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Executive Overview

Portfolio Strategy – More of the Same

Frances Horodelski, CFA – Director, Portfolio Advisory Group

Do you know the only thing that gives me pleasure? It's to see my dividends coming in.

– John D. Rockerfeller

Of course, Mr. Rockerfeller had a lot of dividends coming in! But for more average investors, the first half of 2004 also gave pleasure only to those receiving coupons from bonds and dividends from stocks–capital appreciation was hard to come by. The stock market, after its great start to the year and then the big correction, spent most of the second quarter meandering, largely ending where it started. Bonds were weak through much of the second quarter on the expectation of central bank tightening but strengthened into the last days of June and into the beginning of the third quarter on softer economic data south of the border. So, clipping coupons and receiving dividends were the activities of choice for investors in capital markets – markets that were tentative and not well-attended (equity volumes were disappointing especially through the latter part of the second quarter).

And despite the as expected increase in rates that the U.S. Federal Reserve announced on June 30th, the second half has opened on a disappointing note as the too hot worries mid-quarter are giving way to a now possibly too cold economic backdrop for equity investors (volatile durable goods and weak employment data being the culprits du jour).

As outlined in the following pages, we are interested in a number of underlying themes and trends that should support somewhat higher equity prices and higher interest rates by year-end and support our sector selections in the equity markets and maturity focus in the fixed income arena.

On a forecast basis, the most critical variables in our asset allocation decision-making process include:

- Our forecast for interest rates to be higher six months and one year from today.
- Corporate profit growth expectations for the rest of 2004 and into 2005 that are still positive but less than in the first half of 2004.
- Continued enthusiasm for some of the more cyclical aspects of the global economy as corporate spending picks up momentum.
- Relatively attractive valuation parameters in the U.S. and in Canada for equities.
- The need for a cash cushion given the expectations for rising volatility in equities and a recommendation to buy weakness in the bond markets.

Recommended Asset Allocation

	Previous	Current
Stocks	60%	60%
Bonds	35%	35%
Cash	5%	5%

Source: Portfolio Advisory Group.

Despite the attractive stock market valuations (price/earnings multiples of 15.3 and 17.3 times the respective, likely conservative consensus 12-month forward earnings forecast for the S&P/TSX and the S&P 500), we continue to believe that we will remain stuck in a broad trading range for stock prices. This makes sector selection, and rotation, critical to decent returns. While this strategy is intellectually appealing, the speed at which sector direction changes have occurred has made it virtually impossible to execute in the real world. For example, in the first month of the second quarter, healthcare was the clear sector winner in the U.S. (+3.06%) while in the second and third months, healthcare slipped into negative territory. In Canada, energy started strong, ended weak. Commodity stocks were up, down and up during the first half. A similar experience occurred in technology. While monthly activity doesn't make a trend, the stop and go jerkiness of the market has made it difficult for investors to gain conviction as to strategy. It is likely that this volatility could even pick up as the summer unfolds – especially given high anxiety levels as we approach the Olympics and the various U.S. political conventions. In Canada, we're showing an improving trend in economics terms – and despite our confidence that rates could begin to rise in our country beginning in September, the benefits of a minority government as a political backdrop and better economic numbers could support an overall firmer tone here.

We continue to believe the key to successful investing will be to set appropriate return objectives based on needs and goals; ensure that one understands their specific tolerance for volatility or risk (a tolerance level that should not change because markets are up or down); allocate a portfolio properly between the various asset classes to ensure that one gets the right combination to provide the best risk adjusted return and finally, to take a long term view, avoid the tendency to swing with sentiment, and to diversify within sectors whether by industry, company, style, maturity, etc. The following pages provide our thoughts on the various markets and sectors that may help you with this diversification process. As always, your ScotiaMcLeod adviser can assist in structuring a financial plan and portfolio that is right for you.

Economic Outlook

The Tightening Begins

Andrew Pyle, VP & Head of Capital Markets Research, Scotia Economics

For about the third time since the end of the U.S. recession, the Federal Reserve was expected to raise interest rates, and for the first time since the recession the Fed actually followed through and did so. The decision to lift Fed Funds a quarter point was so widely anticipated that the market needed to create more extreme views in order to generate some extra volatility. With inflation pressures building and the economy starting to crank out solid job growth, tolerance of the Fed's accommodative stance shifted to criticism that the Fed was now well behind the curve in terms of taking pro-active measures to prevent a future inflation build-up. The phrase "behind the curve" implies that the "curve", or market, always has it right. To date, the evidence that there is a major inflation problem in the U.S. has been lacking. Margin-digesting increases in wholesale prices and an acceleration in the rate of growth in employee benefit costs have not been matched by inflation at the retail level, at least not in the core basket of goods (excluding energy). True, the pickup in employment growth by the second quarter has provided consumers with a leg-up, but effectively this growth has only served to offset the combined negative influences of higher mortgage rates (and the collapse in mortgage refinancings) and higher prices for non-discretionary items like gasoline. The release of the June payrolls report and the much weaker than expected 112,000 lift in jobs has brought the market back down to the reality of what happens when employment growth is not necessarily robust enough to counter these headwinds. So, to view the Fed's approach to date as being behind the curve is incorrect.

While the Fed finally did implement its first tightening in monetary policy in four years during June, it did so with a fairly balanced guidance in its accompanying policy statement. The well publicized reference to the need for a "measured" trimming back of the amount of monetary stimulus was repeated in the statement, implying an almost planned and steady procession of moderate (i.e., 25 basis point) rate cuts over the medium term. In the wake of the apparent softening in U.S. numbers last month, the expectation of another three rate increases by the end of the year is justified – a measured approach. The Fed has, however, left the door open to a change in policy stance as numbers unfold during this period, and this was also put in print in the June 30th statement. Inflation worrywarts will look at this as suggesting that the Fed will shift to rate hikes of 50 basis points a meeting in response to signals of excessive inflation, although the flipside is equally valid. Should economic growth moderate to a pace that is significantly below potential, with reduced pressure on inflation, then the Fed would also be in a position to take its foot off the brake pedal, even if only for a meeting or two.

A little perspective is once again useful in this situation. The June 30th hike was the first in four years. When the Fed started to tighten rates in February 1994, that was the first increase in over five years. Cumulative tightening in 1994 (ending with the last increase of 50bps in February 1995) amounted to 300 basis points, or 100%, while consensus forecasts today are for the Fed to lift rates by 100 to 200 basis points, which would be in excess of 100%. The 200 basis points forecast would either imply a quarter point increase in rates at each of the eight meetings in the coming 12 months, or a combination of more aggressive moves as well as

meetings where no policy action is taken. Note, the 1994 episode was punctuated by meetings where the FOMC decided to raise rates by more than a quarter point, as well as by meetings where the Fed stood pat. Back in 1995, the Fed was forced to reverse course and begin easing rates only five months after the last hike. When the Fed started its tightening initiative in 1994, it did so with a considerable amount of consumer pent-up demand still present in the economy. Debt-income ratios were at least 10% below where they stand today and the percentage of household real estate equity was also higher, even after the housing meltdown of the early 1990s.

We have just witnessed the 50th consecutive quarter of positive growth in real consumer expenditures in the U.S., and even during the recession year of 2001, growth in spending averaged more than 2½percent per quarter. At this juncture, the amount of pent-up demand is minimal and the only way that solid growth has been generated in past quarters has been through continued give-away incentives by car makers, one-off tax refunds and the last vestige of mortgage refinancing. Going forward, these stimulants will not be present, with the exception perhaps of auto incentives, so the Fed’s tightening timetable will have to be reconciled with the risk that spending growth could snap quickly after the first few rate hikes.

In the wake of the June employment report, the level of uncertainty in North American equity and fixed income markets has been elevated. Just when it looked like the play was unfolding exactly the way the program said it would, investors have been given a few alternate scenes to ponder. From a strategy perspective, however, the balance of risk is still skewed towards a moderation in growth over the medium term as rates continue to climb. And moderation in U.S. growth will act as a brake on Canadian export demand, especially if the other risk pans out in this period – a sharp correction in the U.S. dollar and rally in the Canadian dollar.

Economic and Market Outlook

	2003 Year-end	2004F Year-end	2005F Year-end
Canada			
S&P/TSX Composite Index			
Earnings (C$)	419.00	550.00	n.a.
Level	8,221	9,150	n.a.
Economic Performance			
Real GDP (average annual % change)	2.0	2.9	3.2
Motor Vehicle Sales (average annual, mln units)	1.596	1.600	1.650
Unemployment Rate (%)	7.6	7.2	7.1
Consumer Prices (% change)	2.8	1.9	2.0
Current Account Balance (average annual, C$ bn.)	23.8	37.0	25.0
Yield Curve (%)			
Bank of Canada Overnight Target Rate	2.75	2.50	3.50
2-Year Canada Bond	2.97	4.20	4.85
10-Year Canada Bond	4.80	5.25	5.50
United States			
Economic Performance			
Real GDP (average annual % change)	3.1	4.5	3.5
Motor Vehicle Sales (average annual, mln units)	16.6	16.9	17.0
Unemployment Rate (%)	6.0	5.5	5.2
Consumer Prices (% change)	2.3	2.5	2.4
Current Account Balance (average annual, US$ bn.)	-531	-570	-520
Yield Curve (%)			
Fed Funds Target Rate	1.00	2.00	3.25
2-Year Treasury	1.83	4.00	4.70
10-Year Treasury	4.40	5.25	5.50
Foreign Exchange Forecast			
Canadian Dollar (US¢/C$)	77.04	76.3	82.0
Canadian Dollar (US$/C$)	1.29	1.31	1.22
Yen (¥/US$)	107	100	90
Euro (US$/€)	1.26	1.27	1.35
Sterling (US$/£)	1.79	1.92	2.00
Commodities			
WTI Oil (average annual, US$/bbl)	31.1	35.5	30.0

e: Estimate (Scotia Economics, based on available data)

f: Forecast (Scotia Economics).

Source: Scotia Capital/Scotia Economics; Statistics Canada; U.S. Dept. of Commerce; U.S. Bureau of Labor Statistics; Bloomberg.

Canadian Equity Outlook

Implications of a Rising Rate Environment

Paul Danesi – Associate Director, Portfolio Advisory Group

Canadians head into the summer of 2004 with a new Liberal minority government, the first minority government since 1979. The initial market reaction was positive with traders sending the dollar higher. The near-term monetary policy implications of the election should be negligible and Scotia Economics continues to forecast the Bank of Canada will begin raising rates in September at the earliest. There are notable winners and losers. For the banks it is negative as mergers are probably off the table. The telecommunications sector is also a likely loser with controversial changes to foreign ownership restrictions and the CRTC likely on the back burner. The auto industry is a winner with the proposed $300 million support pledged by the Liberals.

