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Executive Summary

2011 Fall Outlook

Stewart Hunt — Managing Director, Portfolio Advisory Group

The market volatility over the past three months reminds me of the Clash lyric “*should I stay or should I go?*” With Canadian and U.S. equity markets bouncing up or down, often over 100 points per day, it has been very difficult for investors to determine what to do. Making matters worse, movements in the markets are being driven by headlines rather than fundamentals. One minute, European government and financial leaders have a solution to their sovereign and banking problems, U.S. economic numbers are positive, China’s economy continues to grow; and the next minute, a solution for Europe has broken down, U.S. consumer sentiment is in the doldrums, and China is trying to slow down economic growth and curb inflation. Although market volatility can be difficult it can also be profitable. There have been some aspects of the market where we have found comfort. One, the announcement by the U.S. Federal Reserve they do not expect to raise rates until the first quarter of 2013 provides comfort to investors that short-term rates are not likely to increase for at least a year. Two, North American equity markets look to have defined a trading range providing buying and selling levels for investors willing to trade. While the buy and hold approach has been a positive investment strategy long term, with historically low interest rates and equity markets stuck in a range, opportunities to generate incremental returns exist through trading, “*should I buy or should I sell?*”

Here are some highlights of what our Fall 2011 Investment Portfolio Quarterly (IPQ) offers:

- Scotia Capital Portfolio Strategists Vincent Delisle and Hugo Ste. Marie highlight the equity market downturn from July to September of this year as quite significant although more driven by investment sentiment than the global economy moving into recession. They see tactical investment opportunities in the equity market although markets will remain volatile.
- Scotia Capital Economists Derek Holt and Karen Cordes Woods take a very detailed and interesting look at whether equities are undervalued at current market prices. Based on recent history there may be a compelling argument equities are under valued. However, and we have noted this in our bond observations, current interest rates at long-term, historically low levels could mean equities are reflecting the same long-term values.
- Canadian Equity Advisor Geoff Ho highlights the disconnect of Canadian oil and gas equities and their U.S. peers based on the underlying commodity prices. Ho makes a good case to consider investment opportunities in Canadian oil and gas companies currently trading only 30% above their March 2009 lows when oil was at \$45.00 per barrel, compared to the \$70.00 – \$90.00 per barrel range for oil today.
- With interest rates at historical lows in Canada and the U.S. it is hard to believe bonds have been one of the top performing asset classes between July and September. Andy Mystic and Amy Billingham, our Fixed Income Advisors, provide some guidance on where to be with your bond investments.
- Tara Quinn, our Preferred Share Advisor, reviews the various preferred shares currently available in the market and makes her recommendations based on the current interest rate environment and regulatory changes to capital requirements for financial institutions.
- Carolyn Tsai, our Fund Research Advisor, takes us back to basics when investing in mutual funds. Tsai highlights key considerations in making a mutual fund investment such as; investment objectives and strategy, fund manager, long-term performance, portfolio fit, distributions and fees.

- Susan Forint, our Manager of Marketing for the ScotiaMcLeod Insurance group, provides some compelling reasons for insurance planning, particularly for the high-net-worth investor. Forint discusses tax planning, professional or business planning, retirement planning, charitable or planned giving, and next generation as reasons to consider insurance.
- In conclusion, Steve Uzielli provides his quarterly review and commentary on the performance of the Equity Guided Portfolios and Tim Vlahopoulos provides his quarterly review and commentary on the Core-Plus Bond Portfolio.

We hope you enjoy the Fall 2011 version of the IPQ and recommend you contact your ScotiaMcLeod Wealth Advisor with regard to any ideas presented here which interest you, or to review your investment portfolio.

Stewart Hunt

Portfolio Strategy

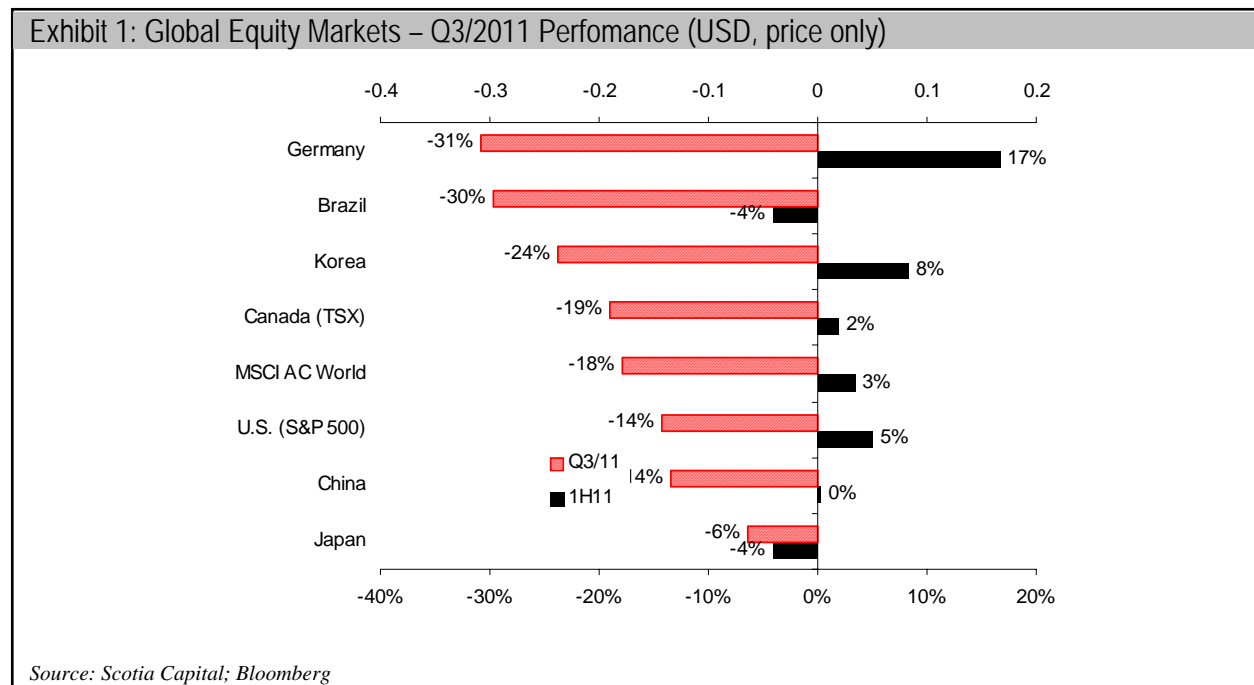
Portfolio Strategy Outlook – Fall 2011

Vincent Delisle, CFA — Portfolio Strategist, Scotia Capital

Hugo Ste-Marie, CFA – Portfolio Strategist, Scotia Capital

"Risk-off" was in full swing in the July to September quarter and investors' risk appetite vanished. U.S. 10-Yr bond yields declined almost 50 basis points (bp) to 1.72%, oil prices (WTI) slipped 10.8% to US\$79.20/bbl, and the MSCI AC World index corrected 18%. The third quarter was excruciating for global equities as losses ranged from 10% in Japan to 25% in Germany.

The S&P 500 maintained its global leadership with a 14.3% decline in Q3/11 (Dow Jones -12%) as a stronger greenback (DXY +6.3% in September; +6% in Q3) supported U.S. equity outperformance. Currency pain was especially visible for commodity-sensitive benchmarks: the Brazilian real was down 15% versus the USD in September and the Loonie lost 7%. Equity benchmarks in Japan (-6% in USD) and China (-14% in USD) also outperformed the MSCI AC World, while Germany (-31% in USD), Canada (-19% in USD; -13% in CAD), Korea (-24% in USD), and Brazil (-30% in USD) were among the most visible laggards in Q3 (see Exhibit 1).



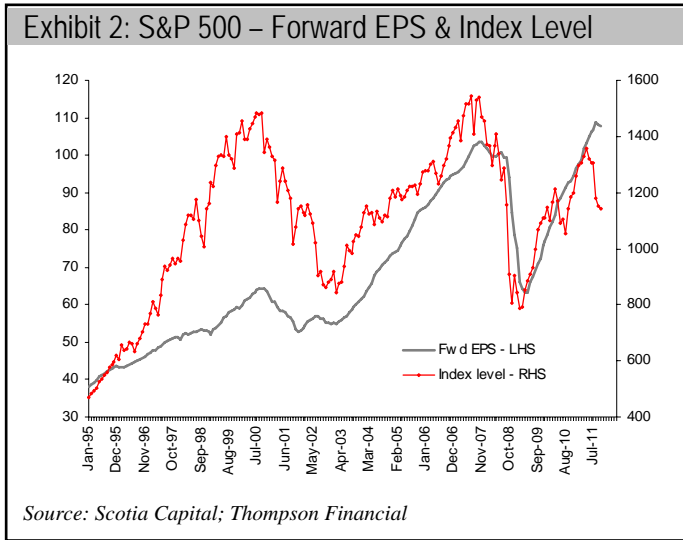
Eroding equity and collapsing euro sovereign sentiment fuelled a massive rally in German and U.S. government bonds. U.S. long-term Treasuries (TLT index) posted a gain of 30% in Q3 (total return), their best quarter since the TLT index was established in 2002. In Canada, the DEX universe, which combines both government and corporate bonds, was up 4.7% (total return) in Q3 with long bonds (+7.4%) outperforming shorter maturities (+2.0%).

Debt woes fuel recession fears...

The U.S. debt ceiling debate in early August and Europe's political posturing in dealing with weaker Euro members have fuelled investor unease throughout the third quarter, sparking renewed global recession fears. Indeed, fundamentals have taken a backseat to U.S. and European political uncertainty since July and it is easy to confuse the gloomy headlines with actual economic/earnings damage. The phenomenal Q3 rally in U.S. Treasury bonds highlights the market's extreme discomfort level and appears to be pricing elevated odds of a global/U.S. recession.

In our opinion, recent U.S. data points to slow growth, but not outright recession. Corporate profit growth will see its first challenge since mid-2009 and negative earnings revisions should continue in the fourth quarter. However, we don't see overwhelming evidence of a pending 15%-20% earnings decline as the recent S&P500 pullback would imply (Exhibit 2).

Collapsing investor confidence has already pushed valuations towards the bottom of their historical range with forward P/E multiples in the high-single digits in Europe and throughout most emerging markets. The S&P500 forward P/E hit 10X in early October (10.6x for the TSX).

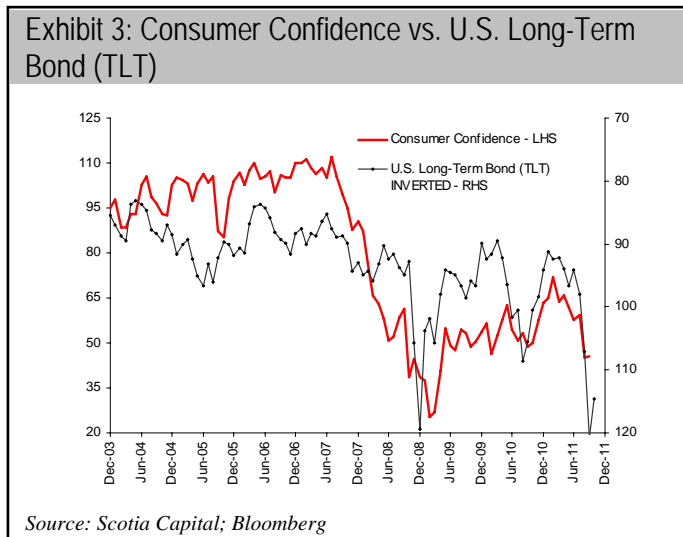


...but data doesn't back the recession scenario yet

Based on the latest U.S. consumer confidence surveys, the recession scenario may look like a done deal. Considering the extreme level of uncertainty linked to the U.S debt ceiling debate and sharp equity sell-off in early August, however, one could make the case that most August surveys may have overshoot to the downside. September regional manufacturing surveys (Philly, Empire, Richmond, Chicago) have mostly come in above August catastrophic levels and September consumer confidence surveys were flat month-over-month.

More importantly, September employment reports released in the first week of October reduced recession odds. The U.S. economy added 103k jobs in September (+137k private) and the unemployment rate remained at 9.1%. August and July payroll numbers were also revised higher. Job growth was also strong in Canada last month with 61k new jobs (64k full-time; UR down to 7.1%). Other key U.S. statistics (auto sales, ISM, claims, non-defense capital goods) have also improved in September. Bottom line: the August collapse in household/business confidence has not pushed North America in recession.

US 10-Yr Bond yields are up 45 bp since the start of October and are yielding 2.15%. Equity sentiment remains vulnerable to Euro politics and we expect markets to stay volatile, but our sense is that September pessimism may have overshoot reality.

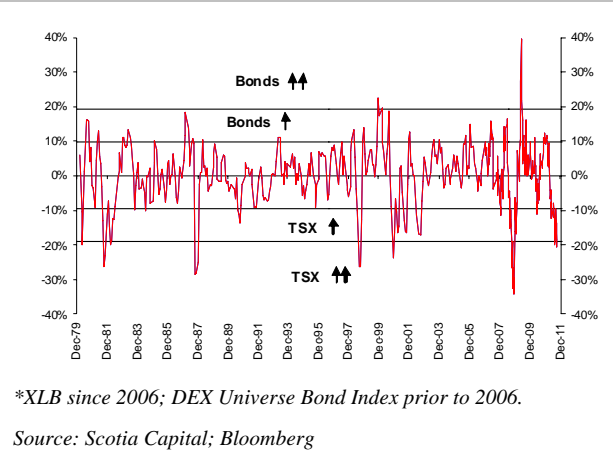


Tactical opportunities in a volatile market

Notwithstanding near-term headline risks and the temptation to dwell on the negatives, asset mix opportunities must be considered. Tactical opportunities have upstaged longer term/buy-and-hold strategies since 2007 and we believe this environment of extreme volatility, marked by sporadic and sizeable equity-to-bond leadership, will continue.

Following last month's sell-off (TSX -9.0% in September; -12.6% in Q3) and commodity slide (TSX Mining -32%/-41%; TSX energy -12%/-19%), the equity risk-reward outlook has gone from attractive to outright compelling. De-risking hit extreme levels in the third quarter, taking the TSX to one of its worst 3-month relative performance since 1979 (see Exhibit 4).

Exhibit 4: Tactical Indicator: 3-M Return TSX vs. Bonds* - 1979-2011



The last few months have been about managing risk exposure and intense volatility. Looking out 6 to 12 months, the balance of opportunities has shifted in favour of cyclicals, in our view. We plan to be disciplined about raising cyclical exposure, especially in the commodity sector, but feel the intensity of the "de-risking" trade commands frequent opportunities to revisit the risk-reward outlook.

We are reversing our August asset mix changes and reallocating 4% from Cash to Equities (+1% U.S.; +2% Int'l; +1% CDA). We are lowering Cash to 2% (from 5%) and TSX-gold to 10% (from 15%). Weighting in Banks (+1%), Insurance (+2%), Technology (+1%), Mining (+3%), and Energy (+2%) have been increased.

Exhibit 5: Scotia Capital Asset Mix – Fall 2011

	Asset Mix		Last Change (October 2011)	Expected Total Return Next 12-M
	Benchmark*	Recommended		
Equities	60%	69%	+4	20%
Canada (TSX)	5%	7%	+1%	
U.S. (S&P 500)	20%	24%	+1%	
Int'l (Europe, Japan)	18%	22%	+2%	
EM-Asia	10%	10%		
EM-LatAm	7%	6%		
Bonds	40%	27%		-3%
Government	30%	13%		-4%
Corporate	10%	14%		-1%
Cash (91-D Tbills)	0%	4%	-4%	1.0%

*Benchmark change on June 30, 2011

Source: Scotia Capital estimates

Economic Outlook

Are U.S. Equities Under-Valued?

Derek Holt, MA, MBA, CFA – Vice-President, Scotia Capital Economics

Karen Cordes Woods, MA – Financial Markets Economist, Scotia Capital Economics

Even just a quick scan of the headlines would leave investors torn between sharply divergent opinions on equity valuations. Some scream that, like early 2009, current market conditions represent the buying opportunity of a lifetime. Other headlines still point to equity over-valuation, while even gloomier headlines warn of sharply further declines in valuations due to shifting investor demographics.

What is needed is perspective that we attempt to provide through a wide variety of U.S. equity valuation measures over long periods of time so as to avoid the trap of making extreme pronouncements based upon solitary pet measures and narrow time references, given that each conceivable valuation metric has its pitfalls and each time period throughout history has been subject to different macroeconomic and geopolitical factors. In so doing, we're approaching the issue through the lens of economists looking at broad markets and with a focus upon the longer-term attractiveness of equities.

