Analysis:** Perpetual preferred share spreads have tightened dramatically since their peak and now sit at 4.64% over 30-year Canada bonds on an interest rate equivalent basis. Although spreads are still wider by roughly 1.00% compared to long term average levels, we have recently seen spread widening and perpetual preferred shares have been trading lower after hitting their 52-week highs.
- **Supply versus Demand:** If we continue to see additional new issuance in the straight perpetual preferred share arena without strong demand, the sector will sell off in accordance with the additional supply.

Straight perpetuals offer investors a preferential dividend income which is taxed more efficiently than interest income. For those investors who are holding perpetual preferred shares in a portfolio for a tax-advantaged source of income may consider switching from a low dividend paying perpetual to a perpetual with a higher dividend. This strategy will minimize the extent of the price fluctuations that are anticipated due to rising interest rates.

There are a variety of different types of preferred shares and it is important to understand the features associated with each particular issue. Contact your ScotiaMcLeod advisor to discuss the preferred share opportunities and recommendations for your portfolio.

Mutual Funds

Selecting the Right Mutual Fund

Carolyn Tsai – Senior Analyst, Portfolio Advisory Group, Mutual Fund Research

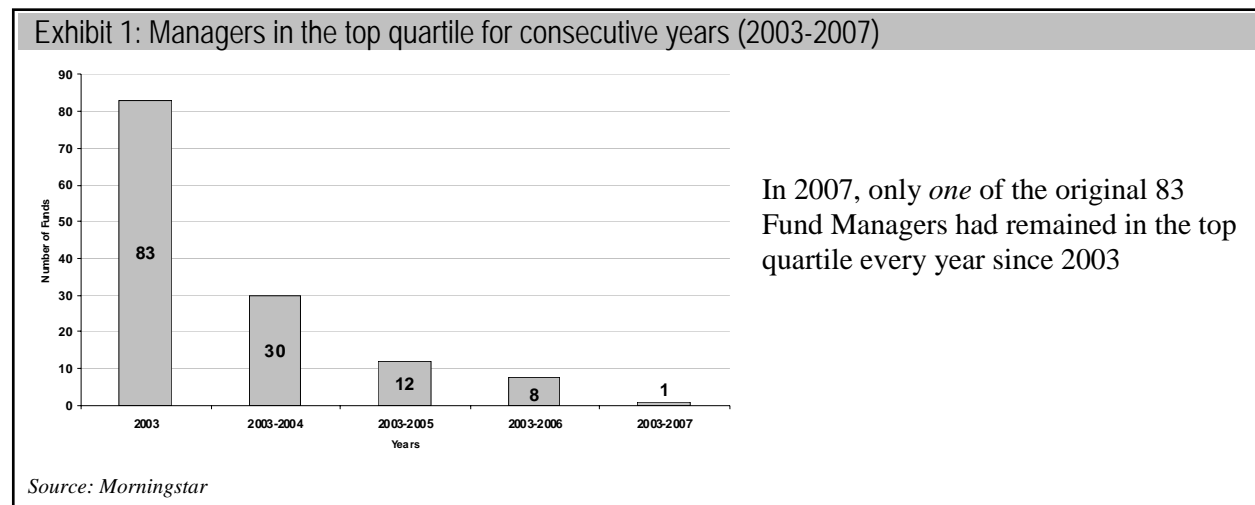
The task of selecting a quality mutual fund can be daunting. There are a vast array of choices, and information overload can be a problem. To make matters worse, the majority of the information available is primarily from marketing material which adds to the confusion since fund companies will always focus on the positive features of its product line as opposed to presenting a balanced opinion.

In this issue of IPQ, I will discuss some common pitfalls and misperceptions that investors may experience when evaluating mutual funds. In addition, I will focus on important criteria to consider when selecting a mutual fund; criteria that our team uses when analyzing and monitoring mutual funds, and when compiling the *ScotiaMcLeod Mutual Fund Recommended List*. Finally, I will highlight some of the key benefits of using the ScotiaMcLeod Mutual Fund Recommended List.

Pitfalls and Misperceptions

The tendency to chase past performance is one of the most common problems regarding investor behaviour. Investors are continually warned that “past performance is not an indication of future results”, but focusing solely on recent returns remains the primary method in which most investors select mutual funds.

As **Figure 1** illustrates, top-performing funds have historically not been able to persistently remain top-quartile over time with only *one fund out of 83* remaining in the top-quartile after a 5-year period. Looking at Chart 1 in isolation might lead a person to think the odds are against them in selecting mutual funds that will outperform over time. To this end, I intend to highlight some parameters that will help investors improve their odds of finding great funds.



The myth of Morningstar’s “Star Rating”

One of the more common tools investors utilize in selecting mutual funds is the Morningstar Star Ratings. There is a great deal of misconception regarding how the Morningstar ratings actually work as many believe it is a rating assigned based on quantitative and qualitative factors by Morningstar analysts. Contrary to popular perception, the ratings are purely quantitative, based solely on a mathematical formula that Morningstar recalculates each month. As defined by Morningstar on their web site, the Morningstar Risk-Adjusted Ratings, commonly known as the “Star Rating”, relates the risk-adjusted performance of a fund to that of its category peers. To determine a fund’s rating, the fund and its peers are ranked by their Morningstar Risk-Adjusted Returns (MRAR). If a fund scores in the top 10% of its fund category, it receives five stars (High); if it falls in the next 22.5%, it receives four stars (Above Average);

a place in the middle 35% earns a fund three stars (Neutral or Average); those in the next 22.5% receive two stars (Below Average); and the lowest 10% get one star (Low).

Morningstar emphasizes the star ratings should be used as an initial screen for narrowing down the universe, but instead of using it as an “initial screen”, more often than not, investors will interpret a highly rated mutual fund as the sole reason to make a purchase.

This behaviour is reinforced by fund companies when they promote their four and five star mutual funds. *If only it were that easy!* There are many factors to consider when selecting a mutual fund and while star ratings will assist in telling one part of the story, the rating should not be used as the sole criteria in selecting a mutual fund.

A Tale of Two Funds

As mentioned earlier, most investors only focus on returns when selecting a mutual fund. A fund should be selected based on its suitability to an investor’s objectives and risk tolerance. This is not a case of one size fits all. Performance numbers alone will not tell the whole story. Risk is a crucial element that investors should consider when selecting a mutual fund. Risk measures can reveal the volatility of a fund, its sensitivity to market changes and the risk a manager is taking for achieving the return. Looking at

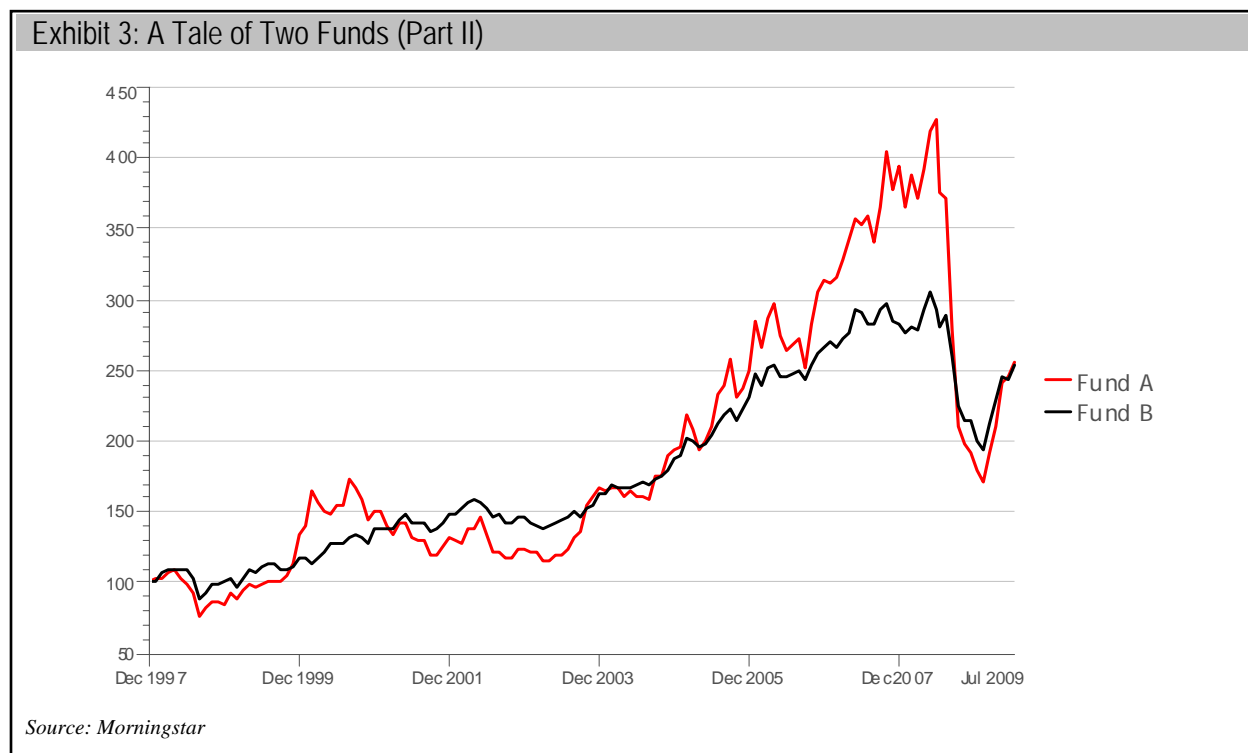
	Fund A	Fund B
Annualized 10 Year Return	9.79%	8.45%
Benchmark	6.47%	6.47%
Value Added	3.32%	1.98%

Source: Morningstar

these characteristics will help determine if a fund is an appropriate investment for an individual. Let’s take a look at an example to further explain.

