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# Executive Summary

## 2011 Spring Outlook

*Stewart Hunt — Managing Director, Portfolio Advisory Group*

In our Winter 2011 executive summary we noted that we are cautiously optimistic about North American equity markets as the Canadian, U.S. and Mexican economies continue to show positive signs of growth. In addition we highlighted the external risks to our assumption being fiscal policy, climate, natural disasters and political unrest which could potentially derail the positive tone to the markets. Interesting that over the first three months of 2011 we have witnessed the U.S. government go into overtime to pass a budget and keep their country running; the minority Conservative government in Canada defeated in a non-confidence vote over the budget; the terrible triple disasters suffered by the Japanese earthquake, tsunami and nuclear breakdown; the fall of the political regimes in Egypt and Tunisia and growing political unrest in the Middle East and Northern Africa and the bailout of Portugal. With all of these external influences you would think it fair to assume a negative impact on equity markets. However, we have seen quite the opposite as only the Nikkei Equity Index in Japan has a negative year-to-date return with the balance of the world's major equity indices offering returns ranging from mid-2.0% to high-6.0%. The impact of the low interest rate environment in the G-7 economies has finally taken hold as investors who have experienced paltry returns by being overweight cash are now beginning to move their cash into equity mutual funds. The first quarter of 2011 was the first time since Q4 2008 where equity mutual funds experienced positive sales. What we find interesting is that Scotia Capital Strategist Vincent Delisle recommends reducing exposure to equities as Canadian and U.S. equity markets move closer to his fair value assumptions. It would seem as long as the North American economy maintains positive growth and jobs are being created investors will be resilient to external influences and will continue to search for enhanced returns above what they can earn on cash.

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

- While Scotia Capital Portfolio Strategist Vincent Delisle remains constructive on equities he is tactically moving towards a neutral position after being overweight equities for 2009 and 2010. Delisle sees S&P 500 at 1,420 and 4.20% on 10-year U.S. Treasury Notes as fair market value. At current market levels, equities are undervalued versus bonds but the magnitude of his overweight equities position is getting smaller.
- Scotia Capital Economists Derek Holt and Gorica Djeric anticipate the current move by the Canadian dollar above parity to the U.S. to increase by 8 cents and this would support their argument to overweight Canada from a global perspective with a positive view on equities. While there is talk of the Bank of Canada raising rates, Holt and Djeric believe the Bank will keep rates on hold even though the output gap is shrinking and the impact on inflation is low. Their belief is economic growth has been front loaded and is expected to slow.
- In our feature article, our Preferred Share specialist, Tara Quinn, discusses the implications of the Basel III standards being applied by the Office of the Superintendent of Financial Institutions (OSFI) to banks regarding securities eligible to be reported as Tier 1 capital. The new standards will have an impact on any investor currently holding bank Tier 1 capital securities and bank preferred shares. Quinn takes you through the various securities impacted and provides her thoughts on future issuance.
- Canadian Equity Advisor Himalaya Jain provides his thoughts on the impact of U.S. President Obama's energy policy on Canadian energy and fertilizer stocks. As a major supplier of energy products to the United States, even with their push to reduce dependency on foreign energy sources, Canada is still well positioned to benefit.
- With U.S. corporations sitting on a record amount of cash, our U.S. Equity Advisor, Paul Danesi, sees this as an opportunity for companies to improve productivity by investing in technology. Danesi highlights 3 U.S. technology stocks and 2 Exchange Traded Funds that could benefit from corporate investment in productivity and which you might want to consider for your portfolio.

- Joey Mack, our Manager Fixed Income Trading and Sales, discusses the merits of unrated debt securities and the knowledge and requirements an investor should meet when trying to assess the risk of a security without the assistance of a credit agency. As Mack points out, unrated debt securities are high risk investments for investors with moderate to high risk appetite, where limited portfolio allocation and diversified holdings represent a prudent investment approach.
- Joel Beriault, our Fund Research Advisor, highlights the opportunities for Canadian investors in U.S. equity mutual funds as the U.S. recovers from its deepest recession since 1929. He highlights the opportunities in investing in U.S. equity mutual funds as U.S. companies benefit from the growing economy. Many of these companies are multi-national with a global presence and the U.S. equity market provides broader sector diversification than the financial, energy and material dominated Canadian equity market.
- Ian Adams, Senior Financial Planning Consultant, provides food for thought on RRSP's and post retirement planning. Adams presents a couple of scenarios to consider when managing your RRSP with five ideas on what you can do to manage around the these situations.
- Dominic Proietti, Director, Financial Planning, Scott Cummings, National Director, Taxation and Shawn Copper, Senior Financial Planning Associate, have prepared 2011 Federal Budget Highlights as they pertain to personal income tax measures. (We would note while the budget was defeated in the House of Commons the proposed personal income tax measures prepared by the Department of Finance are anticipated to be enacted by the new government).
- In conclusion, Steve Uzielli provides his quarterly review and commentary on the performance of the Equity Guided Portfolios including the launch of the Canadian Equity Quant Portfolio, and Tim Vlahopolous provides his quarterly review and commentary on the Core-Plus Fixed Income Portfolio.

We hope you enjoy this Spring 2011 version of the IPQ and recommend you contact your ScotiaMcLeod advisor with regard to any of the ideas presented here that interest you, or to review your investment portfolio.

Stewart Hunt

# Portfolio Strategy

## Executive Summary

Vincent Delisle, CFA — Portfolio Strategist, Scotia Capital

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

### Equities Outperform Bond in Q1, Leadership Narrows

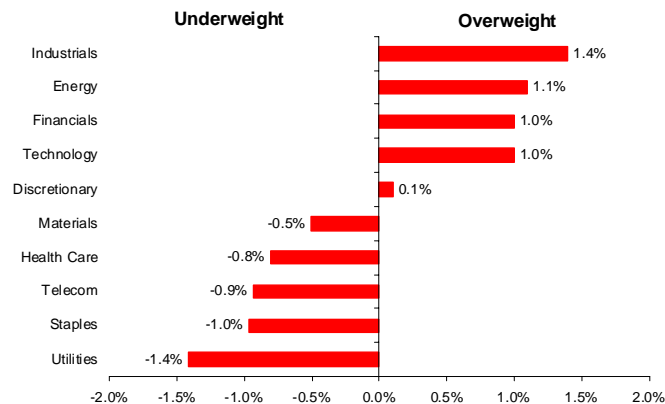
Exhibit 1: Scotia Capital Financial Forecasts

Forecasts	2009	2010	2011 E	2012 E
<b>Equity</b>				
S&P/TSX	11,746	13,443	14,750 ↑	
EPS	600	700	950 ↑	985 ↑
S&P 500	1,115	1,258	1,400 ↑	
EPS	57	83	95 ↑	100 ↑
<b>Interest Rates</b>				
BoC	0.25%	1.00%	1.50%	2.25%
CA 10-Yr	3.61%	3.12%	3.50%	4.10%
Fed Funds	0.25%	0.25%	0.25%	2.00%
US 10-Yr	3.84%	3.29%	3.75%	4.65%
<b>Currencies &amp; Commodities (Yearly Average)</b>				
CAD (USD/CAD)	1.14	1.00	0.95	0.92
EUR-USD	1.39	1.34	1.45	1.48
USD-YEN	94	81	84	90
USD-MXN	13.5	12.4	12.5	12.7
USD-BRL	1.74	1.66	1.65	1.75
WTI	62	80	102	105
Natural Gas	4.17	4.40	4.40	4.75
Copper	2.32	3.42	4.40	4.15
Gold	973	1,225	1,425	1,350

Source: Scotia Capital Estimates; Scotia Economics

The MSCI World AC Index advanced 4% (USD return) in Q1/11, enabling equities to outperform bonds and thus extending the winning streak that started two years ago. Gains in Europe (+6%/USD) and North America (S&P 500 +5%; TSX +8%/USD) outpaced returns in Asia-Pacific ex-Japan (1%/USD) and Latin America (0%/USD). China (A-shares index +5%/USD) led performance among emerging markets (MSCI emerging markets 2%/USD in Q1).

Exhibit 2: Scotia Capital Sector Allocation – Spring 2011



Source: Scotia Capital Estimates; Bloomberg

Bonds (long-term U.S. Treasuries -2.1%; DEX Universe Index +0.3% in Canada) posted flat/negative returns in the first quarter of 2011. Cash (three-month bills) managed to outperform bonds for the second quarter in a row. Government bond performance has been lagging since the global recession ended in Q2/09, and long-term bond performance turned outright negative in Q4/10 and Q1/11. A stronger economic outlook (world GDP expected at +4.2% in 2011), bond outflows, rising inflation pressures, and the potential for tighter monetary policy in the United States and Europe later in 2011 have been hurting bond returns recently.

Equities entered 2011 looking overbought, both on an absolute and relative basis. Moreover, following its 25%+ rebound from last August, the S&P 500 looked poised for a pullback earlier in Q1. Japan's tragic earthquake and social unrest in North Africa and the Middle East did impact risk appetite in early March, but the flight-to-quality was short-lived and well contained. The S&P 500 ended Q1/11 1.3% below its February 1,343 peak and nestled above its 50-day moving average (1,308). Our tactical asset mix indicator is looking more neutral, and we now see much lower odds of a major pullback.

### U.S. Employment Data Is Equity Supportive

The March U.S. payrolls report was an all-around beat: the headline figure came in at +216,000 (versus consensus at +190,000), and private payrolls increased 230,000 (versus 206,000 estimates). In addition, the March unemployment rate eased to 8.8%, hours worked moved up to 34.3, and February data were revised higher. The lower unemployment rate may stem the recent slide in consumer confidence, which is mostly due to rising gas prices.

We view the March U.S. payrolls report as a further sign that the U.S. recovery is sustainable. As long as the trend in U.S. employment improves (lower jobless claims), equities should post positive returns and we will stick to an equity overweight stance. Stronger U.S. payrolls should push yields higher and hurt bond returns, as the next step for the Fed will be to unwind easing (no QE3) and then move to tighten monetary policy (verbally, we expect, in 2H/11; rate hikes expected in Q1/12). Our valuation models point to S&P 500 fair value at 1,420 and U.S. 10-year bond yields of 4.2%. Risk-reward still favours the S&P 500.

### Transitions in Monetary Policy Reshaping Rally

Strong U.S. jobs data is positive for the S&P 500, but the transition to tighter global monetary policy (flattening yield curves, slowing profit growth) will represent a challenge for the higher-beta/risk trade in coming months. Commodities prices may feel heavy if markets link strong U.S. employment data to tightening risks.

In Europe, the European central bank could raise its benchmark rate as early as May 7 (+25 bp to 1.25%). The Bank of Canada (benchmark rate currently at 1%) is expected to resume rate hikes in Q3/11, and the U.S. Federal Reserve (Fed funds at 0.25%) could delay rate hikes to Q1/12. However, verbal tightening (end of QE2) could precede actual Fed rate hikes. The timing of rate hikes remains a matter of debate, but we expect transitions in monetary policy to increase market volatility heading into 2012.

A Q2/12 window for the start of Fed rate hikes would imply a 36-month lag from the end of the last recession (Q2/09), which is slightly longer than the historical lag of 31 months. Although "rate hike" headlines are bound to increase investor anxiety, tangible impacts on bonds (flat/inverted curve) and equities (performance; transportation/utility leadership) typically take hold one year after the start of tightening.

The global transition towards tighter monetary policy should continue to hurt bonds and challenge the equity risk-reward outlook heading into 2012. Global and sector leadership will also narrow. We are not as bullish on equities as we were in 2009 and 2010, but our pro-cyclical bias for 2011 remains unchanged and we expect 8%-10% total return for the S&P 500. Although we recognize this is now the consensus view, being out-of-consensus at the mid-point of the cycle when fundamentals (and U.S. politics) remain supportive can be perilous. When the earnings trend rolls over and the Street complacently dismisses it, it will be time to run against consensus. In the meantime, equity sentiment and flows should remain positive in 2011 as U.S. GDP growth tops 3%, corporate profits rise, and job growth continues. Attractive valuations (S&P 500 forward P/E stands at 13x) and M&A activity also represent supportive drivers.

## Asset Mix and Global Equity Strategy

**Tactical outlook neutral, valuations favour equities.** Our tactical asset mix indicator is currently looking more neutral and our models point to S&P 500 fair value of 1,420 versus 4.2% for U.S. 10-year yields. The S&P 500 is thus 7% undervalued and 10-year bonds are 4% overvalued. This 11 percentage point spread favouring equities warrants an overweight stance, but equities' valuation advantage over bonds is not as compelling as it was in 2009 and 2010. Hence, our core asset mix recommendation for 2011 is still to overweight equities, but the magnitude is smaller than what we were recommending over the past two years.

With short-term interest rates heading higher, the bond-to-cash trade-off doesn't look appealing either, which explains our cash overweight stance.

Relative to our neutral asset mix stance (50% equities–45% fixed income–5% cash), we are positioned as follows: +8% equities (versus +18% in 2009 and 2010), -10% bonds (versus -17%) and +2% cash (versus -1%). See Exhibit 3 for details.

### Our Developed Over Emerging "Tactical" Bias Unchanged for 2011

Exhibit 3: Scotia Capital Asset Mix– Spring 2011 Update				
	Asset Mix		Change from Last Quarter	Expected Total Return Next 12-M
	Benchmark	Recommended		
<b>Equities</b>	<b>50%</b>	<b>58%</b>	<b>0%</b>	<b>8-10%</b>
<i>Canada (TSX)</i>	10%	13%		
<i>U.S. (S&amp;P 500)</i>	15%	20%		
<i>Int'l (Europe, Japan)</i>	15%	18%		
<i>EM-Asia</i>	6%	4%		
<i>EM-LatAm</i>	4%	3%		
<b>Bonds</b>	<b>45%</b>	<b>35%</b>	<b>0%</b>	<b>3%</b>
<i>Government</i>	35%	23%		2%
<i>Corporate</i>	10%	12%		4%
<b>Cash (91-D Tbills)</b>	<b>5%</b>	<b>7%</b>	<b>0%</b>	<b>1%</b>

*Source: Scotia Capital*

Our 2011 global equity preferences have been driven by our belief that diverging monetary policies (EM tightening; Fed still easing/ECB on hold), and fiercer inflation worries in developing economies would lead to temporary S&P 500 outperformance. Since central banks in emerging markets (EM) have intensified tightening measures, and with the Fed on hold, EM leadership has reversed and the S&P 500 has outperformed. When the Fed starts raising interest rates, however, the S&P 500 will lose its monetary edge and EM relative performance should benefit. When year-over-year (YOY) changes in Fed funds move up, EM tends to outperform the S&P 500. Fed funds have been flat since 2009 and this consolidation period has benefited the S&P 500. With the next move likely up for Fed funds, EM leadership could resume in the latter part of 2011 or early 2012. Hence, recent S&P 500 (and DM) leadership should be temporary. Longer term, we do not expect a sustained S&P 500 outperformance cycle until the USD (DXY Index) bear market ends.

### Raising EPS Estimates and Targets

Following Scotia Economics' most recent updates to GDP and commodity forecasts, we have revised our earnings estimates higher. Our top-down S&P/TSX earnings model now yields \$950 (+41% YOY) for 2011 and \$985 in 2012 (+4% YOY). We were previously looking for \$860 in 2011 and \$925 in 2012. Using a 14.7x forward multiple (a 6% premium to the one we use for the S&P 500) on our 2012E earnings, we derive a 12- to 18-month target of 14,750 (was 14,000 previously) for the S&P/TSX Composite Index.