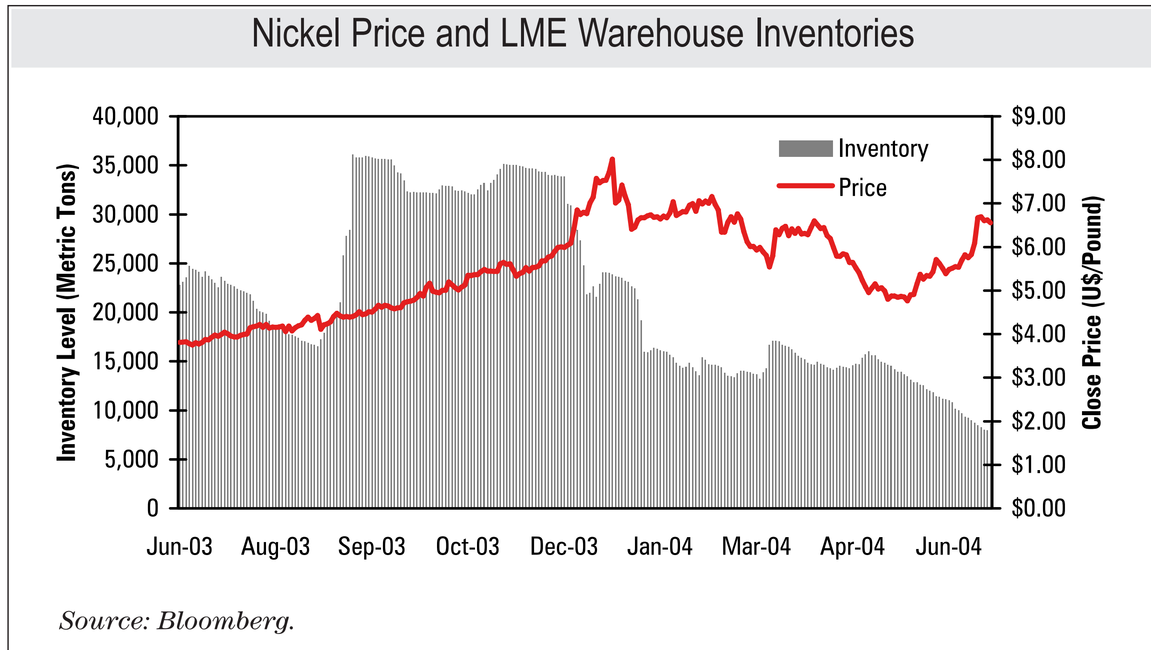
The initial move by U.S. interest rate policy setters is not expected to immediately derail equity markets. Historical precedent suggests that broader market averages will trend higher following this initial shift towards higher rates. Our study of market action following a shift towards tighter monetary conditions shows that not all sectors perform well as we make that transition. To be sure, interest sensitive utilities and telecommunications would be expected to be laggards, but not economy sensitive sectors and surprisingly this time not financial services.

Contrary to some views, we believe that valuation is reasonable with the TSX Composite Index trading at 15.3 times our $550 earnings estimate. Our year-end target of 9,150 implies a justifiable 16.6 times multiple. The surge in corporate profit growth that supports that valuation is driven by the incredible rebound in the materials sector on the back of rising commodity prices, and continued strength in both energy and financial services, which collectively represent two thirds of the composite index weighting.

Sectors Ranked Outperform

Economy sensitive sectors are expected to lead the market in the second half of the year as synchronized global growth provides another leg up for commodity prices and three years of budgetary restraint give way to a rebound in capital spending. Our analysis of market action following interest rate hikes by the U.S. Federal Reserve shows that economy sensitive sectors tend to outperform in the months following the initial move towards higher rates. In this environment information technology, industrial products and materials are all recommended as overweight.

Within the materials sector our top picks are **Inco Ltd.** (N U$34.00, Target U$40.00), **Norske Skog Canada Ltd.** (NS $4.70, Target $5.85) and **Nova Chemicals Corp.** (NCX $39.00, Target $46.00). A protracted bear market in commodity prices has lead to a reluctance to invest in new capacity and/or the closure of existing production. Over the last year growing global demand has been pushing up against limited new supply, an obvious catalyst for higher commodity prices. Nowhere is this situation more visible than in the nickel market.

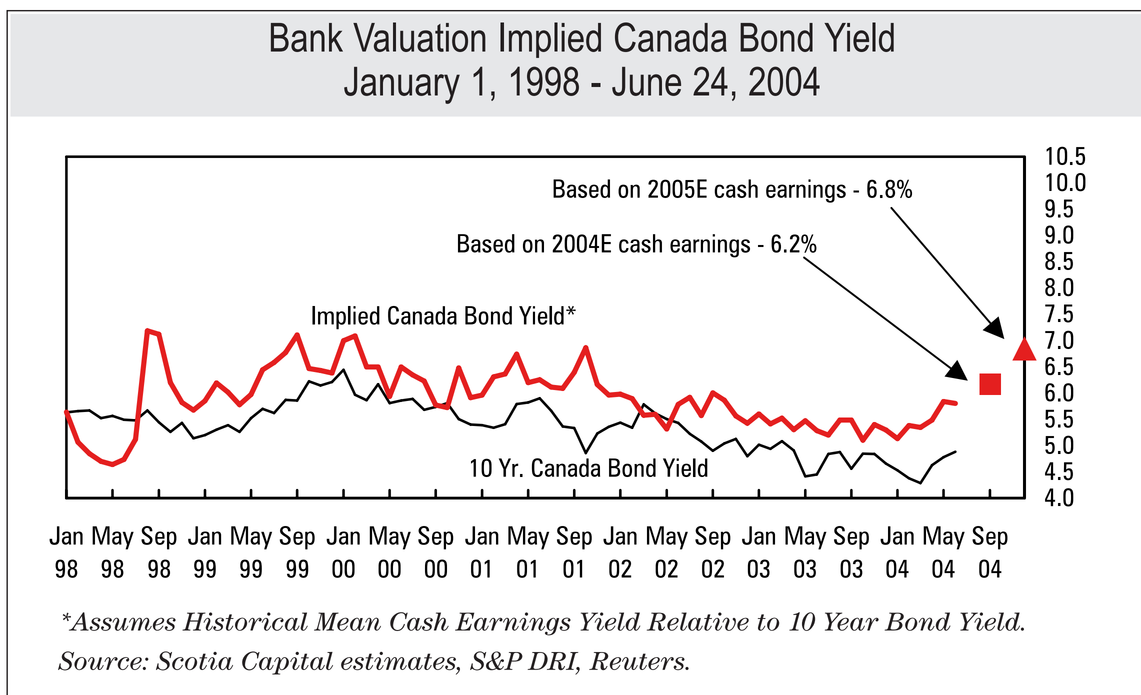


Source: Bloomberg.

In an attempt to boost productivity, Canadian businesses are taking advantage of the cheaper cost of imported technology and accelerated depreciation allowances to boost investment spending. Purchases of capital equipment and machinery have risen and an array of new technology is boosting demand both for hardware and software. Software in particular offers companies a high return on investment. **Cognos Inc.** (COGN U$35.20, Target U$40.00) and **OpenText** (OTC U$31.00, Target U$36.00) with their strong product offerings are well positioned to benefit from the increased spending. Although industry conditions for **Nortel Networks Corp.** (NT $6.34, Target $7.30) appear favourable, without financial statements we have little proof and are reluctant to recommend purchase other than for the most risk tolerant accounts.

Picks in the industrials sector include **ATS Automation Inc.** (ATA $11.67, Target $16.50) and **Tesma International Inc.** (TSM.A $35.60, Target $42.50). ATS Automation designs automated manufacturing systems and precision components. There is significant operating leverage in its business model and new order flow implies a sharp rebound in profitability over the next 12 months. Our second choice, Tesma is a successful auto parts company that is delivering higher sales growth and profitability than the overall North American auto parts industry.

Sectors Ranked Market Perform



**Assumes Historical Mean Cash Earnings Yield Relative to 10 Year Bond Yield.*
Source: Scotia Capital estimates, S&P DRI, Reuters.

Historically, higher interest rates have signaled an impending decline in net interest margin and profitability for the banking sector leading to share price under performance. However, this historically inverse relationship between interest rates and net interest margin becomes positive when interest rates are at extremely low levels as we see today. This anomaly should allow Canada's banks to enjoy margin expansion as interest rates rise.

Our financial services analyst believes that bank fundamentals are arguably the strongest in their history. Over the last 20 years the bank group's financial leverage has declined dramatically. Net interest income as a percentage of revenue has declined from 80% to near 50% over that period. Valuations do not reflect this structural shift and currently imply a 10-year Canada bond yield of 6.8% based on our analyst's 2005 EPS estimate – well above the current rate and Scotia Economics forecast for the year ahead.

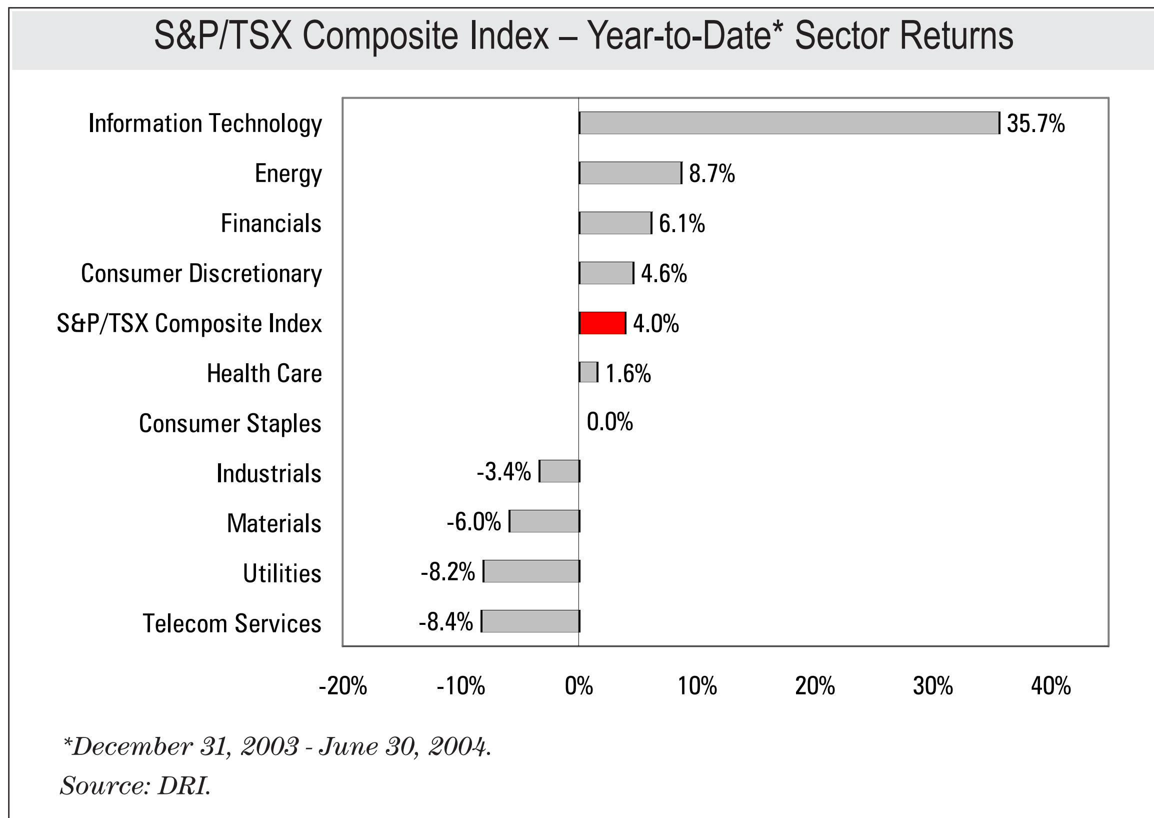
We are buyers of **TD Bank** (TD $44.00, Target $56.00) trading at 11.9 times 2004 EPS and 10.9 times 2005 EPS estimates. TD Bank boasts the highest Tier 1 capital ratio at 11.9% making its 20.8% ROE that much more impressive. Its payout ratio is the lowest in the group at 37% and near the low end of its range leaving plenty of room for dividend growth.