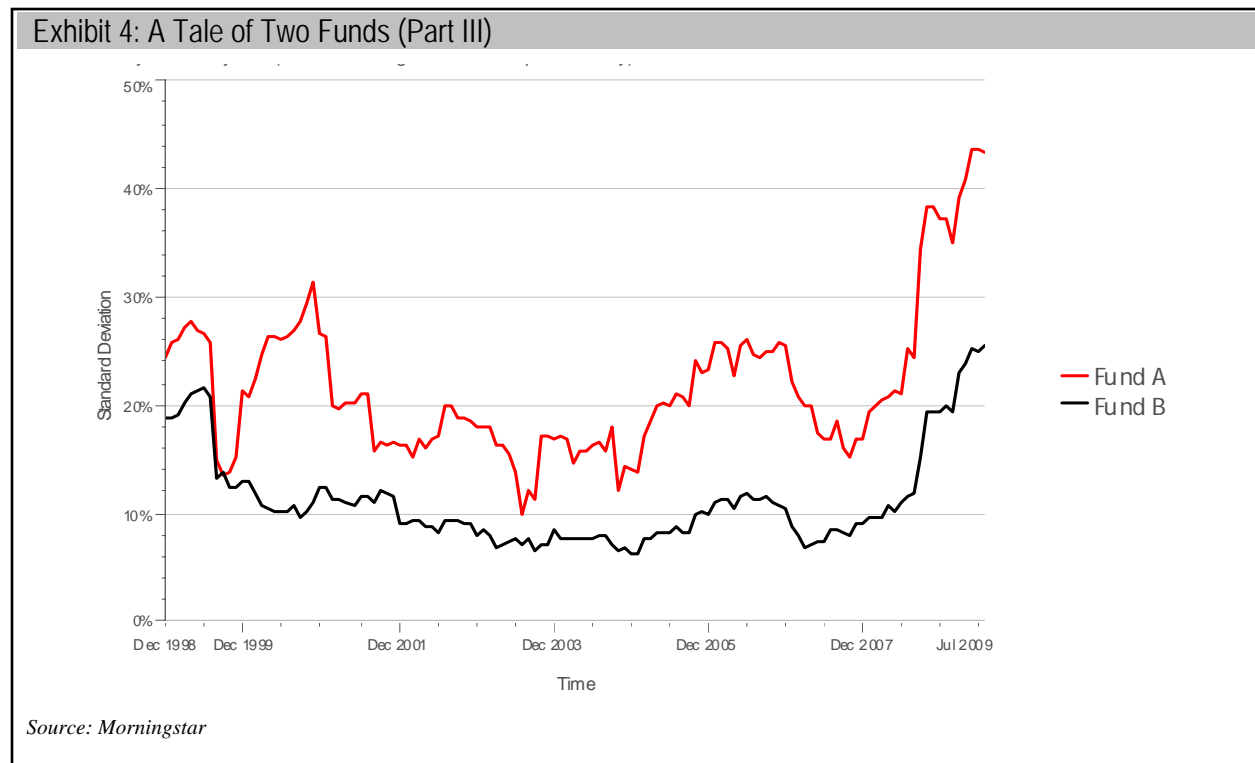
Based on the figures outlined in **Exhibit 2**, most people would select Fund A which has a higher return and more added value in the long term. However, let’s dig a little deeper and look at the returns on a year over year basis.

As illustrated in **Exhibit 3**, we see the return of Fund A has more significant peaks and valleys indicating periods of great outperformance with other periods of significant underperformance. Fund B however, has a relatively stable return line, reflecting that the manager’s style and ability was able to steadily add value over most time periods relative to Fund A.



Moving on to **Exhibit 4**, let's look at one risk metric for these two funds. *Standard deviation* is a commonly used statistic to measure risk. "Risk" in this context refers to the volatility of a fund – i.e. the more a mutual fund's returns vary from its average return, the more volatile the fund.

As we can see in **Exhibit 4**, the standard deviation of Fund A is much higher than that of Fund B, and can be said to be more volatile and hence more "risky" from this perspective.



What does this mean? While both funds have been very good performers over the ten year period, by looking at more than a ten year annualized return number we can see that they have achieved the returns in very different ways. Fund B offered steady returns year over year while Fund A's return profile was more akin to a rollercoaster ride.

While this is not a promise of similar future performance, the long-term return and risk profile provides an important clue into the manager's investment process. An investor close to retirement would likely prefer the slightly lower long-term return of Fund B for less volatility and peace of mind. While an investor with a higher risk tolerance level, and perhaps a longer investment time horizon, may find Fund A more suitable.

By not understanding the characteristic of a fund by looking beyond performance numbers, investors will not benefit from active management. Especially when their fund selection process is combined with other common pitfalls of mutual fund investing such as:

- Chasing performance
- Attempting to "time the market"
- Ignoring asset allocation and other important portfolio-level parameters when adding and/or removing funds from a portfolio
- "Buying" into fund company marketing pitches

So What *Should* You Look for when Selecting Mutual Funds?

Investment Objective and Strategy - One of the main factors to consider when selecting a mutual fund is the fund's investment objective. It is important that the objective matches your investment goals. A fund that seeks long-term capital gains may not be appropriate if you have a current income requirement. In addition, it is important to consider whether the strategy the manager utilizes matches your risk tolerance level. Funds with higher potential rewards may take risks beyond your comfort zone and be inconsistent with your investment goals. Aligning a fund's investment objective and strategy to your goals and risk tolerance level is crucial in selecting a mutual fund that will be best suited for your portfolio.

Fund Manager - The point of investing in a mutual fund is to leave stock picking to the professionals. Therefore, the fund manager is one of the most important factors to consider when looking at a mutual fund. Managers with a high level of discipline will typically be more successful over the long term. With this in mind, take a long-term view of the manager's track record as this will show the manager's discipline in sticking to an investment approach consistently through varying market and economic conditions.

Long-Term Performance - A fund's year over year return relative to its benchmark and peers will shed some light on how a fund has performed under particular market conditions. Long-term performance can also reveal important characteristics of the fund. For example, a fund may perform very well in strong, active markets, but perform very poorly when the market takes a downturn. A more conservative fund may perform well in down markets but trail in up markets. Such clues will help you determine if a fund is appropriate for your objectives and risk tolerance level.

Portfolio Fit - It is important to keep the overall portfolio in mind when making fund changes and/or adding new funds into a portfolio. This relates to the well-known principles and benefits of diversification.

Most importantly, you should read a fund's prospectus before investing to learn about its investment strategy and the potential risks.

So How Do *We* Select Mutual Funds?

With over 5,000 mutual funds to choose from in Canada, the first challenge is to find a way to effectively shorten the list. We find that quantitative factors work well in accomplishing this task, but it is only one part of our process. Although past performance plays a role in the fund selection process, as we stated above, it should not be the primary focus of an investor's fund search.

Our Process Focuses on Both the Quantitative and Qualitative Analysis of Funds

The Quantitative Side - In terms of our quantitative assessment, we use a proprietary model that is essentially comprised of three "buckets". The first bucket includes *performance metrics* such as excess return, batting average, and alpha, among others. The second bucket includes *risk metrics* such as tracking error, downside deviation and skewness. And the third bucket focuses on *risk-adjusted metrics* such as the Sortino and Sharpe ratios. Combining the three buckets in our model produces a ranking of funds over one-, three-, and five-year time periods. We then produce a combined scoring of the funds, which in the end, generates a fund ranking based on all of the quantitative results.

This process is repeated on a monthly basis, and ultimately assists us in accomplishing a couple of things. First, it assists us in narrowing down the universe of funds on which to focus. The model "rewards" funds that have exhibited very consistent performance over time, which for our Recommended List, is an important factor. If we were "chasing returns", we would only focus on those funds that had exhibited higher, more recent returns. Second, the quantitative model assists us in monitoring the funds. We are able to observe, on a monthly basis, any changes that are occurring with the funds, which allows us to further investigate funds that raise "red flags" in terms of the parameters we've indicated.

The Qualitative Side - In terms of the analysis, some of the qualitative factors we consider are manager

tenure, staff turnover, firm-level support, investment idea generation, the philosophy behind the investment process and the consistency in how it is implemented. All of these factors, and more, help us form an opinion about a fund. As time passes, and firms inevitably experience organization changes and/or staff turnover, we assess the changes and what impact they will have, if any.