Our top-down S&P 500 earnings model yields US\$95 for 2011 (up from US\$90) and US\$100 in 2012 (was US\$95). Using a 14x forward multiple on our 2012E earnings, our S&P 500 12- to 18-month target goes up to 1,400 (from 1,325).

## Economic Outlook

### Can the Strongest Economy in the G7 Stall on Rate Hikes?

*Derek Holt, CFA - Vice-President, Scotia Capital Economics*

*Gorica Djeric, M.F.E. – Financial Markets Analyst, Scotia Capital Economics*

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

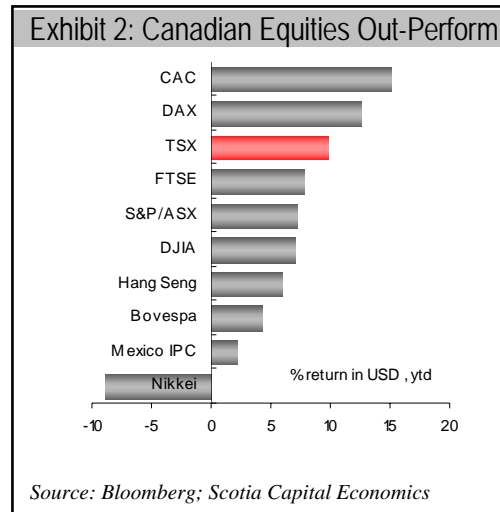
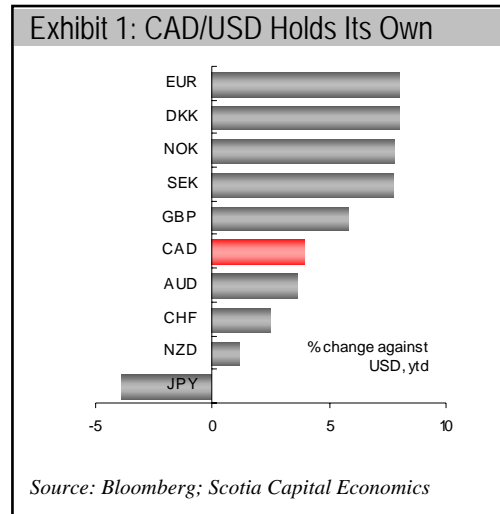
Our recommendation to over-weight Canada in global portfolios on a general asset-allocation bias favouring equities has performed reasonably well so far this year, and we continue to adhere to this recommendation. As Exhibits 1 and 2 demonstrate, CAD has sharply outperformed the dollar block alternatives so far this year, though it has underperformed European currencies and the Mexican peso. The TSX has outpaced key Asian and US benchmarks but underperformed ex-UK Europe. Over-weight doesn't mean Canada has to be a world-beater on all counts – just that it performs better than enough of the alternatives in order to deserve an over-weight allocation within portfolios.

Going forward, despite the fact that Scotia Economics is forecasting a slower-than-consensus pace of rate hikes by the Bank of Canada, Scotia Economics/FX remains the most bullish on the street with respect to CAD's prospects and we expect it to appreciate to eight full cents above parity into 2012. That continues to support our over-weight recommendation on Canadian portfolios into next year. Backing this CAD forecast are our concerns about the US fiscal position, both in the short-term as well as the longer run, that should diminish appetite for USD denominated Treasuries and by corollary continue to boost CAD. Also supportive of CAD are over-shooting risk on momentum, our forecasts for elevated commodity prices, and Canadian balance sheet advantages compared to other global economies.

Thus, it is despite our views on the Bank of Canada that we expect further CAD appreciation. We think the BoC will commence raising rates later than markets expect, will do so at a muted pace when they do start raising again, and that the end point for the Bank of Canada's overnight rate will be lower in 2012 than it would have been in comparable past cycles. A key portion of our reasoning behind this view entails delving into why we don't think narrowing spare capacity will by necessity trip inflation concerns, a variety of mild current inflation readings, and weak overall evidence that low rates are encouraging speculative activity.

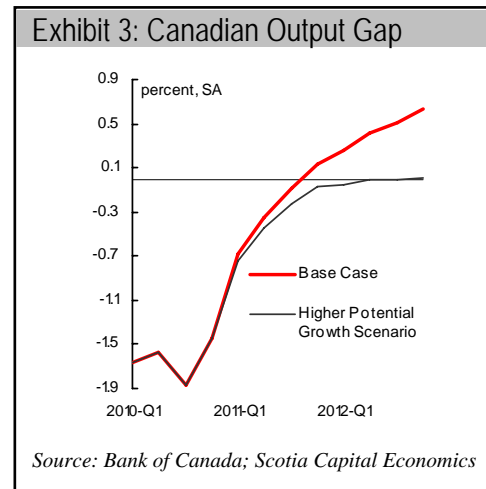
#### Less Spare Capacity Doesn't Mean A Need For Strong Rate Hikes

Because 2010Q4 growth over-shot BoC expectations by a full percentage point, and growth in 2011Q1 could come in slightly higher than the BoC's April forecast for Q1 annualized growth of 4.2%, the output gap (the sum total of current excess capacity in the Canadian economy that helps to keep inflation at bay) is closing off faster than the BoC last assumed in the January Monetary Policy Report and likely still faster than their revised forecast of mid-2012 (April's Monetary Policy Report). Indeed, it looks probable that spare capacity in the Canadian economy disappears by late this year or early next as measured solely by the output gap. Exhibit 3 provides our updated forecast for the output gap. But there are five reasons



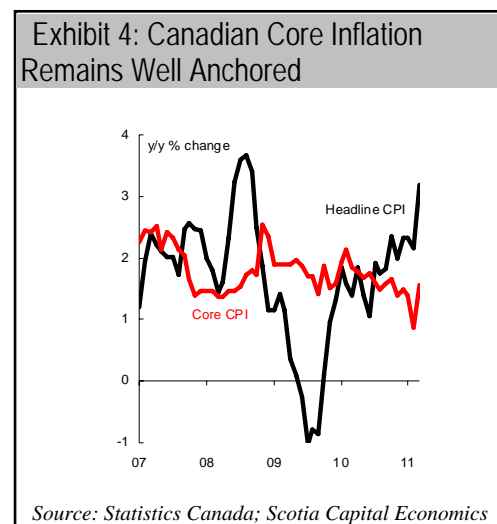
why these shifting dynamics do not mean inflationary pressures are creeping higher nor that they lie just around the corner in a manner that risks breaching the BoC's 1-3% policy band sooner and thus adding to rate hike expectations:

- Our measure of excess demand by 2012 is modest (Exhibit 3). Historically, large swings in inflation readings have generally required large swings in output gap readings to occur, but our fresh output gap forecast only foresees a move into modest excess demand by the end of next year. Indeed, given measurement problems, one cannot say that there is compelling evidence that the economy does anything other than remain near balance in 2012 as opposed to shifting more rapidly into excess demand.
- Price pressures do not occur immediately in response to an economy closing off spare capacity. The usual relationship is roughly a one year lag for this to occur. So, if modest excess demand occurs into 2012, it isn't clear that inflationary pressures build on both headline and core until 2012H2 or later. If monetary policy operates with about a one year lag, then that would be consistent with our view that the BoC begins hiking again only by October.
- Lagged output gaps are tenuously correlated with inflation readings in any event. The relationship was tightest before the BoC adopted inflation targeting in the early 1990s. Since then, a combination of pre-emptively targeting stable inflation, disinflationary external sector influences, and factors resulting in sticky wages and prices have all combined to complement the role of output gaps in driving inflation.
- The BoC's revised forecasts shows that growth is being front-loaded in this cycle and therefore growth momentum will rapidly wane over 2011H2-2012 and with it the pace of improvement in the output gap will also materially slow. There is considerable merit to this view, as reflected in the Scotia Economics quarterly Canadian GDP forecast.
- Lastly, there is no compelling pressure on current inflation readings that would spark alarm over the faster than expected pace by which excess capacity is being closed off – something we'll focus upon next.



### No Rush To Tighten In Terms Of Current Inflation Readings

One would be remiss in failing to point to actual evidence which indicates that current inflation readings in Canada are sharply different than the inflation pressures that are building in Asia, across emerging markets, and in parts of Europe (Exhibits 4-9). While Canadian headline inflation pushed above the BoC's upper target range of 1-3% y/y in the most recent report for March, supported by commodity price gains once again, core inflation, even with the unexpected jump to 1.7% y/y, still remains quite low. Add to this the fact that some of the gain in core inflation (yoy) can be explained away by the February 2010 Vancouver Olympics as prices temporarily jumped last February, reversing course the following month, resulting in an accompanying base effect this past March. Nonetheless, we are also seeing the disappearance of the dampening effect from the HST refunded credits which will bring core inflation back up from artificially low levels although CAD cheapening of import content and crowding out of core pricing power by virtue of higher energy and grocery bills (Exhibit 4) will likely keep core inflation well



anchored. Further, research points to how CPI overstates actual inflation on the order of 0.6% by not fully controlling for substitutability of items within the consumer price index. There is therefore no compelling case out of current inflation readings to shift toward a hawkish bias.

As for finished producer goods prices, we're barely creeping back above the zero marker on y/y terms, and well shy of the 4-10% pre-crisis ballpark (Exhibit 5). Pipeline inflationary pressures through raw and intermediate goods prices are being absorbed in margins. "Business inflation expectations have crept higher but remain reasonably comfortable (Exhibit 6). In any event, business inflation expectations probably speak more to business input costs that in turn are being absorbed in margins and not passed on, as opposed to pressures consumers will face.

Further, business expectations are formed through adaptive measures rooted in extrapolating what has already happened, as opposed to a forecast of what might actually happen."

Further, there is no cost-push labour market pressure since average hourly wages for permanent employees have sharply decelerated from the nearly 5% mark just prior to the crisis to about half that and hence among the weaker readings of the full past cycle (Exhibit 7). Unit labour costs are accelerating, but gently so from a small decline early last year to just shy of 2% y/y on weak base effects, and far weaker than the 4-5% pre-crisis peaks (Exhibit 8). Market expectations, defined by the spread between Canadian nominal bonds and real return bonds, have risen from the depths of the global deflation worries but also the safe haven bid that distorted nominal yields more than real yields, while the spread remains well within historical norms and inside the BoC's 1-3% inflation target band (Exhibit 9).

Exhibit 5: Little Pass-Through Into Finished Producer Goods

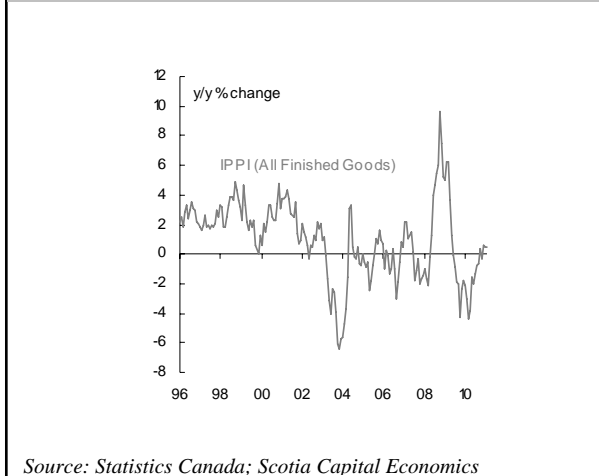


Exhibit 6: Inflation Expectations

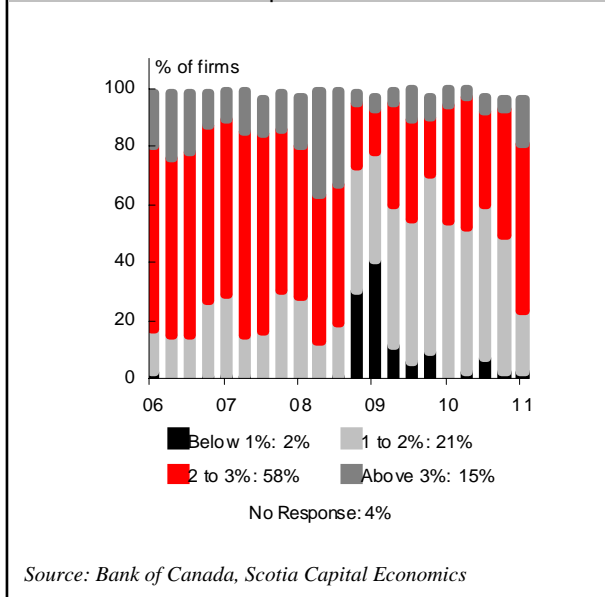
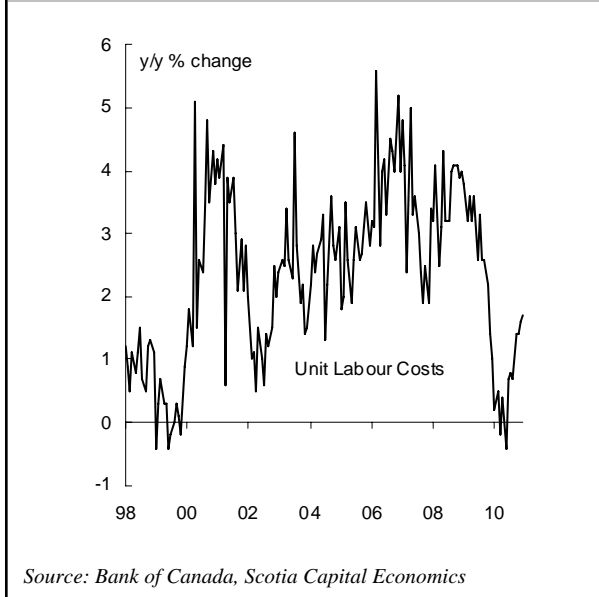
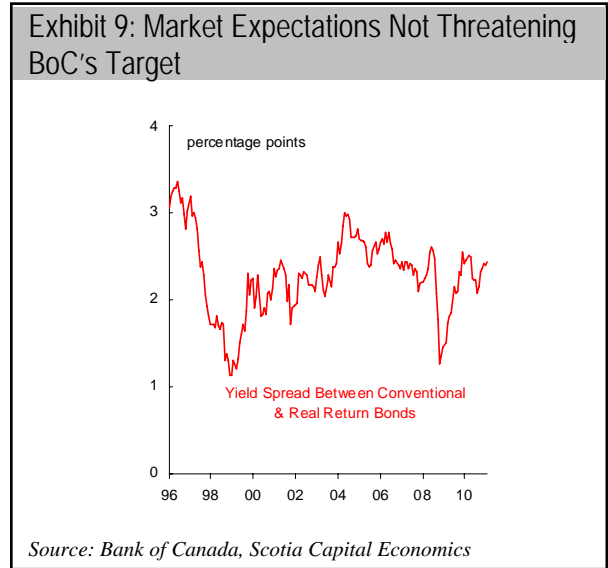
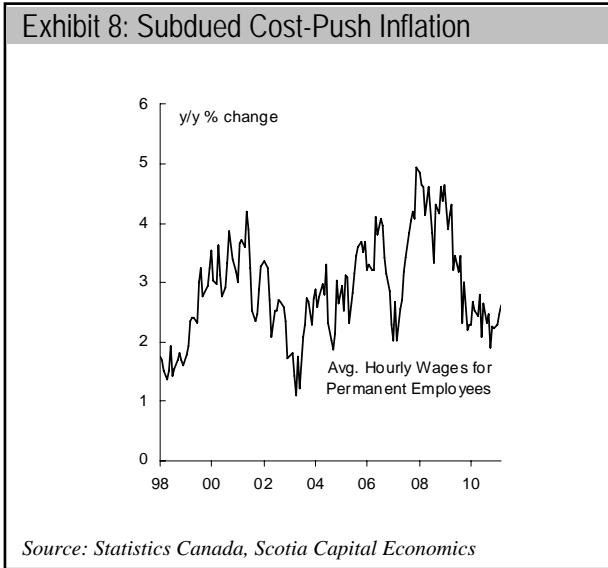