Insurance stocks have posted strong gains over the last year and valuations now appear somewhat extended on an absolute and relative basis. Over the last six months insurance companies have gravitated from a discount to the banks to what is now a slight premium. With **Sun Life Financial Inc.** (SLF $39.00, Target $40) trading at 13.4 times 2004 EPS and pushing up against our analyst's 12-month target we recommend investors with shorter-term investment horizons consider a switch from Sun Life to TD Bank.

We believe the consumer staples, consumer discretionary and health care sectors will perform in line with the broader market in the second half of the year. To reposition within these sectors we recommend a switch from food retailer **Sobeys Inc.** (SBY $29.30, Target $26.00) to industry leader **Loblaw Cos.** (L $60.90, Target $69.50) In the health care sector our top pick is **MDS Inc.** (MDS $21.00, Target $28.00) a play on corporate restructuring. In the consumer discretionary sector we favour **Dorel Industries Inc.** (DIIB U$31.32, Target U$43.00) and **RONA Inc.** (RON $28.00, Target $36.00). Dorel is a highly successful consumer products company with recognizable brands that include Schwinn, GT and Mongoose bicycles and the Safety 1st and Cosi brands of child care products. The shares are trading at less than 10 times this year's earnings estimate. RONA through a successful consolidation program has grown to become Canada's largest home improvement chain.

Sectors Ranked Underperform

Telecommunications services and utilities are the worst performing sectors in the TSX Composite Index so far this year and we expect this trend to continue as the threat of rising rates should put a lid on potential upside.

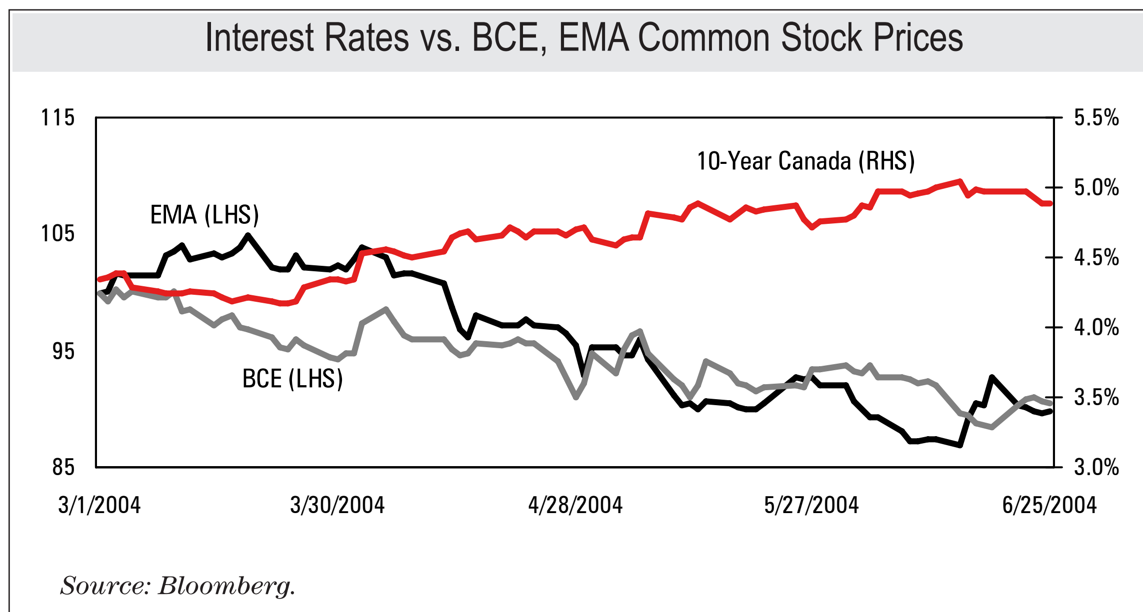


**December 31, 2003 - June 30, 2004.*

Source: DRI.

We are taking a cautious approach towards the telecommunications sector. The retrenchment in valuations reflects both rising interest rates and the challenging competitive landscape (new participants, pricing and consolidation). In addition, dividend growth has generally not kept pace with other interest sensitive sectors and this is also arguably being reflected in current valuations. BCE Inc. has not raised its dividend in nearly nine years. Instead it has chosen to reinvest its free cash flow in some cases with limited success.

The chart below depicts the negative relationship between the yield on the 10-Year Canada Bond and the share prices of both BCE Inc. and Emera Inc., the latter being the most interest sensitive of the electric utilities we follow. This relationship suggests that a further rise in bond yields could place additional pressure on BCE's share price. In the absence of lower rates (not expected) or a dividend increase (possible) we see few catalysts for BCE's share price over the near term. Patience will likely be rewarded on this one, but investors will need to take a longer-term view as the company continues to focus on improving its balance sheet and targets opportunities in a competitive environment. The current yield of 4.5% remains attractive however on an absolute basis and on a pre-tax equivalency basis (approximately 5.8%).



Source: Bloomberg.

Rising oil supplies from Saudi Arabia and United Arab Emirates should lead to rising inventories. The market has already begun to discount that eventuality and the WTI posted crude oil price has fallen from U$42.50/barrel to U$36.50/barrel. With share prices of oil and gas companies correlated with the price of the commodity, we would expect the weakness to persist through the summer. Our longer-term view on energy prices remains favourable and therefore we would use weakness as an opportunity to re-establish positions in integrated and senior producers with strong balance sheets and production growth such as **Shell Canada Ltd.** (SHC $63.00, Target $72.00) and **Talisman Energy Inc.** (TLM $28.80, Target $32.00).

Income Trusts: Pick Your Spots

Blair Wilson – Associate Director, Portfolio Advisory Group

Focusing on Business Trusts

The second quarter saw lots of action in the Income Trust index although in total return terms, the index declined by 2.3%. The fear of central bank interest rate hikes, declining energy commodity prices toward the end of the period and a reduction in the flow of funds into mutual funds that offer income and dividend traits all contributed to the easing of unit prices. The weakest performing sectors during the quarter were the more interest sensitive power (down 11%), utilities/infrastructure (down 8.6%) and REITs (down 7.3%). We maintain that the economically sensitive business trusts should benefit from economic growth and expected low core inflation in Canada during the second half of 2004. Therefore this article highlights the salient investment points surrounding two income trusts that we expect to benefit from this environment and are now on the PAG Income Trust Recommended List.

Yellow Pages Income Fund

The Yellow Pages Income Fund was added to the Recommended List on April 14, 2004 and has maintained its value in the market while completing an equity offering of 66,666,600 units and a healthy correction in the business trust universe. Scotia Capital carries a 1-Sector Outperform, Low Risk recommendation with a one-year target price of $13.20. The reasons to buy this trust include the expectation that it will continue to grow its cash distributions to unitholders, its significant market float (approximately $2.6 billion) which provides a high level of market liquidity, its market dominance, high operating cash flow margin and stable balance sheet.

On April 20, 2004, Yellow Pages increased its monthly cash distribution by 4.5% to an annualized rate of $0.92 per unit. This was the second distribution increase since the Trust's inception in July, 2003. Yellow Pages' first quarter 2004 financial results met Scotia Capital's expectations for earnings before interest, tax, depreciation and amortization (EBITDA) at $98 million driven by better than expected revenue growth. To maintain its steady growth profile, the trust is upgrading its online properties and introduced its own "bundle" that combines print and online media. Based on its current operations and outlook, Yellow Pages management has provided 2004 guidance for revenue growth of 3%, EBITDA growth of between 3% and 5% with distributable cash growth of 4%. We note that management's past guidance has proved to be conservative and Scotia Capital research believes that the current guidance may also be cautious. Scotia forecasts sufficiently higher growth for revenue and EBITDA to support a further increase in distributions in 2004 to an annualized level of $0.96 per unit.

The capital appreciation for income trusts may be hindered over the next 18 months should interest rates rise however Yellow Pages has several investment attributes that we expect will at least partially mitigate the potentially volatile trust environment. First, the fact that the trust already has a track record of increasing distributions will somewhat offset the negative impact of rising rates. Second, the fact that its units trade with substantially higher liquidity than the majority of income trusts offers an element of stability. Third, we note that the Alberta

government recently enacted Bill 34, Income Trusts Liability Act, and the Ontario government introduced similar legislation prior to its summer recess. If passed, this legislation could lead to the potential inclusion of income trusts in the TSX Composite Index. If and when this should occur, we believe that the larger market capitalization trusts that trade more actively would most likely be considered for index inclusion and, if successful, draw an increasing level of investor interest which would be expected to provide some support for unit prices in the market. Yellow Pages certainly meets this market capitalization criteria.

Cineplex Galaxy Income Fund

Favourable trends in the movie going industry have led us to add Cineplex Galaxy Income Fund to the Recommended List this quarter. Scotia Capital carries a 1-Sector Outperform, High Risk recommendation and one-year target price of $11.00 per unit for Cineplex. We recommend that trust investors with higher risk tolerance levels look to Cineplex for its attractive cash-on-cash yield of approximately 10.7%. We believe the trust will be able to grow its distributable cash in the future based on its strong low-cost operating platform that management will endeavour to expand by adding new locations and increase the use of higher margin in-theatre advertising, and music/sporting and corporate events.

The fund owns approximately 41% of Cineplex Galaxy Limited Partnership, which operates two brands with complementary target markets and strategies under the Cineplex Odeon and Galaxy theatre names. The partnership operates Canada's second-largest film exhibition company that garners approximately 31% of estimated box office receipts. It has 83 locations with 750 screens. Seventy-five percent of the screens are less than seven years old, meaning that maintenance capital expenses are not onerous. As well, 72% of its screens are deemed by the company to be in "non-competitive film zones" which gives Cineplex the ability to negotiate on first-run films with favourable terms. In its 2003 Annual Report, Cineplex Galaxy's management cited its focus "on controlling costs while continuing to strategically expand the number of locations, maximize shareholder value and provide an outstanding movie-going experience...". We understand this to mean that it will continue to expand the Galaxy market-specific operating focus that provides access to all motion pictures released and/or provides patrons with a superior motion picture experience through stadium seating and Dolby sound technology. The success of this business strategy relies on attendance levels. Scotia Capital estimates that approximately 70% of patron revenue is generated by admissions and 30% from concessions/other services. The higher profit margins offered by concessions mean that the gross profit breakdown would be approximately 56% from admissions and 44% from concessions/other. We note that the Globe and Mail (June 29th,

2004) highlighted a Statistics Canada report noting that movie theatre attendance has risen by 5.4% in 2002/2003 from 2000/2001 and that while the growth was slowing, that attendance has been on the rise since the early 1990s. The report also noted that it was the larger theatres (like multiplexes run by the market leaders) that were profitable. Both trends support the business profile of Cineplex Galaxy. It is clear that the Canadian theatre industry is becoming more competitive and the experience demanded by movie-goers is increasing due to the options of DVD and pay-per-view alternatives. It is also clear that the industry is consolidated as 92% of the market is made up of five players, which offers growth opportunities for the market leaders that can economically expand through acquisitions or establishing new locations. We believe that Cineplex Galaxy will be successful in implementing their strategic plan and manage cash flow to generate a long-term stream of distributable cash for investors. Scotia Capital forecasts a declining and financially flexible payout ratio profile of 90%, 90% and 86% for 2004, 2005 and 2006, respectively.