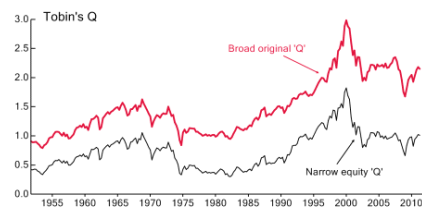
In what follows, a key point is that what one thinks about current valuations may depend upon whether one's experience was acquired during the equity cycles of the 1990s onward or over a longer time-frame. Several metrics point to cheap equity valuations now compared to the past two decades or so, and this may be the market's 'memory' that is guiding the under-valuation bias in some corners. But a longer time-frame doesn't really support this perspective by either portraying equities to be dear, or fairly valued at present. That obviously doesn't preclude the possibility that individual companies range from extreme under-valuation to over-valuation as we focus solely upon the broad market.

Tobin's 'Q'

One such measure is Tobin's 'Q' which divides a firm's market value (equity and all debt) by the replacement cost of its assets. The thinking here is three-fold. For one thing, the higher this ratio, the more attractive it is for a firm to invest in capital goods since the value the market attaches to the firm exceeds the replacement cost of its assets. Second, this measure is also useful as a guide to whether markets have gone too far in assigning high market values relative to the cost of growing organically by acquiring the underlying assets at their replacement cost. Third, Tobin's Q recognizes that one is not just buying a stake in the future earnings of a firm; one is buying the underlying assets net of its debts under present market circumstances and thus the 'Q' ratio complements a more traditional price-earnings ratio.

There are actually two versions of this ratio that can be calculated on an economy-wide basis using the U.S. Federal Reserve's Flow of Funds accounts for non-financial corporations. Exhibit 1 (blue line) depicts a popularly represented version called an equity Q ratio which was the foundation of analysis in a best seller that pointed toward equity over-valuation during the dot-bomb period via referencing an inflated market value relative to the replacement cost of company assets.¹ It just takes the market value of equities and divides that by the replacement cost of the firm's assets net of its liabilities with the latter calculated by Fed economists. We think this measure is flawed because it does not fully consider how shifts in the capital structure decisions of firms over time can influence the total value of the firm (Exhibit 2).

Exhibit 1: Firms are Hardly Under-Valued



Source: "Flow of Funds Accounts of the United States," Federal Reserve, Scotia Economics

¹ Smithers, Andrew and Stephen Wright *Valuing Wall Street: Protecting Wealth in Turbulent Times*, McGraw-Hill Companies, 2000.

Exhibit 1 (red line this time) accounts for this latter point by expressing Tobin's 'Q' in the less popular but originally intended form that relates the market value of all types of short- and long-term debt and equity to the replacement cost of assets. It will more fully account for swings in capital structure and how they can impact equity holders in a classic Modigliani-Miller capital structure theorem sense which posits that the mixture of debt and equity within capital structure positions matters in a world marked by 'frictions' such as bankruptcy costs. We also observed that a gap opened up between the broad 'Q' and the narrower equity 'Q' from the late 1970s through to the early 1990s when the debt-to-equity ratio soared, and then narrowed in by 2000 at which point the debt-to-equity ratio had fallen sharply. This demonstrates our earlier point about which one better captures leverage. The gap between the two measures has opened up again over the past decade as corporate leverage increased.

So which measure is best when it comes to correlating with actual stock market performance? Exhibits 3 and 4 show that the broader Tobin's 'Q' does a better job at lining up with movements in broad stock market gauges like the Wilshire 5000 over time. Note, however, that whether stocks are fairly valued or not depends partly upon whether one uses the narrow or broader 'Q' ratio. The narrow 'Q' ratio was roughly in line with its longer-run historical average as at June 30th 2011 (up to which point flow of funds data is available), but the broad 'Q' was still well above its longer-run average. Indeed, today's broader 'Q' ratio can really only be said to be 'cheap' in relation to the dot-bomb bubble. By shocking equity values in accordance to what has been experienced since June 30th we arrive at an updated narrow 'Q' that is marginally cheaper than at June 30th, but not by enough to alter our longer-run oriented conclusion.

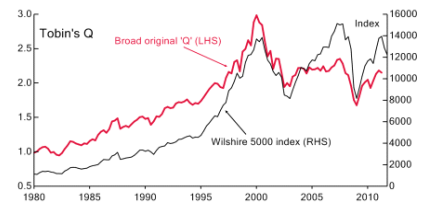
Of further interest, note that Tobin's broad 'Q' ratio is well correlated with M&A volumes in the U.S. (Exhibit 5). This represents a bit of a conundrum in that firms, in theory, shouldn't be feeding strong merger activity when market values are high relative to the replacement cost of the assets. They should tend to have a bias toward organic growth and divesting assets, although the correlation between Tobin's 'Q' and the business investment cycle in productive equipment and structures is relatively weak over the post-war era.

Exhibit 2: Corporate Leverage



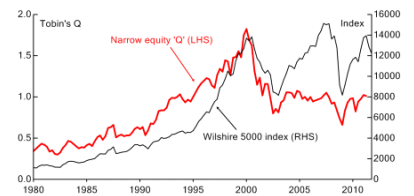
Source: "Flow of Funds Accounts of the United States," Federal Reserve, Scotia Economics

Exhibit 3: Does Tobin's Broad Q Give Equity Investors Much of a Head's Up?



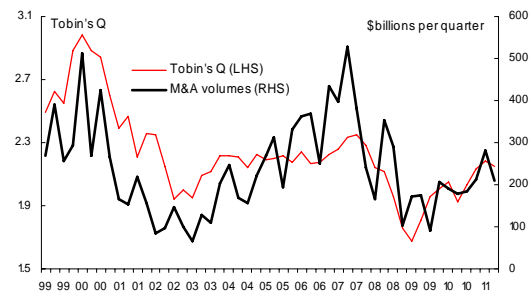
Source: "Flow of Funds Accounts of the United States," Federal Reserve, Scotia Economics

Exhibit 4: Tobin's Narrow Q Is Not As Well Correlated with Equity Market Swings



Source: "Flow of Funds Accounts of the United States," Federal Reserve, Scotia Economics

Exhibit 5: Tobin's 'Q' As An M&A Driver



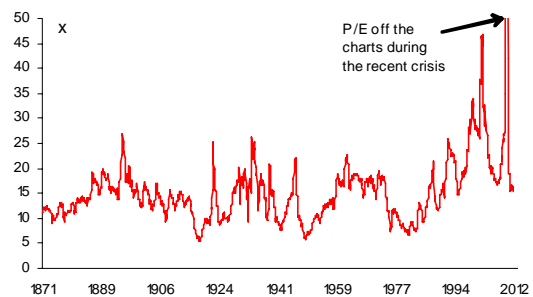
Source: "Flow of Funds Accounts of the United States," Federal Reserve, Scotia Economics

This leads to our point that on balance, we're not too fond of either 'Q' measure in no small part because they don't really give investors much of a heads-up on when valuations may swing. Witness the highly contemporaneous movements in Tobin's Q and equity valuations (Exhibits 3 & 4 again). In fact, it's not clear that observing either 'Q' ratio really tells one much beyond simply observing the level of the stock market index itself. That's because there is little to no lead-lag relationship between 'Q' and the stock market, and indeed there is double counting involved through comparing Tobin's 'Q' to equity indices in that, as stock indices fluctuate, they will by definition swing 'Q' around given that Tobin's Q includes market valuations in its definition. As for the relationship between M&A volumes and Tobin's 'Q', it may well be that the relationship is spurious because a third factor — the simple level of the stock market and/or economic growth — plays a role in driving both measures simultaneously.

Price-Earnings Ratios

Like 'Q' ratios, price-earnings ratios can be computed in various ways. One way is to compare price to trailing earnings of the past year for all firms on the S&P500 far back in time using Robert Shiller's carefully crafted data set (Exhibit 6).² Price-to-forward earnings one year into the future is a preferable approach since it is the future expected earnings stream that one is paying for (Exhibit 7). Like Tobin's 'Q', whether or not stocks are cheap depends upon one's time reference. P/E's are only low in comparison to the recent past. They are not low in relation to the environment prior to the 1990s. Note that both of these measures are potentially distorted by where we sit in the earnings cycle. As Exhibit 8 demonstrates, we're not far off the all-time high in earnings per share after adjusting for inflation so whether or not stocks are cheap by price-earnings ratios depends critically upon to what extent you believe such earnings strength will be retained. The same holds true for being at an all-time high for forward earnings that are typically largely extrapolated by analysts off of the recent history and with a consistent bias to boot (Exhibit 9). That's why even though we have a shorter history for price-to-forward earnings in Exhibit 7 than price-to-trailing earnings in Exhibit 6, we infer that P/E ratios are low today in relation to the 1990s-onward environment regardless of whether one uses forward or trailing earnings. Here too, however, analysts may be too bullish going forward, making reliance upon price to an earnings forecast dicey. But our point here is that to those who would exclude from the sample the low in earnings during the peak of the US recession when comparing Shiller's ratio to the past, we think they would also

Exhibit 6: S&P 500 Index: Trailing P/E



Source: Shiller, Robert, "Irrational Exuberance," Princeton University Press, 2000, 2005, updated; Scotia Economics

Exhibit 7: S&P 500 Index: Forward P/E



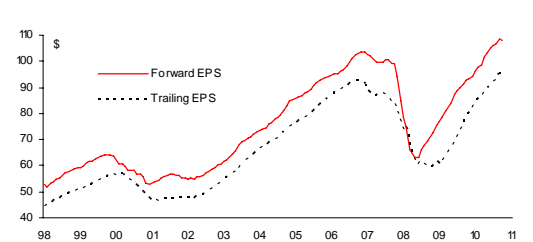
Source: Thompson Financial, Scotia Economics

Exhibit 8: S&P 500 Index: Real Earnings per Share



Source: Shiller, Robert, "Irrational Exuberance," Princeton University Press, 2000, 2005, updated, Scotia Economics

Exhibit 9: S&P 500 Index



Source: Thompson Financial, Scotia Economics

² See: <http://www.econ.yale.edu/~shiller/data.htm>

have to exclude from the sample the upper outlier of today's record high earnings in the absence of abject clarity regarding its sustainability from a growth perspective.

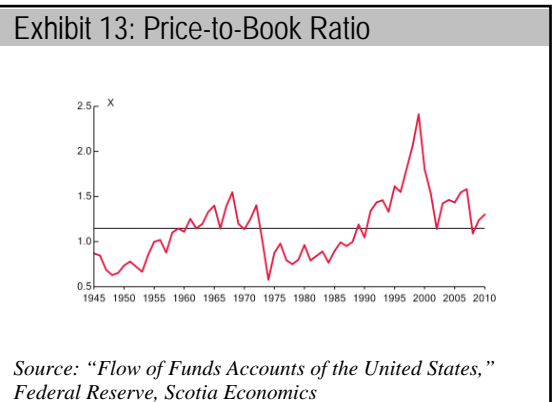
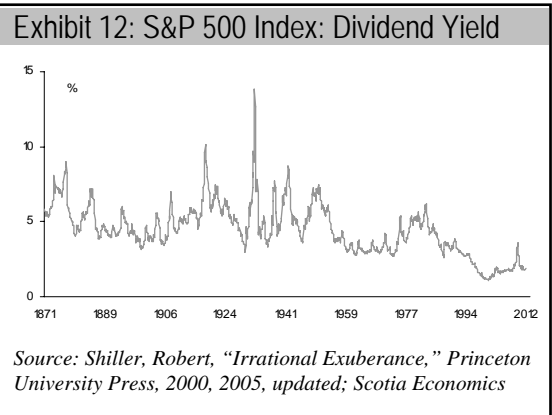
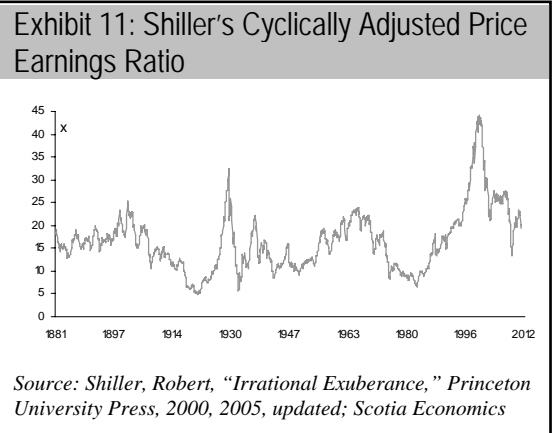
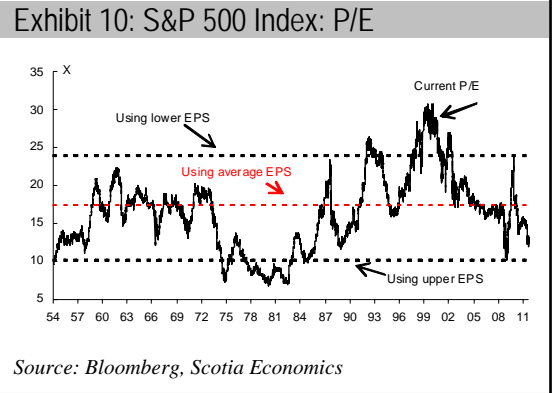
What may be of further interest is to shock price-earnings ratios in accordance with other stress values for earnings should one not necessarily believe the consensus of analysts. Exhibit 10 does just this. The plotted line is price-to-trailing earnings over time. The upper dashed band line is where price-to-earnings would stand today if earnings per share were to test the lows of December 2009; should such a scenario unfold again, then stocks are by no means cheap. The lower dashed band is where P/E's would sit today if earnings were to come in line with rosy forward expectations. The middle dashed line is where P/E's would sit today if earnings per share came in on top of its longer-run average.

Price-to-Cyclically Adjusted Earnings

The U.S. academic economist Robert Shiller prefers his measure of price-to-cyclically adjusted earnings. Cyclically adjusted earnings are calculated as a ten year average of past earnings, and the measure is adjusted for inflation over time. This measure is designed to track a full cycle's earnings and is therefore less susceptible to volatility surrounding a single year's earnings at a particular point in an evolving cycle. While lower than the equity cycles of the late 1990s onward, this measure is by no means low compared to the very long run (Exhibit 11). Note that this metric closely tracks Tobin's Q as it likely should since the sum total of a firm's earning cycle will be highly correlated with the sum total of the replacement cost of a firm's assets acquired over the years in part through reinvested earnings, and because both Shiller's measure and 'Q' contain a measure of the market value of equities in their numerators.

Dividend Yield

For a certain segment of buy and hold investors in it for a regular income stream, it may make sense to focus upon what dividend earnings stream is being earned over time relative to the up-front price of acquiring the equities paying this stream. Exhibit 12 continues our theme that equities look cheap if one compares current dividend yields to the experiences of the relatively very recent past, but not so cheap in the longer run.



Price-to-Book Ratio

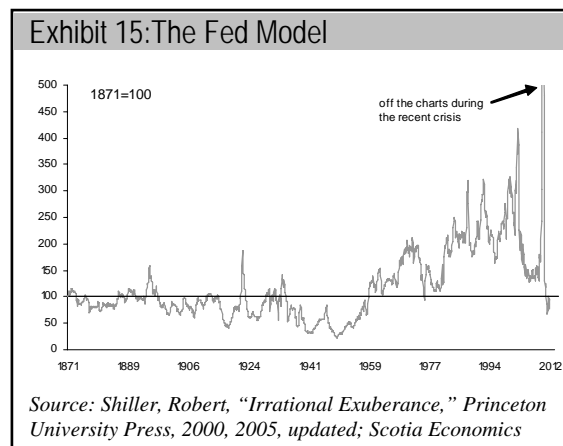
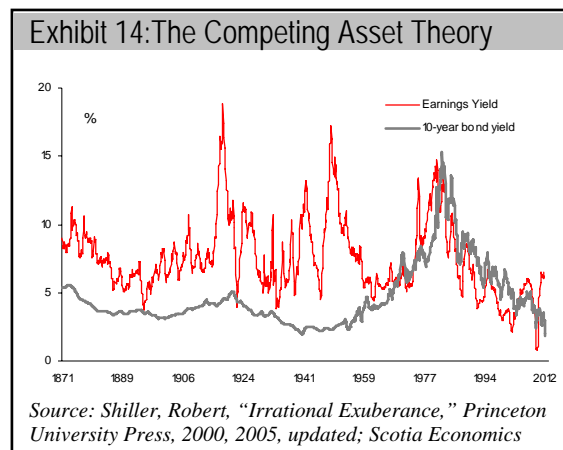
To the extent to which a firm’s book value may represent the cost of building the firm from scratch, comparing price to book value may be instructive. Note the difference here to replacement cost, in that replacement cost values a firm’s assets at their going investment rate, versus book value which is the historical cost of the acquired assets. Exhibit 13 depicts the results by using a proxy measure derived for nonfinancial firms from the US Flow of Funds accounts simply by comparing the market value of outstanding equities to the net worth of firms at historical cost. Like several other measures, while today’s price-to-book ratio is materially lower than it has been at times over the past decade and a half, that is not the case over the full history back to 1945. In fact, the current ratio is slightly higher than its long-run average depicted by the horizontal line on the Exhibit.