Exhibit 7: Little Labour Cost Pressure

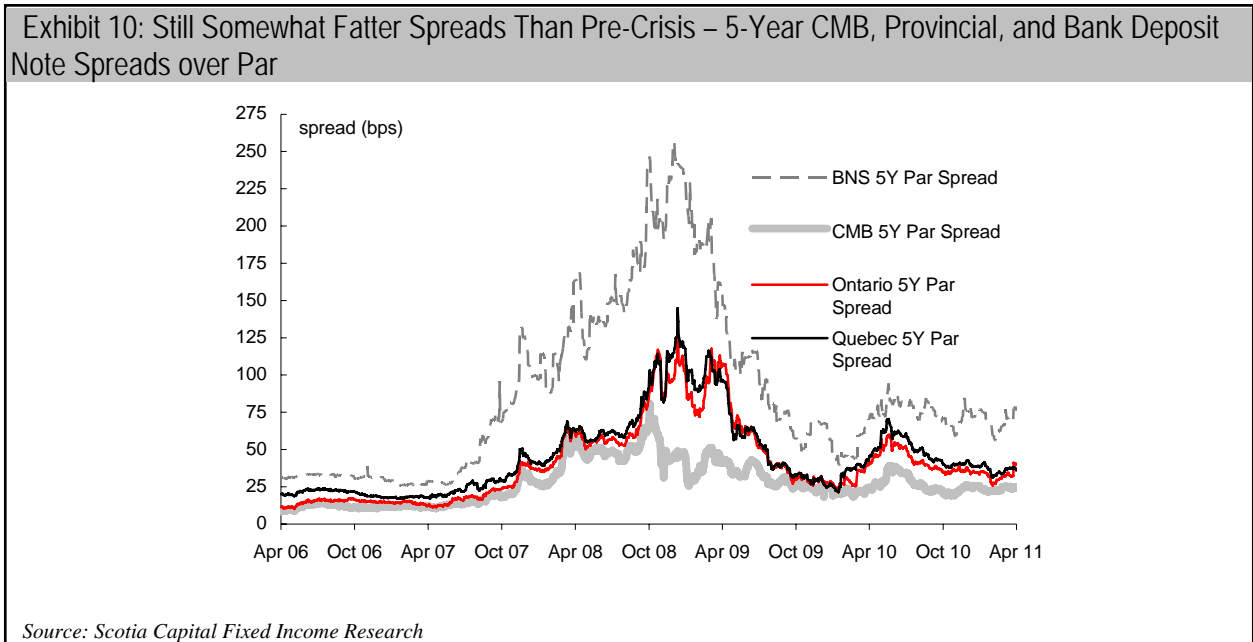


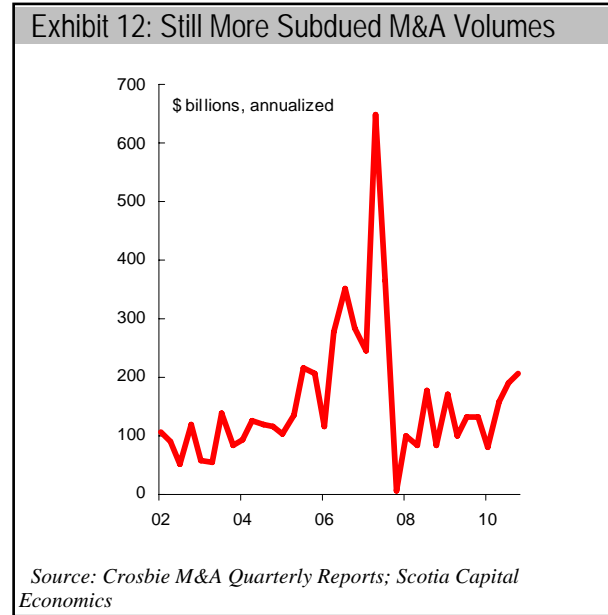
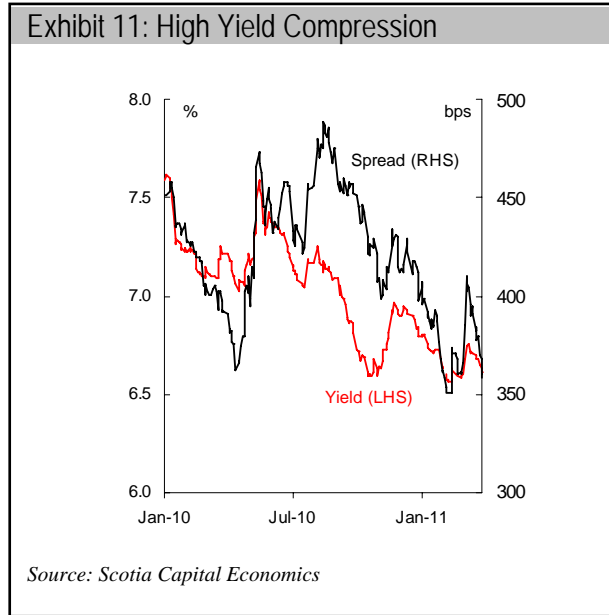


**Too Low for Too Long?**

One of the Bank of Canada’s additional concerns relates to the perils of operating at low interest rates for too long a period of time in a manner that could skew risk taking and create future imbalances that could unwind in damaging ways to the economy. If rampant speculation were occurring, this could add to pressure on the BoC to hike rates more aggressively. We briefly survey some of the Canadian evidence on this count, and conclude that while it’s mixed, on balance the concern is exaggerated at this point but bears continual monitoring.

On credit spreads, in contrast to a strong desire to push pricing to the limit, a lack of conviction exists across accounts. Credit spreads are much thinner than they were during the crisis period, but remain materially wider than pre-crisis benchmarks across provincial bonds, CMBs, and bank deposit notes (Exhibit 10). The chase for yield has stopped out at wider spreads than previously. A possible exception is high yield spreads, but Canada largely lacked a high yield market place until recently so drawing comparisons to pre-crisis spreads and yields is difficult at best (Exhibit 11).





Spreads in the interbank market defined by the gap between CDOR and OIS sit at 27bps in Canada and, while vastly narrower than they were during the crisis, they remain wider than the single digit basis point readings that characterized pre-crisis markets. Thus, Canadian bank funding costs have improved sharply, but are not as leanly priced over market as they were pre-crisis.

Economy-wide merger and acquisition volumes have picked up over the past year but remain far below their pre-crisis peaks (Exhibit 12). Incidentally, this same argument holds true in the US and globally with data until the end of February.

Further, growth in money supply and household credit variables has sharply decelerated.

In conclusion, if there is speculative excess in some respects, in our view it lies in CAD over-shooting fundamental drivers. The strong prospect that this will continue has caused more unease at the BoC with downside implications to both inflation through import-effects and growth, outweighing the risks of feeding speculative excess through low interest rates. In short, there are already various forms of tightening in place in the Canadian economy including CAD, fiscal policy, tighter mortgage rules, rising bond yields, and the impact of higher commodity prices in crowding out other types of discretionary spending. To add to these forms of tightening through premature BoC rate hikes would impose excessive tightening on the economy in our view, especially given evidence of operating at cycle tops in the household sector of the economy.

## Feature Article - Preferred Shares Strategy

### Basel III Implementation Changes the Playing Field

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

During the most recent credit crisis certain non-Canadian financial companies were unable to maintain adequate capital levels without government assistance. In response to this past experience, regulators have created an international framework, which includes new capital guidelines to help protect against any future economic or financial crisis. The new requirements were agreed on by the Basel Committee on Banking Supervision (BCBS) on December 16, 2010 and are collectively referred to as "Basel III".

The Basel III rules require institutions to meet minimum requirements to ensure all regulatory capital, and not just common equity, have mechanisms to absorb losses in the event the entity should become non-viable. Furthermore, there have been changes as to which instruments are eligible as regulatory capital, and the rules provide a transition and phase-out for instruments that do not meet Basel III requirements. These rules apply to banks, bank holding companies and federally regulated trust and loan companies. They do not apply to regulated life insurance companies or insurance holding companies. Life insurance companies expect to be regulated under a similar framework starting in 2014.

On February 4th, 2011, the Office of Superintendent of Financial Institutions of Canada (OSFI) noted its intention to adopt the rules set forth in Basel III in Canada. With these new rules confirmed, all outstanding Bank Capital Trust/Tier 1 securities and bank preferred shares are affected, as they are considered non-qualifying capital and their eligibility as Tier 1 capital will be phased out to comply with the new regulations.

#### Phase-Out of Current Tier 1 Capital Securities

Instruments that no longer qualify as Tier 1 capital will have their capital treatment phased out over a 10-year period beginning January 1, 2013. To start the phase-out, a “cap” will be established for each company based on the total amount of outstanding non-qualifying Tier 1 as of January 1, 2013. Each company will only be able to recognize 90% of the original cap amount as regulatory capital on January 1, 2013. Additionally, the cap will decline by 10% of the original amount each subsequent year as displayed in the table.

This phase-out method for non-qualifying capital instruments can be considered a pooled approach rather than an individual security approach. To obtain a better understanding of the phase-out approach, consider the following example of how Tier 1 capital will be affected in a specific company.



**Exhibit 2: Phase-Out of Current Tier 1 Capital Securities**

Fiscal Reporting Period	Applicable Cap
Q1 2013	90%
Q1 2014	80%
Q1 2015	70%
Q1 2016	60%
Q1 2017	50%
Q1 2018	40%
Q1 2019	30%
Q1 2020	20%
Q1 2021	10%
Q1 2022	0%

Source: OSFI-BSIF

Example: ABC Financial Company (ABC)

As of January 1, 2013, ABC has \$10 Billion worth of Tier 1 capital securities outstanding all of which is considered non-qualifying capital. Therefore, for fiscal reporting of the first quarter of 2013 only \$9 billion (90% x \$10 billion) will be eligible to included as Tier 1 Capital on the company's balance sheet. The amount of non-qualifying Tier 1 in excess of the \$9 Billion limit will not be included as regulatory capital.

The following year (2014), ABC will only be allowed to include \$8 billion (80% x \$10 Billion) out of the original \$10 billion as regulatory capital. This process will continue until 2022 when none of the original \$10 billion of non-qualifying capital will be included as regulatory capital.

During the phase-out period (2013-2022), various financial institutions will have Tier 1 bonds maturing and/or preferred shares being redeemed at their call dates. As bonds mature and preferred shares are redeemed the amount of non-qualifying capital outstanding for the company will diminish, thus reducing or temporarily eliminating the amount of excess capital that will not be included as regulatory capital.

**Impact on Outstanding Tier 1 Capital Bonds**

Following the release of the OSFI guidance, the Canadian banks announced their intentions with respect to the various Tier 1 securities outstanding. Based on these announcements the following securities are not anticipated to be redeemed prior to the call date mentioned.

Exhibit 3: Phase-Out of Current Tier 1 Capital Securities		
Security	Maturity Date	Anticipated Call Date
BMO Capital Trust 10.221%	December 31, 2107	December 31, 2018
BNS Capital Trust 7.802%	June 30, 2108	June 31, 2019
CIBC Capital Trust 9.976%	June 30, 2108	June 30, 2019
TD Capital Trust 6.631%	June 30, 2108	June 31, 2021
TD Capital Trust 9.523%	June 30, 2108	June 30, 2019

Source: ScotiaMcLeod

However, Canadian Imperial Bank of Commerce and Toronto Dominion Bank are expected to exercise early par redemption rights in 2022 on the following securities:

- CIBC Capital Trust 10.25% due June 20, 2108 (callable 2039)
- TD Capital Trust 10.00% due June 30, 2108 (callable 2039)

Effectively, the Tier 1 bonds outstanding in the market are now trading based on their anticipated call dates.

**Impact on Outstanding Bank Preferred Shares**

Based on the notion that outstanding bank preferred shares are considered non-qualifying capital and their eligibility will be phased out accordingly, financial institutions now have a greater incentive to redeem some of their preferred shares.

**Retractable Preferred Shares**

There are only two bank retractable preferred shares outstanding (TD.PR.M & TD.PR.N) and it is expected that the issuer will call these securities between now and their par call date.

### Rate Reset Preferred Shares

These preferred shares are redeemable at the option of the issuer on the reset date and every five years thereafter at par value (\$25.00). Each security has its own reset spread where the dividend will be reset over 5-year Government of Canada bond if not called by the issuer at the reset date. Those issues which have a higher reset spread have the highest probability of being called as these issues will be the most expensive for the issuers to continue dividends past the call date.

Based on the bank rate resets outstanding in the market it is anticipated that most issues will be called at the first reset date as banks will be able to refinance at a cheaper rate. Additionally, with the phase-out starting in 2013, there will be less room for a company to carry non-qualifying capital. However, it should be noted that the rate reset preferred shares which have a lower reset spread could be extended past the first call date.

For example, Bank of Nova Scotia (BNS) 3.85% Series 30 has a reset date of April 26, 2015 and if not called at this time the dividend will reset at Government of Canada 5-year bond yield + 1.00%. Factors such as (1) the refinancing rate that BNS would use to issue a new preferred share at that time, (2) the bank's upcoming maturity schedule and (3) the amount of regulatory capital that can be included as Tier 1 capital will affect BNS's decision to either call or extend this particular security. It should be noted that depending on the amortization of the capital pool, this security has the potential to be extended and still qualify as Tier 1 capital.

In essence, each Canadian bank will play a balancing act throughout the phase-out period to determine which securities are in their best interest to leave outstanding and which securities would be the most beneficial to redeem.

### Straight Perpetual Preferred Shares

This type of preferred share pays a fixed dividend in perpetuity. Although there is a call schedule which allows the issuer to redeem these shares, before the Basel III changes, it was viewed that these securities would not be redeemed as the current dividend rate on most of the outstanding issues are more attractive than refinancing options. After OSFI announced its intentions to comply with the Basel III guideline, straight perpetual preferred shares that were trading at discounts to par saw price improvements as there is now a much higher probability of these securities being called.

Following the phase-out of non-qualifying capital, the banks are likely to consider redeeming some of their straight perpetuals. It is expected that the issuer redeem those securities with the highest dividend first and work to the lower dividend paying perpetuals as long as it still makes sense for the company to redeem the securities.

As an example, Royal Bank Series AA has a fixed dividend rate of 4.45%. The Basel III guidelines dictate that as of January 1, 2022 none of the outstanding bank preferred shares are treated as regulatory capital. Therefore, in 2022 this specific security could stay outstanding yet it would not count on the company's balance sheet as Tier 1 Capital. In order to determine the likelihood of this particular security being redeemed it should be compared to the yield on a Royal Bank long-term deposit note. Dividends are paid from the company's after-tax dollars and thus using a corporate tax rate of 30% a 4.45% dividend rate is an interest equivalent of 6.36% ( $4.45\% / (1 - 0.30)$ ). Therefore, if in 2022 Royal Bank cannot issue a long-term deposit note at a rate below 6.36%, the company may consider leaving this preferred share outstanding as a source of financing. Furthermore, leaving a preferred share outstanding might be more attractive than issuing a deposit note, as the preferred share allows the issuer to call the security at par at anytime once past the initial par call date. This feature increases the flexibility for the issuer regarding redemption.