Recommended List

We have made four changes to the PAG Recommended List for Income Trusts this quarter. We have removed Inter Pipeline Income Fund due to Scotia Capital's expectation that the trust will maintain its annual distribution at $0.72 per unit in 2004 and 2005. In the absence of distribution growth, we are concerned that interest sensitive utility trusts are likely to underperform. We have added Cineplex Galaxy Income Fund, (see above), Allied Properties (for risk tolerant investors in search of special situations opportunities) and Bonavista Petroleum, which gives investors the opportunity to gain exposure to a second high quality royalty trust which Scotia Capital expects to show positive returns over the coming twelve months.

ScotiaMcLeod™

Income Trust Recommended List

Trust	Price (30-Jun-04)	Market Cap (000)	Pre-Tax Yield 2004	Pre-Tax Yield 2005	Forecast Distribution* 2004	Forecast Distribution* 2005	2004E Taxation Dividend	2004E Taxation Income	2004E Taxation Deferred	NAV Value	Price/ NAV	1-Year Target	ROR	Analyst's Rating**	Risk	Stability S&P	Stability DBRS
Power Income Funds																	
TransAlta Power (TPW.UN)	$8.95	$632.77	8.7%	8.7%	$0.78	$0.78	0.0%	5.0%	95.0%	-	-	$9.25	12.1%	2-SP	Low	SR-1 (negative)	STA-2 (mid)
REITS																	
Allied Properties REIT (AP.UN)	$11.60	$118.32	9.7%	10.2%	$1.13	$1.18	0.0%	35.0%	65.0%	$11.00	105.5%	$12.65	18.8%	1-SO	High	N/A	N/A
H&R REIT (HR.UN)	$16.32	$1,442.69	7.6%	7.8%	$1.24	$1.27	0.0%	48.0%	52.0%	$14.25	114.5%	$15.20	0.7%	2-SP	Low	N/A	STA-3 (High)
RioCan REIT (REI.UN)	$16.10	$2,894.78	7.4%	7.7%	$1.19	$1.24	0.0%	52.0%	48.0%	$13.40	120.1%	$15.50	3.7%	1-SO	Low	SR-2 (stable)	STA-2 (Low)
Infrastructure Income Funds																	
Bell Nordiq Income Fund (BNQ.UN)	$12.75	$1,138.58	7.8%	8.6%	$1.00	$1.10	0.0%	86.0%	14.0%	-	-	$14.00	17.6%	2-SP	Low	SR-2 (stable)	STA-2 (High)
Consumers' Waterheater Income Fund (CWI.UN)	$13.64	$675.18	7.8%	7.8%	$1.07	$1.07	0.0%	100.0%	0.0%	-	-	$13.50	6.8%	2-SP	Low	SR-2 (stable)	STA-2 (Mid)
Fort Chicago Energy Prtnrs. (FCE.UN)	$9.75	$1,012.05	8.5%	8.5%	$0.83	$0.83	0.0%	0.0%	100.0%	-	-	$10.25	13.6%	2-SP	Medium	N/A	STA-2 (Low)
Consumer Funds																	
Cineplex Galaxy Inc. Fund (CGX.UN)	$11.19	$532.64	10.3%	10.7%	$1.15	$1.20	80.0%	20.0%	0.0%	-	-	$11.00	8.6%	1-SO	Low	N/A	N/A
Ilndustrials Funds																	
Yellow Pages Inc. Fund (YLO.UN)	$11.34	$3,891.89	8.1%	8.5%	$0.92	$0.96	25.0%	75.0%	0.0%	-	-	$13.20	24.5%	1-SO	Low	SR-2 (Stable)	STA-1 (low)
Oil & Gas Royalty Trust Units																	
ARC Energy Trust (AET.UN)	$15.35	$2,855.10	11.7%	9.8%	$1.80	$1.50	0.0%	85.0%	15.0%	$10.43	147.2%	$14.00	2.9%	2-SP	High	N/A	N/A
Bonavista Energy Trust (BNP.UN)	$23.04	$1,824.77	13.0%	12.5%	$3.00	$2.88	0.0%	96.0%	4.0%	$13.18	174.8%	$23.00	12.8%	1-SO	High	N/A	N/A

** Please note that distributions are subject to change and are a function of the individual trust's ability to generate cash flow.*

*** Rating legend: 1-SO = 1-Sector Outperform, 2-SP = 2-Sector Perform, 3-SU = 3-Sector Underperform.*

Source: Scotia Capital; ScotiaMcLeod Portfolio Advisory Group.

Equity Guided Portfolios: Canadian Core Portfolio

Paul Danesi – Associate Director, Portfolio Advisory Group

On a total return basis, the Canadian Core portfolio has returned 3.5% to the end of June compared with a return of 4.8%% for the TSX Total Return Index. The weaker relative performance so far this year reflects in part our overweight positions in defensive and interest sensitive stocks and the strong relative showing by the technology sector. The goal of providing lower variability of returns remains a key part of our investment mandate and from time to time the portfolio will lag the broader market. CP Rail Ltd., Enbridge Inc., Thomson Corp., Molson Inc. BCE Inc. have underperformed and been a drag on our overall performance. Manulife Financial Corp., now Canada's largest company by market capitalization, is our best performing stock up nearly 30% year-to-date. Finning International Inc. and Power Corp. have also delivered strong relative performance.

During the second quarter we made two changes to the portfolio: 1) we added Dorel Inc. and 2) switched from EnCana Corp. to Norske Skog Canada Inc. Dorel was not a switch but the addition of a 16th company to the portfolio. Dorel is a successful consumer products company with recognizable high-quality brands (Safety 1st, Schwinn, Mongoose), powerful marketing alliances (Wal-Mart, Toys "R" Us and Target) and low cost manufacturing (China). Our decision to remove EnCana was based on our short-term concerns with oil prices in the face of proposed production increases. Rising oil supplies from Saudi Arabia and United Arab Emirates should eventually be reflected in inventories and lower prices. Norske Skog Canada Inc. is a major North American pulp and paper manufacturer and is highly levered to forecast improvements in paper and pulp pricing. Management has taken a disciplined approach to capital expenditures and cost control and now has one of the strongest balance sheets amongst major newsprint producers.

As for our track record over the last four and a half years, we have built and maintained a substantial performance gap between the portfolio and the broader market. Since inception (September 15, 1999) the portfolio has provided investors with a total return of 48.1% versus 30.7% for the TSX Total Return Index.

Canadian Core Equity Guided Portfolio

Company	Symbol	Price (30-Jun-04)	Target Price	Dividend	Dividend Yield
Interest Sensitive *(TSX Weight 40%, Portfolio Weight 38%)*					
BCE Inc.	BCE	$26.70	$37.00	$1.20	4.5%
Bank of Montreal	BMO	$53.37	$66.00	$1.60	3.0%
Enbridge Inc.	ENB	$48.71	$54.00	$1.83	3.8%
Manulife Financial	MFC	$54.05	$60.00	$0.84	1.6%
Power Corp.	POW	$52.85	$65.00	$1.15	2.2%
Toronto-Dominion Bank	TD	$42.88	$56.00	$1.36	3.2%
Consumer Products *(TSX Weight 14%, Portfolio Weight 38%)*					
Astral Media Inc.	ACM.A	$28.45	$35.25	$0.15	0.5%
Dorel Industries Inc.	DII.B	$43.70	$54.00	$0.00	0.0%
Loblaw Companies Ltd.	L	$61.10	$69.50	$0.76	1.2%
MDS Inc.	MDS	$20.60	$28.00	$0.10	0.5%
Molson Inc.	MOL.A	$33.98	$36.00	$0.60	1.8%
Thomson Corp.	TOC	$44.53	$47.00	U$0.76	2.3%
Industrial Products *(TSX Weight 13%, Portfolio Weight 18%)*					
CP Rail Ltd.	CP	$32.75	$35.00	$0.51	1.6%
Cognos Inc.	CSN	$48.19	$50.00	$0.00	0.0%
Finning International Inc.	FTT	$33.25	$33.50	$0.40	1.2%
Resource *(TSX Weight 33%, Portfolio Weight 6%)*					
Norske Skog Canada Inc.	NS	$4.69	$5.85	$0.00	0.0%

Source: Scotia Capital.

Equity Guided Portfolios: Canadian Income Plus Guided Portfolio

Andrew Guy, CFA – Associate, Portfolio Advisory Group

Investment Objective

The Canadian Income Plus Guided Portfolio is a lower risk portfolio designed for conservative investors whose primary objective is dividend income with modest capital appreciation. The Income Plus portfolio is comprised of investments in conservative companies or income trusts that are well established, financially strong and have an excellent record of earnings and dividend growth or operating cash flow and cash distributions. Diversification is achieved by investing in eight to 12 companies over a minimum of five sectors.

Selection Criteria

Investments for the Income Plus portfolio are selected from the S&P/TSX Composite Index or the S&P/TSX Income Trust Index. These investments must satisfy a set of fundamental and quantitative criteria including possessing an acceptable dividend (or cash distribution) yield, minimum market capitalization and liquidity levels. As a result, the portfolio tends to be comprised largely of investments that consistently deliver stable earnings and dividend growth. Higher dividend yielding investments in many cases should be viewed as more sensitive to changes in interest rates than those not paying a dividend.

Performance Update

During the second quarter of 2004, the Income Plus Guided Portfolio generated a total return of -3.6%, underperforming the S&P/TSX that broke even during the period. The second quarter was not a good period for interest sensitive sectors in general as 10-year Government yields increased by more than 0.5% and the bond market began to price in significant future central bank rate increases.

The Income Plus portfolio benefited from its exposure to the TSX financial services sector again. Sun Life Financial increased by 10% over the quarter and has increased by 20% year to date. The other financial holdings have also contributed so far this year. Since being added to the portfolio, RioCan has increased by 6%.

Higher interest rates have had the biggest negative impact on the utilities sector and, since this fund has a large exposure, the performance of these companies has been the major drag on performance. The faint positive in the results is that the sector holdings in this area (Atco, Fortis and TransAlta) have outperformed the relevant TSX sub-index.

For the first six months, the portfolio has returned 1.9% and has underperformed the broader S&P/TSX Composite by 3.0%. Two sectors (utilities and telcom) that are predominant in the portfolio have been the worst performing sectors year-to-date.

Changes

During the second quarter we made two changes to the Income Plus portfolio. We removed Torstar Corp. early in May since the company no longer qualified for the portfolio. Scotia Capital reduced the recommendation on the stock to 3-Sector Underperform due to reduced estimates and a lower target valuation for the company's book publishing segment.

RioCan REIT was added to the portfolio in May. RioCan is the largest REIT and dominant owner of retail real estate in Canada. Through their disciplined growth approach, RioCan management has grown funds from operations and distributions consistently over the past 10 years. Fears of higher interest rates had caused the price of RioCan to return to an attractive entry point for one of the core names in the Canadian REIT universe.