Fed’s competing asset model

A simple but popular approach entails arguing that stock and bond markets are usually in equilibrium with one another such that the yield on, say, 10 year Treasuries should generally ride in tandem with the earnings yield on a broad stock market measure like the S&P500. This bonds versus equity notion has existed for a very long time, and has been emphasized by such famous investors as Benjamin Graham and David Dodd. More recently, it has been inappropriately labeled the “Fed model” of equity valuation since former Fed Chairman Alan Greenspan commonly referred to the bond vs. equity interplay and because economists like Ed Yardeni attributed the model to the Fed.

The simplest way to depict this is just to plot the earnings yield on the S&P500 against the yield on 10 year Treasuries (Exhibit 14). The alternative is to compare the actual value of the S&P500 to a fair value of the index over time (Exhibit 15), with the ratio between the two indexed to equal 100 from the beginning. Fair value is calculated as earnings per share divided by the 10 year Treasury yield. Ideally we’d use forward earnings, but this isn’t available as far back in time as we’d like and there isn’t a tremendous difference in any event since the history that we do have shows that forward earnings are usually just extrapolated off trailing earnings anyway.

The ‘Fed model’ suggests that we may have returned to witnessing fair or under-valuation in equities since the actual value of the S&P index is trading below its fair value. There is just one problem: even though it appeared to work for a time, the model hasn’t really worked throughout the past decade and didn’t work at all prior to the 1970s which translates into a model that isn’t terribly robust. There are serious theoretical flaws with comparing earnings yields to Treasury yields as in Exhibit 15. One is that the former is an inflation-adjusted measure by virtue of being a ratio of prices, whereas the Treasury yield is a nominal measure. Second, the Fed model assumes no earnings growth over time in that it values stocks as a zero growth perpetuity. Third, the Fed model also assumes no equity risk premium to valuing equities by using the government’s cost of borrowing as the discount rate.



For more on the pros and cons of the Fed model, we refer interested readers to two popular but oppositely positioned and useful papers.³

Conclusion

Virtually every valuation metric that we have considered suggests that equities are under-valued only in relation to the fairly recent past from the 1990s onward but not so in relation to conditions prior to this period. In this context, the onus therefore lies upon market participants to explain what makes the period from the 1990s until just before the crisis an appropriate reference period before deciding upon a bullish slant toward current equity valuations. We struggle with this, in that we're biased toward viewing the 1990s-to-crisis period as the anomaly within history, not the benchmark for the future. The 1990s-to-crisis period was marked by excessive risk taking motivated by heavy leveraging and lax regulation that is now at risk of turning excessively tighter. This prompted massive behavioural shifts by investors that had less to do with shifting age structures of the population and far more to do with large intra-cohort shifts in risk taking. For example, 40 years olds in the 1980s held far less debt in inflation adjusted terms and had far lower equity ownership rates than 40 year olds in the lead up to the crisis, and the outcome was similarly portrayed across other age groups through successive U.S. Surveys of Consumer Finances produced by the Federal Reserve. One example of why this is important entails rejecting casual empiricism that naively plots age variables with market performance metrics in that many other macroeconomic and behavioural shifts have occurred in highly correlated fashion to slow moving age trends. Understanding how the psychology of investors may change going forward is therefore at least as important as any fundamental and historical arguments.

³ Joel Lander, Athanasios Orphanides, and Martha Douvogiannis, "Earnings Forecasts and the Predictability of Stock Returns: Evidence From Trading the S&P" Board of Governors of the Federal Reserve System, January 1997. Estrada, Javier "The Fed Model: The Bad, The Worse, And The Ugly," working paper, IESE Business School, January 2006.

Canadian Equity Strategy

Canadian Oil & Gas Equities: The Disconnect from U.S. Peers and the Underlying Commodity Prices

Geoff Ho, CFA – Director, Portfolio Advisory Group

The term brinkmanship is defined in the Webster dictionary as “*the art or practice of pushing a dangerous situation or confrontation to the limit of safety especially to force a desired outcome.*” From our perspective, brinkmanship has been a major driving force behind market activity in recent months as governments and central banks worldwide attempt to stabilize a fragile environment plagued by sluggish economic growth and less-than-ideal credit conditions while also balancing that with political aspirations (presidential elections in the U.S. and France in 2012 plus Germany in 2013) and taxpayer scrutiny. In the U.S., politicians pushed the world’s largest economy to the brink of default before arriving at an agreement to raise the national debt ceiling. In Europe, central bankers and politicians are still struggling with fiscal imbalances, austerity measures, varying political views between member-nations, plus increasing tensions among taxpayers. The dangerous mix of politics and the urgent need to stabilize the global economy certainly has created a volatile investing environment recently and the risk of political brinkmanship could very well continue to be a key overhang on markets over the near- to medium-term.

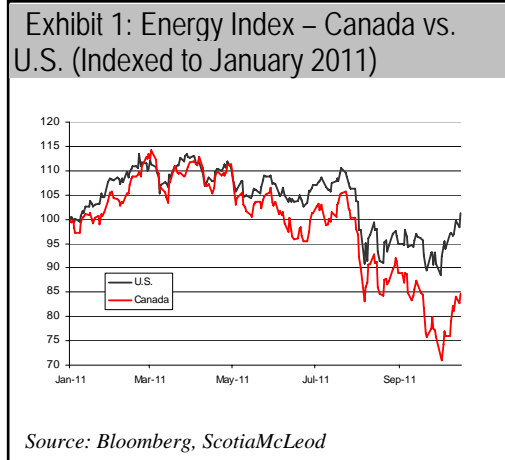
In part reflecting the above concerns, the S&P/TSX Composite Index is down approximately 14% on a year-to-date basis as investors continue to trim exposure to cyclical stocks in this uncertain economic environment. This flight from the economically sensitive sectors has had a notable impact on energy stocks as the sector is down 21% over the same period. The underperformance of oil and gas stocks in Canada relative to the broader index is actually quite remarkable when you consider the fact that 15% of the S&P/TSX Energy Index is represented by TransCanada Corp (TRP) and Enbridge (ENB), both of which rallied over 8.5% and 17% on a year-to-date basis, as they are generally perceived to be much more stable investments than the actual exploration and producing companies. Looking at some of the large-cap energy producers such as Suncor (SU) and Talisman (TLM), the shares are down 31% and 41% respectively since the start of 2011, drastically underperforming a number of other sectors and also the underlying commodities as the price of crude is off 12% thus far in 2011 while the price of natural gas has fallen 15.5%. Furthermore, it is worth noting that the energy sector in the U.S. is off a more modest 12.5% so far in 2011, materially outperforming their peers in the north.

In the following sections, we attempt to provide some rationale for the weak performance of the Canadian oil and gas equities relative to their U.S. counterparts and to the underlying commodities. Generally, we acknowledge that some of the underperformance is warranted but in light of this recent correction, we believe that shares are already discounting a reasonable amount of risk. At current levels, given the current macro uncertainties marked by sluggish economic data and the risks of political brinkmanship over the near term, we are reluctant to materially increase the weighting of the energy sector in a portfolio. However, for those that are underweight the sector or are looking for switch opportunities to capitalize on better risk/reward opportunities, we believe that the Canadian oil and gas stocks present a compelling opportunity at current price levels. Until there is more clarity on the European debt situation and until there is some confirmation that this is merely a mid-cycle slowdown in the economy, we continue to recommend a focus on large-cap equities.

Canadian Energy Sector Versus U.S. Peers

As demonstrated in Exhibit 1, there has been a noticeable divergence in the performance of the shares of Canadian energy companies versus their counterparts south of the border. On a year-to-date basis, the S&P Energy Index in the U.S. has outperformed the Canadian companies by a material 8.5%. Some of the reasons for this discrepancy relates to:

- **The Cushing glut.** Canadian oil production has been gradually increasing over the years and industry observers indicate that this has caused a significant bottleneck effect at Cushing, the delivery point for the benchmark West Texas Intermediate futures contract. While there is sufficient transport capacity to export the product into the United States to the Cushing hub, it appears that storage levels there remain at fairly lofty levels. Analysts believe that new pipelines such as the proposed Keystone XL line and growing demand from Asia will help to alleviate this bottleneck over the next few years but for now, the glut at Cushing could continue to be an issue for Canadian producers given that long-term production growth will partly depend on export capacity.
- **Foreign exchange factors.** The strength of the Canadian dollar could be less advantageous for domestic producers relative to their U.S. peers. On the revenue line, the price of crude oil is typically priced in U.S. dollars and as such, there is a negative translation effect for Canadian companies when sales are converted back to their reporting currency. This is particularly meaningful given that it is likely that a substantial portion of their operating costs are in Canadian dollars. Generally speaking, other company-specific factors aside, an appreciating Canadian dollar could make the operating margins of Canadian companies relatively less robust than their U.S. peers.
- **Different cost structures.** Depending on the extraction method, costs can vary significantly among energy producers. Of late, it appears that companies mining for the commodity (versus other extraction methods such as Steam Assisted Gravity Drainage or SAGD) have reported higher relative expenses as a result of rising costs for items such as energy and labor. Accordingly, for companies that mine for oil (ie. Suncor, Canadian Natural Resources, and Canadian Oil Sands), some investors are now gradually factoring higher cost structures for these producers.
- **Supermajor status.** Supermajor is a name used to describe the world's five, and at times six, largest publicly owned oil and gas companies, that in aggregate represents approximately 6% of global oil and gas reserves. Exxon Mobil (XOM-NYSE), one of the supermajors, is the largest energy company in the U.S., boasting a market cap of US\$350 billion. By contrast, Canada's largest integrated energy company by market capitalization is Suncor, which has equity value of C\$44.3 billion. Accordingly the size and scale of the operations between the producers are drastically different. Generally, large-cap energy plays in the U.S. typically boast higher credit quality than the Canadian large-cap energy plays as they present more sizeable operations with less leverage. That said, however, by no means does this imply the producers in Canada are over-levered.
- **Political and environmental concerns.** The oil sands regularly face criticism for its carbon-intensive production process and certain groups (environmentalists, government bodies, etc.) have lobbied to reduce reliance on "dirty oil". This has been an ongoing debate and will likely continue to be so for some time. While this creates negative headline news, our opinion is that, the benefits of the oil sands (friendly political environment, significant resource base, improving technologies helping to reduce emissions) outweigh such concerns. Nonetheless, this occasional criticism of the oil sands could possibly also help to explain the underperformance of the Canadian energy sector relative to the U.S. producers.

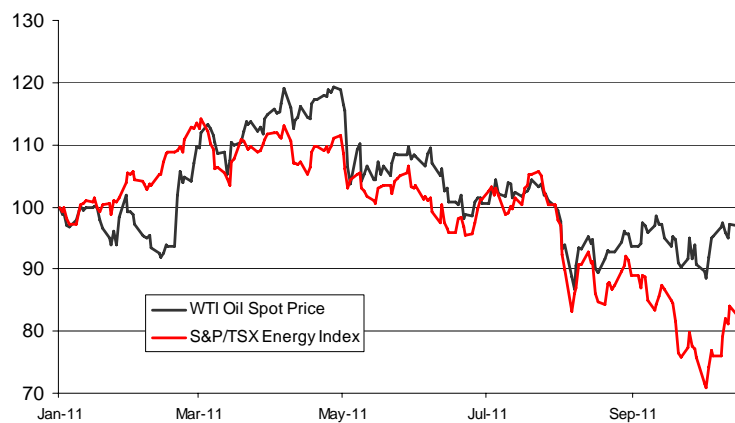


- **More natural gas companies in the Canadian index.** The price of natural gas remains fairly weak given a sluggish economic outlook, record supply levels, and a significant backlog of drilled wells that are near completion. Depressed natural gas prices and a rather bearish near-term outlook for the commodity have certainly had a negative impact on the share price performance of the related producers. Given that there are more natural gas companies included in the Canadian index, and considering that the price of oil has held in relatively well compared to natural gas prices, one can rationalize some outperformance by the S&P Energy Index in the U.S.

Disconnect between commodity prices and equities

The price of crude oil is currently down 12% since the start of the year while the price of natural gas is down 15.5% over the same time period. By contrast, the S&P/TSX energy sector has lost 21% in value since the start of the year. At current levels, the spread between the price of the underlying commodities and the S&P/TSX Energy Index is approaching six year highs and hovering near levels not seen since the distressed period in 2008 when Lehman Brothers filed for bankruptcy protection. There are various factors that can influence this diverging price performance, including:

Exhibit 2: S&P/TSX Energy Index vs Crude Oil (Indexed to January 2011)



Source: Bloomberg, ScotiaMcLeod

- **Investors are discounting lower future crude prices.** While the WTI spot price is trading north of US\$80 per barrel at the moment, the share price of a number of the senior producers are effectively discounting US\$70 per barrel over the longer-term horizon. Put differently, investors are using lower oil price assumptions in their long-term cash flow and valuation models. Given the lingering concerns over European debt issues and the chance of yet another global recession, one could certainly make a case for near-term downside risks in the spot price of crude. Based on the current uncertainties, this downside risk could possibly be fuelled by improving weather conditions that have impacted production in the Gulf region and/or subsiding geopolitical risks in the Middle East.
- **Higher operating costs, less leverage to crude prices.** A number of producers have cited materially higher operating costs in recent quarters. Accordingly, if costs are rising at a faster pace than the price of the underlying commodity, margin pressure results in relatively lower returns for shareholders of these energy producers. Effectively, every incremental dollar increase in oil prices does not necessarily flow directly through to the bottom line.
- **Preference for owning the commodities.** As with any company irrespective of the sector, energy producers are subject to environmental, regulatory, and operating risks. As such, some investors ultimately prefer to own the underlying commodity instead of shares of a company in an effort to avoid company-specific risks. This preference of select investors could also influence the performance of commodities versus the related equities.

Summary

Reflecting on some of the considerations previously discussed, we believe that the lagging performance of the Canadian energy sector relative to its U.S. counterpart and the underlying commodity prices is not entirely unwarranted. That said, the magnitude of the underperformance appears to be rather extreme with a number of the senior energy producers effectively discounting an oil price of US\$70 per barrel at the moment. As well, while most energy stocks are still trading approximately 30% above the lows of March 2009, it is worth noting that the last time names such as Suncor and Talisman traded down to these levels, the price of crude was actually around US\$45 per barrel.

Accordingly, in our opinion, the recent correction has created some opportunities as the risk/reward profile of the Canadian energy sector becomes increasingly attractive. Although the stocks have yet to put in a definitive bottom from a technical perspective, one modestly positive signal is that at current prices, there has been a noticeable rise in share buybacks and insider buying. For investors who are underweight the sector or are looking for switch opportunities, the oil-weighted large-cap senior producers in Canada present compelling value. We caution there could be some near-term downside risk to the price of crude given the recent sluggish economic data and the risks of political brinkmanship. As such, we would prefer to slowly and gradually accumulate on weakness. Our preferred picks at current levels include Suncor, Canadian Natural Resources, and Talisman.