Demonstrated in the example above there are many factors which affect the likelihood of the bank perpetual preferred shares being called. It is fair to say that the banks are likely to redeem some of their outstanding perpetuals as the higher dividend rate securities will become expensive financing if not eligible as regulatory capital.

### Future Issuance of Tier 1 Capital Securities

Tier 1 capital instruments are intended to be permanent and are usually comprised of common shares, retained earnings and qualifying innovative instrument (Tier 1 bonds) and non-cumulative perpetual preferred shares. Banks are required to hold sufficient capital to ensure that an unexpected loss will not cause losses to the bank's depositors and senior creditors. BCBS has set a minimum of 8.00% total capital and 6.0% Tier 1 Capital. Based on the first quarter's earnings release Canadian banks are well above the minimum Tier 1 Capital threshold as seen in the table.

Looking forward, any capital instruments issued after January 1, 2013 must meet all of the Basel III criteria in order to qualify as regulatory capital. Post 2013, newly issued Tier 1 bonds and preferred shares are required to include a feature that allows for the conversion to common shares when OSFI feels the firm is at the point of non-viability. It is expected that OSFI will not convert these securities if it felt that the firm could be not saved with the conversion. Furthermore, upon conversion the capital security holders will essentially own a major portion of the firm, and that the restructured entity will be strong enough to continue to exist as a going concern.

Meanwhile, in the near term, banks still have the ability to issue the current form of Tier 1 bonds or preferred shares. We have seen this happen; on March 9th, 2011 the Bank of Montreal (BMO) issued a rate reset preferred share with an initial dividend rate of 3.65% until August 25, 2016. If not called at this time the dividend rate will be reset at Government of Canada 5-year bond yield +1.15%. Based on BMO's original Tier 1 base level, this security has the ability to garner full capital treatment until the first call date. It is expected that banks add the required conversion provisions into new issues closer to the 2013 date.

It is expected that OSFI will continue to provide further guidance in the coming quarters as we approach January 1, 2013. As more clarity is provided it is important to discuss your specific holdings with your ScotiaMcLeod advisor who can analyze your situation and make you aware of any upcoming redemptions that make take place in your portfolio.

Issuer	Q1 Tier 1 Capital Ratio
Bank of Montreal	13.0%
Bank of Nova Scotia	11.8%
Canadian Imperial Bank of Commerce	14.3%
Laurentian Bank	10.9%
National Bank of Canada	14.6%
Royal Bank of Canada	13.2%
Toronto Dominion Bank	12.7%

*Source: Scotia Capital*

## Canadian Equity Strategy

### America's Road Toward Energy Independence Travels Through Canada: Investment Ideas Arising from President Obama's Energy Policy

Himalaya Jain, CFA – Director, Portfolio Advisory Group

On March 30, 2011, U.S. President Obama unveiled his administration's energy policy that aims to reduce America's reliance on foreign oil imports by boosting domestic oil production in the near term and developing alternative energy sources for the long term. We note that every U.S. president over the last 40 years has talked about freeing the U.S. from dependence on foreign oil, and yet oil imports remain at approximately 50% of U.S. oil consumption (Exhibit 1). Quantifiable targets in Obama's energy policy included:

- One-third reduction in oil imports by 2025, measured from the beginning of Obama's presidency (January 2009)
- By 2035, 80% of electricity should come from cleaner sources, such as wind, solar, efficient natural gas, clean coal, hydro electric, and nuclear

Obama's energy policy made it clear that while overall oil imports will be targeted for reduction (i.e. Middle Eastern oil), there will be greater reliance placed on America's neighbours (and friends): Canada, Mexico, and Brazil. Clear for Canadians, but purposely left unmentioned in Obama's speech, was that the Canadian oil sands would play a prominent role in meeting America's oil demand in the future. Canada is already America's largest single supplier of oil, with further development of oil reserves expected to boost this relationship further (Exhibit 2).

While political pontification rarely translates into actionable investment ideas, we think Obama's energy policy aligns well with Scotia's equity portfolio strategy and the views of some of our sector analysts. With Obama's energy policy having little impact in the near term, we expect the ongoing economic recovery to drive oil demand and prices (see Exhibit 3). In the medium term, we think that nuclear energy will have recovered from the negative sentiment resulting from the damaged nuclear power plant in Japan. During this time horizon, we expect the push towards cleaner electricity sources will be beneficial for wind/solar equipment suppliers. Obama's energy policy will likely prolong the rally for certain food commodities, and fertilizers, through an expanding bio-fuel market. And finally, a sustained commitment to convert trucks and buses to natural gas may prove to strengthen long-term natural gas prices. Increasing dependence on natural gas fired electric power plants should also boost long-term demand for natural gas. With these broad themes in mind, we highlight several short- and medium-term investment ideas.

Exhibit 1: Oil Imports Remain Stubbornly High

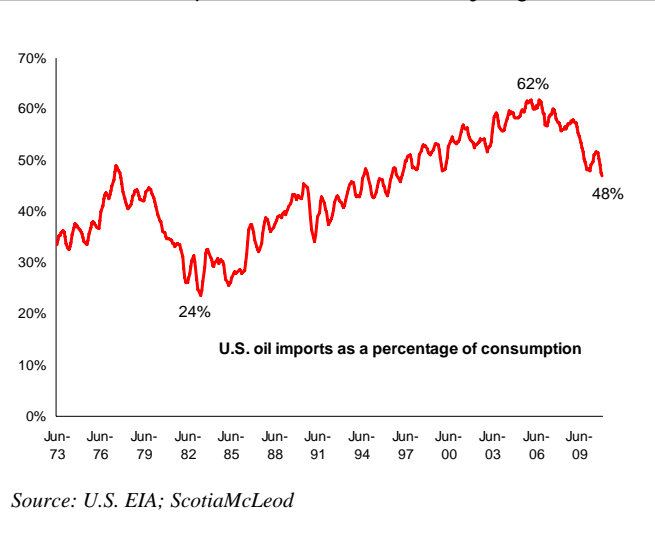
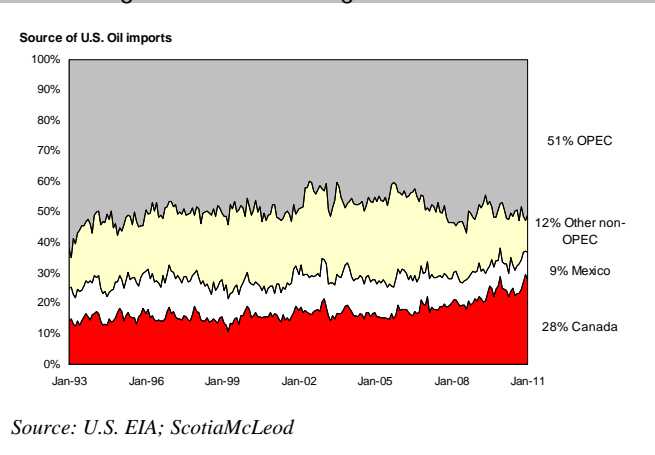


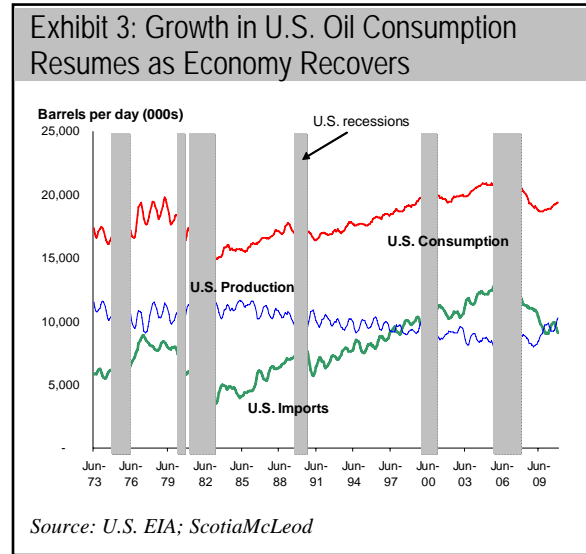
Exhibit 2: America's Dependence on Canadian Oil is Growing; Mexico is Waning



Short-term investment ideas:

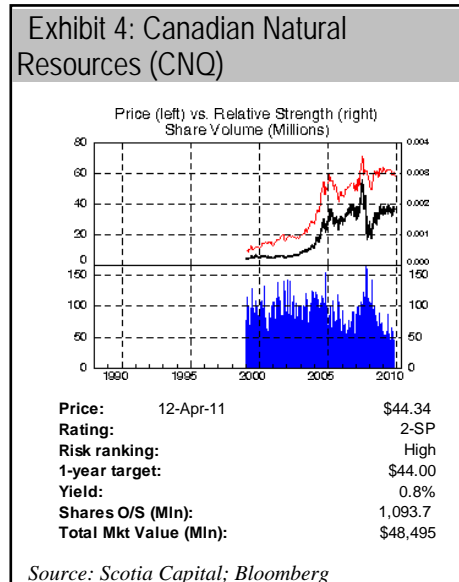
**Energy (Oil and Nat Gas)**

Share prices for oil exploration and producing companies have followed oil prices up in recent months, thereby limiting near-term expected returns. According to some analysts, current share prices are discounting oil prices of US\$80-US\$90/barrel. The Scotia Capital energy team is currently using US\$90/barrel for 2011 and US\$85/barrel for 2012 in the valuation of companies in their coverage universe. These prices are predicated on near-term U.S. dollar weakness, but also tempered by a more moderate pace of global economic growth over the next two years. Should the pace of global economic recovery be stronger than expected, we expect oil price forecasts and oil equity valuations to trend higher.



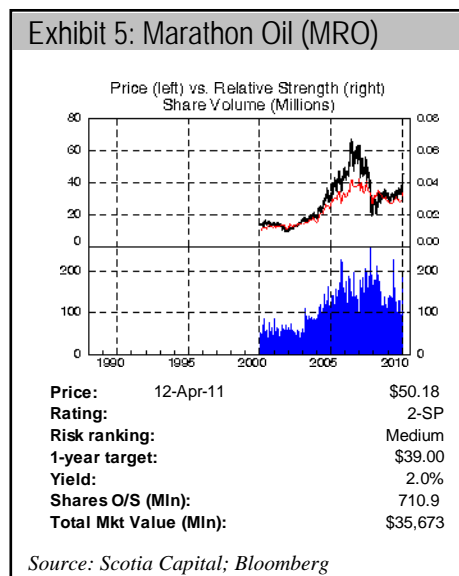
**Canadian Natural Resources (CNQ) – Lower initial production at Horizon is priced-in**

Canadian Natural Resources is deeply rooted in the Canadian energy industry and, through growth involving both property and corporate acquisitions, has become one of the dominant producers in Western Canada. CNQ expanded internationally with the purchase of Ranger Oil, which provided production in the North Sea and offshore West Africa. It is also transitioning into oil sands through its Horizon oil sands venture. The company recently reduced 2011 oil production guidance by 13% due to a 55% reduction at Horizon and an 8% reduction in West Africa. The company expects Horizon to reach half capacity (55,000 bbl/d) in Q2/11 and full capacity (110,000 bbl/d) in Q3/11.



**Marathon (MRO US) – Spin-off of refining business is positive catalyst**

Marathon Oil Corporation is an integrated international energy company with operations in the US, Canada, Africa, Europe, Equatorial Guinea, Libya and the North Sea. MRO's production is over 60% weighted toward crude oil which includes its 20% interest in Shell Canada's Athabasca Oil Sands mining project. Marathon also has a refining business and the company's retail network encompasses 1,600 Speedway SuperAmerica and 4,600 Marathon-branded sites. Earlier this year, MRO finalized the decision to spin-off its refining business. The spin-off, anticipated to be effective June 30, 2011, will create a refining company (MPC) which is expected to be the fifth largest U.S. refiner. The upstream operations will continue as MRO with the company's current exploration and production asset portfolio. Shareholders will receive 1 MRO share and 0.5 shares of MPC.



**ARC Resources (ARX) – World-class resources with significant un-booked potential**

ARC possesses large resources with visible inventory, plus a track record of efficient risk management and capital execution. ARC’s Montney resources in Northeast British Columbia offer >9.2 tcf of discovered petroleum in place, versus only 3% produced to date and 9% booked on proven and probable reserves. Talisman Energy’s recent JV deal with Sasol Limited attests to the scale and potential of ARC’s Montney position. Driven by new infrastructure at Dawson Plant 2 and Ante Creek, our estimates suggest ARC offers production growth per share in the range of 14% for 2011E. We anticipate the reserves book may similarly benefit from these organic initiatives over the next couple of years. We note ARC offers exposure to further resources at Pembina, in Southeast Saskatchewan, and also to emerging potential in the Swan Hills/Beaverhill Lake complex in Northern Alberta.

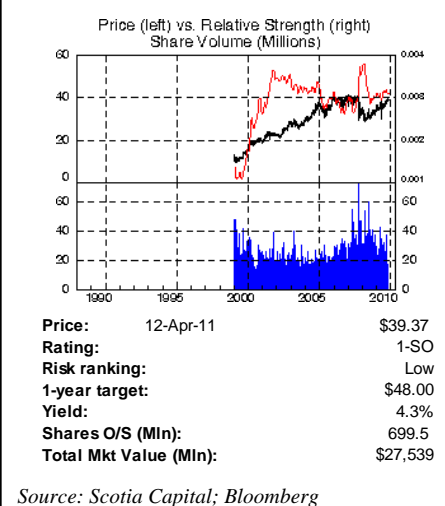
Exhibit 6: ARC Resources (ARX)



**TransCanada Corp. (TRP) – Top pick in the pipeline sector**

TransCanada Corp. owns and operates the largest Canadian gas pipeline (Mainline) and Alberta’s largest gas-gathering pipeline system (Alberta System). TRP also owns several equity and master limited partnership (MLP) interests in U.S. pipelines, 100% of a gas co-generation plant in the U.S. Northeast (Ocean States), 47.9% of Bruce Nuclear A, and 31.6% of Bruce Nuclear B. The Japan nuclear crisis temporarily weighed on TRP’s stock due to the company’s investment in two Ontario nuclear asset leases. TRP is well-positioned for the evolving energy environment going forward with its extensive gas pipelines and growing wind and co-generation assets.

Exhibit 7: TransCanada Corp. (TRP)



**Fertilizers / Agriculture**

Compounding strong food demand, particularly from emerging markets, elevated oil prices have boosted prices for biofuels, combining to drive fertilizer demand higher. In 2009, global biofuels production reached 22 billion gallons, 85% of which was food-based ethanol production. In recent years, a major driver of fertilizer price growth has been various mandated future biofuel blending requirements for gasoline. The explosive growth of corn-based ethanol production in the U.S. now accounts for about one-third of U.S. corn production. However, as a means to control food price inflation, governments around the world have responded with caps to incremental food for fuel use. Over the long term, and with all else equal, our analyst thinks fertilizer demand growth could decelerate if biofuels production moves away from food-based crops, such as corn, soybeans, and sugar cane, and towards second-, third-, and fourth-generation non-food-based. Expected delays to the development (likely until 2014-2015) of second-generation U.S. ethanol capacity should be positive for U.S. corn prices and fertilizer prices.