Canadian Income Plus Guided Portfolio

Company	Symbol	Price (30-Jun-04)	Target Price	Dividend	Dividend Yield
ATCO	ACO.X	$47.74	$54.00	$1.40	2.9%
BCE Inc.	BCE	$26.70	$37.00	$1.24	4.6%
CIBC Inc.	CM	$65.20	$84.00	$2.40	3.7%
Enbridge Inc.	ENB	$48.71	$54.00	$1.83	3.8%
Fortis	FTS	$58.15	$61.00	$2.16	3.7%
Power Financial Corp.	PWF	$54.85	$64.00	$1.46	2.7%
RioCan REIT	REI.UN	$16.10	$15.50	$1.21	7.5%
Sun Life Financial	SLF	$38.41	$40.00	$0.84	2.2%
TransAlta Corp.	TA	$16.75	$20.00	$1.00	6.0%
TD Bank	TD	$42.88	$56.00	$1.36	3.2%

Source: Scotia Capital estimates.

U.S. Equity Outlook

The Four Ps

Frances Horodelski, CFA – Director, Portfolio Advisory Group

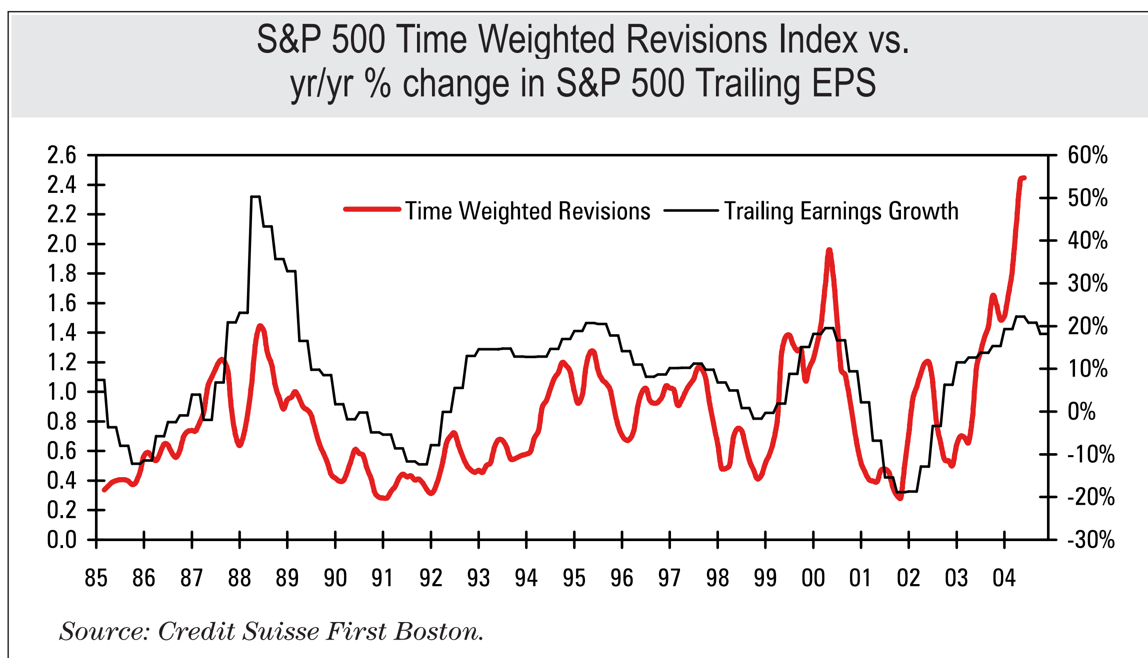
For investors, the second half direction for U.S. equity markets will likely be dictated by politics, purchasing power (inflation), profits and power struggles.

The presidential election campaign will heat up through the summer (with the party conventions) and into the fall. The uncertainty that could come with swings in the polls could work to keep investors on hold. We note that historically strong consumer confidence numbers are consistent with a re-election of the incumbent (with the exception of 2000) supporting a successful Bush campaign. Equity markets tend to dislike change so strong Bush polling numbers could be positive for stock investors.

Purchasing power as reflected in inflation data will be a part of the mix as well as we move through the rest of 2004 and into 2005. The central bank in the U.S. has been especially generous with respect to lower interest rates – a situation that changed with the Fed's 25 basis point hike on June 30th. The strength in the economy has resulted in a shift in sentiment from deflation to a focus on inflation. Already investors have increased their expectations toward interest rate hikes such that the consensus is now at 2.5% for the Fed Funds rate one year out. A steeper rise in short term rates as well as more pressures on interest rates at the long end than that currently expected will ultimately mute stock price appreciation potential. The direction of interest rates is especially problematic given the high level of government and consumer debt (where debt service is now at historic highs) as well as the large percentage of S&P 500 company earnings that come from financial services (30% today versus 5% 20 years ago).

U.S. corporate profits are extremely strong on both an absolute basis and relative to expectations. Indeed, the pace of earnings revisions is at record levels. While some of this might be consistent with the new level of cautiousness in corporate guidance, this pace of enthusiasm is difficult to sustain as is actual earnings improvement. Earnings growth is running about 15% above mid-cycle levels suggesting we're in the later stages of this profit cycle. Indeed, there have only been four previous times when earnings have seen four sequential quarters of more than 20% year-over-year growth, an event that is expected to occur again when second quarter earnings are reported in July. The interest rate tightening cycle and the likely unsustainability of this profit growth bodes for a softening of equity market performance as the year unfolds and likely into 2005.

Finally, power struggles could manifest themselves in a variety of ways from the handover in Iraq, to changing relationship with Iran through repositioning of power within Saudi Arabia and/or OPEC. Any adjustment of the balance of power within the volatile Middle East but also terrorist activity around the world could put upward pressure on the risk premium in markets – a risk premium that has narrowed substantially over the past 10 years.



Source: Credit Suisse First Boston.

A combination of worries (debt, peaking economic and profitability momentum, global uncertainties) positioned against a fairly valued market (and against expectations for price/earnings multiple compression to continue), underscores the importance of an investment strategy that focuses on quality issues (with attractive dividend yields, dividend growth and reasonable valuation with strong financial statistics). At the same time, a number of underlying trends support our sector emphasis. Commodity and inflationary pricing pressures, attractive demand versus supply for many commodities, the potential for a retrenching consumer, still low levels of capital spending relative to GDP and free cash flow but also a long period of increasing interest rates suggests that a barbell approach to investing (some aggressive cyclical and technology positions offset by defensive staples) could provide the best combination of risk and return.

Top Recommendations

As outlined in our U.S. core portfolio discussion elsewhere in this document, our core portfolio is constructed around a diversified selection of large cap long term growth opportunities that provides a balance between cyclical and defensive industries. Beyond the fourteen companies presented in that portfolio, we offer here a selection of companies that could add to overall performance given valuation, profitability momentum, special situation status and/or opportunistic positioning. For example, we continue to be positive on a number of heavy equipment manufacturers given strong demand profile. **Navistar** (NAV $39.00, Target $60), which to date has disappointed in its share price performance, looks well situated for accelerating earnings.

In software, **Intuit** (INTU $39.50, Target $56) also remains a favourite. The key driver for this company is demand from small to intermediate business for accounting and management software. It is estimated that there are 39 million firms with less than 100 employees worldwide; several hundred thousand with 100 to 400 employees. With the company's 2.6 million installed base of QuickBooks, there is substantial opportunity for Intuit to leverage their market share into this large market. Intuit is also focussed on benefitting from the growth in electronic tax filing. Its record of revenue and profitability growth is exceptional (five year annual growth in revenues and income of 20% and 26%, respectively) in our opinion isn't reflected in the current valuation of 11 times free cash flow and 20 times next year's estimated earnings of $1.95.

There continue to be substantial opportunities in healthcare. Unfortunately, the tone towards the group has been negative. Reasons for the stock pricing pressures include patent challenges (two significant ones against Pfizer's Lipitor and Eli Lilly's Zyprexa goes beyond those two companies), election worries (a Democratic win is viewed negatively), the attractiveness of alternative investments (healthcare, especially big cap pharmaceuticals, tends to do poorly when cyclical earnings expectations are positive and even during the early stages of a Fed rate hiking environment), high profile misses (especially with reference to disappointing clinical data in the biotech sector). Despite these negative big picture issues, we continue to believe Pfizer and Amgen offer attractive upside potential. Pfizer's earnings growth rate is above average, its pipeline of new products is deep, there are a series of positive catalysts likely as the year unfolds (including new product introductions). Amgen, a company that has seen earnings almost triple in the past five years and yet seen its share price stay essentially flat, is another example of a great opportunity. An extensive pipeline of potential new products, a high quality portfolio of existing products, 20%+ earnings growth rate and a multiple substantially below its peers supports our bullish outlook for the company's share price.

Finally, we continue to have a favourable outlook towards the U.S. entertainment stocks. Both **TimeWarner** and **Walt Disney** show up well on a relative valuation basis, but also have internal catalysts that could provide earnings that come in ahead of expectations. Disney's turnaround continues with all the major drivers of profitability (movies, theme parks and television) showing improvement. Our fundamental target, while potentially aggressive, is $40. TimeWarner too could be in a position to beat the street when they report in July. While **AOL** remains a long term concern, its cash flow contribution plus strong results from **Turner Broadcasting**, cable, publishing and advertising as well as theatrical releases suggest that its bottom of the group valuation is not justified. The stock has potential into the $23 target area.

Equity Guided Portfolios: U.S. Core Portfolio

Frances Horodelski, CFA – Director, Portfolio Advisory Group

The U.S. Core Guided Portfolio put in a decent performance during the month of June (+4.39%) and +4.22% for the first half outperforming the market's 3.44% return. For the month of June, each position in the portfolio appreciated with the exception of the healthcare stocks Amgen and Pfizer. For the year to date, the best performance was provided by Raytheon (+19.9%) and Clorox (+9.9%).

There were no changes made to the portfolio during the quarter. Target prices were raised on Diageo, Kraft Foods, General Electric and Microsoft.

The portfolio benefitted from a surprisingly strong first quarter for most of the companies and confident guidance on a go-forward basis. For the next reporting season, we continue to expect the companies in the portfolio to put forth decent profit numbers. We also expect dividend boosts from a number of companies during the second half including Kraft Foods (August), Pfizer (December), General Electric (December), Walgreen (July) and possibly another boost from Deere. We note that Clorox is in a position to raise its dividend but until the ownership issue of 30% of the company's share by Henkel is settled, any changes will be postponed. Our guess is that if Henkel sells its ownership in Clorox, the company will step forward and purchase for retirement that position. This could add an estimated $0.38 to per share earnings which are currently estimated at $2.65 for fiscal 2005. If this doesn't occur, we would expect Clorox to resume its regular share repurchase program adding $0.10 per share to earnings forecasts.