People may argue that the quantitative side is more important than the qualitative side. We don't really see it as a situation of one being more important than the other. In our view, understanding the qualitative process employed by a fund manager will ultimately assist us in explaining the quantitative results they achieve. In other words, both sides of the analysis are critical to forming a well-rounded opinion on a fund.

Key Benefits for Using the ScotiaMcLeod Mutual Fund Recommended List

Now that we've explored some of the rationale behind identifying great funds in which to invest, I will provide some background and highlight some of the many benefits that you have available through your ScotiaMcLeod advisor as supported by the ScotiaMcLeod PAG Fund Research team, and the Recommended List.

In-Depth due Diligence - As highlighted in the previous section, our investment process in identifying quality mutual funds in which to invest is robust. From our quantitative modeling to our qualitative work, we cover as many angles as possible on an ongoing basis to ensure advisors can rely on us for support as it relates to the funds we cover.

Access to Fund Managers - We meet with every fund manager on our Recommended List at least once per year, and more often than not, multiple times per year. With over 200 meetings a year, we also meet a wide variety of fund managers that are not on our Recommended List on a regular basis. In this way, we see first hand what the portfolio managers are thinking from a big picture perspective and are able to question them on what their plans are for the portfolios they manage.

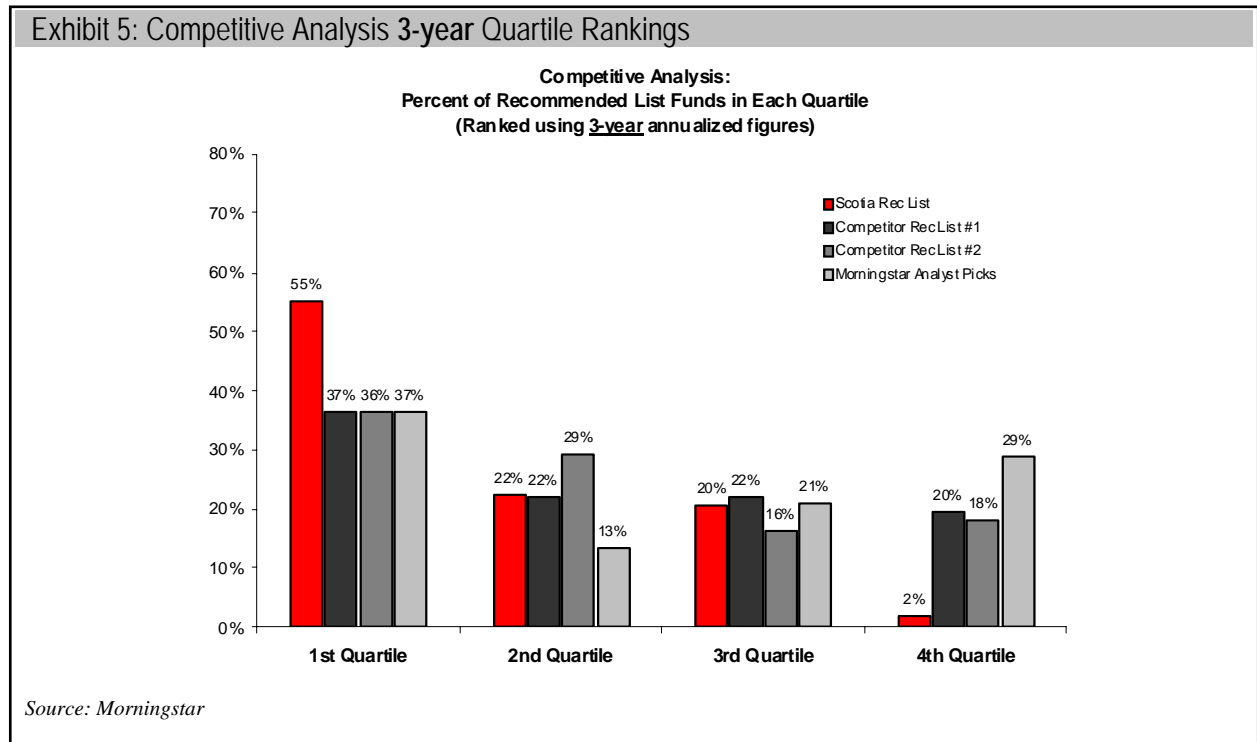
Ongoing Monitoring - Most investors purchase a fund and will not revisit their investment unless either great returns or poor returns attract their attention. The same effort used in making the initial purchase decision should carry into the monitoring of the investment. As part of our process, we run the entire mutual fund universe through our quantitative model on a monthly basis. This analysis allows us to look at how the funds perform over time, highlighting long-term trends, consistency and most importantly, any anomalies. We proactively investigate any issues of concern to ensure that our thesis for recommending the funds remain unchanged.

“The Proof is in the Pudding” - We generated some competitive analysis that put our Recommended List against the Recommended Lists of two competitor wealth management firms, as well as Morningstar's Fund Analyst Picks. The Morningstar Fund Analyst Picks do not refer to the “Star Rating” that Morningstar calculates, but rather, to the actual analysts at Morningstar who have generated a list of funds they believe will outperform.

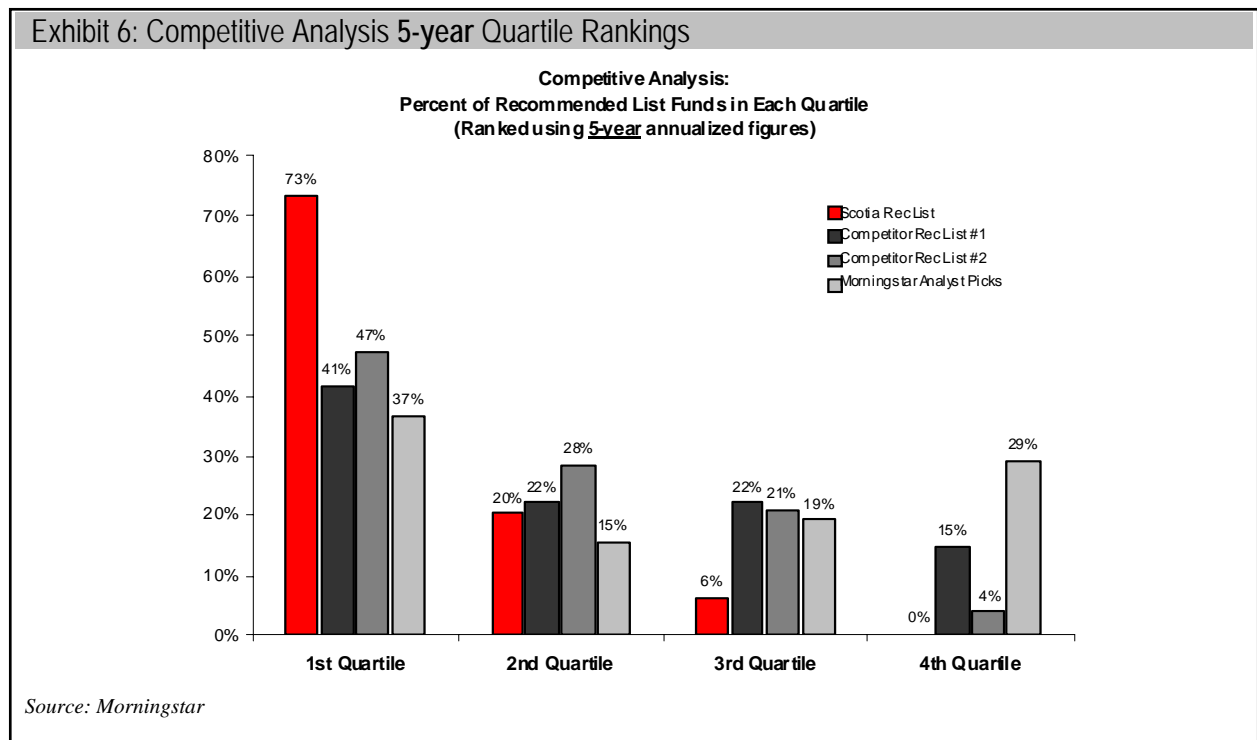
In **Exhibit 5** below, we show the percentage of Recommended List funds that are in each quartile based on 3-year annualized figures. We have made our fund picks with the intention that the funds will outperform their peers over multiple time periods, but with particular focus over the longer term since we believe mutual fund investing should not be a short-term exercise.

It is also important to note that we have made our fund picks over time which includes ongoing monitoring and periodic review for fund removals and/or additions (generally done annually).

As Exhibit 5 illustrates, ScotiaMcLeod’s Mutual Fund Recommended List contains the most funds in the top quartile as of July 31, 2009, with our competitors trailing behind, in some cases, significantly.