**Agrium Inc. (AGU) – Fertilizer bull market continues**

Agrium Inc. is the largest retail supplier of agricultural products and services in North America, a major producer of nitrogen, phosphate, and potash, and a supplier of specialty fertilizers in North America. Agrium’s agricultural retail presence consists of nearly 1,000 outlets, scattered mostly throughout the United States, with some in Canada and South America. Its wholesale operations consist of 8.7 million (net) tonnes of capacity: 62% nitrogen, 24% potash, and 14% phosphate. The USDA’s 2011 Prospective Plantings report offers near-term support for fertilizer stocks, particularly North American nitrogen (Agrium and CF Industries). Specifically, corn and soybean inventories were below expectations and estimated planting for corn was above expectations.

**Viterra Inc. (VT) – Weather related headline risk represents buying opportunity**

Viterra is a global agri-business, with operations across Western Canada, Australia, New Zealand, and the United States and plans to build a canola crushing facility in China by the end of 2011. Viterra has three business segments (Grain Handling and Marketing, Agri-products, and Processing) which are vertically integrated to maximize its ability to connect producers and their commodities with end customers. The company reported strong Q1/11 results that beat consensus. Scotia’s analyst expects Q2/F11 to be a softer quarter and is somewhat cautious ahead of the Canadian planting season due to flood risk. Weakness in share price may present a buying opportunity.

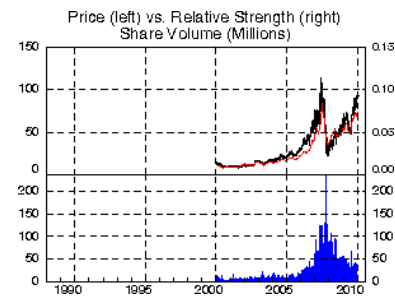
**Medium-term investment ideas:**

The push to generate more electricity from cleaner sources cannot ignore nuclear power. Despite the nuclear crisis resulting from the earthquake in Japan, “we can’t simply take it off the table” (President Obama, March 30, 2011). Nuclear power currently supplies 20% of America’s electricity needs through 65 nuclear power plants. There are 436 commercial nuclear power plants globally. We suspect that the situation in Japan will further delay the 15 nuclear reactors that are currently under review in the U.S. Even before the Japanese earthquake, nuclear’s share of overall U.S. electricity generation was forecast to decline to 17% by the year 2035.

**Cameco Corp. (CCO) – Stability should return once crisis in Japan comes under control**

Cameco is one of the world's largest uranium producers accounting for about 16% of the world's production from its mines in Canada and the US. The company’s leading position is backed by about 480 million pounds of proven and probable reserves and extensive resources. Cameco holds premier land positions in the world's most promising areas for new uranium discoveries in Canada and Australia as part of an intensive global exploration program. Shares of Cameco have declined 20% since

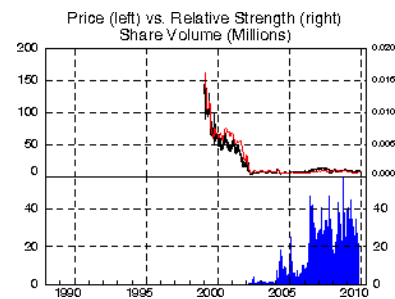
Exhibit 8: Agrium Inc. (AGU)



Price:	12-Apr-11	\$85.69
Rating:		1-SO
Risk ranking:		High
1-year target:		\$111.00
Yield:		0.1%
Shares O/S (Mln):		157.7
Total Mkt Value (Mln):		\$13,513

Source: Scotia Capital; Bloomberg

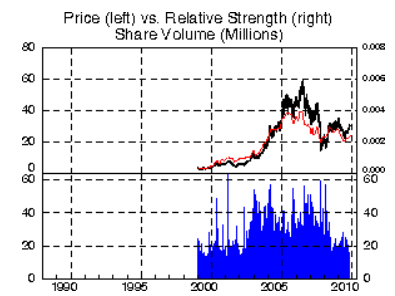
Exhibit 9: Viterra Inc. (VT)



Price:	12-Apr-11	\$11.58
Rating:		2-SP
Risk ranking:		Medium
1-year target:		\$12.50
Yield:		0.9%
Shares O/S (Mln):		371.7
Total Mkt Value (Mln):		\$4,304

Source: Scotia Capital; Bloomberg

Exhibit 10: Cameco Corp. (CCO)



Price:	12-Apr-11	\$27.18
Rating:		No Coverage
Risk ranking:		N/A
1-year target:		N/A
Yield:		1.5%
Shares O/S (Mln):		394.5
Total Mkt Value (Mln):		\$10,724

Source: Scotia Capital; Bloomberg

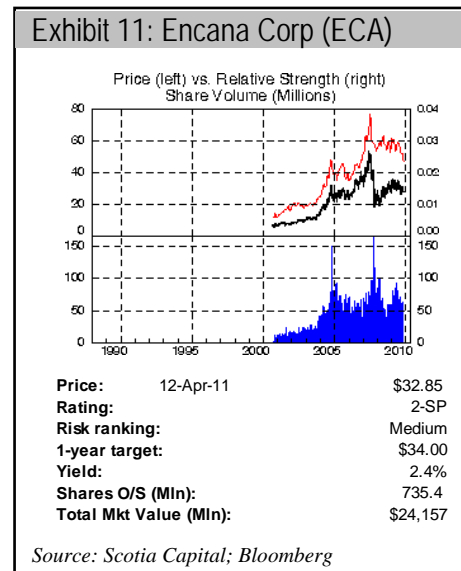
the March 11, 2011 earthquake in Japan. While the sentiment for nuclear power and uranium producers may remain depressed in the short term, the eventual containment of the leak at the Fukushima plant and ensuing port-mortem should mark the beginning of a recovery. We highlight the need for caution and patience with this medium-term opportunity.

**Natural Gas**

Natural gas prices are expected to remain range-bound due to above-average storage levels and a relatively high rig count this year and into 2012. The demand side of the equation for natural gas is expected to show mild growth in 2012, coming mainly from electricity generation and increased industrial activity. With significant North American reserves of natural gas, we expect natural gas should gain share over coal and nuclear in terms of U.S. electricity generation. Natural gas as a transportation fuel may see further penetration in coming years but is likely to be limited to trucking and public transit vehicles. The infrastructure required (i.e. filling stations) for natural gas powered personal automobiles may prevent meaningful penetration even in the medium term. Electric cars are likely going to be the clean fuel choice for personal automobiles going forward.

**Encana (ECA) – Fairly valued; Broad portfolio of North American natural gas assets**

Encana is one of the largest natural gas producers in North America, with natural gas production accounting for over 90% of its of production (after royalties). As part of it unconventional natural gas portfolio, Encana’s assets include Jonah, Barnett, Deep Bossier, Piceance, CBM, and Cutbank Ridge. Growth prospects for the company include continuing development of its Montney program, the Horn River joint project with Apache, Haynesville play in Louisiana and Texas, and the Deep Panuke field offshore Nova Scotia. Encana’s recent agreement to sell a 50% interest in its Cutbank Ridge asset for C\$5.4 billion was larger than expected and displayed the embedded value in Encana’s portfolio of gas assets.



## U.S. Equity Strategy

### Three Technology Stocks for Your Portfolio

*Paul Danesi, CIM – Director, Portfolio Advisory Group*

In response to the credit crisis of 2008 and ensuing recession, U.S. corporations cut spending at a record rate in an effort to protect profit margins. With the global economy on the mend, and margins and cash near record highs, corporations are beginning to loosen their purse strings – good news for many companies in the U.S. technology sector.

Companies have actually been under investing for the better part of last decade creating significant pent-up demand for capital equipment including IT hardware and software. Corporate spending as measured by business investment share of GDP remains at depressed levels. Earlier this year, Credit Suisse's global strategy team noted the level of nominal GDP is 1.8% above the previous peak in the U.S., yet the level of business investment is still 22.5% below its prior peak. However, the tide is beginning to turn and Bank of America Merrill Lynch believes corporate spending could rise 11% in 2011.

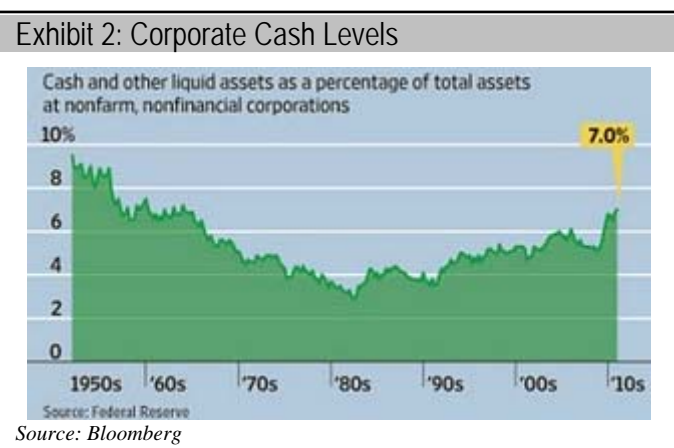
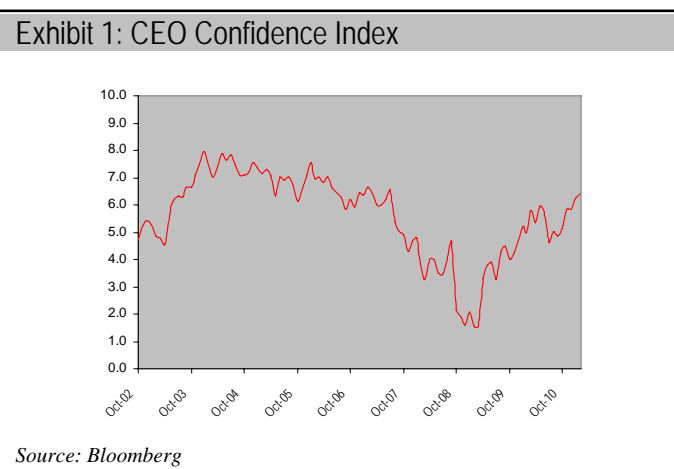
The “great recession” is now well in the rearview mirror and prospects for the global economy for the next few quarters have brightened. Corporate profitability has recovered and balance sheets are in good shape. Chief Executive Magazine's CEO Confidence Index, an assessment of how confident CEOs are in the economy and prospects for their business over the coming year, is at a recovery high. The index value is a rating on a scale of 1 to 10 with the recent reading of “6.02” suggesting CEOs generally view business conditions as “good.”

That renewed sense of confidence may help them to loosen their purse strings. U.S. corporations are sitting on a record amount of cash. According to recent government figures, U.S. businesses have stockpiled US\$1.9 trillion in cash, a record. Cash is now 7% of total assets at nonfarm, nonfinancial corporations the highest level since the mid 1960s.

While some of that cash is likely to go toward share buybacks, dividends and acquisitions, margin pressure may prove to be a catalyst for increased spending. Credit Suisse analyst Pankaj Patel remarked in a recent report, “The easy part of the margin expansion period via cost savings appears to be over for this cycle

and any further improvement is going to be hard earned via improving revenue footprints and superior strategy.” CEOs want the highest return on their investment. With productivity and margin gains harder to come by, and the economy recovering, corporations have little choice but to invest if they intend to grow their businesses. Information technology is productivity enhancing and an integral part of corporate strategy.

Low financing costs and government tax breaks are also incentives that will spur capital spending. A 100% bonus depreciation tax benefit approved by the U.S. Congress last December may encourage IT managers to buy new equipment before the tax break expires at the end of this year. There is no cap on the amount of

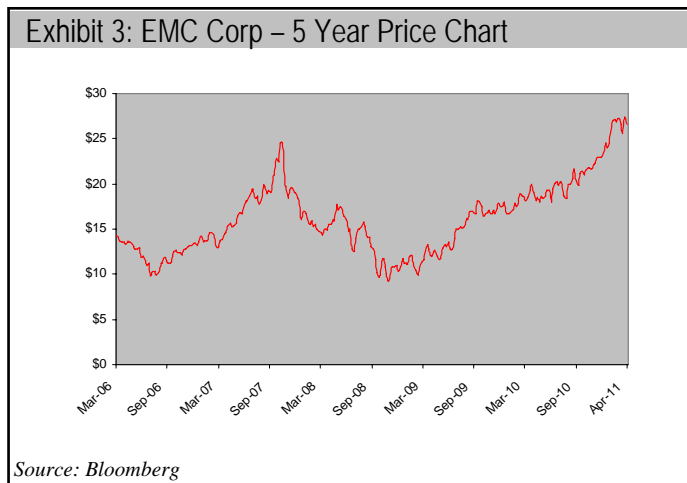


equipment that can be depreciated, but it must be new. The tax incentive will likely pull forward IT purchases into 2011 which to be fair leaves some uncertainty about the pace of investment in 2012.

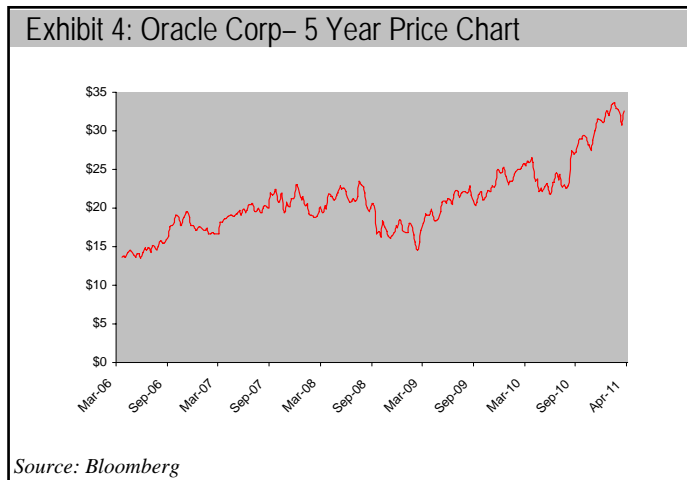
IT Services and software provide the greatest exposure to corporate spending. According to data compiled by Credit Suisse, IT Services and software derive 95% and 79% of revenues come from corporations. Software giant Oracle Corp. (ORCL) derives 100% of its revenue from corporate spending. Software has historically been one of the highest growth and value-creating sectors within IT. Software provides a high cash return on investment for businesses. According to Credit Suisse, volume growth in software has averaged 12% per annum over the past decade.

It's not too late to build exposure to the technology sector. IT is arguably one of the most attractive sectors in which to invest based on its growth to value proposition. Balance sheets are pristine, cash flows are abundant, earnings growth is superior to the overall market, and yet valuations remain highly attractive. We believe U.S. technology leaders including EMC Corp., Oracle Corp., and even Apple Inc. are likely to benefit from an expected uptrend in corporate IT spending. Another option would be to buy an exchange traded fund. We view exchange traded funds as an attractive option for investing thematically as they eliminate much of the company specific risk inherent with investing in a single stock. We would recommend the iShares S&P North American Technology-Software Index Fund (IGV) or the Technology Select Sector SPDR Fund (XLK).

**EMC Corp. (EMC U\$, Outperform, Target U\$34)** - EMC Corp. is the world's leading mass data storage device maker with about 26% market share. EMC's RAID (redundant array of independent disks) devices allow the storage and quick retrieval of huge amounts of data. EMC also makes file servers, and software designed to manage, share, and protect data. EMC is the majority owner of VMware (VMW), which provides virtualization and cloud computing software, and its RSA division provides security software and is being integrated with VMware products. EMC is well positioned to benefit from the secular growth story in networked storage driven by explosive data growth and the trend toward virtualization, which in turn is driving the move toward cloud-computing architecture. Credit Suisse believe the networked storage market can grow at a 10% compound annual growth rate through 2015 as data centers are re-architected to accommodate virtualization. EMC Corp. is uniquely positioned to gain market share given its 80% stake in VMware.