Fixed Income Strategy

Bonds: Where to Be Positioned at the Zenith of a Secular Trend

Andrew Mystic, MBA – Associate Director, Portfolio Advisory Group, Fixed Income

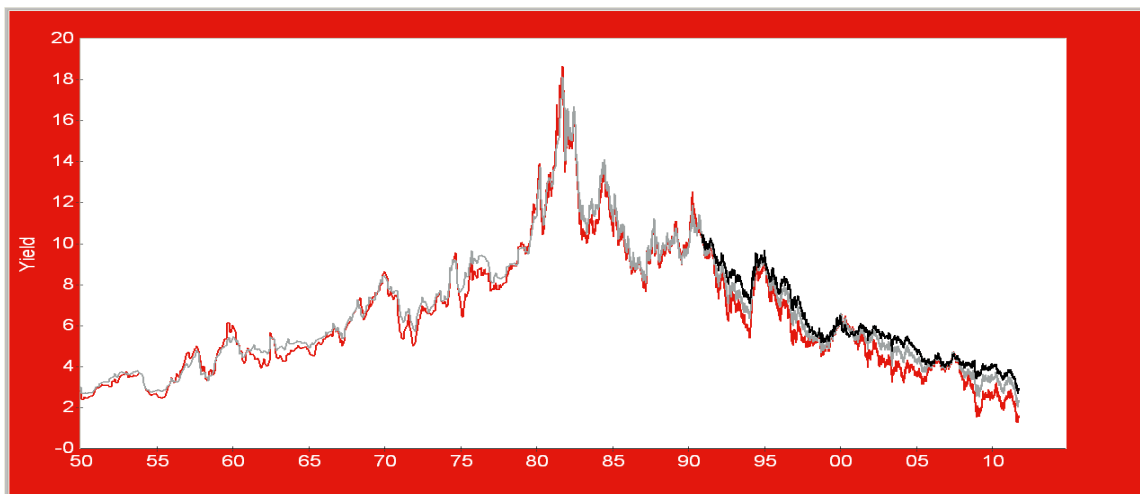
Amy Billingham – Associate, Portfolio Advisory Group, Fixed Income

Have Canadian Bonds Reached the Zenith of Their Secular Rate Trend?

Since the beginning of 2010, bond yields have steadily moved lower reaching both their recent and historical lows. As the credit crises unfolded in 2008, and a general flight to quality ensued, government of Canada bonds offered up strong double digits returns – with the all Canada DEX index returning 11.51% and the Short Canada index 10.48%. As credit markets began to heal we saw a dramatic reversal as investors shifted into riskier assets, leading to a relative outperformance of corporate bonds evidenced by the DEX Corporate overall and short indices, which returned 16.26% and 10.97% respectively, in 2009. Over 2010 and 2011 overall yields across most major fixed income sectors have continued to grind to their recent and historical lows.

Looking from a broader perspective, Canada yields over the past 30 years have largely trended downward begging the question: Have interest rates reached the peak of their secular trend? Looking at (Exhibit 1), which plots interest rate levels of 5, 10 and 30 year Canada bonds – we can see that interest rates have not even approached the levels seen today since the 1950s – supporting the view that bond prices have likely reached their secular peak, or are at the very least, are close to it. As interest rates begin to normalize, bonds will see some degree of underperformance relative to other asset classes – although the timing and degree of that underperformance remains debatable.

Exhibit 1: Overall DEX Index Yields



5-Year Canada: Red; 10-Year Canada: Grey; 30-Year Canada: Black

The DEX Index provides the most broadly based representation of the Canadian Bond Market. This chart plots 5, 10 and 30-year DEX Index Rates between 1950 and 2011

Source: PC Bond

Although the possibility exists that interest rates could continue to grind lower from current levels, the relative merits of positioning for that eventuality, doesn't warrant the risks. It is possible that factors in the global economy could lead to even lower rate levels, and potentially even a deflationary cycle reminiscent of that seen by Japan during the 1990s, but this scenario doesn't seem likely at the moment. Scotia Economic's view is that although we will see lower growth from most developed economies in the coming years, it will nevertheless remain positive. Sharply reduced borrowing costs in the advanced economies; cash rich businesses capable of bolstering investment; comparatively robust

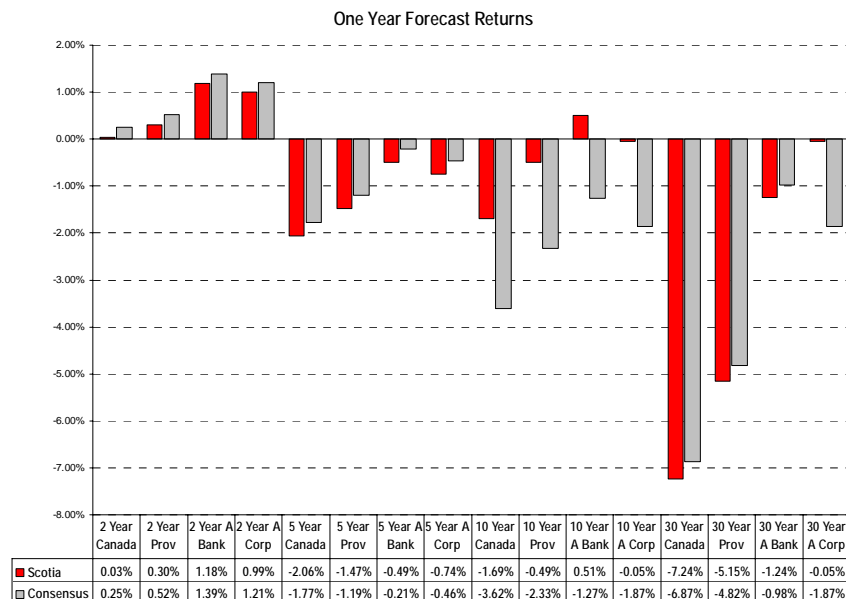
growth in emerging market economies; and lower oil prices should all work to keep growth pointed upward – albeit at a slow and uneven rate.

With rates having seemingly run their secular course, and current forecasts suggesting an upward trend, we continue to believe that shorter-term fixed income portfolios will outperform longer ones in the near term. Based on Scotia Economics and consensus rate forecasts, bond performance for maturities beyond 2-years should be decidedly negative in one year’s time. Along with modestly positive growth, Scotia Economics expects that the Bank of Canada overnight rate to rise from its current 1.00% to 1.75% by Q4/12, while 5, 10 and 30 year rates are expected to rise by between 60-80 basis points over the same period. The net effect of these rate movements would be a decidedly negative performance for bonds beyond a 2-year maturity (Exhibit 2).

Although the rate normalization process did appear to be gaining traction in Q1 and Q2 2011, several events conspired to derail recovery of the industrialized nations in Q3/11. Q3/11 saw the culmination of several events that conspired to push rates to historical lows – the impact of these events could persist and act as a further drag on growth in the coming quarters, if not beyond. During the final quarter of 2010 and early part of 2011, rates did appear to be normalizing and economic prospects brightening. The factors which derailed this improving course included:

- Market pressures tied to the US debt ceiling debates and the subsequent downgrade of the US government rating from AAA to AA+ by Standard and Poor’s rating agency. Congressional haggling and the resulting downgrade paradoxically saw US rates fall as equity markets sold off and investors sought the safety of liquid US government Treasuries in a flight to... “quality”?
- The ongoing impact of the European credit crisis and the potential risks to the global financial system in the event of a European credit contagion.
- The impact of the Federal Reserve’s Operation Twist (selling of short-term Treasuries and purchasing of long Treasuries) which saw long Treasury yields fall 40 basis points in a two day period.
- Most significant has been the Fed’s commitment to keep interest rates on hold until Mid 2013.

Exhibit 2: Forecasts Returns



Based on Scotia Economics forecasts, and current rate levels, 2-year bank paper is expected to provide the best total return across the Canadian curve at 1.18% (next 12 to 15 months). (Note: Bank paper forecasts are based on Bloomberg Fair Value Canada Bank A curve) – Long dated paper remains decidedly negative while some positive total returns can be realized in the front end.

Source: Scotia Economics Forecasts; ScotiaMcLeod Portfolio Advisory Group

So What Should Fixed Income Investors Be Doing?

In response to the general economic climate, and broader headline developments, we continue to believe that investors should maintain their Canadian dollar fixed income exposures, remain short duration, overweight corporate, provincial and municipal debt but – most of all – maintain your discipline!

- **Maintain your exposure to Canadian dollar fixed income investments.** Scotia Economics forecasts continue to expect the Canadian dollar to outperform relative to most major currencies over the coming year. Particularly given the recent upswing in the US dollar as a result of the recent global flight to quality, we'd expect some reversal of these movements in the coming months as growth prospects begin to resume. For this reason, we continue to believe that investors are best served by keeping their fixed income exposures in Canadian dollars.
- **Retain shorter duration fixed income portfolios.** With interest rates at all time lows, short duration portfolios will likely outperform longer dated ones as rates normalize. Although laddered portfolios do effectively remove timing risk (by positioning investors to be interest rate neutral) more active fixed income managers will want to retain shorter duration portfolios. This will also be true for investors who are beginning the laddering process, or who have been retaining large cash positions. Theoretically, longer-term ladders should outperform shorter ones over the longer term. Having said that, relatively low rate levels, and a potential shift in broader secular rate trends, suggests that shorter-term portfolios will likely outperform in the near term.
- **Remain overweight corporate, provincial and municipal bonds – pick up spread where available within tolerable risk parameters.** Relative to government of Canada bonds, municipal, provincial and corporate bonds will provide a spread pick up, or added risk compensation. With government of Canada bond rates at historical lows, investors should attempt to capture added yield where possible. Keep in mind that, since the credit crisis in 2008, many Canadian corporations have substantially strengthened their balance sheets while Canadian banks have significantly bolstered their capital positions. With many corporations cash rich and well positioned to weather a further economic downturn, investors should remain overweight corporate credit within reasonable limits.
- **Most importantly-remain disciplined!** The purpose of an Investment Policy Statement (IPS) is to act as a roadmap to an investor's wealth destination. The IPS is developed with an eye to realizing achievable returns, within the confines of an investor's risk tolerances, over a defined time frame. Although there might be bumps along the road, the map is meant to be your guide past those irregularities. If, as an example, an IPS requires a 50/50 split between equities and fixed income, ensure you are rebalancing and exercising your investment discipline. With the recent run up in fixed income, many investors are likely overweight fixed income relative to their overall asset allocation targets. When we consider that many defensive stocks pay dividends in excess of the 2.8% currently paid by 30 year Canada bonds, the benefit of rebalancing becomes apparent. As well, in this environment maintaining modestly higher cash positions (up to 5%) likely makes sense as well – allowing investors to invest as opportunity materializes.

Remember that although the temptation to deviate from your roadmap may be significant in volatile markets, *discipline is the bridge between goals and accomplishment* that will see you through!⁴

⁴ “Discipline is the bridge between goals and accomplishment” – Jim Rohn

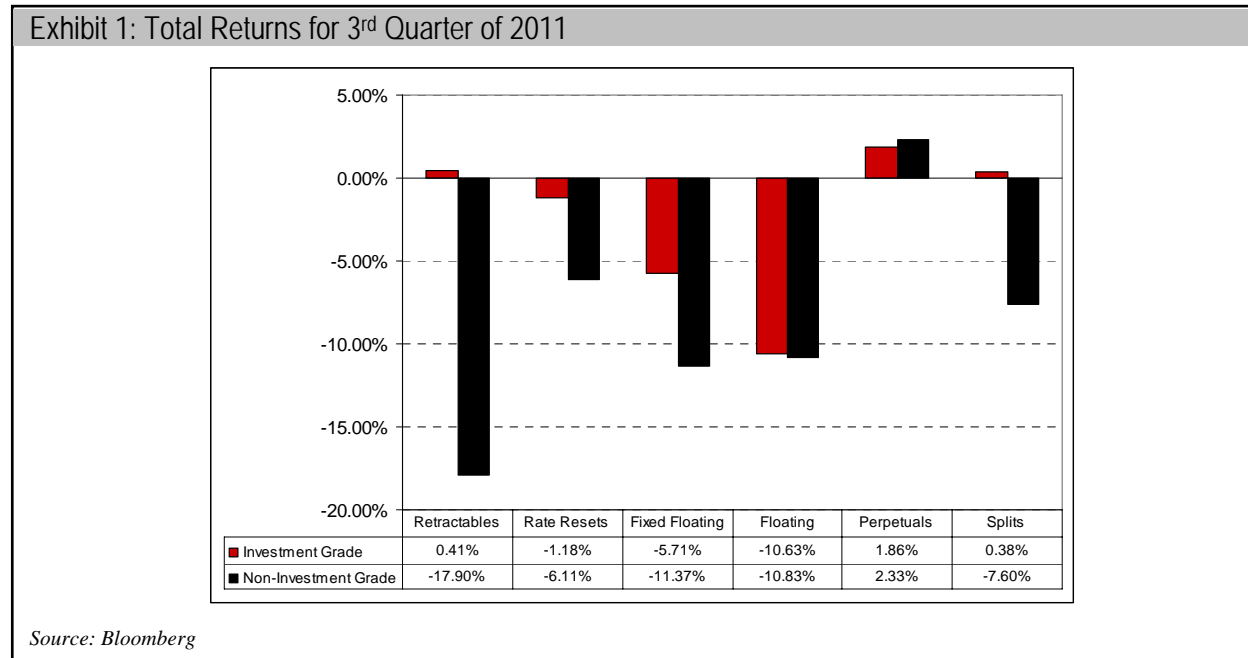
Preferred Shares

Include Preferred Shares for a Stable Source of Income

Tara Quinn, CFA, MBA — Associate Director, Portfolio Advisory Group

During a quarter where global concerns were apparent in the market investors searched for quality investments with limited risk. In this type of environment the Canadian Preferred share market underperformed the bond market (DEX Universe 5.12%) yet outperformed the equity market (S&P/TSX Composite -12.61%). For the third quarter of 2011 the S&P/TSX Preferred Share Index was negative (-1.84%) and has pushed the year-to-date performance for the Index into negative territory (-0.62%). The S&P/TSX Preferred Share Index is designed to serve the investment community’s need for an investable benchmark representing the Canadian preferred share market. This index is comprised of preferred shares trading on the Toronto Stock Exchange that meet criteria relating to minimum size, liquidity, issuer rating, and exchange listing. The Index is based on a market capitalization weighted scheme and is rebalanced on a quarterly basis.

On a total return basis, which includes the income provided from the various securities, the returns for the various types of preferred shares are indicated in the graph below.



During the quarter, government bond yields fell across the curve anywhere between -0.20% and 1.00% as investors became risk adverse and moved into the safety of Government securities. At the same time, corporate credit spreads have widened by approximately 0.53% thus, putting pressure on corporate securities. In this environment, the non-investment grade preferred shares were affected the most and performed poorly over the quarter. Focusing on the investment grade preferred shares, it was the straight perpetual preferred shares which outperformed. This positive performance can be attributed to the newest regulations (Basel III) as there is now the expectation that most bank preferred shares will be called prior to 2022. The floating rate preferred shares demonstrated a strong sell-off recently. This particular type of preferred share pays a variable dividend based on the bank prime rate. As a result of the Fed's guidance to keep interest rates on hold until 2013 this type of security underperformed based on the expectation that prime will continue to stay at low levels for the next year. Currently, Scotia Economics is forecasting the overnight rate to remain at 1.00% until the third quarter of 2012.

Expectations of Preferred Shares in a Low Interest Rate Environment

In this challenging, low- interest rate environment it is important to stay disciplined with your investment strategy. Generally speaking, the main advantage of including preferred shares in a portfolio is the tax-efficient stable income they generate. Therefore, during times when credit spreads are widening or interest rates are rising, thus causing prices of preferred shares to decline, it is important to remember the dividend income that is being acquired. Additionally, different types of preferred shares will respond differently in a low- interest rate environment.

Rate Reset Preferred Shares

This type of preferred share pays a fixed dividend rate until the reset date at which time the company has the option of redeeming the security at par. If the security is not redeemed the dividend rate will be reset at a pre-determined spread over the 5-year Government of Canada bond yield. At the reset date, the holder also has the option of choosing between the new fixed dividend rate, or a floating rate dividend for the next five years.

The prices of rate reset preferred shares fluctuate based on factors such as:

5- year Canada bond yields	<ul style="list-style-type: none"> ■ Similar to other fixed income instruments, prices will move inversely to changes in the yield. ■ As 5-year Canada bond yields move higher, prices of rate resets will decline.
Term to reset date	<ul style="list-style-type: none"> ■ As the reset date approaches, those securities which are anticipated to be called will move toward their par value (\$25). ■ Rate resets with a longer term to reset will fluctuate more in price than those with a shorter term to reset.
Corporate Credit Spreads	<ul style="list-style-type: none"> ■ The widening of credit spreads will adversely affect the price of rate resets. ■ Non-investment grade securities typically will be more affected by the widening and tightening of credit spreads.
Reset spread	<ul style="list-style-type: none"> ■ The higher the reset spread the higher the probability of the issue being redeemed at the reset date. ■ If the current financing rate for a particular company is higher than the reset spread – the security will likely trade at a discount due to likelihood of extension.

Recommendations:

- Create a 5- year (2013-2017) laddered portfolio of various rate resets. This buy and hold strategy will create a stable tax-efficient cash flow and also allows reinvestment each year which minimizes interest rate risk.