If we look at **Exhibit 6**, the case is even more compelling for the 5-year quartile rankings as our focus on consistent long-term results has paid off with 73% of the funds on our Recommended List in the top quartile, and over 93% in the top half, which compares very favourably against each of the competitors and Morningstar’s 5-year results.



Of course, this picture may vary over time, but we are pleased to report that our objective process has been working thus far, and we have confidence it will continue to do so.

In summary, with the abundance of choices and information available, selecting a mutual fund can be a complicated and time-consuming task. There are many more factors to consider beyond looking at recent performance and Morningstar Star Ratings. We feel our robust analytical process consisting of both quantitative and qualitative methods allows us to effectively compare and contrast the funds in the universe. The options available on the Recommend List combined with the expertise provided by your ScotiaMcLeod advisor, should result in a portfolio of high-quality mutual funds which will help you meet your investment goals and objectives.

To find out more information about the ScotiaMcLeod Mutual Fund Recommended List, please speak to your advisor.

Financial & Estate Planning

Update on the Home Renovation Tax Credit

Adam Salahudeen L.L.B. – Senior Manager, Taxation Advisory Services, Financial & Estate Planning Group

Earlier this year, the federal government introduced a new tax credit called the “The Home Renovation Tax Credit” (HRTC) which is based on eligible expenses for improvements to your house, condominium or cottage. It can be claimed on your 2009 income tax return and applies to eligible purchases made only after January 27, 2009, and before February 1, 2010.

The HRTC applies to eligible expenses of more than \$1,000, but not more than \$10,000, resulting in a maximum non-refundable tax credit of 15% which is equal to a tax savings of \$1,350. The HRTC will not be reduced by other government tax credits, grants, or incentives that you may be entitled to.

There is less than four months remaining for Canadians to take full advantage of the credit. Listed below are some of the answers to frequently posed questions regarding the HRTC regime.

What is an Eligible Dwelling for the Purposes of the HRTC?

An eligible dwelling is a housing unit that is eligible to be an individual's principal residence or that of one or more of their family members, at any time between January 27, 2009 and February 1, 2010. In general, a housing unit is considered eligible to be an individual's principal residence where it is owned by the individual and ordinarily inhabited by the individual, the individual's spouse or common-law partner, or their children. This means that any dwelling that you own and use personally could qualify, including your home or your cottage.

For the purpose of the HRTC, families consist of individual, spouse, or common law partner and children under the age of 18. Thus the unused portion may be potentially utilized by one or more family members. If two or more families share ownership of a particular eligible property (e.g. a cottage), then each family may be eligible to claim their own HRTC based on the amount of their eligible expenditures. Note that the maximum amount of eligible expenses you can claim for the HRTC is \$10,000 per family and not per eligible dwelling. As a result, this may mean additional decision making and planning for what repairs you may want to incur and on which of the properties you are considering to renovate before the program expires in February 2010.

Rental and/or business use of an eligible dwelling

If you earn business or rental income from part of an eligible dwelling, you can claim the HRTC only for expenses incurred for the personal-use areas of the dwelling. For expenses incurred for common areas or that benefit the housing unit as a whole (such as re-shingling a roof), you must divide the expense between personal use and income-earning use. For further information, consult CRA's Business and Professional Income Guide (<http://www.cra-arc.gc.ca/E/pub/tg/t4002/README.html>) or their Rental Income Guide (<http://www.cra-arc.gc.ca/E/pub/tg/t4036/README.html>).

Condominiums and co-operative housing corporations

For condominiums and co-operative housing corporations, your share of the cost of eligible expenses for common areas qualifies.

What is an Allowable and Eligible expenditure?

In order for any expenditure to be eligible, it must be of an enduring nature and integral to, or built into, the dwelling. The following are some examples of an eligible expenditure:

- Replacing a section of your floor or sanding and refinishing of hardwood floors
- Carpeting
- Painting
- Replacing windows and/or doors
- Upgrading wiring, plumbing or insulation
- Driveway resurfacing
- Installing a permanent swimming pool or hot-tub (both above or below ground)
- Laying sod, landscaping, retaining walls
- Building of a backyard deck
- Tree removal (if the removal relates to a renovation project that is of an enduring nature and integral to the home)

Examples of non-eligible expenses:

- Furniture, appliances, tools, and audio and visual electronics
- Routine repairs, seasonal maintenance and cleaning (e.g., furnace cleaning, snow removal, lawn care, pool cleaning, house cleaning)
- Financing costs

In addition, all of the associated costs of permits, equipment rentals, professional services (e.g. hiring an architect) and incidentals would qualify as an eligible expenditure. Goods and services provided by persons that you are not dealing at arms length with (e.g. close relative(s)) will not qualify unless that particular person is registered to collect GST/HST.

For further clarification and information of eligible expenses please refer to CRA's website (<http://www.cra-arc.gc.ca/tx/ndvdl/sgmnts/hmwnr/hrtc/menu-eng.html>) in order to check and review the entire list to make sure that your purchases qualify.

How Will I Claim the HRTC?

A new line and schedule will be included in your personal income tax return for 2009 to allow you to calculate and claim the HRTC. You do not have to submit your supporting documents with your income tax and benefit return; however, you must ensure this information is available should the Canada Revenue Agency request it.

The CRA has also introduced a yellow HRTC envelope in which to save your receipts. Envelopes are available at various retail stores such as Canadian Tire and Home Depot. For a more detailed list of retail outlets that carry the HRTC envelopes, please consult CRA's website (<http://www.cra-arc.gc.ca/tx/ndvdl/sgmnts/hmwnr/hrtc/nvlps-eng.html>).

What Does CRA Consider to be Acceptable Documentation for the HRTC?

Any agreements, invoices and receipts, must clearly identify the type and quantity of goods purchased or services provided, including, but not limited to the following information:

- Information that clearly identifies the vendor/contractor, their business address and if applicable, the GST /HST registration number;
- A description of the goods and the date when the goods were purchased;
- The date when the goods were delivered (keep your delivery slip as proof) and/or when the work or services were performed;
- A description of the work performed which includes the address of the dwelling where the work was performed;
- The amount of the invoice requires proof of payment. Receipts or invoices must indicate paid in full or be accompanied by other proof of payment, such as a credit card slip or cancelled cheque.

To avoid problems with your HRTC claim, make sure you:

- Get your contracts in writing (www.hiringcontractor.com);
- Check out CRA's dedicated website on the HRTC (<http://www.cra-arc.gc.ca/tx/ndvdl/sgmnts/hmwnr/hrtc/menu-eng.html>) and,
- Keep your receipts.

Equity Guided Portfolios

Stephen Uzielli — Portfolio Manager, Portfolio Advisory Group

The Equity Guided Portfolios are models designed to provide investors with a convenient way of investing directly in individual holdings and building diversified portfolios composed of equity securities. The portfolios are actively managed by a dedicated Portfolio Manager with oversight from the Investment Committee of the ScotiaMcLeod Portfolio Advisory Group. Each portfolio has a specific mandate but they all have the common objective of providing investors with a consistent long-term rate of return through holding a portfolio of stocks comprised of industry leaders with unique franchises and strong management teams, combined with an attractive trend in profitability.

ScotiaMcLeod Canadian Core Guided Portfolio

Performance Update

Equity markets continued their upward trajectory in the third quarter following the pattern established in the previous quarter after the market bottomed in early March. At the time of the equity market lows, investors appeared to be discounting everything that could possibly go wrong in the global economy; since then market participants have been increasingly encouraged by improving economic data supporting a significantly more optimistic outlook, and consequently driving equity prices higher. As the third quarter concluded, we have increasing confidence in the economic recovery while acknowledging there will likely be bumps along the road. The market is fairly valued at current levels, not expensive, but not cheap either, and thus there exists the potential for occasional market pullbacks resulting from investor fatigue or negative headlines. The market trend remains positive however so any declines in equities are likely to be modest and short lived. We recommend investors buy cyclical stocks in the event of any pullbacks in order to position portfolios for stronger equity performance through the end of the year.

Eight of the ten broad industrial sectors generated positive returns in the Canadian market during the quarter and investors demonstrated their increased risk appetite by virtue of market leadership seen among cyclically oriented groups like Financials, Materials, and Industrials while more defensive sectors lagged. As observed in the second quarter, most industrial commodities were strong during the quarter in response to an improving global demand outlook combined with ongoing selling pressure on the U.S. dollar. Crude oil futures increased only 1% and closed the quarter at US\$70.61 per barrel. Natural gas futures rallied from exceedingly low levels caused by excess inventories, ending the quarter 26% higher at US\$4.84/MMBtu. Gold bullion futures crossed over the psychologically significant US\$1000 level, closing September at US\$1009 per ounce while copper increased another 24% after a similar increase in the previous quarter.