**Oracle Corp. (ORCL U\$, Outperform, Target U\$42)** – Oracle Corp offers a comprehensive suite of business software systems which allow customers to manage information and streamline business processes. Through acquisitions and in-house development, Oracle built upon its original database offering with a package of enterprise applications and middleware. Oracle has 370,000 customers, including all 100 of the Fortune 100 companies; providing significant exposure to a recovery in business investment. The company's recent financial results and prospects are encouraging. Oracle reported strong overall results in its most recent quarter with new software license sales up 27% over the prior year with business strong across all geographies.

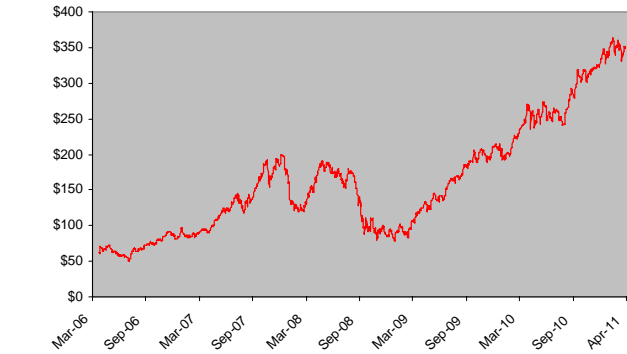


Credit Suisse's investment thesis has been a "stronger for longer" recovery in applications spending. They also believe Wall Street continues to under appreciate how disruptive a force Oracle's integrated appliance strategy could be to the server, networking, and storage hardware markets.

**Apple Inc. (AAPL U\$335.06, Outperform, Target U\$500)** -

Apple is one of the world's largest computer and electronic device makers and one of the great success stories in the realm of American business history. Apple has a diverse suite of products and services including the highly successful iPhone, iPad, iPod, and iTunes music store. Apple is a true innovator redefining and in some instances creating new product segments within the consumer electronics market. Apple's online iTunes music store was revolutionary and changed the way consumers bought and listened to music. While largely viewed as a "consumer" electronics play, the iPhone and iPad provide Apple with an inroad for greater corporate penetration. According to Apple's CEO, 80% of Fortune 100 companies are deploying or piloting the iPad. Credit Suisse estimate the enterprise market could deliver an incremental U\$20+ billion in revenue by 2015. At its recent quotation, investors are buying one of the world's fastest growing and most recognizable brands, incredible product momentum and innovation, along with superior earnings growth, all for less than the market multiple.

Exhibit 5: Apple Inc – 5 Year Price Chart



Source: Bloomberg

# Fixed Income Strategy

## Unrated Debt Securities

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

### Key Considerations for Investors

Investors primarily buy debt securities for the income they generate, be it to fund their retirement, education, or any other cash flow need. Debt securities are also the choice of investors seeking safety of capital, as they carry a greater degree of principal protection and guarantee of investment returns in comparison to equities, real estate or other investments. The timely payment of principal and interest are therefore of utmost importance to the debt holder.

Although the owner of the debt obligation is owed certain rights as a creditor, the debt obligation does not represent any type of ownership rights over the issuer. Rather, creditors receive a higher-ranking claim on the borrower's income and assets than do owners or shareholders in the case of bankruptcy.

A formal contractual document accompanying the issuance of debt securities, known as a trust indenture, outlines the rights and protections afforded. The trust indenture specifies the debt holder's security over the assets of the borrower, any restrictions on operations and financing, the relative ranking of the debt, and rights and remedies that are available if the covenants are violated.

The trust indenture does outline important legal obligations of the borrower, but it does not measure the ability of the borrower to meet their obligations in a timely manner. This type of evaluation is known as credit analysis.

In the public debt markets, investors typically have a useful source of credit analysis from the Credit Ratings Agencies, including Dominion Bond Rating Service (DBRS), Moody's Investor Service (Moody's), Standard and Poor's (S&P), and Fitch Ratings (Fitch).

Ratings agencies classify their opinion in the form of a credit rating. A credit rating is not a recommendation to buy, sell, or hold an investment; rather, it represents the respective ratings agencies' opinion over the general credit worthiness of the borrower in regards to a debt security. These ratings are framed in to a scale in order to classify this general credit worthiness.

### Unrated Debt Securities – a definition

Unrated securities are simply debt securities that do not have a credit opinion from a rating agency. This is not necessarily a negative connotation. Issuers who chose not to pay for a rating from a Credit Ratings Agency may do so for a number of reasons, such as:

- The relatively small size of the offering in comparison to the cost of obtaining a rating.
- The company perceives limited benefit in obtaining a rating.
- Obtaining a rating may have a negative impact on current indebtedness:
  - Certain lenders may no longer be able to maintain the same level of borrowing with a low credit rating,
  - A low credit rating may increase to cost of future borrowing in public debt markets.

Regardless of the reason, the lack of a rating essentially results in the investor not having an independent, professional opinion about credit quality. Hence, investors in unrated debt securities must therefore consider the general credit worthiness of the borrower – in other words, perform an independent credit analysis.

To do so, investors must consider what the issuers existing obligations are, by analyzing liquidity, borrowing, and cash flow needs, in order to form an opinion over the ability to meet interest and principal payments. Furthermore, investors must consider what assets are available for protection, by analyzing the firm's financial statements, make any necessary adjustments to reflect measurements of book versus market value, and account for any off balance sheet activity. Furthermore, this analysis should also be forward looking, to take into account where the borrower is heading, in order to assess their ability to meet their obligations going forward.

Given the limited ability of most investors to perform this level of analysis, caution is warranted in buying any unrated security. However, there are other sources of opinion and analysis outside of credit ratings that are useful tools.

**Comparable Yields** – There is no free lunch in the capital markets. Yield is a very good proxy of the consensus opinion of risk inherent in any investment – and generally the higher the yield, the riskier the investment, and hence the higher likelihood of default. The following table highlights yields on the DEX Canadian Bond Market Indices as of February 28, 2011:

Exhibit 1: Comparable Yields			
DEX Government Index	DEX Corporate Index	DEX BBB Corp Index	DEX High Yield Index
2.99%	3.83%	4.57%	6.60%

*Source: PC Bond*

Essentially, the higher the yield, the higher the market perceives the risk of default, and hence investors should exercise extreme caution when investing in debt securities that yield well above those on the Corporate and High Yield Index averages.

**Equity Research Reports** – Where there may be no credit rating available, there are often equity research reports available on issuing entities. It is of course important to consider that what may be positive for the underlying company is not positive for the market value of the debt instrument. However, a positive outlook on the equity ownership of the company is usually also positive for the prospects for the timely payment of both interest and principal.

### Risk Factors to Consider

When available, the prospectus and other issuing documents will highlight the key risk factors of the investment. The prospectus should therefore be consulted and is paramount with respect to risk disclosure.

In addition to credit risks as highlighted above, the following risk factors are important considerations for investing in debt securities.

- Interest Rate Risk
- Reinvestment Risk
- Marketability Risk
- Call Risk
- Inflation Risk
- Political/Legal Risk
- Event Risk
- Sector Risk

Of these, in addition to credit risk, marketability and timing risk we consider to be heightened with unrated securities.

**Marketability/Liquidity Risk** - Marketability risk concerns the ease with which a debt security can be sold prior to maturity at, or near, its true value. It should be noted that in the case of unrated securities, issue sizes are normally relatively small, and are primarily held by individual investors who trade less frequently, resulting in very little secondary market trade activity, if any at all.

One key metric that provides an indication over the liquidity of an issue is the difference between the bid and the offer price, regardless of whether the security is traded on an exchange or in the over the counter bond market. The larger the price difference between the bid and offer not only means that it is more costly to transact, but that it may be difficult to execute large orders at posted prices.

**Timing or Call Risk** - Many bonds contain embedded options, including call options where the issuer can call the debt instrument prior to maturity, or prepayment options where the borrower can pay down a portion of the principal amount of the loan prior to maturity. This is a disadvantage to the investor – the cash flow of the investment is not certain, the call will only be exercised when it is an advantage to the issuer (and therefore most often a disadvantage to the investor), and any opportunity for capital gains due to falling interest rates will be capped by the call features. To compensate for these disadvantages, callable bonds normally carry a higher yield.

These embedded options also have an impact on price performance. Volatility of interest rates will affect the valuation of the embedded option, and therefore the value of the debt security. For example, as interest rate volatility rises, the value of a bond’s call option rises – a negative factor from an investor’s perspective who has essentially sold the option to the borrower.

**Recommendation**

Unrated securities require a much higher degree of investor due diligence given their lack of professional secondary opinions. Furthermore, most issuers who choose not to have a credit rating would likely not be given an investment grade rating as this often increases the cost of financing – suggesting that non-rated securities for the most part should be considered in the same category as high yield/non-investment grade bonds.

The following default study from Moody’s Investor Service provides a snapshot of cumulative credit defaults over any five year period, in a study covering issuers in the public debt market from 1982 to 2009.

Exhibit 2: Average Cumulative Credit Loss Rates by Letter Rating, 1982-2009					
YEAR	Year 1	Year 2	Year 3	Year 4	Year 5
Aaa	0.00%	0.01%	n.a.	0.00%	0.02%
Aa	0.02%	0.04%	0.06%	0.07%	0.14%
A	0.04%	0.10%	0.21%	0.35%	0.47%
Baa	0.11%	0.30%	0.55%	0.82%	1.16%
Ba	0.66%	1.93%	3.58%	5.45%	7.02%
B	2.86%	6.76%	10.43%	13.46%	15.51%
Caa-C	11.53%	19.12%	25.61%	29.58%	33.77%
Investment Grade	0.06%	0.14%	0.27%	0.41%	0.57%
Speculative Grade	3.04%	6.30%	9.40%	11.95%	<b>13.84%</b>
All Rated	1.11%	2.25%	3.30%	4.13%	4.75%

*Source: Moody’s Investor Service, Corporate Default and Recovery Rates, 1920-2009*

As the table indicates, over any 5-year period, almost 1 in 7 speculative grade credits (also known as non-investment grade or junk) will default. Hence, investors must be prepared to accept losses when investing in this category, and achieve a high enough yield on their portfolio to offset these losses – diversification is the most important rule when making any foray into high yield bonds as an asset class.

Therefore, we consider most unrated issuers to be high risk instruments that are suitable only for sophisticated investors with a high risk tolerance. Furthermore, investors must also have the ability to build a well diversified portfolio– we recommend investor’s with such a high risk tolerance limit exposure to any one issuer to no more than 3% of total market value, and greater diversification is encouraged.

**Non-investment grade securities do not have a place in the portfolios of investors with a moderate to low risk tolerance.** Investors in this category should instead consider high yield bond funds which provide adequate diversification, and may also offer professional managers who are able to complete the high level of credit risk analysis and due diligence required.

## Mutual Fund Strategy

### Finding Opportunities in the U.S.

*Joel Beriault, CIM – Associate, Portfolio Advisory Group, Mutual Fund Research*

The year 2010 continued the trend from 2009 for U.S. stock markets with the Dow Jones, S&P 500 and NASDAQ Composite Indices returning 11.0%, 12.8%, and 16.9% respectively (all in USD). More specifically, the S&P 500 has risen nearly 90% from its low set in March of 2009 to December 2010. However, fund flows into U.S. equity funds have been tepid with many Canadian investors still resistant to the idea of investing in the U.S.

In this edition of the IPQ, we will first examine the economic challenges facing the United States, the investment opportunities in light of these challenges and the rationale for investing in the U.S. from a portfolio perspective.

#### Economic Challenges in the U.S. Creating Uncertainty

There remains uncertainty in the markets today which forms the basis of investors' fear of investing in the U.S. Some of the factors we note are:

- **Uncertainty over sustainable recovery.** The U.S. economy is showing signs of recovery; however this is in part largely due to the fiscal and monetary policy programs established by the Fed. It is still unclear how the economy will behave once these programs cease to exist or once their stimulus impact wanes.
- **Inflation.** Monetary stimulus, in the form of quantitative easing (the Federal Reserve is buying Treasuries, effectively printing money) could eventually create inflation and therefore slow growth.
- **U.S. corporations not fully recovering.** The fear is that U.S. corporations are unable to fully recover from the recession and the global changes resulting from it. Although sales and inventory spending has rebounded, investment spending has not.
- **Challenges facing U.S. consumers.** The unemployment rate remains high at 9.0% or 13.9 million unemployed persons.<sup>1</sup> Faced with the uncertainty of maintaining or finding a job, U.S. consumers have retrenched in spending and many have either sold or lost their houses thereby creating an over supply in real estate.
- **The “New Normal”.** PIMCO, a leading global investment management firm, coined the term “New Normal” in early 2009. The “New Normal” in today’s economic context signifies a slower rate of growth in developed economies, and will see developing countries driving global growth. This has pushed investors to Emerging Markets funds rather than U.S. equities.

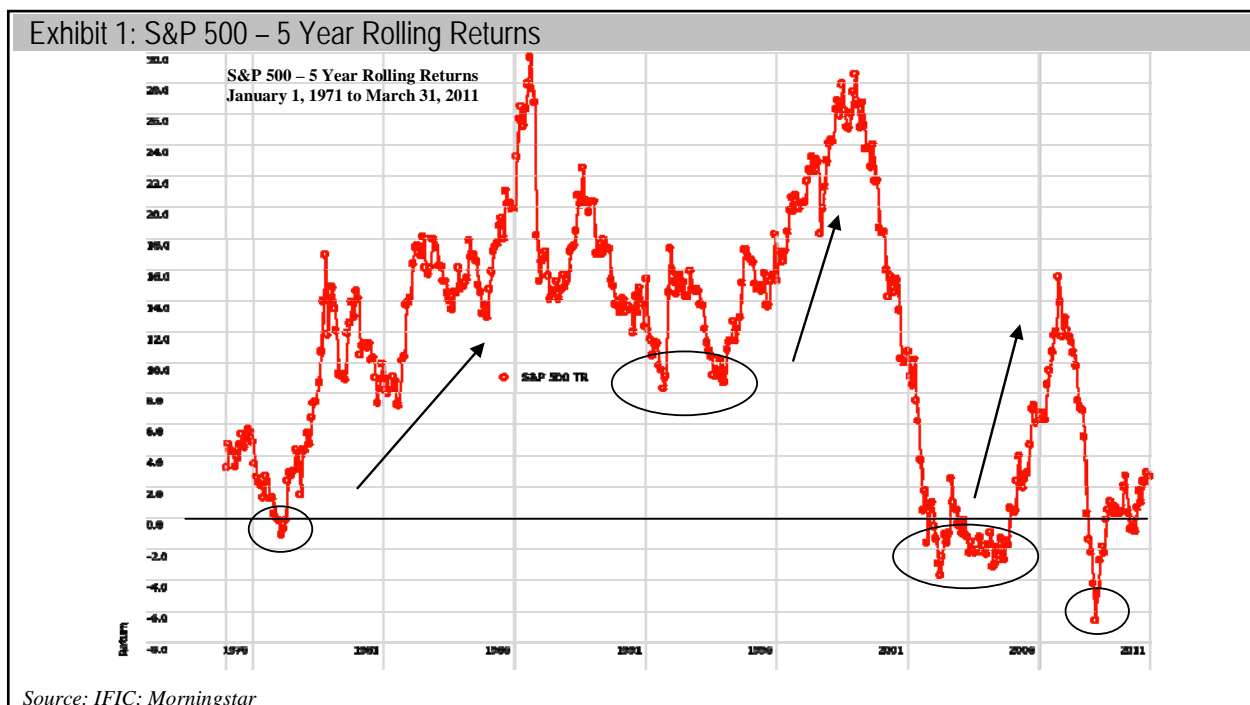
#### Investment Opportunities in the U.S.