U.S. Core Equity Guided Portfolio

Company	Symbol	Price (30-Jun-04)	Target Price	Dividend	Dividend Yield
Interest Sensitive *(S&P 500 Weighting 27.5%)*					
Allstate Financial	ALL	$46.55	$55.00	$1.12	2.4%
JP Morgan	JPM	$38.77	$50.00	$1.36	3.5%
Consumer Products *(S&P 500 Weighting 35.6%)*					
Amgen	AMGN	$54.57	$77.00	$0.00	0.0%
Clorox	CLX	$53.78	$59.00	$1.08	2.0%
Diageo	DEO	$54.75	$62.00	$1.86	3.4%
Kraft Foods	KFT	$31.68	$34.00	$0.72	2.3%
Pfizer	PFE	$34.28	$42.00	$0.68	2.0%
Walgreen	WAG	$36.21	$40.00	$0.17	0.5%
Industrial Products *(S&P 500 Weighting 28.2%)*					
Deere	DE	$70.14	$85.00	$1.12	1.6%
General Electric	GE	$32.40	$36.00	$0.80	2.5%
Microsoft	MSFT	$28.56	$32.00	$0.16	0.6%
Raytheon	RTN	$35.77	$35.00	$0.80	2.2%
Resource *(S&P 500 Weighting 8.7%)*					
GlobalSantaFe	GSF	$26.50	$34.00	$0.20	0.8%
PPG Industries	PPG	$62.49	$77.00	$1.76	2.8%
S&P 500		*1140.75*	*1200*	*$17.45*	*1.5%*

Source: Scotia Capital; Credit Suisse First Boston.

Fixed Income Outlook

"Here we go, here we go, here we go…"

Stewart Hunt – Director, Portfolio Advisory Group

North American bond market participants could use this chant, usually reserved for rabid soccer fans cheering their team on to victory, as they prepare for the U.S. Federal Reserve and the Bank of Canada to begin raising interest rates. With the trend in North American interest rates generally declining since 1980, we could be reaching the end of an era as rates begin to move higher. The U.S. target federal funds rate at 1.00% marked a 46-year low for interest rates in the United States. On June 30th, the U.S. Federal Open Market Committee (FOMC) began the process of raising interest rates when they increased the federal funds rate 25 basis points from 1.0% to 1.25%. Scotia Economics has forecast the federal funds rate to reach 2.00% by the fourth quarter of 2004 and to continue to increase in 2005 closing that year at 3.25%. However, if we consider where interest rates have been over the past 25 years federal funds at 2.00% to 3.25% would still be near rock bottom even though it would be 100% to 225% higher then where it was! As interest rates peaked in the early 1980's based on inflation and inflation expectations, it is this same catalyst that we expect to drive yields higher in the next year to year and a half. So as North American central banks begin their offensive on inflation, "here we go" can be called out as interest rates move higher.

Once the U.S. employment data gave investors comfort that the economy was growing their attention was switched to inflation. Comments in early June by U.S. Federal Reserve Governor Poole that the central bank would need to begin a diligent approach to inflation got the bond market all in a lather. The two-year U.S. Treasury note and 10-year U.S. Treasury bond jumped 40 basis points (2.934%) and 22 basis points (4.87%) respectively, as fear swept the market that inflation was on a run away pace and that the Federal Reserve was preparing to raise rates 50 basis points at the end of the month. The mid-June release of the May consumer price index showing relatively subdued growth in core inflation growth brought the bond market back to earth. The feeling that the U.S. Federal Reserve was in a position to take a "gradual" approach to raising interest rates based on the pace of inflation became more realistic. This was further emphasized as U.S. interest rates across the yield curve all declined after the FOMC made its rate increase announcement. Over this period the North American bond market witnessed a significant movement in rates effectively moving up and down 40 to 80 basis points depending on the term to maturity. This type of market volatility should be expected over the next year and half as rates move higher.

Taking Advantage of Volatility

Based on this expected volatility, investors should look to take advantage of buying opportunities when the bond market over reacts and pushes yields either to or through their technical support buying levels. However, much like the U.S. Federal Reserve's gradualist approach to raising rates, we recommend investors take a gradual approach in putting their money to work. Called "dollar cost averaging" by equity investors, or putting on a "Texas Hedge" from the bond perspective, we suggest building core positions and adding to them as prices move lower. An investing activity supported by traders having to deal with a bear market; "If you loved it at 3.00% you've got to be all over it at 3.50%". For investors currently running active fixed income portfolios, the best market strategy is to take on a defensive approach by reducing the duration or term to maturity of the portfolio. Taking shelter in shorter dated maturities reduces exposure to capital losses as interest rates move higher and prices move lower.

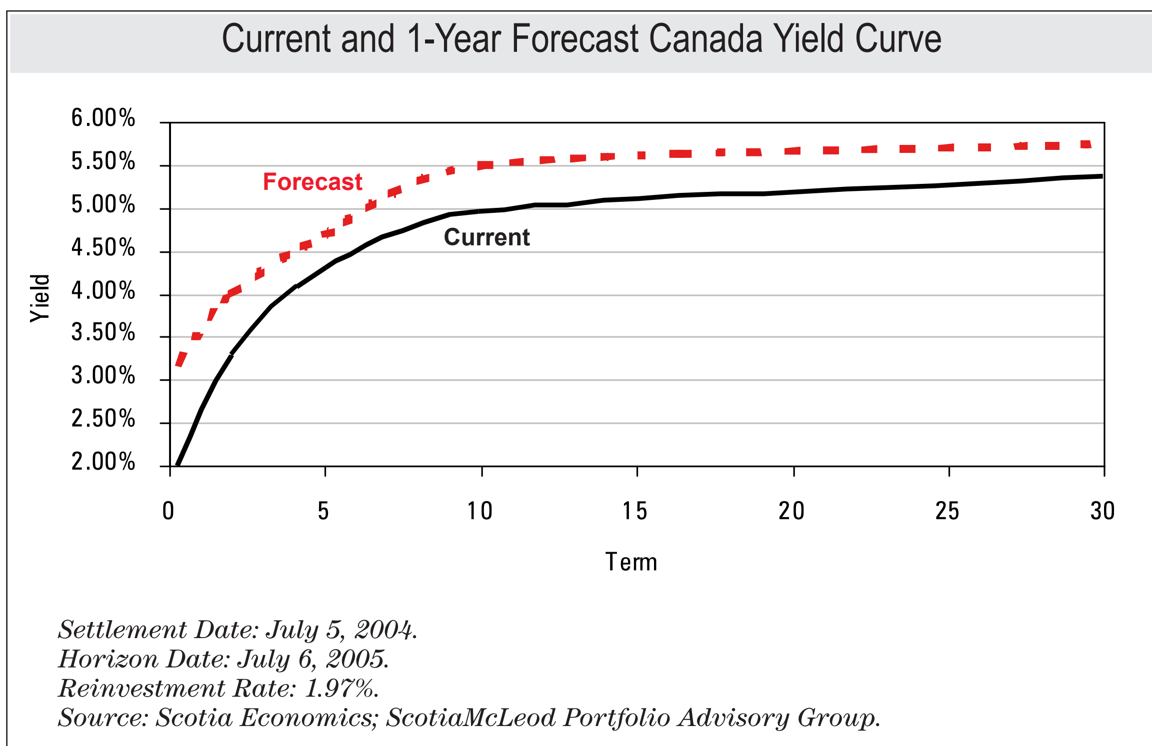
Finally, from a Canadian perspective Scotia Economics forecasts the Bank of Canada to begin raising rates in September 2004 with the overnight rate closing the year at 2.50% and rising to 3.50% by the end of 2005. Canada's fiscal austerity, current account surplus and inflationary targets will allow the Bank of Canada to take a much more measured approach to dealing with pending inflation. As a result, we expect the yield differentials between Canada and the U.S. to narrow as Canada continues to be an attractive investment to foreign investors. Overall, both the Canadian and U.S. yield curves are expected to flatten as administered rates move higher with buying opportunities presenting themselves as rates move to or through their technical buying support levels.

Fixed Income Feature: Active Fixed Income Strategies

Kevin Martin, CFA, Associate – Portfolio Advisory Group

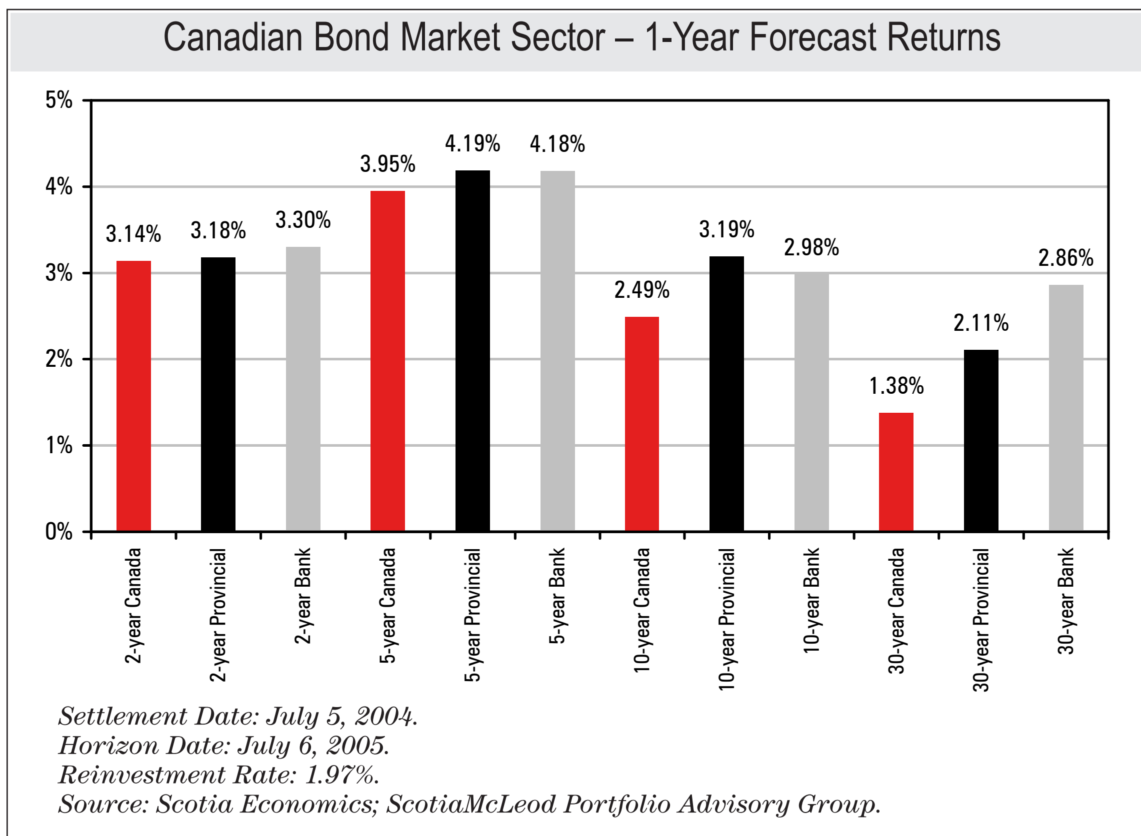
The second quarter was not particularly bond-friendly and although the outlook for bond yields is not fantastic going forward, we believe that there are still opportunities for positive returns over the next year. The Scotia Capital overall bond universe had a negative 2.39% total return over the second quarter as yields increased dramatically in response to firmer economic data from Canada and the U.S. and a strong message from the U.S. Fed that interest rate hikes are on the horizon. The market quickly began pricing in monetary tightening in both the U.S. and Canada yield curves, resulting in higher overall rates and a flattening of the curves (with short and mid term yields rising at a greater rate than long term yields).

The trend remains towards higher bond yields (lower prices) for the balance of the year. The main driver behind the market will be monetary policy tightening and the expectations of future monetary policy tightening by the U.S. and Canadian central banks. Scotia Economics is forecasting a 2.00% U.S. federal funds rate by the end of 2004 (0.75% above the current 1.25% rate), and a 2.50% overnight lending rate in Canada by the end of 2004 (0.50% above the current 2.00% rate). The chart below projects the forecast Canada yield curve one year forward (dotted line) versus the current Canada yield curve (solid line). The forecast calls for a continued increase in yields over the next year and further flattening of the yield curve.