Straight Perpetual Preferred Shares

This type of preferred share pays a fixed dividend in perpetuity and only the issuer has the option of redeeming the security if the company decides it is in their best interest to do so. Based on the recent Basel III regulations the environment has changed and there are now four groups of preferred shares, each which will act differently based on the environment.

1. Bank Straight Perpetuals (not convertible to common shares)

This entails most of the bank perpetuals outstanding. These will no longer be considered Tier 1 Capital and will be phased out between 2013-2022 (based on Basel III regulations). These preferred shares are now expected to be called prior to 2022 and trade in a similar fashion to 10-year corporate bonds. These securities provide a good source of stable income for investors.

2. Bank Straight Perpetuals (convertible to common shares)

There are 5 bank perpetuals (BMO.PR.V, CM.PR.E, D, G, & RY.PR.W) which currently have the conversion to common share privilege detailed in the various prospectuses. There is no incentive from a regulatory perspective for the issuers to call these securities. Therefore, it is likely that these securities stay outstanding in the market indefinitely and will be very volatile to interest rate moves due to their long duration.

3. Insurance Straight Perpetuals

Life insurance companies are expected to be regulated under a similar framework to Basel III starting in 2014 however, there has been no announcement as of yet. Therefore, these securities are still trading as if they will remain in the market indefinitely. At this time insurance, perpetuals will be very volatile to interest rate moves and credit spreads.

4. Other Straight Perpetuals

The non-financial (eg. energy or industrial) straight perpetuals are not affected by the recent regulatory changes. Therefore, these securities will trade based on staying outstanding indefinitely and will be very volatile to interest rate moves due to their long duration. An issuer would only consider redeeming these securities if they were able to re-finance in perpetuity at a cheaper rate than the current dividend. At this time it is not expected that any of these perpetuals will be redeemed.

Recommendation:

- Increase exposure of bank straight preferred shares (not convertible into common shares) to 20-30% of portfolio. These securities have a strong likelihood of being called prior to 2022 based on the Basel III changes and will increase the yield on portfolios in a low interest rate environment.
- For the most tax-efficient income, purchase bank perpetual preferred shares in a fully taxable account.
- Reduce/Eliminate exposure to bank straight perpetuals which can be converted into common shares as these will likely stay outstanding indefinitely and fall in price as 30-year Canada yields increase.

Floating Rate Preferred Shares

This type of preferred share pays a variable dividend which floats in relation to bank prime (Prime). Currently, floating rate preferred shares are trading at a discount to their par value as interest rates and hence Prime is at low levels. However, floating rate preferred shares perform well in a rising interest rate environment and when there are inflation concerns. Although we are currently in a low-interest rate environment and Prime is 3.00%, as soon as there are any inflation concerns the prices of these securities are expected to increase. Additionally, when Prime increases holders will benefit from higher dividend payments and the opportunity for capital gains.

Recommendation:

- Incorporate 5-10% of a preferred share portfolio into floating rate securities. These preferred shares have sold off and now trade at a significant discount.
- As we are in a low-interest rate environment, this type of preferred share performs well in a rising rate environment and will provide an inflation and interest rate hedge when interest rates move higher in the future.

There are a variety of different types of preferred shares and it is important to understand the features associated with each particular issue. It is important to discuss your specific needs and goals with your ScotiaMcLeod advisor who can analyze your situation and present you with well reasoned recommendations.

Mutual Fund Strategy

Back to Basics

Carolyn Tsai – Associate, Portfolio Advisory Group, Mutual Fund Research

Why invest in a mutual fund?

A mutual fund, put simply, is a professionally managed investment product that pools together the money of like-minded investors to achieve an investment goal. Investors receive units, or shares in the fund in exchange for the money that is invested. These units are a fractional representation of the entire mutual fund's diversified holdings. Mutual funds are "open-ended" investment funds, meaning that new units can be created for new investors, and existing investors have the ability to redeem their units daily, unless otherwise stipulated by the fund company.

There are several advantages to investing in mutual funds. They include:

Diversification. Many of the risks associated with investing can be reduced through investing in a number of securities. Mutual funds make it easy for investors to own a diversified portfolio of securities by investing in a single fund, an investor is in actuality investing in a number of securities. However, it is important to keep in mind that diversification may help to reduce risk but will never completely eliminate it. Investors are still at risk of losing partial or all of their investment.

Professional management. Mutual funds are managed by investment professionals with dedicated time, skills and resources to research investment opportunities. This alleviates the difficult task and costs associated with researching and transacting on securities, not to mention the time required to do so successfully. This is especially true for those markets that may be difficult to access or are unavailable to the individual investor.

Affordability. The minimum investment amount for many mutual funds is quite low (e.g. \$500) for the initial purchase. Some mutual fund companies also offer regular investment plans with even lower minimum investment amounts (e.g. \$25 per month).

Liquidity. As mentioned above, most mutual funds offer investors the ability to redeem their units on a daily basis, however, there may be associated costs (please see Fee section below).

There are also disadvantages in investing in mutual funds.

Mutual fund investments are not guaranteed. Mutual fund investments are not guaranteed by the federal or provincial governments or any other institution. The value of the fund is based strictly on the market value at any given time and therefore may decline due to changes in market conditions.

Mutual fund investments are not insured. Mutual funds are not covered by the Canadian Deposit Insurance Corporation (CDIC).

Rate of return is not fixed. Mutual funds do not pay a fixed rate of return. The return is based on the market values and performance of the underlying securities minus any applicable fees.

Fees and taxes. Fees and commissions associated with owning a mutual fund affect overall return. Taxes will also play a large role in determining the net return received by the investor and should be an important part of any investment strategy.

How is the value of a mutual fund unit determined?

The unit value of a mutual fund is determined by the calculation of its Net Asset Value per Unit or Share, or more commonly known as "NAV". The NAV is calculated by adding up the market value of all the fund's underlying securities, subtracting all of the fund's liabilities, and then dividing by the number of outstanding shares in the fund. The resulting NAV per share is the price at which shares in the fund are bought and sold (plus or minus any sales fees). Mutual funds only calculate their NAVs at the close of the trading day.

How do investors make a return on their mutual fund investments?

Mutual fund investors may achieve a return on their investments from:

Income Distributions. A fund may earn income in the form of dividends and interest on securities in its portfolio. This income is distributed to investors by the fund after covering its expenses.

Capital Gains Distributions. A fund earns capital gains when it sells a security for more than the initial purchase price. At the end of the year, funds distribute the net capital gains to investors according to the number of units owned by the investor.

Capital Growth. If the market value of a fund’s portfolio increases after deduction of expenses and liabilities, then the NAV of the fund increases. The higher NAV reflects the higher value of the investment. Conversely, the value of the shares could also decrease depending on the current market value of the portfolio.

As mentioned, taxes play a large role in determining the net return received by the investor and should be an important part of any investment strategy.

What are the fees associated with mutual fund investing?

There are two main costs to consider when investing in a mutual fund.

Sales Fees The Sales fee or load charge of a mutual fund refers to when the investor pays the commission at the time of purchase or redemption.

Front-load fees: This commission, often negotiated between the client and the advisor, is charged at the time of purchase, effectively reducing the investment amount. For example, when \$1000 is invested at 1% front-end commission, \$990 will actually purchase units while \$10 in commissions is paid to the dealer and advisor.

Deferred Sales Charges (DSC): There is no up-front cost to the investor at the time of purchase however, there may be fees charged on redemption depending on how long the investor has owned the fund. Typical DSC schedules are five or seven years in length.

Exhibit 1: Example of DSC Schedule								
DSC Schedule	1st Year	2nd Year	3rd Year	4th Year	5th Year	6th Year	7th Year	After the 7th Year
DSC Rate	6.0%	5.5%	5.0%	4.5%	4.0%	3.0%	2.0%	Nil

Low-load fees (LSC): Similar to the DSC but the amount of the fees decreases faster than a DSC fund. A typical LSC schedule is for three years.

Exhibit 2: Example of LSC Schedule				
LSC Schedule	1st Year	2nd Year	3rd Year	After the 3rd Year
LSC Rate	3.0%	2.0%	1.0%	Nil

No-load fees: There are no fees for investing.

Management and Operating Expenses. Since mutual funds are professionally managed investments, there are management fees and operating expenses associated with investing in a fund. These fees and expenses charged by the fund are passed onto the shareholders and deducted from the fund’s return. The expenses are typically expressed as the Manager Expense Ratio (“MER”) – the percent of fund assets spent, on an annual basis, on day-to-day operations. The management fee component covers, among other things; manager salaries and costs of investment research, marketing and dealer advisor compensation. Operating expenses include fund administrative, audit, legal and custody expenses. GST or HST is paid on the MER and is included in the calculation. It is important to note that the management fee is a component of the Management Expense Ratio (MER) as many investors mistakenly use the two terms

interchangeably, which can be misleading. To illustrate, for a fund with \$100 million in assets with a management fee of 1.50% and MER of 2.0%, what would be the reported return? Due to the misperception of the two being equal, many investors will deduct the management fee. However, as the management fee is only one component of the MER, the MER should be utilized in the calculation. Therefore, if the fund has a gross return of 9% for the year, the reported return is 7%.

Other Fees

Short-term trading fee: Mutual funds are meant to be long-term investments. Therefore, most fund companies will withhold a short-term trading fee of typically 2% on units sold within 30 or 90 days of purchase depending on the fund. Short-term trading can have a negative impact on other investors in the fund because it increases the fund's trading and administrative costs and therefore can decrease the value of the fund.

Performance fee: Formerly restricted to hedge funds, performance fees are becoming more common in prospectus-based funds. Similar to a bonus, the performance fee is paid to the portfolio manager if the value of the fund passes a pre-set benchmark over a certain period of time.

Investors should consult the fund's simplified prospectus for details on associated fees.

What are the risks of investing in mutual funds?

Just like any investment, a mutual fund has its own set of risks. A mutual fund's portfolio consists of different investments and the value of these investments may be vulnerable to changes in interest rates, economic conditions, market and company news. A general rule of investing is the higher the potential for gains, the higher the risk for losses.

A mutual fund's level of risk depends on its investment objectives and the kinds of securities it invests in. For example, amongst the risks that a bond fund faces are interest rate risk and income risk (as bond values are inversely related to interest rates). Similarly, an equity fund faces market risk, country risk and currency risk in addition to a number of others. Specific risks of investing in each fund can be found in the fund's simplified prospectus or fund fact sheet.

How are mutual fund investments protected?

As previously stated, mutual fund investments are not covered by the Canada Deposit Insurance Corporation or other deposit insurance. However, under various circumstances, there are safeguards in place to help protect investors.

If a mutual fund company goes bankrupt. There are currently no investor contingency plans in place for mutual fund companies. The built-in safeguard for mutual fund assets is that they must, by law at all times, be segregated from those of the fund's trustee, manager or custodian (usually a bank or trust company) and the asset are kept in trust and separate from any other business of the fund company.

If a dealer firm goes bankrupt. Canadian Investor Protection Fund (CIPF) provides protection to eligible clients of a dealer firm that is a member of Investment Industry Regulatory Organization of Canada (IIROC), Bourse de Montreal Inc or TSX Group. Accounts at member firms are covered for up to \$1 million in the difference between the market value of the securities in the account and what the insolvent company can return to the client. For more information, visit www.cipf.ca

So what should an investor 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 the investor's investment goals. A fund that seeks long-term capital gains may not be appropriate for an investor with a current income requirement. In addition, it is important to consider whether the strategy the manager utilizes matches the risk tolerance level of the investor. Funds with higher potential rewards may take risks beyond the investor's comfort level and be inconsistent with the investor's investment goals. Aligning a fund's

investment objective and strategy to the investor's goals and risk tolerance level is crucial in selecting a mutual fund that is best suited for the investor's portfolio.

Fund Manager. The point of investing in a mutual fund is to leave the investment management 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 investors determine if a fund is appropriate for their objective and risk tolerance.

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

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

The above addresses the most common questions we receive regarding mutual funds. As always, should you have any questions, please contact your ScotiaMcLeod advisor.

Insurance

Insurance Planning for the High-Net-Worth Investor

Susan Forint, MBA — Manager, Marketing, ScotiaMcLeod

It is a common notion that insurance strategies at their most fundamental level are about managing risk and protecting against future financial loss; that, for the main-stream investor, insurance serves the purpose of protecting debt, a mortgage, a child's education, or to provide for loved ones after death. And it is a fairly common belief that high-net-worth investors do not need insurance for such purposes.

As a high-net-worth investor, you may be surprised to learn that insurance solutions have a place in your investment strategy and your overall financial plan as well. Regardless of market performance and accumulated wealth, most people would rather leave more of their hard earned wealth as a legacy and less to the Canada Revenue Agency. Insurance solutions can play an integral role in ensuring that your net-worth is preserved during your lifetime and, at death, lessen your tax liability and help to transfer your wealth as efficiently and effectively as possible.

Tax Planning

Much of your tax planning likely involves strategies for tax-deferral. But without proper planning, a large tax liability could be levied on your estate at death. Insurance solutions can provide tax-sheltered investment returns, estate preservation, and liquidity to pay the final tax bill. Proceeds from life insurance, payable at death, are distributed tax-free, and avoid probate fees, unlike many other investment options. Proceeds can also be utilized to cover the projected tax liabilities on investment assets and the capital gains tax on assets such as the family vacation home.

Professional Planning

If you are a professional or business owner, life insurance can provide a source of tax-free capital for your family or business in the event of your premature death, as well as creditor protection, and the proceeds avoid probate fees and delays in your estate. Life insurance can also create a flexible tax-deferred savings vehicle that could be used for a variety of purposes in the future. Instead of having to distribute a fully taxable dividend to the estate, the corporation is able to pay tax-free dividends to the estate, thereby substantially increasing the net estate value of those corporate assets.

Retirement Planning

Regardless of level of wealth, most investors want to ensure they can live the retirement they have worked hard to reach, yet also preserve their wealth to pass on to the next generation. Utilizing existing funds within your portfolio that are invested in currently low-yielding fixed income vehicles to purchase a life annuity and a life insurance policy can provide you with the cash flow you need in retirement while preserving your estate. Alternatively, a stand alone life insurance policy with cash value can be used to borrow against as a tax-free loan to supplement your retirement income needs.

Planned Giving

Charitable giving with life insurance offers a number of benefits to both you, the investor, and to the charity itself. The gift of life insurance can be effective in providing a practical way to make sizeable charitable gifts to your favourite charities or private foundation. Not only will life insurance help increase the size of your gift, in most cases it will provide significant tax benefits. At death, the proceeds from the insurance policy flow to your named charity, tax-free and avoid any probate and estate settling challenges and delays. The tax credits can be issued in either one of two ways: it can be issued for the premiums paid to the life insurance policy (with no credit issued for the death benefit) or it can be issued for the death benefit (with no credit issued for the premiums paid into the policy).

Planning for the Next Generation

With life insurance, your wealth can shift with greater ease to the next generation, on a tax-advantaged basis. Transferring a portion of your existing investment assets from fully taxable positions into a tax-exempt insurance policy can result in a significantly enhanced estate plan. Through the years, as your policy grows, your ultimate estate benefit builds as well. Eventually, the proceeds are distributed tax-free to your beneficiaries when you die, eliminating probate fees and delays.

Or perhaps not all of your children are interested in joint ownership of your vacation home; once again, an insurance solution can be used to ensure that all of your children receive an equal financial inheritance. Your child, or children, who are interested in keeping the vacation property would be named beneficiaries of the property in your will. A permanent life insurance policy would be purchased for the benefit of the remaining child or children, the proceeds of which would be equal to the difference between what their inheritance is and what it would have been if they had received their other share of the property.

Contact your ScotiaMcLeod advisor for more information about how insurance strategies fit into your personal investment plan.

All insurance products are sold through ScotiaMcLeod Financial Services Inc., the insurance subsidiary of Scotia Capital Inc., a member of the Scotiabank Group. When discussing life insurance products, ScotiaMcLeod advisors are acting as Life Underwriters (Financial Security Advisors in Quebec) representing ScotiaMcLeod Financial Services Inc.

This article is for information purposes only. It is recommended that individuals consult with their own tax advisor before acting on any information contained in this article.