During the third quarter the Canadian Core Guided Portfolio outperformed the benchmark as it increased 13.9% on a total return basis while the S&P/TSX60 moved up 8.8%. The relative outperformance resulted from a combination of appropriate sector allocation and effective stock selection. During a period when economically sensitive stocks led the market higher, the heavy emphasis on Financial holdings contributed significantly to overall performance; this was particularly evident in the shares of **AGF Management** which rallied 35%, **Brookfield Asset Management** which climbed 23%, while **Royal Bank** increased 21% during the quarter supported by strong Q3 earnings released in late August. In sympathy with stronger commodity prices resource holdings in the portfolio also got a lift, most noticeably in the shares of **Canadian Natural Resources** which advanced 18% while **Teck Resources** delivered another solid quarterly performance climbing 59%. Consistent with the overall market strength, only three portfolio holdings declined in value during the quarter; the single negative move of significance was the 12% decline in shares of **Shoppers Drug Mart**. **Shoppers** dropped despite reporting solid Q2 earnings growth in line with analyst expectations. That earnings report was overshadowed by investor concerns surrounding pending reforms by the Ontario Ministry of Health that

might impact future profitability; based on previous similar events we expect the company will successfully navigate any new legislation and may indeed derive a net benefit.

Changes

Early in the quarter we re-balanced the weightings of holdings specifically due to the strength in the price of **Teck Resources** and its impact on the portfolio. **Teck Resources** had had a huge increase of 245% since the previous rebalancing that occurred coincident with a switch in bank holdings. As a result the portfolio weight of the position in **Teck** had grown to more than 10% of the portfolio, which is excessive, and thus it was prudent to rebalance and return all positions back to equal weights of 5% each. **Teck** shares had advanced an impressive 584% since they hit their closing low price of \$3.42 per share on March 5, 2009. We reiterated at that time our confidence in the long-term outlook for **Teck Resources** and the intention to continue holding a position in the portfolio. Not unlike the broader stock market over the past few months, **Teck** shares had made a remarkable bounce off their lows and were vulnerable to a pullback; trimming extra-large positions, especially at a profit, was both timely and prudent.

Later in July we switched out of **Power Financial (PWF)** and replaced it with a direct investment in its core underlying component **Great West Lifeco**. Since the market bottomed in early March, **PWF** shares had outperformed the broader Financials sub-index which and were then trading at only a 6.4% discount to the Net Asset Value (NAV) of the company, at the low end of the historical trading range between 6% and 21%, and thus were fairly valued. **Power Financial's** NAV is dominated by equity stakes in **Great West Lifeco** (72%) and **IGM Financial** (29%); **IGM** shares were also fully valued at then current levels and as such investors are better served holding a direct investment in **Great West Lifeco** rather than **PWF** as its shares offer greater capital appreciation potential in addition to an attractive dividend yield.

In August we affected a switch out of **Fortis Inc.** and into shares of **Research in Motion**. Following the Q2 earnings release for **Fortis Inc. (FTS)** which was essentially in-line with expectations, Scotia Capital analyst Sam Kanen downgraded his recommendation on the stock to 3-Sector Underperform. There was no change in his \$27 target price, but given the modest rate of return to his target price relative to his coverage universe he elected to downgrade the ranking. By virtue of the Investment Policy Statement for the Canadian Core Guided Portfolio that triggers a review of holdings that Scotia Capital downgrades to 3-Sector Underperform, we removed the position in **Fortis Inc.**, eliminating exposure to the very lightly weighted Utilities sector in the process, and redeployed the proceeds in the shares of **Research In Motion (RIM)**.

Research In Motion Limited (RIM) is a leading designer, manufacturer, and marketer of innovative wireless solutions for the worldwide mobile communications market. The addition of **RIM** represents a shift in sector allocation toward a more cyclical emphasis in anticipation of the economic recovery. **RIM** is currently the only truly investment grade Canadian technology company available to investors and the company is the market leader in smart phone technology, both in terms of market share and product innovation. **RIM's** valuation is low relative to historical precedent for this company but also relative to its consistent 30% + growth rate. Near the end of the quarter **RIM** released Q2 results which disappointed investors and knocked the stock lower; **RIM** delivered earnings as expected on slightly lower-than-expected revenues but raised concerns for investors with financial guidance which implied margin reductions and fostering reduced confidence in future earnings prospects. We remain confident in the company's competitive position, continue to advocate holding existing positions, and will be buyers again after a period of consolidation; in the short term this stock will be driven more by technical trading factors than fundamentals.

The final change made during an uncharacteristically active quarter in this portfolio was the switch out of **Yellow Pages Income Fund** and into **Thomson Reuters Corporation**. After **Yellow Pages Income Fund (YLO)** lowered their annual distribution by 32%, to \$0.80 per unit to, conserve capital we stated that we were putting the holding "under review" pending replacement. In September we exited the position in **YLO** and redeployed the proceeds in the shares of another Consumer Discretionary investment with solid growth potential and attractive valuation: **Thomson Reuters Corporation (TRI)**.

As a result of the merger of **The Thomson Corporation** and **Reuters Group Plc**, **TRI** is the largest provider of market data, applications, and information solutions to customers in the securities and investment management industry. **TRI** has been a holding in the Canadian Income Plus Portfolio for the past two years and in that period has re-invented itself into an electronic information distribution company with excellent growth potential. **TRI** has consistently exceeded expectations on both revenue and earnings per share since the merger of **The Thomson Corporation** and **Reuters Group Plc** last year. **TRI** has demonstrated resilience in a weak global economy due to its recurring revenue model. The company has continued to surprise analysts with its ability to expand operating margins through higher integration synergies and other cost cutting initiatives. We believe that the company will continue to exceed its own guidance and consensus estimates in this regard.

Exhibit 1: ScotiaMcLeod Canadian Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 30-Sep-09	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
AGF Management Limited	AGF.B	1-SO	High	\$17.15	\$20.00	\$1.00	5.8%	22%
Bank of Nova Scotia	BNS	2-SP	Low	\$48.87	\$55.00	\$1.96	4.0%	17%
Brookfield Asset Management	BAM	1-SO	Medium	\$24.37	\$28.33	\$0.61	2.5%	19%
Great West Lifeco	GWO	1-SO	Low	\$26.56	\$31.00	\$1.23	4.6%	21%
Manulife Financial	MFC	1-SO	Low	\$22.50	\$28.00	\$0.52	2.3%	27%
Rogers Communications	RCI.B	1-SO	Medium	\$30.23	\$39.00	\$1.16	3.8%	33%
Royal Bank of Canada	RY	1-SO	Low	\$57.55	\$75.00	\$2.00	3.5%	34%
Sun Life Financial	SLF	2-SP	Low	\$33.55	\$37.00	\$1.44	4.3%	15%
Consumer Products:								
Shoppers Drug Mart	SC	1-SO	Low	\$43.94	\$57.50	\$0.86	2.0%	33%
Thomson Reuters Corporation	TRI	1-SO	Low	\$5.40	\$47.00	\$0.80	14.8%	785%
Industrial Products:								
Canadian National Railway	CNR	1-SO	Medium	\$52.73	\$58.00	\$1.01	1.9%	12%
Research in Motion	RIM	1-SO	Medium	\$72.38	\$103.00	\$0.00	0.0%	42%
Resource:								
Agrium Inc.	AGU	Restricted	Restricted	\$53.52	R	\$0.11	0.2%	
Barrick Gold	ABX	1-SO	Medium	\$40.54	\$55.56	\$0.44	1.1%	38%
Canadian Natural Resources	CNQ	1-SO	High	\$72.30	\$80.00	\$0.53	0.7%	11%
Nexen Inc.	NXY	1-SO	High	\$24.34	\$27.00	\$0.20	0.8%	12%
Suncor Energy	SU	2-SP	Medium	\$37.40	\$38.00	\$0.40	1.1%	3%
Talisman Energy	TLM	1-SO	Medium	\$18.63	\$22.00	\$0.23	1.2%	19%
Teck Resources Ltd.	TCK.B	1-SO	High	\$29.50	\$32.50	\$0.00	0.0%	10%
TransCanada Corp.	TRP	1-SO	Low	\$33.37	\$40.00	\$1.52	4.6%	24%

Source: Scotia Capital; Bloomberg.

ScotiaMcLeod Canadian Income Plus Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

During the past six months of impressive stock market gains since the lows of March, equity market leadership has come from mostly cyclical sectors in anticipation of an economic recovery. Strength has been observed in the Energy and Materials space, but also among the heavily weighted Financials. When Financials are strong it generally leads to strong gains by dividend oriented stocks as measured by the benchmark Dow Jones Canada Select Dividend Index, which as of the end of Q3 has a 71% weighting in Financial stocks. The portfolio generated a total return of 8.2% during the quarter while the benchmark index increased 11.4%; portfolio performance lagged during the quarter as the exposure to Financials is currently only 40% of the portfolio.

During the quarter all but two holdings in the Income Plus Guided Portfolio moved higher, led by moves in **Royal Bank** along with **Great West Lifeco** that rallied 17% during the period. More defensively oriented sectors like Telecommunications and Pipelines still lagged the performance delivered by other higher yielding dividend stocks although returns were still positive. The two decliners during the period were **Shaw Communications** which dropped only 1% and the recently acquired **Shoppers Drug Mart** that fell less than 1% since being added to the portfolio.