Despite these problems the Portfolio Advisory Group believes there are great investment opportunities in the U.S.

- **Road to recovery for the largest world economy.** There is evidence the U.S. economic recovery is becoming relatively self-sustained and developed markets, including the U.S., can expect a slow but steady recovery. The United States boasts the largest economy in the world by far, with total GDP nearly three times that of the world’s second largest economy (China) which surpassed Japan in 2010. The U.S. also accounts for nearly 30% of total global consumption with only five percent of the population. On the global scale, the sovereign debt problems were not severe enough to disrupt global growth, U.S. public politics are accommodative, and tax rates are relatively low. In addition, the U.S. House of Representatives is controlled by the Republicans who are known to be “pro-business”, business confidence is improving, and the Federal Reserve is keeping overnight rates low, all factors that favour economic growth.

<sup>1</sup> Source: Bureau of Labor Statistics – (seasonally adjusted) January 2011

- U.S. corporations adjusting after the recession.** U.S. companies are also benefitting from the low borrowing rates that allow them to refinance debt at lower rates – or borrow at low rates to fund new projects. In addition, during the recession, many companies lowered their spending by reducing employees, eliminating some inefficiencies, clearing some inventory, in short, by reducing overall costs. As a result, U.S. companies have the most liquid balance sheets in years. They have built up cash that will allow them to be in a better position for merger and acquisitions, raise their dividends, buy-back their stocks, increase capital expenditures including new technology, all factors that typically drive stock prices. A great number of U.S. companies have therefore made positive changes during the recession and as a result have strengthened their businesses and should be in good shape during the recovery. In addition, many U.S. companies domiciled and trading in the U.S. are not entirely dependent on the U.S. for growth – many are multinationals doing business globally in fast growing economies. In fact, approximately 25% of the companies trading on the S&P 500 generate more than half of their income from outside of the U.S. Furthermore, recent weakness in the U.S. dollar is positive for U.S. exports. In other words, it is still possible to find great value in U.S. companies regardless of the performance of the U.S. economy.
- Resiliency of the U.S. stock market.** In the last 10 years alone investors have faced two major stock market crashes: the Dot-Com bubble in 2000 and the Housing bubble that started in 2007. Exhibit 1 below shows periods of 5-year returns highlighting other periods of low returns notably in the late 1970s, 1990's and the recent market crash. However each severe downturn was followed by a long period of recovery. While we can't predict the future this chart illustrates the resiliency of the U.S. stock market.



### U.S. Equities from a Portfolio Context

In the previous sections we showed how despite the current economic issues facing the U.S., there are still some compelling reasons for investing in the U.S. In addition, the United States has an approximate 50 percent weight in the MSCI World Index - versus only five percent for Canada – and has a well diversified stock market consisting of a great number of global leading multi-nationals. Because of the considerable global presence it is important not to neglect this market within a well diversified portfolio.

- Difficult to predict the next top performing equity class.** We have seen from previous newsletters that investors attempting to time the market often do so with little success. Why? Because these same investors will tend to chase the “winners” while getting rid of funds or stocks no longer in favour.

Many investors also have short-term memories when it comes to investing. We forget that over-time, no single asset class has consistently been a top performer. In the 1980s, international stocks (MSCI EAFE) led the way in terms of returns followed by the S&P 500 and S&P/TSX. In the 1990s, the S&P 500 was the clear winner almost doubling the returns of the MSCI EAFE and S&P/TSX indexes. In the 2000s, it was the S&P/TSX leading the pack. In the 30 years from 1980 to 2009, the MSCI EAFE was the top performer 9 of the 30 years, the S&P/TSX, 10 of the 30 years and the S&P 500, 11 years out of 30. While we know market returns can be quite unpredictable in the shorter term, over the longer term, returns are often smoothed out. For example, in the 1980's, the S&P 500 returned 17.5%, 20.9% in the 1990's and -4.1% in the 2000's. However, over the entire time span, annualized return is 10.8%. History has shown that no one asset class has dominated consistently over time therefore diversified exposure can be the key to successful long-term investing.

Exhibit 2: Rates of Returns from 1980-2009

RORs From 1980 to 2009	1980's	1990's	2000's	1980 to 2009	# of Years with the top return
<b>S&amp;P 500 TR</b>	17.5%	<b>20.9%</b>	-4.1%	<b>10.8%</b>	<b>11</b>
<b>S&amp;P/TSX Composite TR</b>	12.2%	10.6%	<b>5.6%</b>	9.4%	10
<b>MSCI EAFE GR</b>	<b>22.7%</b>	9.8%	-1.7%	9.8%	9

Source: Morningstar Direct

- **Sector diversification.** In some cases, investors will choose to invest the majority of their money in their home country, also known as the “home bias”. Not only does Canada’s market account for a small weighting within the MSCI World Index but also lacks breadth with the three largest sectors (financials, energy and materials) comprising more than 75% of the S&P/TSX Composite Index. More specifically, as of the end of January 31 of this year, the same three sectors accounted for 79.3% of the Canadian index versus only 20.7% in the U.S. Therefore, a good way to eliminate some sector concentration risk would be to combine U.S. equity funds to a portfolio overweight in Canadian equities.
- **Low correlation to Canadian equities.** Exhibit 3 shows the correlation over the last three years between the S&P 500 and S&P/TSX indexes and some of the largest (in assets) Canadian and U.S. equity mutual funds. The correlation grid shows low correlation between the Canadian and U.S. indexes and correlation of between 0.55 to 0.60 between the Canadian and U.S. equity mutual funds. Correlation measures how two investments move in relation to each other. Correlation analysis is an effective tool in determining if a portfolio is properly diversified. Within a portfolio context, investments highly correlated will tend to go up in value in unison when conditions are favourable - at the same time however, the portfolio will decrease in value when conditions go the other way. In other words, if the underlying investment holdings are highly correlated the portfolio will exhibit larger upside and downside swings. Ultimately, investments that are highly correlated mean the portfolio in question is not properly diversified. The data in Exhibit 3 suggests, as expected, a high correlation between the Canadian equity funds (and between the U.S. equity funds) but lower correlation between Canadian and U.S. equity funds.

## Exhibit 3: 3-Year Correlation Matrix

Time Period: 2/1/2008 to 1/31/2011	1	2	3	4	5	6	7	8	9
1 S&P 500 TR									
2 S&P/TSX Composite TR	0.59								
3 Dynamic American Value	0.63	0.88							
4 Fidelity American Disciplined Eq Sr B	0.92	0.68	0.73						
5 Trimark US Companies	0.95	0.57	0.60	0.88					
6 Dynamic Power American Growth	0.80	0.61	0.57	0.79	0.81				
7 RBC Canadian Equity Advisor	0.60	1.00	0.88	0.69	0.59	0.63			
8 Fidelity True North Sr B	0.56	0.99	0.88	0.66	0.53	0.59	0.99		
9 Fidelity Canadian Disciplined Eq Ser B	0.58	0.99	0.88	0.67	0.55	0.60	0.99	0.99	
10 Beutel Goodman Canadian Equity Cl...	0.69	0.94	0.87	0.75	0.67	0.59	0.94	0.92	0.93

Source: Morningstar Direct

### Summary

The National Bureau of Economic Research declared the recession in the U.S. officially ended in June 2009 (see [www.nber.org](http://www.nber.org)). The recession lasted 18 months, making it the longest downturn since the Great Depression of the 1930s. Despite the fact that the U.S. economy has been in recovery mode for over a year and a half, and the stock market has been up since its low in early 2009, many Canadian investors continue to shy away from the U.S. In light of the challenges facing the U.S. today, there are compelling reasons for investment. The economy is in recovery and many corporations are in the best shape they have been in years poised to participate in global growth. From a portfolio context, the U.S. is simply too large to ignore – from its size to the diversification it provides.

# Financial Planning Strategy

## Post-Retirement Planning – RRSP Considerations

*Ian Adams – Senior Financial Planning Consultant, Financial Planning*

When planning for retirement, strategies often focus on contributing to RRSPs prior to retirement. However, a proper financial plan should always consider what will happen when those RRSP investments need to be used or liquidated when you need them - usually after you retire.

One of the most important facts to consider is that any withdrawals from your RRSP are fully taxable as income in the year of the withdrawal. There is no way to avoid income tax when you withdraw RRSP funds, but there may be ways to lessen the impact. In theory, when you contribute to your RRSP, you are able to deduct the amount when you are in a higher tax bracket and when you withdraw the funds from the RRSP, you should be in a lower tax bracket and you would therefore save tax.

However, if you have a sizeable RRSP account, there are some things you should take into consideration. Here are some scenarios that will help to put things in perspective:

**Scenario 1** - You and your spouse both pass away in the same year and you both have sizeable RRSP accounts in your own names. *Result:* The RRSPs you own are fully taxable at the highest marginal tax rates in the year of death. If only one spouse passes away, then the RRSPs can be rolled over to the surviving spouse tax free. However, when the surviving spouse passes away, the Estate or their beneficiaries will likely end up paying the highest marginal tax rate on the assets of the RRSP (this rate will vary by province and is currently at 46.4% in Ontario).

**Scenario 2** – You are considering transferring your RRSP assets into a RRIF as you are approaching age 72. Your minimum withdrawal under the RRIF rules may mean that you are in the highest tax bracket - again. *Result:* If you have to withdraw more than \$67,668 (2011 value) per year, then you will also have your Old Age Security (OAS) payments reduced and fully eliminated if you earn more than approximately 109,764 (in 2011). As an example, at age 72, the minimum withdrawal rate is 7.48%. If you have \$1 million in your RRIF, then you would have to withdraw \$74,800 for that year. Assuming no other income, this would put you in the middle income tax bracket and you would start to lose your OAS benefits. If you add any other income such as CPP, dividend or interest income in a non-registered account to your tax return, then you would likely be paying tax at the highest marginal tax rate again. Also remember that the minimum withdrawal rate slowly increases as you age, so your income will also increase. It can get as high as 20% at age 94.

### What can you do?

- 1.** Plan your RRSP withdrawals to minimize your income tax liability. In the years after retirement and before you turn 72, when you would likely have reduced income, start to make withdrawals out of the RRSP. Income below \$40,000 is taxed at the lowest rate. Don't forget about all of your other income and consider all other sources of taxable income before implementing a strategy.
- 2.** Base your RRIF withdrawals on the age of the youngest spouse - this works well if your spouse is a lot younger. For example, if you are 72, your withdrawal rate is 7.48%. If your spouse is only 60, your withdrawal rate is only 3.33%.
- 3.** When you convert your RRSP to a RRIF after age 65, any withdrawals can then be considered pension income. You will be able to take advantage of the Pension Income Splitting rules with your spouse. It may make sense to convert to a RRIF earlier than 71. This works well if one spouse has a much larger RRSP balance than the other. Essentially withdrawals can be shared on your tax returns, so you can reduce your tax rate.

**4.** Maximize your RRIF withdrawals when markets fall. The withdrawal rate from a RRIF is based on the previous year end balance. If the markets are down and you are in the correct tax bracket, consider taking more than the minimum and save on future taxes. Even if you don't need the money you can transfer assets from your RRIF to a non-registered account so you are not selling your investments in a down market. Consider contributing the withdrawals to a Tax Free Savings Account for even more tax savings.

**5.** Consider your personal tax bracket every year. Get your tax accountant involved to help you with the decision.

Remember, you planned to save for retirement, now is the time to plan for your retirement withdrawals.

# Tax Strategy

## 2011 Federal Budget Highlights

*Dominic Proietti, CA – Director, Financial Planning*

*Scott Cummings – National Director, Taxation*

*Shawn Cooper, CFP, CIM, FMA – Senior Associate, Financial Planning*

The 2011 Federal Budget was delivered on March 22, 2011, and contained a limited number of personal income tax measures impacting the taxation of individuals and the charitable sector. While the conservative government, who presented the 2011 Federal Budget, was defeated in a non-confidence vote, the changes presented in this article were proposed by the department of finance and in our opinion will be maintained under a new government.

### Personal Income Tax Measures

#### **Children's Art Tax Credit**

Budget 2011 proposes to allow parents to claim a non-refundable tax credit based on 15% of eligible expenses up to \$500 per child under 16 years of age. The 15% non-refundable tax credit may be claimed on an additional \$500 disability supplement amount for a child that is under 18 years of age and is eligible for the Disability Tax Credit when a minimum of \$100 is paid in eligible expenses. The credit is applicable to eligible programs of artistic, cultural, recreational and developmental activities. This measure will apply to eligible expenses paid in 2011 and subsequent years.

#### **Family Caregiver Tax Credit**

Budget 2011 proposes to introduce a 15 % non-refundable Family Caregiver Tax Credit based on an amount of \$2,000. Caregivers will be entitled to claim an enhanced amount for an infirm dependant under either the Spousal or Common-law Partner Credit, the Child Tax Credit, the Eligible Dependant Credit, the Caregiver Credit or the Infirm Dependent Credit. This measure will apply beginning in 2012.

#### **Medical Expense Tax Credit for Other Dependants**

Budget 2011 proposes to eliminate the \$10,000 limit on eligible medical expenses that a taxpayer can claim for a dependant relative under the Medical Expense Tax Credit. Currently, individuals can claim up to \$10,000 of eligible medical expenses for a dependant relative if the expenses exceed the lesser of 3% of the dependant's net income and an indexed threshold (\$2,052 for 2011). This measure will apply to 2011 and subsequent years.

#### **Child Tax Credit Eligibility**

Budget 2011 proposes to repeal the rule that prevents more than one claimant per domestic establishment from claiming the Child Tax Credit. This measure will apply to 2011 and subsequent years.

#### **Tuition Tax Credit – Examination Fees**

Budget 2011 proposes to change the Tuition Tax Credit to include fees paid to an educational institution, professional association, provincial ministry or other similar institution to take an examination that leads to a professional designation or trade recognized in Canada. This measure will apply to examination fees paid in 2011 and subsequent years.

#### **Education Tax Measures – Study Abroad**

Budget 2011 proposes to reduce the minimum course duration that a Canadian student at a foreign university must meet in order to claim Tuition, Education and Textbook Tax Credits and Educational Assistance Payments from 13 consecutive weeks to 3 consecutive weeks. This measure will apply to tuition fees paid for courses taken in 2011 and subsequent years and to Educational Assistance Payments made after 2010.

**RESP – Asset Sharing Among Siblings**

Budget 2011 proposes to allow a transfer of assets between individual RESPs for siblings, without any tax consequences and without triggering any repayment of Canada Education Savings Grant. The beneficiary of the plan receiving the assets must have been under 21 year of age when the plan was opened. This will apply to asset transfers that occur after 2010.

**RDSP – Shortened Life Expectancy**

Budget 2011 proposes to allow beneficiaries to make asset withdrawal without triggering the 10 year repayment rule which requires the repayment of Canada Disability Savings Grants (CDSG) and Canada Disability Savings Bonds (CDSB) provided the taxable portion of the withdrawals does not exceed \$10,000.

In order to qualify, the beneficiary must make an election and a medical doctor must certify in writing that the beneficiary has a life expectancy of five years or less.

**RRSP – Anti-Avoidance Rules**

Budget 2011 proposes to enhance existing anti-avoidance rules in order to combat inappropriate tax planning strategies similar to the rules in place for the Tax Free Savings Accounts. These rules will generally apply to transactions occurring and investments acquired, after March 22, 2011.