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

So much for the “summer doldrums.” The past several months have been anything but dull as the Canadian market traded lower for three consecutive months during the third quarter, occasionally offering brief periods of strength, only to be beaten lower by another negative headline. Corporate fundamentals have taken a back seat to macro-economic and political forces. As has been the case for most of this year, overshadowing capital markets throughout the quarter were European sovereign debt concerns, the risk of contagion to the global financial system, and the threat of another economic recession. Layered on top of these issues was investor anxiety surrounding debt and deficit issues in the United States and the political wrangling which swirls in its wake. PMI (Purchasing Managers Index) data for September essentially confirmed that Europe is in recession; although U.S. economic data suggests the U.S. has so far avoided that fate, its equity markets have already priced in a recession scenario. Investors are fearful of not only recession, but a repeat of the global credit crunch experienced in 2008. Equity trading activity suggests investors are lacking faith in global political and economic leadership to resolve the current crisis in Europe and limit its impact on the North American economy. Stock price declines were intensified by fund flows out of equities, hedge fund redemptions, and electronic/program trading.

Canadian equity indices sold off sharply in the quarter, particularly in September. Not so much from concern about the strength of the Canadian economy, but more reflecting the risk of weakening global demand and thus lower prices for commodities, specifically energy and base metals, which represent almost 50% of the S&PTSX Composite Index. Other than the impact of the 19% decline in shares of **Research In Motion**, (a position we exited in the previous quarter), which led the Technology sector to be the second worst performing group during the period, the sectors having the largest negative impact on index performance were Energy and Materials, while only the defensive Utilities sector posted a positive return. The weakness in Materials can be attributed to the price declines in base metals like copper which declined 26.4% in the quarter, and latterly gold bullion, which although posting an increase for the quarter overall, fell 11% in September, closing at US\$1622/oz. after having reached an all time intra-day high of US\$1924/oz. in early September. Energy stocks came under significant selling pressure in the quarter in sympathy with the 17% decline in crude oil futures in the period caused by reduced demand expectations; oil closed the quarter at US\$79.20/barrel.

The Canadian Core Guided Portfolio generated a negative total return of 14.2% during the quarter, worse than the benchmark S&PTSX60 Index which declined 12.1% on the same basis. Only three portfolio holdings posted gains during the period, and unfortunately these gains were overwhelmed by a number of holdings which suffered double-digit declines. **Barrick Gold** rallied 12% in the quarter along with gold bullion, **TransCanada Corp.** edged higher by 0.4%. The largest positive contributor was **Dollarama Inc.** which advanced 11%, propelled higher by another great quarterly earnings report, the eighth quarter in a row which exceeded analyst estimates; clearly the discount retail space is attractive for both consumers and investors as the economic outlook has weakened. As might be expected, the worst performing portfolio holdings were all found within the resource sectors: Energy stocks **Canadian**

Natural Resources (-24%); **Suncor Energy** (-29%); and **Talisman Energy** (-35%) all fell in sympathy with the downdraft in oil and gas prices. The last time some of these stocks traded at such low prices, oil was closer to US\$40/barrel. Shares of **Teck Resources** (-37%) suffered the biggest decline among portfolio holdings as the stock moved in line with the decline in copper futures; **Teck Resources** shares are inexpensive at current levels but the share price reflects the depths of negative investor sentiment toward economic growth potential.

Eventually corporate fundamental analysis will matter; but despite seemingly attractive valuations, we do not expect any sustained strength in equities until more concrete resolution of the Greek debt crisis is achieved. Given our outlook for an extended period of slow economic growth, whether falling into outright recession in North America or not, equities are expected to trade in a range for the next several years so focusing on quality dividend paying equities will reward investors over the long term.

Changes

In August we made a switch out of **Thomson Reuters Corp. (TRI)** and into **Shaw Communications (SJR.B)**. In late July **TRI** announced plans to restructure their Markets division with CEO Tom Glocer personally taking over responsibility of Markets. This division, which represents more than half of revenues, was failing to continue delivering the revenue and cost synergies which had initially been observed during the early days of integrating **Thomson** with **Reuters Group Plc**. Given the market response to the various macro-economic events occurring in both Europe and the United States it had become increasingly apparent that **TRI**'s Markets division would likely remain challenged. The Capital Markets divisions of major financial institutions are expected to have their own cost issues to deal with, and even if that does not result in staff cuts, the perception of weakness is likely to weigh on **TRI** shares as investors ascribe a lower multiple to **Thomson Reuters**' earnings. Accordingly, we elected to exit the position and switch into another Consumer Discretionary name which is less economically sensitive: **Shaw Communications**.

Shaw Communications is the largest cable TV company in Canada, with 2.3 million basic cable subscribers, 1.8 million high-speed Internet subscribers, and 1.2 million VoIP (internet telephony) subscribers. **Shaw** also has conventional and specialty TV assets acquired last year through the purchase of CanWest's broadcasting business. **Shaw** is a more defensive play in the Consumer Discretionary sector as most of its product and service offerings are more non-discretionary in nature. The addition last year of CanWest's broadcast assets adds an element of cyclicity to **Shaw**'s business, but overall the company's business model and earnings are reasonably predictable.

In mid-September we reduced our exposure to Financials by exiting the position in **Genworth MI Canada Inc. (MIC)** while increasing our gold weighting via a new position in a gold bullion ETF, the **Claymore Gold Bullion Exchange Traded Fund (CGL)**. Part of the investment thesis for the holding in **MIC** was predicated on the expectation for higher interest rates in the second half of 2011; recent events including commentary from the U.S. Fed and the Bank of Canada suggest this expectation is no longer valid. Despite the seemingly attractive valuation for **MIC** shares, the market has punished the stock along with most insurance related securities and led to significant underperformance relative to the market. In keeping with our recommendation to high-grade equity portfolios and add to defensive holdings, we decided to exit the position in this smaller cap financial holding and add to our gold exposure which had been significantly underweight relative to the benchmark.

Gold bullion has been on an upward trend for the last ten years with a more pronounced move over the past several years in the aftermath of the credit crisis of 2008; gold has more than doubled since the fall of Lehman Brothers in autumn of 2008. There is considerable debate surrounding the long-term investment merit of gold, but what cannot be disputed is the significant performance generated by this commodity during times of economic and political uncertainty. Gold is expected to continue its upward trend due to its role as a currency, particularly during this extended period of global instability as part of the solution in Europe will ultimately involve the printing of more money by central banks. In previous economic and investment cycles, gold equities lag the underlying commodity for a period of time and at some point begin to outperform to reflect the significant operating leverage for many, but not all gold producers. So

far in 2011, gold equities have been true to historical precedent in underperforming gold bullion and we expect this to continue as investors remain concerned about increasing operating costs in addition to political risk in certain circumstances. In addition, during particularly weak periods for equities, gold equities have a tendency to behave more like stocks than like gold bullion. It is for these reasons that in adding to our gold weighting we chose to do so through a direct investment in gold bullion as opposed to selecting another gold producer.

The **Claymore Gold Bullion ETF (CGL)** invests 100% of its assets in gold bullion. The investment objective of the Fund is to replicate the performance of the price of gold bullion, in Canadian dollars, less fees and expenses. The management fee of 0.5% includes all operating expenses of the fund, including custody fees. This ETF trades in Canadian dollars and closely tracks the movements of gold bullion.

Near quarter-end we sold **Sun Life Financial** and replaced it with a new position in **Calloway REIT**. In an environment where life insurance stocks have come under significant selling pressure over recent months, shares of **Sun Life Financial** had been the worst performing Financial holding in this portfolio on a year-to-date basis. The reason lifeco stocks have sold off relates to the earnings sensitivity and thus historic correlation of these businesses, and their shares, with the direction of equity markets and interest rates. The bigger issue in the current environment relates to lower interest rates as lifecos attempt to match a large part of their long-term liabilities with long-term bond portfolios. With the pronouncement from the U.S. Federal Reserve that they will likely keep interest rates lower for the next two years, and the recent announcement of “Operation Twist,” a policy that will see the Fed replace shorter-term bond holdings with longer dated maturities in an effort to reduce longer-term rates, lower re-investment rates are likely to maintain pressure on lifeco earnings. Although the dividend yield on **Sun Life** shares is attractive at 6%, and despite reasonable capital levels for the company, our concern was that the stock is a value trap and will likely continue underperforming in the context of uncertain equity markets and a prolonged period of low, if not lower, interest rates; hence the decision to exit the position and switch into another holding in the Financial sector which offers greater risk-adjusted total return potential: **Calloway REIT**.

Calloway REIT (CWT) owns a 24.3 million sq. ft. portfolio of predominantly large, format unenclosed retail properties across Canada. Its single largest tenant is **Wal-Mart** which accounts for 27% of gross rents and anchors 76% of its properties. The REIT has a strategic relationship with SmartCentres, a Canadian-based private developer of retail properties, and **Wal-Mart**, Canada's largest development partner. Although technically considered part of the “Financial” sector, the addition of a Real Estate Investment Trust (REIT) holding provides differentiation within the sector and enhances portfolio diversification. **Wal-Mart** is the dominant anchor tenant in the **CWT** portfolio, which should attract other strong tenants as well as shoppers. **CWT** has a successful track record of controlling long-term cost of capital and operating costs. Based on current annual distributions of \$1.55 per unit, the REIT provides a current yield of 6.2%.

Exhibit 1: ScotiaMcLeod Canadian Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 30-Sep-11	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
Bank of Nova Scotia	BNS	2-SP	Low	\$52.72	\$62.00	\$2.08	3.9%	22%
Brookfield Asset Management	BAM	1-SO	Medium	\$28.98	\$35.00	\$0.52	1.8%	23%
Calloway REIT	CWT.UN	2-SP	Medium	\$25.73	\$27.00	\$1.55	6.0%	11%
Rogers Communications	RCI.B	2-SP	Medium	\$35.87	\$39.00	\$1.42	4.0%	13%
Royal Bank of Canada	RY	1-SO	Low	\$48.06	\$57.00	\$2.16	4.5%	23%
Toronto Dominion Bank	TD	1-SO	Low	\$74.59	\$93.00	\$2.72	3.6%	28%
Consumer Products:								
Dollarama Inc.	DOL	1-SO	High	\$36.30	\$42.00	\$0.36	1.0%	17%
Shaw Communications Inc.	SJR.B	1-SO	Medium	\$21.26	\$27.00	\$0.92	4.3%	31%
Industrial Products:								
Canadian National Railway	CNR	1-SO	Medium	\$70.03	\$80.00	\$1.30	1.9%	16%
SNC -Lavelin Group Inc.	SNC	1-SO	Medium	\$44.03	\$57.50	\$0.84	1.9%	33%
Resource:								
Agrium Inc.	AGU	1-SO	High	\$69.75	\$109.00	\$0.11	0.2%	56%
ARC Resources Ltd.	ARX	1-SO	High	\$22.56	\$28.00	\$1.20	5.3%	29%
Barrick Gold	ABX	2-SP	Medium	\$49.11	\$62.50	\$0.47	1.0%	28%
Canadian Natural Resources	CNQ	1-SO	High	\$30.77	\$44.00	\$0.36	1.2%	44%
Claymore Gold Bullion ETF	CGL			\$14.58		\$0.00	0.0%	
Crescent Point Energy Corp.	CPG	1-SO	High	\$39.45	\$55.00	\$2.76	7.0%	46%
Suncor Energy	SU	1-SO	Medium	\$26.76	\$40.00	\$0.44	1.6%	51%
Talisman Energy	TLM	1-SO	High	\$12.88	\$20.00	\$0.27	2.1%	57%
Teck Resources Ltd.*	TCK.B	Not Rated	High	\$30.92	\$60.00	\$0.60	1.9%	96%
TransCanada Corp.	TRP	1-SO	Low	\$42.54	\$50.00	\$1.68	3.9%	21%

*Currently Scotia Capital does not provide research coverage - target price based on consensus data.

Source: Scotia Capital; Bloomberg.

ScotiaMcLeod Canadian Income Plus Guided Portfolio

Stephen Uzielli – Portfolio Manager, Portfolio Advisory Group

Performance Update

While the Canadian Financial sector declined overall during the third quarter, it still outperformed the broader market; as a result, dividend stocks as measured by the Dow Jones Canada Select Dividend Index, also outperformed. Due to the high weighting of Financials within the benchmark, and despite the relative underweight position in the Income Plus Portfolio (33% by the end of the period), the portfolio modestly outperformed. The portfolio generated a negative total return of 5.2% for the quarter while the benchmark declined by 5.6% on the same basis.

As stated above, Financial stocks sold off during the period due to a weaker economic outlook and a further decline in interest rates; a low and declining interest rate environment negatively impacts both banks and life insurance companies, but it tends to influence lifeco stocks to a greater extent. As a result **Sun Life Financial** shares were weak leading up to our decision to exit the position during the quarter and **Power Corp.** shares fell 15% during the period as their largest holding is **Great West Lifeco**. **Royal Bank** (-13%) was the poorest performer during the quarter among bank holdings. The decline in oil & gas prices also impacted this portfolio as shares of **Crescent Point Energy** (-12%) were among the biggest decliners.

Losses among these portfolio holdings were offset to some extent by gains achieved in other sectors like Pipelines and Utilities, along with **Calloway REIT** which advanced 2% while the REIT Index actually declined by a similar amount. Utility play **Emera Inc.** climbed 2% while pipeline **Enbridge Inc.** rallied almost 7% and **TransCanada Corp.** ticked higher by a more modest 0.4%. Pipeline and Utility stocks, or so called Energy Infrastructure stocks are particularly appealing to investors due to the predictability of their cash flows resulting from the highly regulated nature of their businesses. The current and sustained low interest environment will compel investors to maintain their pursuit of higher yielding, predictable, steady, and growing dividend paying stocks; the universe of potential Canadian investment candidates that meet these criteria is quite narrow, which helps support valuations.

Changes

We also elected to exit the **Thomson Reuters** position in this portfolio for the same rationale described previously in the commentary for the Canadian Core Portfolio; however, in this situation we switched into shares of another high yielding stock in the Energy sector: **Vermilion Energy Inc.**

Vermilion Energy Inc. is an international oil and gas producer with operations both onshore and offshore in Western Canada, Australia, France, Ireland, and the Netherlands; approximately 70% of production is from outside Canada. More than 60% of current production is oil, mostly light sweet crude. The company's reserve and production growth comes from a combination of development drilling, reservoir optimization and strategic acquisitions. **Vermilion** management targets a very conservative 5% reserve and production growth profile on a per unit basis. The company has a deep resource base with a long reserve life exceeding 12 years; management has a strong track record of execution on its strategy and the stock is accorded a premium valuation as a result. Most importantly for this portfolio, the current dividend is sustainable as the payout ratio is very low at 47% of annual cash flow. The current yield on **Vermilion** shares is 5.1%.

Near quarter end we sold holdings of **Bank of Montreal** and **Sun Life Financial** and replaced them with new positions in **Brookfield Renewable Power Fund** and **Inter Pipeline Fund**. The sale of **Sun Life Financial** was based on the same rationale described previously for its removal from the Canadian Core Portfolio while the sale of **Bank of Montreal** was triggered by the downgrade of the stock by Scotia Capital's bank analyst; the Investment Policy Statement that governs the managing of this portfolio compels us to remove holdings as a result of the 3-Sector Underperform recommendation from Scotia Capital. In seeking other investments that meet our criteria, we look to make investments in companies

that demonstrate a combination of both above-average income and growth characteristics; hence the switch into **Brookfield Renewable Power Fund** and **Inter Pipeline Fund**.

Brookfield Renewable Power Fund (BRC) is an owner, operator, and developer of environmentally friendly renewable power facilities, primarily located in North America. “Renewable” energy is created from natural sources such as solar, wind, rain, tides, and geothermal heat, which are renewable, or naturally replenished as opposed to depleted. Under its current structure, **BRC** operates mostly hydroelectric assets in Ontario, Quebec, and to a lesser extent British Columbia and New England, along with two wind farms operating in Canada. In a transformational deal announced on September 13, 2011, the company’s parent **Brookfield Asset Management (BAM)**, which currently owns 34% of **BRC**, will combine its international power assets (U.S. and Brazil) with **BRC** to create **Brookfield Renewable Energy Partners L.P.**, which upon approval will become one of the world’s largest publicly traded (on both the TSX and NYSE) renewable power businesses with approximately \$13 billion of power generating assets. Once the merger is approved, **BAM** will own 73% of the combined entity.

BRC is backed by a proven sponsor in **Brookfield Asset Management**, formerly known as **Brascan**, with extensive expertise in operations and finance, not only in North America, but Brazil in particular. As currently structured, **BRC** has long life assets in that none of its Canadian contracts are up for renewal until 2019, and the average contract duration of the proposed merged entity would be 24 years. The combined entity is seen as a superior portfolio of power generating assets given its lower operating costs and low requirement for maintenance. **BRC** is attractive in its own right, but the merger is seen as an accretive transaction for **BRC** unit holders and the company expects to increase annual distributions by 3%-5% annually. Although the units trade at a higher valuation relative to its peer group in the Power & Utilities sector, the premium is justified by its superior asset base, proven sponsorship by **BAM**, long term contracts and thus low risk business model, and growth potential. The current quarterly distribution is sustainable as the payout ratio is low at 76% of 2011 cash flow. The current yield on **BRC** units is 5.2%.