Changes

Similar to the actions taken in the Canadian Core Portfolio in late July, we made a switch out of **Power Financial** for the same reasons explained previously, and replaced it with a holding in **Manulife Financial**. This portfolio has in effect been "double weighted" in its exposure to **Great West Lifeco (GWO)** by virtue of its holding in both **PNF** and **GWO** which is not optimal in terms of portfolio diversification, but also reflects the narrow universe of potential holdings that qualify for investment in this income portfolio. Henceforth the portfolio will continue to hold shares of **Great West Lifeco** which still offer significant upside, but we believe investors will be better served and more appropriately diversified by holding a different investment than **PNF** that provides greater capital appreciation potential in addition to an attractive dividend yield. Our analysis indicated **Manulife** shares were valued at a discount valuation to the company's peer group and represented a unique investment opportunity for a stock that has traditionally traded at a premium to the group. However, concurrent with their Q2 earnings release, **Manulife** announced a 50% cut in their dividend. Though a reduction in the dividend was recognized as a potential risk, the probability was deemed low; clearly the move into **Manulife** would not have been made had we anticipated an imminent dividend cut. By virtue of the Investment Policy Statement for the Canadian Income Plus Guided Portfolio that triggers the automatic removal of any holding in the event of a cut in the dividend or distribution, these shares no longer qualify for investment in this portfolio, ultimately leading to the elimination of the **Manulife** position and a new investment in **Bank of Montreal**.

Bank of Montreal (BMO) is the fourth-largest Canadian chartered bank in terms of assets and the fifth-largest by market capitalization. The bank owns investment dealer BMO Capital Markets (formerly BMO Nesbitt Burns) and a network of community banks in the Chicago area under the Harris brand. We have been looking for an opportunity to increase the weighting in bank holdings in the portfolio and adding **BMO** at this time is consistent with portfolio strategy which is to identify investments with a combination of both positive growth and income characteristics. While acknowledging the significant increase in the share price over the past six months, for investors with an investment horizon beyond one year, buying shares of **Bank of Montreal** should be rewarding as the stock market will become increasingly confident in the strength and sustainability of an economic recovery and expand valuation multiples accordingly. Scotia Capital bank analyst Kevin Choquette upgraded his investment recommendation on **BMO** in August from 2-Sector Perform to 1-Sector Outperform "based on the continuing strength of its operating platforms, leverage to a turn in the credit cycle given its industry high loan losses and expected positive earnings surprises".

We also removed the **Fortis** position from this portfolio for the same reasons described earlier in the commentary for the Canadian Core Portfolio, and a new position was established in **Shoppers Drug Mart (SC)**. **Shoppers** is a company well known to investors in the Canadian Core Portfolio and is also suited to this portfolio due to a combination of growth in profitability and dividends. **Shoppers** has a dividend yield of 2.0% but importantly has also evolved into a solid dividend growth story as the company has an average annual dividend growth rate of almost 19% since its inception as a public company.

In another effort to add financial weight to the portfolio we also switched out of **Finning International** and established a position in **TD Bank**. Since the Canadian market reached its trough on March 9, 2009, the shares of **Finning** had rallied 59%, and had achieved a modest total return of 4% since the original investment in this portfolio. Despite improvement in most commodity prices this year, earnings visibility for **Finning** remained elusive. The company reported Q2 earnings in August, well below analyst estimates with low earnings quality also contributing to a 15% decline in the share price. Subsequently the shares had bounced somewhat and we elected to lock in a modest profit in this position and redeploy the funds in another investment that will benefit earlier in the economic recovery while also providing a higher dividend yield and greater upside potential: **Toronto Dominion Bank**.

Toronto-Dominion Bank (TD) is the second-largest Canadian chartered bank based on both assets and market capitalization. The addition of another bank holding is consistent with our strategy of seeking greater exposure to the Financial sector. Scotia Capital bank analyst Kevin Choquette upgraded his investment recommendation on **TD** after the company reported Q3 earnings which exceeded analyst estimates. All the major banks beat consensus forecasts for Q3, with the exception of **CIBC** which is indicative in some measure of the improving economic environment in which the Canadian banks operate. Choquette had downgraded **TD** earlier this year due to concerns regarding its high relative exposure to Retail banking and therefore sensitivity to net interest margin pressure, as well as the vulnerability of its U.S. business to the ongoing credit crisis. As events transpired, the analyst concedes in his report that his reversal in ranking resulted from “less-than-expected deterioration in the U.S. business and improvement in the earnings power of its wholesale business, aided by the bank’s high counterparty credit rating.”

Exhibit 2: ScotiaMcLeod Income Plus Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 30-Sep-09	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
BCE Inc.	BCE	2-SP	Medium	\$26.39	\$27.00	\$1.62	6.1%	8%
Bank of Nova Scotia	BNS	2-SP	Low	\$48.87	\$55.00	\$1.96	4.0%	17%
Great West Lifeco	GWO	1-SO	Low	\$26.56	\$31.00	\$1.23	4.6%	21%
Bank of Montreal	BMO	1-SO	Low	\$54.17	\$65.00	\$2.80	5.2%	25%
Rogers Communications Inc.	RCI.B	1-SO	Medium	\$30.23	\$39.00	\$1.16	3.8%	33%
Royal Bank of Canada	RY	1-SO	Low	\$57.55	\$75.00	\$2.00	3.5%	34%
Sun Life Financial	SLF	2-SP	Low	\$33.55	\$37.00	\$1.44	4.3%	15%
TELUS Corp.	T	1-SO	Medium	\$34.54	\$39.00	\$1.90	5.5%	18%
Toronto Dominion Bank	TD	2-SP	Medium	\$34.54	\$80.00	\$1.90	5.5%	137%
Consumer Products:								
Shaw Communications	SJR.B	2-SP	Low	\$19.38	\$21.00	\$0.84	4.3%	13%
Thomson Reuters Corp.	TRI	1-SO	Low	\$35.90	\$47.00	\$1.23	3.4%	34%
Resource:								
Enbridge Inc.	ENB	1-SO	Low	\$41.57	\$49.00	\$1.48	3.6%	21%
Inter Pipeline Fund LP	IPL.UN	2-SP	Medium	\$9.68	\$10.50	\$0.84	8.7%	17%
TransCanada Corp.	TRP	1-SO	Low	\$33.37	\$40.00	\$1.52	4.6%	24%

Source: Scotia Capital; Bloomberg.

ScotiaMcLeod U.S. Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

U.S. equities ended the third quarter with a seventh consecutive positive monthly performance. Every sector of the market moved higher, and in keeping with the previous quarter, leadership was found among more cyclically oriented industries like Financials, Industrials, Materials, and Consumer Discretionary while more defensive groups underperformed. By the end of the period the benchmark S&P500 Index generated a total return of 15.6%, while the U.S. Core Guided Portfolio marginally underperformed while advancing 14.2% including dividends. Underperformance was largely attributable to certain stock selections lagging their respective sectors in combination with sector allocation not being sufficiently skewed toward economically sensitive industry groups. Markets were propelled by better than expected Q2 earnings results and several positive economic releases including Leading Economic Indicators and improving housing statistics. The incidence of companies beating analyst expectations for earnings results exceeded 72% in the second quarter while historically earnings "beats" occur approximately 65% of the time. As highlighted in this space last quarter, consensus earnings revisions have turned positive over the past few months which serve as a positive indicator for future earnings momentum.

Among portfolio holdings, low interest rates and a positive economic outlook propelled the shares of **MetLife, Inc.** higher by 27% while **Occidental Petroleum** rallied 19% despite only a modest move higher in crude oil prices. **Walt Disney** shares increased 18% during the quarter in which they reported Q2 earnings in line with analyst expectations. **Nike Inc.** advanced 25% in the quarter with a big move before the end of September following better-than-expected earnings results driven largely by cost cutting which improved gross margins. **McKesson Corp.**'s stock moved up 35% during the quarter, initially driven by the renewal of its distribution agreement with **CVS Caremark** and subsequently fuelled by better than expected Q1 earnings results and increased financial guidance for fiscal 2010. Among other large positive contributors during the period was the holding in **Freeport McMoRan Copper & Gold** that advanced 37% on the back of higher copper prices. Only two stocks in the portfolio declined during Q3 including a 2% decline in the shares of **Becton, Dickinson** which late in July reported Q3 results in-line with analyst estimates but lowered guidance for 2010, thus resulting in a reduced valuation outlook.

Mixed economic data is likely to remain a constant for several quarters, if not years, until the economy achieves a more "normal" state. In the meantime investors will be provided with many shorter-term trading opportunities resulting from market volatility surrounding the release of economic and earnings results; ultimately however, the trend for equity markets remains positive through the end of 2009 and investors should be adding to equity holdings on market pullbacks.