Settlement Date: July 5, 2004.
Horizon Date: July 6, 2005.
Reinvestment Rate: 1.97%.
Source: Scotia Economics; ScotiaMcLeod Portfolio Advisory Group.

Using this forecast we can project the possible returns provided by different sectors and different maturities of the bond market.



Settlement Date: July 5, 2004.
Horizon Date: July 6, 2005.
Reinvestment Rate: 1.97%.
Source: Scotia Economics; ScotiaMcLeod Portfolio Advisory Group.

Despite what we believe will be a rising yield environment, we are forecasting slightly positive returns for the majority of bond market sectors. This may seem counter intuitive but the coupon payments that bonds pay out are forecast to soften the blow caused by dropping valuations. Gains over the next year are likely to be limited to these coupon payments with the five-year area of the curve projected to have the best returns (approximately 4.3%).

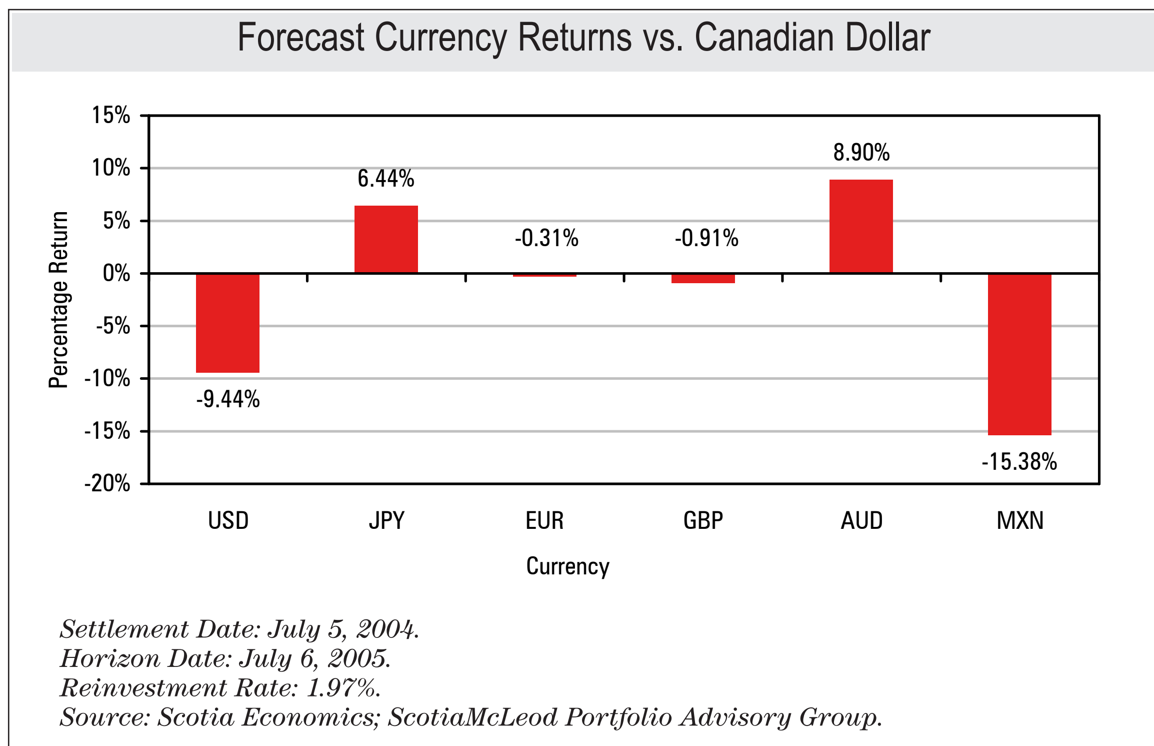
Going forward, the downside risks for North American bond prices include stellar economic growth, a rapid increase in inflation, and a general flight from quality as capital flows from the bond market into other asset classes. We are currently recommending and utilizing two investment strategies to mitigate these downside risks.

Fixed Income Portfolio Strategies

The first strategy is to keep the term to maturity of bond portfolios short. We are currently utilizing this strategy in our Core Plus fixed income guided portfolio by investing in one-month Bankers Acceptance paper. This is a practical investment approach in the current environment of rising bond yields because it allows us to reinvest the proceeds each month at more favourable rates. The position has worked well for us over the second quarter, returning 0.49% and shielding us from the large drop in bond prices. By keeping the term to maturity of bond portfolios short, investors also shorten duration (the sensitivity of bond prices to interest rate moves) which is beneficial in a rising yield environment.

The second strategy is to invest in non-North American bonds. This strategy involves investing in foreign currency bonds with the goal of obtaining better returns via yield pick up and currency appreciation. We are currently utilizing this strategy in our Core Plus fixed income guided portfolio by investing in a five-year Yen-denominated bond. This position had a negative return of 1.16% over the second quarter (before considering the currency gain or loss). This compares favourably with the performance of the five-year benchmark Canada bond which had a negative return of 2.31% over the same period. This can be a very effective strategy, particularly if you select a country where the threat of inflation is minimal and economic growth is lackluster compared to Canada or the U.S. It is important to note that this strategy exposes the investor to the often volatile currency exchange markets where upward and downward movements can be large and swift. For example, the Canadian dollar-Yen cross had a negative 2% return in the second quarter, negatively affecting the returns of the five-year Yen denominated bond position in our Core Plus portfolio. Again, the goal of this investment strategy is to earn a return via either an increase in the value of the bonds (while collecting the coupon payment) and/or a currency gain versus the Canadian or U.S. dollars.

The chart below projects the 1 year returns of a selection of foreign currencies vs. the Canadian dollar using the latest Scotia Economics forecast.



Settlement Date: July 5, 2004.
Horizon Date: July 6, 2005.
Reinvestment Rate: 1.97%.
Source: Scotia Economics; ScotiaMcLeod Portfolio Advisory Group.

These two strategies can be effective tools for avoiding the downside risks discussed above and reducing negative returns in a bond bear market. Contact your ScotiaMcLeod Investment Advisor if you would like to learn more about these strategies or the Core Plus Fixed Income Guided Portfolio.

Mutual Fund Strategy

All Other Things Being Equal

Ian Filderman, MBA – Director, Mutual Fund Research

Everything should be made as simple as possible, but not simpler. – Albert Einstein

Like many things in life, the investment world is relatively complex. In order to make sense of virtually endless amounts of information and data, we often make certain assumptions and take various mental shortcuts to come to conclusions we believe we can act on. Assumptions, where reasonable, can be a good thing in allowing us to make sense of complex information. However, they can also be detrimental if we rely too heavily on them.

There are a few typical assumptions in the investment world that must always be looked at with a critical eye by investors. First and foremost among these, in my opinion, is one that is taught early on in virtually every introductory economics class. This is the concept of "Ceteris Parabis" – all other things being equal. This is an absolutely crucial assumption to make in many circumstances where there is a multitude of variables that could influence the answer to a particular question. It allows for the focus on one or two variables in solving a problem instead of all of them at once.

This assumption becomes a cornerstone of so many analyses we read, attributing outcome x to factor y. This is why it is both powerful, and potentially problematic. Very often, a particular outcome is determined by a variety of factors to varying degrees. Often there is not so much a linear connection between two things as a tangential one.

For example, in the mutual fund world, a point often debated has to do with the impact of MERs (management expense ratios) on fund performance. The typical position is that investors should buy funds with lower MERs (or taking the argument to its extreme eliminate actively managed portfolios and funds for low cost, index tracking Exchange Traded Funds) and they will do better. This position is usually backed up with an analysis that centers on holding a variety of key factors constant – the essence of Ceteris Parabis. It usually goes something like this. Two funds have gross returns of, let's say, 9.5%. Fund A has an MER of 2.5% and fund B has an MER of 1.5%. With a $10,000 investment held for 20 years, investor A, who had a net return of 7% after fees and expenses, has $37,847 at the end of the period. Investor B, with the same $10,000 and 20 year time horizon ends up with $45,998 from their net return after all fees and expenses of 8%.

This argument seems pretty logical, right? The key assumption here is that other than fees and expenses, all other things are held equal, including the gross performance of two different funds run by two different managers. How reasonable is this assumption? In my opinion, not very. Let's take a look at why that is the case.

Can MERs Help Explain Fund Returns?

First, take a look at the range of returns of various funds in a particular long-term mutual fund category. We'll use the Canadian equity universe for the last five years to the end of May 2004. There were 169 Canadian Equity Mutual Funds (excluding pooled funds and segregated funds) with track records of at least five years. They had trailing five-year compound returns ranging from +38.26% to -32.36% after all fees and expenses. If we were to take out the extremes in this universe and eliminate the top 5% and bottom 5% of performers in the category, we would have a range of 13.56% at the top end to -0.35% on the bottom end. We'll refer to this as the trimmed universe. This gives a range of returns, from the best to the worst in the category of 70.62% for the whole universe and 13.91% for the trimmed universe. This is the difference that needs to be explained by one or more factors in order to understand on what basis we should make decisions about or distinctions between funds.

One factor that could explain performance differences is Management Expense Ratios, and that is what many commentators regularly point to as they attempt to argue that one should only purchase lower cost funds. Let's take a look at whether or not this is reasonable. For the same universe of Canadian equity funds, the range of MERs goes from 4.39% at the top end to 0.58% at the bottom. This makes the total range 3.81%.

Assume for a moment that the worst-performing fund in this universe of funds had the highest MER and the best performing fund had the lowest MER. This would mean that we have explained, at best, 381 basis points of the difference in performance between the two. For the trimmed universe this would still leave 1,010 basis points (or 10.10%) of performance difference left to explain by other factors. For the full universe the amount left to explain would be over 66%.

When we last looked at the explanatory value of MERs relating to fund returns, we found some pretty intriguing results. In Canadian, US and Global equity fund categories, MERs were only found to explain somewhere between 2% and 15% of fund performance over five and 10 year periods. It is fair to say that this relationship changes dramatically when you move from equity categories and funds to money market funds, where the explanatory value of MERs is upwards of 60% where the higher the MER one can expect a lower net return much of the time. Correlations between MERs and fund returns ranged from strongly negative for money market funds to weakly negative for equity categories.

What conclusion can we draw from this? I think it is fair to say that there is a relationship between MERs and fund returns but the relationship ranges from strong to very weak. The relationship is far more important in a category like money market funds than it is in equity fund categories. Another way to look at this is that things are much closer to being equal amongst money market funds, where there is little room for a manager to add or detract value through their investment process. However, in broad equity categories things are rarely, if ever equal, rendering MERs as an important but less than primary piece of information to use in selecting mutual funds.

We have long advocated that what investors need to be most concerned about when selecting long-term fund managers is the people, process and philosophy which ultimately lead to performance. While tough to quantify, we strongly believe that it is these factors that ultimately end up explaining the differences between managers. Where all other things truly are equal, such as between two index funds, it is intuitively obvious to select the one with the lower MER. With active funds though, just selecting on the basis of MERs could lead to less than expected or satisfactory results.