Inter Pipeline Fund (IPL) is structured as a limited partnership with midstream operations including 4.8 million barrels of storage capacity and an oil pipeline-gathering network which transports petroleum products within Alberta and now moves about a third of all oil sands production through Cold Lake, Corridor, and Polaris. “Midstream” assets typically encompass all operations and processes between “upstream” or production assets, and “downstream” or refining and marketing operations. In addition, **IPL** has ownership in three major NGL (Natural Gas Liquids) extraction facilities at Cochrane and Empress, Alberta. **Inter Pipeline's** bulk liquids storage business is based in Europe, with 8 million barrels of capacity primarily in the U.K. and Germany.

We previously held **IPL** units in this portfolio, electing to remove the position in November, 2009 on the premise the units were fully valued. In hindsight, we never should have sold the position as the company, as expected, continued to perform well corporately, delivering stable cash flow to support its growing distribution; however, the units have responded with better performance than anticipated. The partnership is well diversified by business mix as well as geography, offering investors protection from downside in any one component of the business. The units trade at a slight discount to its peer group in the Pipelines and Midstream sector but are expected to perform at least in line with the group due to its track record, predictable organic growth with upside potential, and business diversification. The monthly distribution is sustainable as the payout ratio is low at 74% of 2011 cash flow. The current yield on **IPL** units is 6.1%.

Exhibit 2: ScotiaMcLeod Income Plus Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 30-Sep-11	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
Bank of Nova Scotia	BNS	2-SP	Low	\$52.72	\$62.00	\$2.08	3.9%	22%
Brookfield Renewable Power Fund	BRC.UN	1-SO	Low	\$25.89	\$30.00	\$1.30	5.0%	21%
Calloway REIT	CWT.UN	2-SP	Medium	\$25.73	\$27.00	\$1.55	6.0%	11%
Emera Inc.	EMA	2-SP	Low	\$32.31	\$33.00	\$1.35	4.2%	6%
Power Corp. of Canada	POW	2-SP	Low	\$22.97	\$29.00	\$1.16	5.1%	31%
Rogers Communications Inc.	RCI.B	2-SP	Medium	\$35.87	\$39.00	\$1.42	4.0%	13%
Royal Bank of Canada	RY	2-SP	Low	\$48.06	\$57.00	\$2.16	4.5%	23%
TELUS Corp.	T	2-SP	Medium	\$51.35	\$53.00	\$2.20	4.3%	7%
Toronto Dominion Bank	TD	1-SO	Low	\$74.59	\$93.00	\$2.72	3.6%	28%
Consumer Products:								
Shaw Communications	SJR.B	1-SO	Medium	\$21.26	\$27.00	\$0.92	4.3%	31%
Resource:								
Crescent Point Energy Corp.	CPG	1-SO	High	\$39.45	\$55.00	\$2.76	7.0%	46%
Enbridge Inc.	ENB	2-SP	Low	\$33.45	\$40.00	\$0.98	2.9%	23%
Inter Pipeline Fund	IPL.UN	1-SO	Medium	\$16.01	\$18.00	\$0.96	6.0%	18%
TransCanada Corp.	TRP	1-SO	Low	\$42.54	\$50.00	\$1.68	3.9%	21%
Vermilion Energy Inc.	VET	2-SP	High	\$44.04	\$45.00	\$2.28	5.2%	7%

Source: Scotia Capital; Bloomberg

ScotiaMcLeod U.S. Core Guided Portfolio

Stephen Uzielli – Portfolio Manager, Portfolio Advisory Group

Performance Update

U.S. equity markets have now declined for five months in a row and in each successive month, market sentiment has reflected the collective lack of confidence by investors in light of the seeming inability of global leaders to resolve the very complex economic challenges of the day. Despite another strong showing in terms of earnings performance delivered by corporate America for Q2, equity investors have been overwhelmed by negative reports surrounding the raising of the debt ceiling in the U.S., followed as it was by the downgrade of U.S. debt by rating agency Standard & Poor's, and the current lack of clarity from Europe regarding resolution of their sovereign debt and potential banking crisis.

Capital markets are working through an adjustment phase to reflect a somewhat slower economic growth outlook. Unfortunately, any valid solution to the debt and deficit problems faced by Europe and the U.S. will require austerity measures which will be a further drag on growth for an extended period. In the U.S., jobs and housing data are expected to remain weak for several years. During the third quarter, U.S. Federal Reserve Chairman Ben Bernanke spoke on several occasions, at times confusing the market with his comments. First indicating the Fed would likely keep interest rates low until mid-2013, and then subsequently speaking with some optimism toward the economic outlook for the second half. In September the Fed unveiled "Operation Twist", an effort to push down long-term interest rates and flatten the yield curve which the market took as an indication of weak growth and/or recession; the Fed's reference to "significant downside risks to the economic outlook" also drove the market lower.

Despite the negative macro overhang, given the extreme sell-off in share prices and the massive outperformance in the bond market, our asset allocation favours equities over bonds. Underlying our bias toward equities is the observation that corporate profitability remains strong and even if forward earnings decline somewhat from current levels due to a slowdown in the economy, balance sheets are still solid as evidenced by large cash positions and continued announcements of dividend increases.

The U.S. Core Guided Portfolio performed in line with the benchmark during the third quarter, with both the portfolio and the S&P500 Index generating a negative total return of 15.3% for the period. Very few stocks were able to post positive returns as only the Utility sector moved higher and only three portfolio holdings generated gains. The negativity which permeated the market led to a relative flight to quality during the quarter as investors pushed down cyclicals like Materials, Energy, and Financials in their rush to exit positions for the relative safety of more defensive sectors. Recent portfolio acquisition Utility play **Southern Co.** advanced 3% after adding it in late August. Consumer Discretionary stalwart **McDonald's Corp.**, which behaves very much like a Consumer Staple stock added 4% in the period on continued solid earnings results and steady same store sales growth reported during the period. The top performer in the quarter was **Apple Inc.** which rallied 14% on solid results and market dominance; at one brief moment in the quarter, **Apple Inc.**'s market value increased such that it was the highest valued stock in the U.S. market. (Note that subsequent to quarter end, **Apple** co-founder Steve Jobs died after a lengthy illness; sad news as it is, we remain confident in the outlook for **Apple** given the succession planning that Jobs had already implemented prior to removing himself from day-to-day management responsibilities earlier this year).

As stated, cyclical sectors bore the brunt of investor selling in the quarter and this was demonstrated by the largest decliners among portfolio holdings. Although we reduced exposure to Financials in August, the two remaining holdings **MetLife, Inc.** and **State Street Corp.** dropped 36% and 29% respectively as investors were concerned about the impact of lower interest rates and slow economic growth on their business lines. **Fluor Corp.** shares fell 28% in reflection of the big decline in oil prices and its impact on the company's revenues, a majority of which is provided by the oil & gas sector. Also impacted by lower oil prices were **Marathon Petroleum** (-34%) and **Occidental Petroleum** (-31%). However, the holding experiencing the most violent price decline was **Freeport McMoRan** which fell 42% in the quarter along with copper and gold prices. Although cyclicals are out of favour, we find **Freeport** shares particularly compelling at the current share price given our longer-term optimism toward copper.

Changes

Effective after the market close on June 30, 2011, **Marathon Oil Corp. (MRO)** distributed to shareholders one common share of **Marathon Petroleum Corp. (MPC)** for every two shares of **MRO** common stock held. As a result of the spin-out of shares of **MPC** to **MRO** shareholders, investors following the ScotiaMcLeod U.S. Core Guided Portfolio were holding 21 positions as opposed to 20 roughly equal-weighted positions as mandated by the Investment Policy Statement which governs this portfolio. In August we sold the position in **MRO** and redeployed the proceeds to top up the new position in **MPC**.

Marathon Petroleum Corp. is the fifth largest transportation fuels refiner in the U.S. and the largest refiner in the Midwest. **MPC**'s refining, marketing and transportation business is concentrated primarily in the Midwest, Gulf Coast and Southeast regions of the U.S. In their first quarter as a separate public entity, **MPC** reported strong Q2 results with the refining part of their business posting 81% growth in EBITDA year over year, and 46% growth sequentially, generating significant free cash flow in the process. As highlighted by Credit Suisse in their initiating coverage report, **MPC** offers investors an EBITDA growth story through de-bottlenecking at their Garyville refinery facility and participation in the growth of the Speedway retail and logistics system, a dividend growth story, a refined product demand recovery story, and margin improvement potential through the company's Mid-Continent refining business.

Later in August we sold **JP Morgan (JPM)**, and bought **Southern Co.** We added the position in **JPM** in early February of this year on increased optimism resulting from improving conditions for the banking sector due to a healthier economic outlook. Our note at the time suggested "both banks and life insurance companies should enjoy enhanced profitability as long-term interest rates trend higher later this year and capital markets return to relative stability." Since that time, capital markets had a brief period of "stability," but market volatility has increased markedly and the outlook for interest rates has changed in the intervening period with the prospect of low interest rates continuing for the next two years. **JPM** has long been considered one of the best positioned U.S. banks in terms of capital levels, profitability, credit quality, and management execution; and these positive attributes remain valid today. In fact, it is these characteristics that likely explain why the stock held in relatively well, (didn't decline as much), compared with other Financial stocks.

With the deteriorating economic outlook it became prudent to reduce exposure to Financials as they are vulnerable to negative investor sentiment tied to the impact of economic stress in Europe, an extended period of sluggish growth in the U.S. economy, and implications for foreclosure and other mortgage issues related to the continued weak forecast for the U.S. housing market. In addition, loan growth is expected to remain a challenge in this environment. Consistent with our recommendation that investors add defensive, higher quality, higher yielding dividend paying stocks during this period of market instability, we switched out of **JPM** and into a new holding in the Utilities sector: **Southern Co.**

Southern Co. (SO) is one of the largest electrical utility companies in the United States with generating capacity of almost 43,000 megawatts and provides electricity to over 4 million customers in the U.S. Southeast. The company has been operating for over 100 years and participates in both regulated and unregulated (competitive) markets; power is produced by more than 280 coal, oil, gas and hydro generating units at 73 power plants. Consensus estimates forecast 8% earnings growth in 2011 and 6% in 2012 as compared to the peer group which is expected to show earnings declines for the same periods. The current yield on **SO** is 4.5% per annum; the company's dividend was raised in June by almost 4% implying a payout ratio of 74% which is within the company's targeted range of 70% to 75%.

Exhibit 3: ScotiaMcLeod U.S. Core Guided Portfolio

Sector	Symbol	Rating	Risk Ranking	Price 30-Sep-11	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
AT&T Inc.*	T	Restricted	Low	\$28.52	\$31.00	\$1.72	6.0%	15%
MetLife, Inc.	MET	Outperform	Medium	\$28.01	\$44.00	\$0.74	2.6%	60%
Southern Co.	SO	Outperform	Low	\$42.37	\$45.00	\$1.89	4.5%	11%
State Street Corp	STT	Outperform	Low	\$32.16	\$47.00	\$0.72	2.2%	48%
Consumer Products:								
McDonald's Corp	MCD	Outperform	Low	\$87.82	\$104.00	\$2.80	3.2%	22%
McKesson Corporation	MCK	Outperform	Low	\$72.70	\$96.00	\$0.80	1.1%	33%
Nike Inc.	NKE	Neutral	Medium	\$85.51	\$91.00	\$1.24	1.5%	8%
PepsiCo, Inc	PEP	Neutral	Low	\$61.90	\$75.00	\$2.06	3.3%	24%
Pfizer Inc.	PFE	Outperform	Low	\$17.68	\$23.00	\$0.80	4.5%	35%
Industrial Products:								
Apple Inc.	AAPL	Outperform	Medium	\$381.32	\$500.00	\$0.00	0.0%	31%
Fluor Corp.	FLR	Outperform	Low	\$46.55	\$73.00	\$0.50	1.1%	58%
Intel Corp.	INTC	Outperform	Low	\$21.34	\$30.00	\$0.84	3.9%	45%
Microsoft Corp	MSFT	Outperform	Medium	\$24.89	\$35.00	\$0.80	3.2%	44%
Oracle Corp	ORCL	Outperform	Low	\$28.74	\$42.00	\$0.24	0.8%	47%
General Electric Co.	GE	Outperform	Low	\$15.22	\$22.00	\$0.60	3.9%	48%
Waste Management Inc.	WM	Neutral	Medium	\$32.56	\$36.00	\$1.36	4.2%	15%
Resource:								
ExxonMobil Corp.	XOM	Neutral	Low	\$72.63	\$95.00	\$1.88	2.6%	33%
Freeport McMoRan Copper	FCX	Outperform	Medium	\$30.45	\$55.00	\$1.00	3.3%	84%
Marathon Petroleum Corp.	MPC	Outperform	Medium	\$27.06	\$65.00	\$0.40	1.5%	142%
Occidental Petroleum	OXY	Neutral	Medium	\$71.50	\$128.00	\$1.84	2.6%	82%

*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 North American Core Guided Portfolio generated a negative total return of 7.3% during the quarter, outperforming the hybrid benchmark North American index which declined 9.6% on the same basis, largely as a result of avoiding several holdings which suffered particularly damaging declines during the period. The U.S. dollar advanced against global currencies as the greenback is seen as a relative safe-haven in unsettled economic times; the U.S. dollar also moved higher versus the Canadian dollar during the third quarter, mostly the result of the decline in oil prices. Ultimately the U.S. dollar rallied 7.9% against the loonie which had the effect of minimizing the negative performance contributed by U.S. portfolio holdings during the period after allowing for currency translation.

In addition to **JP Morgan** shares which dropped significantly before we exited the position, other big decliners during the period included **Fluor Corp.**, **Canadian Natural Resources**, **Occidental Petroleum**, **Suncor Energy**, and **Teck Resources**. The only portfolio holdings generating positive returns were **Southern Co.** for the brief period it was held in the portfolio prior to quarter-end, **McDonald's Corp.**, **Apple Inc.**, **TransCanada Corp.**, and **Barrick Gold**.

Changes

We made a switch in this portfolio during August as well: also selling the position in **JP Morgan Chase** and replacing it with **Southern Co.** for the same rationale as explained previously in the commentary for the U.S. Core Guided Portfolio. In addition to those reasons, in the context of a North American equity portfolio it was particularly prudent to reduce exposure to U.S. Financials and to focus on Canadian holdings for exposure to the Financial sector. Through the credit crisis in 2008-2009, Canadian banks demonstrated their relative strength resulting from Canada's more conservative regulatory environment and more risk-averse management style.

Near the end of the quarter we also replaced **Sun Life Financial** with **Calloway REIT** in this portfolio for the same rationale explained previously in the commentary for the Canadian Core Portfolio.