Changes

Near the end of July we switched out of **Edison International** and into **McDonald's Corp (MCD)**. The holding in **Edison** shares had delivered disappointing performance during a weak economic environment in which defensive Utility stocks are expected to outperform. We had stated previously that the next move in our diversified portfolios was to shift slowly toward a more cyclical emphasis to take advantage of an economic recovery. At the same time, the shares of **Edison** had not performed particularly well despite their 3.8% dividend yield. Accordingly we sold the position in **Edison International**, eliminating exposure to the very lightly weighted Utilities sector in the process, and redeployed the proceeds in the shares of an additional Consumer Discretionary company: **McDonald's Corp.**

McDonald's is the leading global foodservice retailer with more than 31,400 local restaurants serving more than 58 million people in 118 countries every day. **MCD** is a true multinational with foreign operations contributing about 65% of company sales and 50% of profits. Many to refer to the company as recession resistant but an investment in **MCD** also provides leverage to an economic recovery as it will benefit from any increase in discretionary spending by consumers. **McDonald's** has a strong balance sheet and a history of dividend growth. The stock has a current dividend yield of 3.6% which will reward shareholders as they await better top line growth coincident with an economic recovery.

Exhibit 3: ScotiaMcLeod U.S. Core Guided Portfolio

Sector	Symbol	Rating	Risk Ranking	Price 30-Sep-09	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
AT&T Inc.*	T	Not Rated	Low	\$27.01	\$30.00	\$1.64	6.1%	17%
MetLife, Inc.	MET	Outperform	Medium	\$38.07	\$38.00	\$0.74	1.9%	2%
State Street Corp	STT	Outperform	Low	\$52.60	\$54.00	\$0.04	0.1%	3%
Consumer Products:								
Becton, Dickinson & Co.	BDX	Neutral	Low	\$69.75	\$66.00	\$1.32	1.9%	-3%
Colgate-Palmolive Co.*	CL	Not Rated	Medium	\$76.28	\$81.00	\$1.76	2.3%	8%
CVS Caremark Corp	CVS	Outperform	Medium	\$35.74	\$37.00	\$0.31	0.9%	4%
McDonald's Corp	MCD	Neutral	Low	\$57.07	\$64.00	\$2.20	3.9%	16%
McKesson Corporation	MCK	Outperform	Low	\$59.55	\$59.00	\$0.48	0.8%	0%
Nike Inc.	NKE	Outperform	Medium	\$64.70	\$75.00	\$1.00	1.5%	17%
Pfizer Inc.	PFE	Outperform	Low	\$16.55	\$21.00	\$0.64	3.9%	31%
Wal Mart Stores	WMT	Neutral	Low	\$49.09	\$53.00	\$1.09	2.2%	10%
Walt Disney	DIS	Outperform	Medium	\$27.46	\$28.00	\$0.35	1.3%	3%
Industrial Products:								
Cisco Systems	CSCO	Outperform	Low	\$23.54	\$25.00	\$0.00	0.0%	6%
Microsoft Corp	MSFT	Outperform	Low	\$25.72	\$27.50	\$0.52	2.0%	9%
Oracle Corp*	ORCL	Not Rated	Low	\$20.84	\$25.00	\$0.20	1.0%	21%
United Technologies Corp*	UTX	Not Rated	Low	\$60.93	\$65.00	\$1.54	2.5%	9%
Waste Management Inc.	WM	Neutral	Medium	\$29.82	\$33.00	\$1.16	3.9%	15%
Resource:								
Freeport McMoRan Copper	FCX	Outperform	Medium	\$68.61	\$70.00	\$0.00	0.0%	2%
Occidental Petroleum	OXY	Outperform	Medium	\$78.40	\$76.00	\$1.32	1.7%	-1%
XTO Inc.	XTO	Outperform	Medium	\$41.32	\$43.00	\$0.50	1.2%	5%

*Currently Credit Suisse does not provide research coverage - target price based on consensus data.

Source: Scotia Capital Credit Suisse; Bloomberg; Value Line

ScotiaMcLeod North American Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

The ScotiaMcLeod North American Core Guided Portfolio is suitable for growth investors seeking consistent long-term rates of return from a portfolio of high quality Canadian and U.S. companies. The current portfolio holds 25 equal-weighted (4%) positions. Country allocation within the portfolio is determined in a bottom-up, stock-specific fashion as opposed to making any particular country “call.” Generally speaking, but not exclusively, resource holdings will likely come from the Canadian universe, and Health Care, Information Technology, and Consumer stocks will usually be drawn from the United States. Performance of the portfolio is measured against a North American Index which is a composite benchmark equally weighted between the S&P/TSX 60 Index (50%) and the S&P500 Index (50%), translated into Canadian dollars.

The U.S. dollar fell more than 4% against a basket of global currencies during the quarter but dropped almost 8% against the Canadian dollar, partly due to market concerns about the current state of the U.S. government balance sheet, but mostly attributable to the strength in the loonie resulting from higher commodity prices. As a result, U.S. stock performance which was positive in absolute terms was substantially diluted after currency translation back to Canadian dollars. Canadian holdings increased on average 12% during the period while the U.S. positions advanced 13% in local currency terms, which after translation led to an average increase of only 4%. Two holdings actually moved lower in the period with the largest being **Shoppers Drug Mart**, followed by **Oracle Corp.** The biggest contributors to portfolio performance were spread across several sectors led by **Teck Resources**, **Brookfield Asset Management**, and **Royal Bank**, and included **Walt Disney**, **McKesson Corp.**, and **Occidental Petroleum**, all mentioned previously.

Changes

In July we also switched out of **Edison International** and into **McDonald's Corp.** in this portfolio, applying the same rationale as was explained earlier in the commentary for the U.S. Core Portfolio.

In August we upgraded the holdings among Energy stocks in the portfolio with a switch out of **XTO Energy (XTO)** and into **Canadian Natural Resources**. **XTO** was added to the portfolio in January of this year and the shares had increased 20% since the original purchase. **XTO's** operations are highly levered to unconventional natural gas resource plays, specifically shale and coal bed methane gas plays in the U.S. **XTO** has a proven track record of adding incremental reserves to acquired properties through cost controls, applying horizontal drilling, and operational expertise. The fact that the company's shares have performed as well as they have in a period where natural gas prices have plummeted to seven year lows is attributable to the strong hedge position the company enjoys at much higher prices. As a longer-term holding we expect the stock should perform well given the company's low cost structure, production and cash flow growth, ongoing hedge position, and decent dividend yield; however, given that the outlook for natural gas remains poor for the intermediate term, we believed it was prudent to lock in the gain and move into another Energy investment with greater upside potential.

Canadian Natural Resources Limited (CNQ) has been a holding in the Canadian Core Portfolio since November of 2008 and has been a key contributor to portfolio returns this year. Although the company's production profile is currently relatively balanced between oil and gas, as heavy oil production has begun to ramp up, natural gas as a proportion of total production is forecast to decline to 37% in 2009 and 33% in 2010. Total oil and gas production is forecast to grow 3% in 2009 and 7% in 2010, with several new projects coming on stream shortly. Valuation is very attractive as the stock trades at a significant discount to Net Asset Value (NAV) and also at a discount to its peer group on a Price/Cash Flow basis.

Exhibit 4: ScotiaMcLeod North American Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 30-Sep-09	Target Price	Dividend	Dividend Yield	Potential ROR
Financials:								
Bank of Nova Scotia	BNS	2-SP	Low	\$48.87	\$55.00	\$1.96	4.0%	17%
Brookfield Asset Management	BAM/A	1-SO	Medium	\$24.37	\$28.33	\$0.61	2.5%	19%
Manulife Financial	MFC	1-SO	Low	\$22.50	\$28.00	\$0.52	2.3%	27%
Royal Bank of Canada	RY	1-SO	Low	\$57.55	\$75.00	\$2.00	3.5%	34%
Sun Life Financial	SLF	2-SP	Low	\$33.55	\$37.00	\$1.44	4.3%	15%
Telecommunication Services								
AT&T Inc.*	T	Not Rated	Low	\$27.01	\$30.00	\$1.64	6.1%	17%
Rogers Communications	RCI/B	1-SO	Medium	\$30.23	\$39.00	\$1.16	3.8%	33%
Consumer Discretionary								
McDonald's Corp	MCD	Neutral	Low	\$57.07	\$64.00	\$2.20	3.9%	16%
Walt Disney	DIS	Outperform	Medium	\$27.46	\$28.00	\$0.35	1.3%	3%
Consumer Staples								
Colgate-Palmolive*	CL	Not Rated	Medium	\$76.28	\$81.00	\$1.76	2.3%	8%
Shoppers Drug Mart	SC	1-SO	Low	\$43.94	\$57.50	\$0.86	2.0%	33%
Health Care								
McKesson Corporation	MCK	Outperform	Low	\$59.55	\$59.00	\$0.48	0.8%	0%
Pfizer Inc.	PFE	Outperform	Low	\$16.55	\$21.00	\$0.64	3.9%	31%
Industrials								
Canadian National Railway	CNR	1-SO	Medium	\$52.73	\$58.00	\$1.01	1.9%	12%
United Technologies Corp*	UTX	Not Rated	Low	\$60.93	\$65.00	\$1.54	2.5%	9%
Information Technology								
Cisco Systems	CSCO	Outperform	Low	\$23.54	\$25.00	\$0.00	0.0%	6%
Microsoft Corp.	MSFT	Outperform	Low	\$25.72	\$27.50	\$0.52	2.0%	9%
Oracle Corp*	ORCL	Not Rated	Low	\$20.84	\$25.00	\$0.20	1.0%	21%
Energy								
Canadian Natural Resources	CNQ	Outperform	High	\$72.30	\$80.00	\$0.42	0.6%	11%
Occidental Petroleum	OXY	Outperform	Medium	\$78.40	\$76.00	\$1.32	1.7%	-1%
Suncor Energy	SU	2-SP	Medium	\$37.40	\$38.00	\$0.40	1.1%	3%
Talisman Energy	TLM	1-SO	Medium	\$18.63	\$22.00	\$0.23	1.2%	19%
TransCanada Corporation	TRP	1-SO	Low	\$33.37	\$40.00	\$1.52	4.6%	24%
Materials								
Barrick Gold	ABX	1-SO	Medium	\$40.54	\$55.56	\$0.44	1.1%	38%
Teck Resources Ltd.	TCK/B	1-SO	High	\$29.50	\$32.50	\$0.00	0.0%	10%