Risk is also a Factor

The other difficulty I have with simplistic arguments around issues like MERs and returns is that they also hold crucial issues like risk as being "equal" when again they rarely are. When you buy a mutual fund, you are in effect hiring a money manager to do a certain job for you. Part of that job may be to generate the highest possible returns within that asset class. It is a truism that higher returns generally come with a price – higher risk. For other managers, their job or mandate may be to generate market like returns, but at substantially lower risk than the market. We have found a number of managers and funds that fit this profile. This would lead to high risk adjusted returns deriving not from spectacular returns, but rather from lower risk. Is this a skill worth paying for and a type of manager worth investing with? Is it an important factor to consider when evaluating various funds? For many investors, the answer to these questions would undoubtedly be yes.

Let me be clear. I am not trying to argue that fees and expenses don't matter. Clearly they do to varying degrees depending on the type of fund we are talking about. Management fees and expenses represent the cost of hiring a manager to do a certain job – investing your money for you for the long term. If the cost seems unreasonable to you for a particular manager and fund, then look for another one who offers both what you are looking for (people, process, philosophy, risk and reward characteristics) and a cost you find acceptable. However, the simplistic, "all other things being equal" based arguments around the primary importance of MERs have to be critically questioned. Investment success over time stems from many things. For individuals, the starting point is their asset allocation. A multitude of other factors then come into play like time horizon, geographic, sector, style and security specific risk and diversification as well. For many investors, issues like taxes and cash flow requirements are also key. It is only by taking into account all of these different variables that key investment decisions can and should be made. Focusing on one variable (whether MERs, past performance, standard deviation, or any other) and assuming all others are constant may help to simplify the process. However it can just as easily lead to an unexpected or contrary outcome.

Managed Asset Group

A Tactical or Strategic Investment Approach?

Andrew Smith, Vice-President – Northern Trust Global Advisors

It can, and has, been said that all investing involves some degree of market timing. We are all trying to buy something before it increases in value and sell before it declines. It's the philosophy behind "buy low, sell high".

It's astonishing that such a simple philosophy could generate so much controversy until you consider the words of wisdom of Charles D. Ellis: "the real challenge in portfolio management is not how to increase returns, but how to manage risk."

The thought behind this quote is that our real goal as investors is to increase wealth. This implies protecting past gains, while making new ones. The subject of risk is really what generates controversy. How much risk should we take? Do we bet everything on the next roll of the dice or protect past winnings? Inevitably it depends on your taste for risk and ability to absorb losses.

Risk

The subject of investment risk fills volumes, but in reality it is a personal decision. Investment experts have developed numerous methods to control risk, with diversification – or not putting all of your bets in one place – being the basic risk control.

When it comes to diversification, there are two general approaches – tactical asset allocation and strategic asset allocation. For the tactician, diversification means holding a portfolio of stocks diversified by sector. The portfolio tactician accepts market risk, carefully timing investments between various markets to generate additional gains when the conditions are right. Having said this, some investors are unwilling or unable to fully accept this risk. Investors who need certainty of capital or cash flow can't take the chance that declines in a single market will jeopardize their savings. They need to carefully diversify market risk as well. This requires a strategic strategy where protecting past gains and capital appreciation are joint priorities.

A Tactical vs. Strategic Approach

So which is the better approach? Both have supporters, but the record is far from clear. Tactical asset allocation, in its simplest form, means timing investment flows between two asset classes – stocks and bonds – in an attempt to anticipate which asset class will outperform over the next period. This provides little protection in the event of an incorrect decision, as it is essentially a "right or wrong" decision.

With annualized differentials between Canadian stock returns and Canadian bond returns being as great as 50 per cent, the penalty for guessing wrong is high. More complex tactical models add other asset classes, including U.S. and international stocks and bonds, and cash. This provides more levers to control risk, but complicates the tactical process, as every possible combination of assets has a different risk profile.

Assessing which decisions worked and which didn't can also be a challenge. This game is best played using sophisticated mathematical models and is called global tactical asset allocation. In either case, the success rate of tactical approaches is determined by market conditions, with choppy markets providing more opportunities to trade in and out profitably. Strongly trending markets (either upward or downward), meanwhile, provide little opportunity to add value.

Strategic asset allocation consists of implementing a long-term strategy based on an analysis of historical market relationships and a long-term forecast. A target portfolio allocation is established at inception based on an investor's long-term goals, such as capital preservation, income requirements, and liquidity needs, as well as their tolerance for risk. Once the strategic allocation is established, the portfolio is rebalanced periodically to its target to adjust for any relative movements in underlying markets. This approach focuses on the long-term with stock picking adding value over market timing.

Different Strategies for Different Investors

Another key difference between the two asset allocation approaches is their view of risk. A tactical approach assumes that an investor's risk tolerance levels change with market conditions. At the same time, a tactical approach can be challenging to implement when combined with active stock picking (pure tactical approaches use index funds). Think of tactical asset allocation, for example, as being like traffic control, directing airplanes to different locations, and think of stock picking as being like piloting the planes. For a single investor, the challenge of doing both simultaneously increases the chance of a crash. A bad tactical decision can overwhelm good stock picking, just as a bad air traffic control decision overrides good piloting. We would therefore suggest that tactical asset allocation may be better suited to more hands-on investors who accept the risk of a larger loss in order to achieve potentially higher gains.

A strategic approach, meanwhile, assumes that an investor's risk tolerance is dictated primarily by non-market factors such as retirement plans, income needs, or capital preservation. It is, therefore, well suited to delegative investors who don't wish to make frequent investment decisions, and can stick to a long-term plan.

The Bottom Line

Both tactical and strategic investing should be the result of a robust investment process where investment decisions reflect a well thought out plan with well-documented decisions. With the Summit and Pinnacle Programs, we can provide you with this process. Your advisor will work with you to develop a customized Investment Policy Statement to determine the asset allocation approach that works best for you and construct a portfolio that leverages some of the world's leading money managers to help you achieve your long term goals. It's all about a disciplined investment process.

Insurance

Critical Illness Insurance: Protection Worth Considering

Monica Macieszkiewicz, CFP – Assistant Product Manager, Insurance

in·sur·ance *(Pronunciation: in-'shur-&n(t)s)* ***1****: coverage by contract whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril;* ***2****: a means of guaranteeing protection or safety.* *Mirriam-Webster Dictionary, 2004*

This definition does a good job of summarizing what insurance is and what its use is. What it doesn't do though, is describe the various types of insurance that are available, or identify all of the various types of risks which it can protect you against. With a myriad of different products available, it isn't easy to keep up with what each product's purpose actually is. Even within a specific part of the industry – life insurance – it is not uncommon for many to think "that all types of coverage are the same" or "that if you have one type of insurance, that is all that you need".

This misunderstanding is especially common with Critical Illness insurance (CII), a relatively new product on the insurance block. This type of coverage is different from the more traditional types of insurance such as life or disability, none of which are interchangeable, as they all provide different means of protection against different risks.

What is Critical Illness Insurance?

Critical Illness insurance is designed to provide coverage in the event you are diagnosed with any of the policy's covered illnesses. A lump sum benefit will be paid for surviving a specific waiting period (usually 30 days) after diagnosis of the first occurrence of a critical illness, as defined by the contract. The most commonly covered conditions are life-threatening cancer, heart attack, stroke and major organ transplant, however, most policies cover upwards of eighteen or more other illnesses. People are living longer and medical advances now provide the potential for someone who could have died 30, 20 or even 10 years ago from certain illnesses, to survive. The lump sum that CII provides upon a diagnosis is meant to protect you from financial worries allowing you to focus on more meaningful things, most importantly your recovery.

One of the greatest values of a CII policy is the fact that the money is yours to spend in whatever way that you see fit. It can be used to pay for experimental medical treatment, fund child-care, pay off a mortgage, allow your spouse to take a leave of absence from their job or support your business while you recuperate. Another important use is asset preservation. You may already have a substantial portfolio that could fund your recovery, but is this how you envisioned spending the money you've worked so hard to build? This coverage can provide you with peace of mind in knowing that those assets will be there for you to enjoy once you've recovered.

How Do CII Premiums Compare to Other Products?

The truth of the matter is that CII premiums are more expensive compared to traditional life insurance coverage. Since the risk of developing a critical illness is more likely than dying prematurely, insurance providers are far more likely to pay out on these policies and as such, must transfer their risk through higher premiums. With that being said, although premiums may seem high to some right now, signs across the industry indicate an increase in costs within the coming months. For many, this coverage is simply too expensive – but if it can be afforded, it's something that should be considered now, rather than having to end up paying more than you have to if you wait too long to decide.

Although statistics indicate the great likelihood of developing a critical illness, unlike death, it isn't a certainty. For that reason, many companies offer an optional rider that will return your cumulative premiums when the policy expires if you are lucky enough to avoid any of the policy's specified illnesses. In this case, if you make it to the end of your coverage (typically age 75, although some riders may allow for a partial return of premium sooner) and don't make a Critical Illness claim, the good news is that you'd be healthy, never having suffered a critical illness and you get your money back.

So Just How Much Would it Cost?

To give you an idea of how much this coverage would cost, attached is a chart outlining monthly premiums for Term-to-75 coverage for 3 different face amounts for 40 and 50 year-old male and female non-smokers. What you pay depends on factors such as age, sex, smoking status and current health status, specifically looking at things like your height, weight, lifestyle, and medical and family history. When applying for CII coverage, you would go through a process similar to that for life insurance, including medical tests and answering questions about these personal subjects.

Sample Monthly Premiums* for Level Term-to-75 Critical Illness Coverage

Coverage Amount	Male Non-Smoker Age 40		Male Non-Smoker Age 50		Female Non-Smoker Age 40		Female Non-Smoker Age 50	
	Regular Premium	With "Return of Premium" Rider	Regular Premium	With "Return of Premium" Rider	Regular Premium	With "Return of Premium" Rider	Regular Premium	With "Return of Premium" Rider
$100,000	$88.92	$103.68	$156.15	$206.19	$75.06	$92.34	$119.07	$167.13
$250,000	$202.28	$252.45	$381.15	$508.73	$170.10	$224.10	$274.05	$411.08
$500,000	$397.80	$500.40	$755.55	$1012.95	$333.45	$443.70	$541.35	$817.65

Regular Premium   *With "Return of Premium" Rider*

** Premiums obtained from companies on ScotiaMcLeod Financial Services Inc.'s approved list of insurance carriers.*

Source: ScotiaMcLeod.

When we are healthy, it's difficult to fathom the possibility of developing a critical illness, but in practicality, it is the best time to consider the impact that something like this would have on ourselves, our loved ones and our entire financial well being. Speak to your life-insurance licensed ScotiaMcLeod advisor to find out more about incorporating critical illness insurance into your overall financial plan.

Notes

Notes

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ScotiaMcLeod

ABBOTSFORD
(604) 864-3750

BARRIE
(705) 725-0300

BELLEVILLE
(613) 968-6459

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(905) 796-2424

BRIDGEWATER
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Investment Centre
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Brunswick Sq.
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(905) 641-7702

ST. JOHN'S
(709) 576-1305

SUDBURY
(705) 674-8558

THUNDER BAY
(807) 626-5182

TORONTO – Scotia Plaza
11th Floor
(416) 862-3110

TORONTO – Scotia Plaza
Head Office Branch
15th Floor
(416) 863-7272

TORONTO – Scotia Plaza
48th Floor
(416) 945-4048

TORONTO – Eglinton
(Uptown)
(416) 945-4840

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VICTORIA
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