Exhibit 4: ScotiaMcLeod North American Core Guided Portfolio								
Company	Symbol	Rating	Risk Ranking	Price 30-Sep-11	Target Price	Dividend	Dividend Yield	Potential ROR
Financials:								
Bank of Nova Scotia	BNS	2-SP	Low	\$52.72	\$62.00	\$2.08	3.9%	22%
Brookfield Asset Management	BAM/A	1-SO	Medium	\$28.98	\$35.00	\$0.52	1.8%	23%
Calloway REIT	CWT.UN	2-SP	Medium	\$25.73	\$27.00	\$1.55	6.0%	11%
Royal Bank of Canada	RY	2-SP	Medium	\$48.06	\$57.00	\$2.16	4.5%	23%
Toronto Dominion Bank	TD	1-SO	Low	\$74.59	\$93.00	\$2.72	3.6%	28%
Telecommunication Services								
AT&T Inc.*	T	Restricted	Low	\$28.52	\$31.00	\$1.72	6.0%	15%
Utilities								
Southern Co.	SO	Outperform	Low	\$42.37	\$45.00	\$1.89	4.5%	11%
Consumer Discretionary								
McDonald's Corp	MCD	Outperform	Low	\$87.82	\$104.00	\$2.80	3.2%	22%
Nike Inc.	NKE	Neutral	Medium	\$85.51	\$91.00	\$1.24	1.5%	8%
Consumer Staples								
PepsiCo, Inc.	PEP	Neutral	Low	\$61.90	\$75.00	\$2.06	3.3%	24%
Health Care								
Pfizer Inc.	PFE	Outperform	Low	\$17.68	\$23.00	\$0.80	4.5%	35%
Industrials								
Canadian National Railway	CNR	1-SO	Medium	\$70.03	\$80.00	\$1.30	1.9%	16%
Fluor Corp.	FLR	Outperform	Low	\$46.55	\$73.00	\$0.50	1.1%	58%
General Electric Co.	GE	Outperform	Low	\$15.22	\$22.00	\$0.60	3.9%	48%
Information Technology								
Apple Inc.	AAPL	Outperform	Medium	\$381.32	\$500.00	\$0.00	0.0%	31%
Intel Corp.	INTC	Outperform	Low	\$21.34	\$30.00	\$0.84	3.9%	45%
Microsoft Corp.	MSFT	Outperform	Medium	\$24.89	\$35.00	\$0.80	3.2%	44%
Oracle Corp	ORCL	Outperform	Low	\$28.74	\$42.00	\$0.24	0.8%	47%
Energy								
Canadian Natural Resources	CNQ	1-SO	High	\$30.77	\$44.00	\$0.36	1.2%	44%
Crescent Point Energy Corp.	CPG	1-SO	High	\$39.45	\$55.00	\$2.76	7.0%	46%
Occidental Petroleum	OXY	Neutral	Medium	\$71.50	\$128.00	\$1.84	2.6%	82%
Suncor Energy	SU	1-SO	Medium	\$26.76	\$40.00	\$0.44	1.6%	51%
TransCanada Corporation	TRP	1-SO	Low	\$42.54	\$50.00	\$1.68	3.9%	21%
Materials								
Barrick Gold	ABX	2-SP	Medium	\$49.11	\$62.50	\$0.47	1.0%	28%
Teck Resources Ltd.**	TCK/B	Not Rated	High	\$30.92	\$60.00	\$0.60	1.9%	96%
*Currently Credit Suisse does not provide research coverage - target price based on consensus data.								
**Currently Scotia Capital does not provide research coverage - target price based on consensus data.								
Source: Scotia Capital Credit Suisse; Bloomberg; Value Line								

ScotiaMcLeod Canadian Quant Guided Portfolio

Stephen Uzielli – Portfolio Manager, Portfolio Advisory Group

Many investors find themselves looking for an investment methodology which removes the sometimes harmful element of emotion and human instinct from the decision making process. Quantitative (Quant) investing addresses this issue head-on as all investment decisions are driven exclusively by the output from a computer model which eliminates subjective factors while assessing investment opportunities. By following the results of historically successful, pre-determined statistical investment criteria, investors are relieved of the burden of decision making and can instead invest confidently by following a consistent, disciplined, and repeatable investment process.

The ScotiaMcLeod Canadian Quant Guided Portfolio was launched effective March 31, 2011 and is based on the results of a quantitative screening process utilizing a proprietary investment strategy developed by the ScotiaMcLeod Portfolio Advisory Group and driven by screening software and data provided by the Morningstar CPMS Equity Market Service (“EMS”). Morningstar is one of North America's leading independent equity research firms and enjoys a reputation for delivering only the highest quality data. Morningstar maintains EMS proprietary databases for the Canadian and US Markets, including historical data, adjusted for unusual, non-recurring items and/or discontinued operations. The EMS ranking software allows for simultaneous screening of fundamental characteristics, expectational, and technical data. (Morningstar is not acting as an investment advisor to ScotiaMcLeod or any ScotiaMcLeod client, and ScotiaMcLeod will not hold Morningstar out to any third party as acting in that capacity).

Holdings in the ScotiaMcLeod Canadian Quant Guided Portfolio will be selected from constituents of the S&PTSX60 Index. As this portfolio has a quantitatively driven investment mandate, there will be no requirement to have fundamental research coverage, favourable or otherwise, by Scotia Capital Equity Research or any other fundamental research provider, as this would be irrelevant to the process. Inclusion is determined by the top 15 ranked stocks based on a proprietary investment strategy which considers a combination of growth, dividend, and value criteria, creating a portfolio positioned in equal weights in each investment selected; there will be no attempt to derive specific sector allocation. Changes to the Canadian Quant Guided Portfolio, if any, are made on the first trading day of each month, based on results using previous month-end data. Due to the concentrated nature of this portfolio, it will be subject to greater volatility as a result of the lack of diversification, and thus is inherently higher risk. As such it is appropriate only for investors with a medium to high risk tolerance.

The **ScotiaMcLeod Canadian Quant Guided Portfolio** provides investors with a focused investment solution which follows a consistent, disciplined, and repeatable investment process in pursuit of higher risk-adjusted returns.

Performance Update

In the third quarter, the Canadian Quant Portfolio slightly underperformed the benchmark as it declined 13.9% on total return basis while the S&PTSX60 Index dropped 12.1% on the same basis. Since inception on April 1, 2011, the portfolio has given up 18.4% versus the benchmark which gave up 16.4%. The single biggest contributing factor to the relative underperformance in both periods was the holding in **Yellow Media Inc.** which was removed, as described below, in mid-September. Although the holding ranked well in the model due to its apparent high yield, notwithstanding prior dividend cuts, and low price/book ratio, by definition the quantitative modelling process does not always capture the qualitative measures that might anticipate future dividend cuts and/or the distinction between tangible versus non-tangible book value. Had the model not included **Yellow Media**, the portfolio would have outperformed in both the third quarter and since inception, generating returns of -10.3% and -12.1% respectively.

Changes

For the first time since this portfolio's inception on April 1, 2011, the monthly screen that dictates portfolio composition indicated two changes. As per the quantitative screen conducted using closing data from August 31, 2011, we made the following changes:

Sell: First Quantum Minerals (FM) and Agnico-Eagle Mines Ltd. (AEM); Buy: BCE Inc. (BCE) and Barrick Gold (ABX)

In addition, we made a special intra-month change in the portfolio during September. Effective at the market open on the morning of Monday, September 19, 2011, **Yellow Media Inc.** was replaced in the S&P/TSX60 Index. As stated previously, all holdings in this portfolio will be selected from constituents of the S&P/TSX60 Index; therefore, as **Yellow Media** was deleted from the index, it no longer qualified for inclusion. As a result we switched out of **Yellow Media** and replaced it with the next top ranked stock in the universe not already held in the portfolio: **Nexen Inc.** There were no further changes indicated at the review done after the end of September.

As per the quantitative screen conducted using data from month end on September 30, 2011, we present the holdings for the ScotiaMcLeod Canadian Quant Guided Portfolio:

Exhibit 5: ScotiaMcLeod Canadian Quant Guided Portfolio						
Company	Symbol	Quant Rank	Price 30-Sep-11	Dividend Dividend	Dividend Yield	Risk Ranking
Rogers Communications Inc.	RCI.B	1	\$35.87	\$1.42	4.0%	Medium
Suncor Energy Inc.	SU	2	\$26.76	\$0.44	1.6%	Medium
Shaw Communications Power Corp.	SJR.B	3	\$21.26	\$0.92	4.3%	Medium
Husky Energy Inc.	POW	4	\$22.97	\$1.16	5.1%	Low
TELUS Corp.	HSE	5	\$22.69	\$1.20	5.3%	Medium
Nexen Inc.	T	7	\$51.35	\$2.20	4.3%	Medium
Sun Life Financial	NXY	8	\$16.30	\$0.20	1.2%	High
Canadian Oil Sands Ltd.	SLF	9	\$25.03	\$1.44	5.8%	Medium
Canadian Imperial Bank of Commerce	COS	10	\$20.39	\$1.20	5.9%	High
Barrick Gold	CM	11	\$73.38	\$3.60	4.9%	Low
BCE Inc.	ABX	12	\$49.11	\$0.47	1.0%	Medium
National Bank of Canada	BCE	13	\$39.29	\$2.07	5.3%	Medium
Bank of Montreal	NA	14	\$69.89	\$2.84	4.1%	Low
Potash Corp. of Saskatchewan	BMO	15	\$58.67	\$2.80	4.8%	Low
	POT	25	\$45.25	\$0.29	0.6%	High

**As this portfolio has a quantitatively driven investment mandate, there are no recommendations or target prices listed.*

Source: Scotia Capital; Bloomberg

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

Tim Vlahopoulos — Associate Director, Portfolio Advisory Group

Investment Objective

The ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio (“Portfolio”) is designed for investors with a moderate to higher investment risk profile and who want to take a more active approach to managing their fixed income assets within a diversified portfolio. The objectives of the portfolio are to provide both a high level of current income, and a reasonable level of return to protect against future inflation. The overall goal of the portfolio is to exceed the performance of the DEX Universe Bond Index (“Index”). Typically, superior returns are not achieved every year; however, the goal is to achieve these rates of return over the long-term. Approximately 75% of the portfolio is invested in a 10-year bond ladder and 5% is invested in inflation-protected securities. These comprise the core holdings of the portfolio. The remaining 20% is allocated toward two active value-added trade strategies that attempt to outperform the benchmark.

Market Update

Investors experienced significant volatility and uncertainty in all markets during the third quarter of 2011. The quarter started with the uncertainty as to whether the US government was going to be able to negotiate an increase in the debt ceiling by the early August deadline. Fortunately, a last minute deal was reached in time to avert a default by the US government. Unfortunately, the result of this event was a credit rating downgrade by Standard and Poors to AA+ from AAA for the Government of the United States of America.

The market shrugged off this downgrade and instead focused on weak economic numbers that emerged during the quarter. These weak economic numbers pointed, for the first time, to a US economy that might be heading for a recession during the second half of 2011. This prompted the Federal Reserve to state that it plans to maintain short-term interest rates at their current low levels until the middle of 2013. These statements along with the Quantitative Easing program helped drive interest rates between the overnight and the ten year to lower levels during the quarter. However, long-term interest rates remained stubbornly high relative to shorter-term rates.

The Federal Reserve, in response to the relatively high, long-term interest rates, unveiled "Operation Twist" on September 21st. The program as outlined has the Federal Reserve sell some of their short-term holdings to buy long-term securities.

The hope was the program would remove a significant amount of supply in the long end of the yield curve and cause long-term interest rates to decline. That was exactly what happened after the program was announced. There was a significant rally in long-term bond prices which caused long-term interest rates to go down by 0.40% percent over two days.

However, the overshadowing event that cast doubts on a US economic recovery and indeed a global economic recovery has been the inability of the European Union to deal with the sovereign debt crisis plaguing a few of its members. The lack of a plan to deal with the Greek debt crisis and the contagion effect that a Greek default would have on the rest of the world caused investors to shun risky investments in favour of safer assets like US Treasuries and Government of Canada bonds. Risky assets like equities, high yielding securities, and commodities took the brunt of the sell off during the quarter.

All of these factors helped explain the surge in North American bond markets which caused overall interest rates to decrease and provided bond portfolio gains during the quarter.

Performance Update

The ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio returned 3.18% for the third quarter that ended on September 30th, 2011 and 5.82% year-to-date. The overall Canadian bond market, as measured by the DEX Universe Bond Index, rose by an impressive 5.12% for the quarter and a total of 7.43% for

the year-to-date. There were two contributing factors that caused the Core-Plus Portfolio to underperform the Index for the quarter. These were the lack of investments in the long end of the yield curve, where the bond market experienced a significant rally, and weakness in the high yield space.

The best performing sector in the third quarter of 2011 was the provincial sector, with the DEX Provincial Index returning 6.61%. The long end of the yield curve has been the best performing area of the curve with the DEX Long Term Index returning 9.84% for the quarter. The Portfolio being underweight term and duration was the key reason the Portfolio underperformed versus the Index. The second factor was the underperformance of the high yield market as the Portfolio's position in the iShares US High Yield Bond Index Exchange Traded Fund dropped 7.81% during the quarter.

Current Active Strategies

Active trades were implemented to add value and to try to outperform the Index.

The Laurentian Bank Fixed Floater 3.70% due November 2, 2020 and callable on November 2, 2015 was sold in August after it generated an overall return of 5.44% for the portfolio. The proceeds from the sale are currently in cash and await opportunities to present themselves.

The second active position, the iShares US High Yield Bond Index Exchange Traded Fund hedged against the Canadian dollar (XHY on the TSX) continued to experience significant volatility as investors continued to sell higher risk assets during the quarter. This position was down 7.81% for the quarter and -2.78% for the year-to-date. This ETF attempts to replicate, as closely as possible, the performance of the Markit iBoxx USD Liquid High Yield Index but the currency exposure is hedged back to the Canadian dollar.

Exhibit 1: ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio					
Issuer Name	Coupon	Maturity or Call Date	Current Weighting	Total Return for Q3 2011	Total Return Year To Date
Core Positions					
Canada	5.000%	Jun 1, 2014	7.5%	2.60%	4.03%
CMHC	4.350%	Feb 1, 2017	7.6%	5.16%	7.35%
Canada	3.250%	Jun 1, 2021	7.9%	9.07%	8.65%
Canada RRB	3.000%	Dec 1, 2036	5.0%	5.17%	9.13%
Royal Bank Fixed Floater	5.450%	Nov 4, 2013	7.4%	1.46%	3.27%
Canadian Tire Corp	4.950%	Jun 1, 2015	7.5%	2.22%	4.36%
Telus Corporation	5.050%	Jul 23, 2020	7.6%	7.12%	10.01%
Metro Toronto	5.600%	Dec 18, 2018	7.6%	5.98%	9.00%
Manitoba	5.250%	Dec 3, 2012	7.2%	0.96%	2.11%
Saskatchewan	4.500%	Aug 23, 2016	7.5%	4.36%	6.84%
Quebec	4.500%	Dec 1, 2019	7.7%	6.16%	8.63%
Active Positions					
iShares US High Yield Bond Index ETF			8.7%	-7.81%	-2.78%
Cash			11.1%	0.00%	0.00%
Returns for the ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio			100.0%	3.18%	5.82%
Returns for the DEX Universe Bond Index				5.12%	7.43%

Source: ScotiaMcLeod Portfolio Advisory Group

Forward Outlook

Going forward, the European sovereign debt crisis will likely continue to act as a drag on global growth, particularly if the European Union is unable to implement a credible action plan to deal with the crisis in a timely manner. The risk remains that a broader credit contagion could cascade through the European Union – potentially sparking a liquidity crisis reminiscent of 2008 – as counterparty risks for European banks mount. The stability of the global financial system could be challenged if this event were to materialize making the opportunity to achieve global economic growth increasingly remote.

Monetary authorities appear willing to keep rates low for an extended period in anticipation of broader macro economic risks and general weak global data. In North America, the US has publicly committed to keeping interest rate levels on hold until mid 2013. There is also growing speculation that the Federal Reserve might implement an additional measure of quantitative easing, in addition to the most recent Operation Twist. Other monetary authorities may be contemplating similar measures in order to avoid stagnation. In the case of Canada, bond markets here are pricing in the possibility that the Bank of Canada could initiate a 0.25% cut before the end of 2012 should global risks continue to play out to the downside.

It is important to keep in mind that Scotia Capital continues to believe that global recession will be averted but that growth will remain slow and uneven in the coming quarters. Sharply reduced borrowing costs in the advanced economies, cash rich businesses capable of bolstering investment, comparatively robust growth in emerging market economies, and lower oil prices should all work to keep growth pointed upward. As a result, the expectation continues to be that fixed income returns beyond the 2-year range will be decidedly negative – suggesting that investors who are managing active positions in their portfolios continue to keep some cash on the sidelines (up to 5%) and continue to look for opportunities to materialize.

Notes

Notes

The author(s) of the report own(s) securities of the following companies.

Bank of Nova Scotia, Canadian National Railway Company, Enbridge Inc., Power Corporation of Canada, Rogers Communications Inc., Royal Bank of Canada, SNC-Lavalin Group Inc., Suncor Energy Inc., TELUS Corporation, Teck Resources Limited, Toronto-Dominion Bank, Talisman Energy Inc., TransCanada Corporation, Sun Life Financial Inc., Bank of Montreal, General Electric Co. Wal-Mart Stores Inc.

The supervisors of the Portfolio Advisory Group own securities of the following companies.

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Bank	Symbol	Scotia Capital Recommendation	Risk Rating	1 Yr Target
Bank of Montreal	BMO	3-Sector Underperform	Low	\$66.00
Bank of Nova Scotia	BNS	2-Sector Perform	Low	\$62.00
CIBC	CM	1-Sector Outperform	Low	\$93.00
National Bank	NA	3-Sector Underperform	Low	\$80.00
Royal Bank	RY	1-Sector Outperform	Low	\$57.00
Toronto-Dominion Bank	TD	1-Sector Outperform	Low	\$93.00

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