*Currently Credit Suisse does not provide research coverage - target price based on consensus data.

Source: Scotia Capital Credit Suisse; Bloomberg; Value Line

The Guided Portfolios returns are not calculated according to CFA Institute "Performance Presentation Standards". Returns are calculated on a total return basis (including dividend income). The returns are used to gauge our performance by comparing the returns of the Portfolios to benchmark total return indices such as the S&P/TSX 60 and the S&P 500. Historical performance of the Guided Portfolios is not necessarily indicative of future performance. Each client's return will vary depending on the number of shares purchased, as well as the timing of purchases or sales. The Guided Portfolios themselves should not be used as benchmarks with which to compare our clients' portfolios.

ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio

Chris Kennedy, CFA — Associate Director, Portfolio Advisory Group

Investment Objective

The ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio (Core) is designed and managed for our clients with a moderate to higher risk investment profile, whose investment horizon and objectives focus on both current income and a reasonable level of returns to protect against future inflation. Based on these criteria, the portfolio's objective is to meet or exceed the performance of the portfolio's benchmark, the DEX Universe Bond Index. Typically, this rate of return is not achieved every year but rather it is the desired average performance over the longer-term time horizon. Approximately 75% of the portfolio is placed in a 10-year laddered bond portfolio and 5% is placed in inflation-protected instruments, comprising the core holdings of the portfolio. The balance of 20% of the portfolio is focused on active value added trade strategies that attempt to help the portfolio outperform the benchmark.

Current Active Strategies

There was one change to our active strategy last quarter. On August 27th, we sold our short-term Bankers Acceptance (cash) position to purchase a 6-year Ontario agency bond, the Ontario Strategic Infrastructure Financing Authority (OSIFA) 4.60% due June 1, 2015. The OSIFA credit spread (yield pick up over Canada) had not tightened along with the overall Provincial sector at that time, and we felt offered excellent relative value while continuing to provide a very high level of safety. We believed the OSIFA spread should tighten, offering an opportunity for superior relative returns. In addition, the 5-year area of the yield curve was the area where both Scotia Economics and Consensus Forecasts suggested would outperform the rest of the curve over the next 12 months. We continue to hold our other portion of the active strategy, the Glacier Credit Card (GCC) Trust 5.027% due February 20, 2013.

Performance Update

The Core Plus Portfolio returned 2.67%, slightly underperforming the return on its benchmark, the DEX Universe Bond Index, which returned 2.71% for the quarter ending September 30, 2009. The main factors driving the performance difference were the portfolio's term and sector composition versus the benchmark. The Core Plus is naturally overweight the short and mid-term sectors of the index (1-10 year bonds), and with longer-term bonds outperforming the shorter end of the market last quarter, there was a natural drag on the performance of the Core Plus relative to the benchmark. However, sector differences played a factor towards performance last quarter as well. Both the Provincial and Municipal sectors largely outperformed the overall index last quarter. As the Core Plus portfolio is overweight these sectors compared to the index, this helped add to performance last quarter. Finally, the corporate sector weighting in the Core Plus remains slightly overweight compared to the benchmark. Although the corporate market has had a tremendous rally year to date, last quarter saw this sector continue to outperform the index, thereby adding to the Core Plus returns.

Each of our active trades performed well last quarter. The Glacier Credit Card Trust 5.027% due February 20, 2013 had an excellent quarter, returning 5.13%, doubling the performance of the benchmark which returned 2.71% ending September 30, 2009. The overall securitization sector had a strong quarter as investors saw relative value in the sector compared to corporate bonds. While we believe at this time there is less room for further spread tightening, we think the overall Asset Backed Securities (ABS) sector may continue to improve further based on an overall lack of new issuance. As such, we will hold the position, but are beginning to review possible replacements.

Our second active portion of the portfolio, the 6-yr OSIFA bond, has performed quite well since initiated on August 27th and returned 1.16% for the month of September, outperforming the overall index. The OSIFA credit spread (yield pick up over Canada) has tightened along with the overall Provincial sector during the month of September, producing a stronger relative return. We continue to believe the OSIFA spread will tighten, offering an opportunity for superior relative returns. In addition, Scotia Economics and Consensus Forecasts continue to believe the 5-year area of the yield curve will outperform the rest of the curve over the next 12 months.

The Canadian corporate market has returned 15.30% year to date, nearly tripling the return of the overall index. However last month we began to see the pace of these gains slow and in some cases, weaken. Our overall market call going into the year end is for investors to consider taking profits on the corporate positions they have held over the past year. We continue to believe Municipal and Provincial backed paper provide stronger relative value compared to corporate bonds and our recent calls to overweight the Provincial and Municipal sector relative to the index have proven successful. To give an example outside of the active trades named above, we highlight our successful change to the ladder portion of our portfolio made on June 11th. While the ladder portion of the Core Plus portfolio strategy typically entails holding until maturity, we made this change to take advantage of a significant opportunity. Leading up to the middle of June, we had seen unprecedented positive returns on Tier 1 Capital Security bank debt, as credit spreads (the yield pick up over Canada bonds) has tightened significantly, driven by significant investor demand for exposure to the corporate bond sector.

With most investors being overweight corporate debt, we believed the sector had become expensive, and having realized a significant gain of 23.9% since December 2008, we decided to sell our ladder position in the RBC Capital Trust 6.821% due June 30, 2018. With Municipal government credit spreads not having tightened to the degree of corporate debt; we felt there was not only safety, but excellent relative yield in this sector. Hence, with the funds from the RBC position, we purchased the Metro Toronto 5.60% due 12/18/18. Since the trade was initiated, the Metro Toronto has returned 6.88%, while the RBC position would have returned only 2.41% - a clear outperformance and successful reallocation to overweight municipals versus corporate bonds.

Going forward, we continue to believe there is a growing risk of a selloff in the corporate sector after such strong gains year to date and heading into year end. While investor demand for corporate new issue will likely continue, secondary market profit taking will also likely continue as witnessed again last month from investors that have been overweight corporate holdings and are moving to a more index neutral weight going into their own year end reporting periods. This should prevent overall credit spreads from tightening materially in the near term, and as such our recommendation to remain neutral in weighting towards the corporate sector remains unchanged.

Exhibit 1: ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio					
Issuer Name	Coupon	Maturity Date	Weighting*	Rate of Return*	Benchmark***
Core Positions					
Export Development Corp.	5.75	1-Jun-11	7.31%	0.62%	
Canada	5.00	1-Jun-14	7.32%	0.74%	
CMHC	4.35	1-Feb-17	7.24%	1.75%	
Canada RRB	3.00	1-Dec-36	5.13%	3.29%	
CIBC Fixed Floater	3.750	9-Sep-10	7.21%	1.00%	
Royal Bank Fixed Floater	5.45	4-Nov-13	7.51%	3.40%	
Canadian Tire Corp	4.95	1-Jun-15	7.53%	3.56%	
Metro Toronto	5.60	18-Dec-18	7.95%	4.75%	
Manitoba	5.25	3-Dec-12	7.34%	1.42%	
Saskatchewan	4.50	23-Aug-16	7.45%	3.13%	
Quebec	4.50	1-Dec-19	7.69%	3.71%	
Active Positions					
Glacier Credit Card Trust	5.03	20-Feb-13	10.01%	5.13%	
OSIFA**	4.60	1-Jun-15	10.31%	1.51%	
Total				2.67%	2.71%
*For quarter ending September 30, 2009					
** Position and returns since August 27, 2009					
*** DEX Universe Bond Index					
Source: ScotiaMcLeod Portfolio Advisory Group					

Notes

Notes

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