The Advantage Rules will be enhanced, which makes certain transactions taxable if they are intended to exploit the tax rules.

Prohibited Investments, as defined in the Income Tax Act will have to pay a special tax equal to 50% of the fair market value of the Prohibited Investment. The annuitant of the RRSP will be subject to this tax.

Non-qualified investments held within an RRSP, will be subject to a special tax equal to 50% of the fair market value of the non-qualified investment and will apply to the annuitant of the RRSP. These rules will replace the inclusion and deduction rules and the one-percent per month tax.

**Individual Pension Plans**

Budget 2011 proposes that annual minimum payments, similar to RRIFs, be required once a plan member attains the age of 72. This will be applicable in 2012 and subsequent tax years.

Contributions made to the IPP that relate to prior years of employment will be required to be funded first from the plan members existing RRSP or reducing the individual's accumulated RRSP contribution room. This will be applicable in 2012 and subsequent tax years.

The IPP will be required to pay a minimum amount equal to the greater of: a) the amount payable according to the pension plan terms and b) the minimum amount required if the assets were held in a Registered Retirement Income Fund (RRIF).

**Tax on Split Income – Capital Gains**

Currently the tax on split income for minors, (commonly known as the kiddie tax), does not apply to capital gains. The 2011 Budget proposes to extend the kiddie tax to apply to capital gains realized by a minor from the disposition of shares to a person who does not deal at arm's length with the minor if taxable dividends on the shares would have been subject to kiddie tax. The capital gain that fall under this measure will be treated as dividends and will not qualify for the lifetime capital gains exemption. This applies to gains realized on or after March 22, 2011.

## Charitable Sector

Budget 2011 announced a number of measures to enhance the regulatory regime for qualified donees as part of its “Tax Fairness – Closing Tax Loopholes” proposals.

The budget includes a package of integrity measures for charities to help combat fraud and abuse with respect to charitable donations. For example qualified donees will be required to be on a publicly available list maintained by the Canada Revenue Agency. In addition, qualified donees will become subject to the requirements applied to registered charities for the issuance of official donation receipts for gifts received. All qualified donees will be required to maintain proper books and records and to provide access to those books and records to the CRA when requested. If standards are not maintained, the charity can lose the ability to issue donation receipts.

Budget 2011 proposes to permit a recovery of tax assistance for returned gifts. In cases where property has been donated but then eventually returned to the donor, qualified donees will be required to re-issue a donation receipt when the amount of the receipt has changed by more than \$50. This measure is effective for gifts or property returned on or after March 22, 2011.

In the case of donating options, Budget 2011 proposes that the Charitable Donations Tax Credit or Deduction is not available to a taxpayer until the donee acquires the property that is attached to the option. The taxpayer will be allowed a credit or deduction at that time based on the amount by which the fair market value of the property exceeds the total amount paid by the donee for the option and the property. This measure will apply in respect of options granted on or after March 22, 2011.

Budget 2011 proposes to limit excessive tax benefits relating to the donation of publicly listed flow through shares. Currently the taxpayer generally receives a deduction in computing income for the cost of flow through shares; these shares are treated as having a cost of zero for calculating the gain or loss on their disposition. Donations of flow through shares also carry relief from capital gains tax, including tax on the portion of the gain attributable to the zero cost for the shares.

By way of example, assume that the cost of a flow through share is \$120. When the share is donated, assume its value is now \$100. If a 46% marginal tax rate is used, the tax benefit would be \$115 including any flow through and other charitable deductions and tax credits. The net after-tax cost of the donation to the taxpayer is only \$5. (The charity has actually received \$100 but of that the government has funded \$95).

The new rules will now tax the capital gain on the donation of the shares to a charity. In the above example, this now means that the \$100 value of the share at the time of the donation is now subject to capital gains tax resulting in \$23 of taxes. The after-tax cost of the donation is now \$28 instead of \$5.

This measure applies for shares issued pursuant to a flow-through share agreement entered into on or after March 22, 2011.

## 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

Notwithstanding a long-overdue sluggish month of performance in March, North American equity markets were remarkably strong during the first quarter of 2011, despite the evident calamities and distractions which presented themselves during the period. In perhaps more “traditional” periods in capital markets history, any one of the mishaps which occurred over the past three months might have served as the catalyst for a significant correction, but it is a testament to the strength of the underlying fundamentals supporting the most recent equity market surge that investors were willing to look beyond current market risks and drive stock prices higher.

We began the year with the perspective that the positive influence of continued strong corporate earnings, healthy balance sheets, and reasonable valuations would remain supportive of equities, and that most of the negative factors long overshadowing the market were known to investors for some time, and thus largely priced in. So, sovereign debt issues in the eurozone, although disturbing, would ultimately be “handled” and therefore weren’t a major threat to capital markets. But civil unrest leading to civil wars in the Middle East and North Africa caused barely a ripple in equity markets and in March, the devastating earthquake and subsequent tsunami and nuclear radiation risks caused only a modest retrenchment, from which equities ultimately rebounded almost entirely by the end of the period.

The Canadian Core Guided Portfolio generated a total return of 3.1% during the quarter, lagging the benchmark S&PTSX60 Index which advanced 5.8% on the same basis. All but two of the ten major sectors registered positive returns with only Consumer Discretionary and Materials posting declines. The weakness in Materials was largely due a drop in copper prices and a volatile period for Gold bullion futures which closed less than 1% higher than at the end of 2010 but achieved an all-time high of US\$1440/oz.. At the same time, the S&PTSX Gold Index declined 5% for the quarter and shares of portfolio holding **Barrick Gold** dropped a commensurate amount.

Instability in the Middle East caused crude oil futures to move higher by almost 17% in the quarter as investors feared the disruption of oil supply from the region. Although lagging the price performance in the underlying commodity, Energy stocks got a lift with portfolio holdings **Suncor Energy** advancing 14% and **Canadian Natural Resources** shares climbing 8%; as a group however, Energy holdings in this portfolio underperformed the sub-index during the period. Copper futures reversed somewhat during the period, falling 4% after an extraordinary 22% increase in the previous quarter, and shares of **Teck Resources** dropped almost 17% in response.

Despite advancing in January and February, the performance of **Research In Motion** weighed on the portfolio, falling 6% in the quarter following the almost 15% plunge in March after the company reported Q4 results; although earnings were better than expected, the stock dropped in response to disappointing guidance for the current fiscal quarter. Importantly, the company provided guidance for the full year which exceeded analyst estimates. It would appear that **RIM** shares are in the “penalty box” until the launch of their *PlayBook* tablet device on April 19; we remain optimistic regarding the sales potential for this new product offering and believe the stock is undervalued at current levels.

Reflecting the ongoing economic recovery in Canada which underpins much of the encouraging performance witnessed in the quarter, shares of **Canadian National Railway** climbed 10%. Bank stocks were particularly strong as evidenced by the positive moves seen in shares of **Royal Bank** and **Toronto Dominion Bank** which advanced 15% and 16% respectively on the back of much better than expected first quarter earnings reported during the period.

Although the specific trigger could not possibly have been predicted, and not to minimize the human tragedy in Japan and the new civil war in Libya, we would have expected these unforeseen global events might serve as a catalyst for a necessary and healthy sell-off for equity markets, and yet the positive trend persists. We still anticipate a modest decline in equity markets but are biased toward buying any market weakness. The present geopolitical climate dictates that central banks will likely maintain accommodative monetary policies for the foreseeable future. Stock selection remains critical, but these policies combined with further evidence of strong corporate profitability and reasonable valuations, suggests equity portfolios can be expected to continue generating positive returns.

### Changes

In February we made a switch in this portfolio: out of **Great West Lifeco (GWO)**, and into shares of **Genworth MI Canada Inc. (MIC)**. The catalyst for the change came by virtue of the Investment Policy Statement that governs the managing of this portfolio which compels us to remove a position subject to a 3-Sector Underperform recommendation from Scotia Capital. Scotia Capital Equity Research recently initiated research coverage of the North American lifeco sector and rated shares of **GWO** 3-Sector Underperform; the rating is a relative call based on the analyst's belief the current valuation suggests little upside over the next 12 months, preferring stocks offering greater value and more leverage to stabilized equity markets and rising interest rates. **Genworth MI Canada Inc. (MIC)** is Canada's leading private residential mortgage insurance provider, and the only public pure-play mortgage insurance company. **MIC** competes in an effective duopoly with only two main players in Canadian mortgage insurance: Canada Mortgage and Housing Corp. (CMHC) has approximately 75% market share with **MIC** having most of the balance. Industry conditions continue to look positive as barriers to entry are significant, and the Canadian housing market remains stable. The conservative nature of the Canadian mortgage lending culture, particularly relative to the U.S., makes mortgage insurance a compelling industry in Canada and **MIC** shares trade at an attractive valuation.

Later in February we exited the position in **Fortis Inc. (FTS)** and bought a position in **SNC-Lavalin Group Inc. (SNC)**. Although the specific catalyst for the change was the downgrade of **FTS** by Scotia Capital from 2-Sector Perform to 3-Sector Underperform, we had viewed **FTS** as approaching fair value for some time. We had been shifting sector allocation in the Guided Portfolios in line with Scotia Capital's recommended strategy which in the current economic and market environment is committed to being overweight cyclical sectors and underweight more defensively oriented stocks. We also felt that **Fortis** shares were near full valuation and sought another investment in a sector that is more economically sensitive and has leverage to the ongoing economic recovery/expansion. We increased our weight in Industrials by one holding, bringing the sector weight to 10%, while eliminating exposure to the defensive Utilities sector.

**SNC-Lavalin Group** is one of the leading engineering and construction companies in the world providing engineering, procurement, construction, project management, facilities management and project financing services. **SNC** provides exposure to the ongoing demand for both expansion and maintenance of global infrastructure projects which is a recurring investment theme in a growing global economy. The company's business model includes generating revenues and profits not only through the provision of services, but also in many instances as an equity participant, or owner operator through infrastructure concession investments. Order backlog is a key metric for the construction and engineering sector, providing visibility on future revenue and earnings potential. Coming out of the economic downturn when many corporate capital expenditure programs were put on hold, global capex programs, particularly in the mining and energy sectors are expected to grow substantially in 2011 and 2012 which will lead to increased backlog.

Since adding the position in **SNC**, the stock came under pressure due to investor concerns related to the company's exposure to recently volatile Northern Africa; this region represents approximately 15% of total revenues with Algeria and Libya accounting for half this amount. Although certain projects in Libya have been suspended temporarily, apparently projects in Algeria, Tunisia and Egypt continue to operate. While we cannot predict the timing of a return to "normal" in the region, we think ultimately these projects are vital to the respective economies and that the current share price weakness provides an attractive entry point for investment in **SNC**.

## Exhibit 1: ScotiaMcLeod Canadian Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Mar-11	Target Price	Dividend	Dividend Yield	Potential ROR
<b>Interest Sensitive:</b>								
Bank of Nova Scotia	BNS	2-SP	Low	\$59.49	\$72.00	\$2.08	3.5%	25%
Brookfield Asset Management	BAM	1-SO	Low	\$31.51	\$35.50	\$0.50	1.6%	14%
Genworth MI Canada Inc.	MIC	1-SO	Low	\$26.17	\$31.00	\$1.04	4.0%	22%
Rogers Communications	RCI.B	2-SP	Low	\$35.24	\$39.00	\$1.42	4.0%	15%
Royal Bank of Canada	RY	1-SO	Low	\$59.99	\$75.00	\$2.00	3.3%	28%
Sun Life Financial	SLF	1-SO	Low	\$30.47	\$37.00	\$1.44	4.7%	26%
Toronto Dominion Bank	TD	1-SO	Low	\$85.80	\$105.00	\$2.64	3.1%	25%
<b>Consumer Products:</b>								
Thomson Reuters Corporation	TRI	1-SO	Low	\$38.05	\$44.00	\$1.19	3.1%	19%
<b>Industrial Products:</b>								
Canadian National Railway	CNR	1-SO	Medium	\$73.15	\$80.00	\$1.30	1.8%	11%
SNC -Lavelin Group Inc.	SNC	1-SO	Medium	\$55.24	\$69.00	\$0.84	1.5%	26%
Research In Motion	RIM	1-SO	Medium	\$54.83	\$99.00	\$0.00	0.0%	81%
<b>Resource:</b>								
Agrium Inc.	AGU	1-SO	High	\$89.47	\$111.00	\$0.11	0.1%	24%
Arc Resources Ltd.	ARX	1-SO	High	\$26.35	\$28.00	\$1.20	4.6%	11%
Barrick Gold	ABX	1-SO	Medium	\$50.39	\$84.00	\$0.47	0.9%	68%
Canadian Natural Resources	CNQ	1-SO	Medium	\$47.85	\$49.00	\$0.36	0.8%	3%
Crescent Point Energy Corp.	CPG	1-SO	High	\$47.05	\$56.00	\$2.76	5.9%	25%
Suncor Energy	SU	2-SP	Medium	\$43.48	\$46.00	\$0.40	0.9%	7%
Talisman Energy	TLM	1-SO	Medium	\$23.97	\$25.00	\$0.25	1.0%	5%
Teck Resources Ltd.*	TCK.B	Not Rated	High	\$51.39	\$69.00	\$0.60	1.2%	35%
TransCanada Corp.	TRP	1-SO	Low	\$39.31	\$48.00	\$1.68	4.3%	26%

\*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

The Financial sector was among the largest index point contributor to the Canadian equity market in the first quarter, outperforming 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 (54% as of March 31, 2011), and despite the relative underweight position in the Income Plus Portfolio (47%), the portfolio outperformed due to strong stock selection. The portfolio generated a total return of 7.2% for the quarter while the benchmark increased 6.2% on the same basis.

Financial stocks were largely positive during the quarter as bank stocks, as described in the commentary for the Canadian Core Portfolio previously, advanced on mostly higher than forecast first quarter earnings reports which in some cases included dividend increases. **Royal Bank** and **Toronto Dominion Bank (TD)** delivered the strongest results relative to expectations, while **TD** raised their quarterly dividend by 8%. **National Bank's** profit report was received favourably as the stock rallied 15% in the quarter, while shares of **Bank of Nova Scotia (BNS)** advanced only 4%; **BNS** was the last of the big six banks to report, and despite beating consensus estimates and raising the annual dividend by 6%, investors were driven to sell the stock as the earnings beat was deemed insufficient in comparison with its peer group.

Energy holdings, which include pipeline stocks also performed well during the period. **Crescent Point Energy** advanced almost 7% coincident with the rally in crude oil futures, while the prospect of increased global demand for Canadian oil specifically, due to the conflict in the Middle East, has improved the outlook for Canadian oil and gas pipeline companies **Enbridge Inc.** and **TransCanada Corp.** which climbed 6% and 4% respectively.

### Changes

We also switched out of the position in **Great West Lifeco** in this portfolio for the same reasons stated previously and into **Calloway Real Estate Investment Trust (REIT) (CWT.UN)**. **Calloway** owns a portfolio of predominantly large-format unenclosed retail real estate properties. Its single largest tenant is **Wal-Mart**, which accounts for 27% of gross rents and anchors 76% of its properties spread across Canada. Although technically considered part of the "Financial" sector, the addition of a REIT holding provides differentiation within the sector and enhances portfolio diversification. **Calloway's** assets include 129 locations across Canada with 5.1 million sq. ft. of future development potential. Recent interest by U.S. retailers for Canadian locations should improve the company's development pipeline; U.S. discount chain **Target** announced plans to purchase and convert up to 220 Zellers locations across Canada. In response, **Wal-Mart** announced 8 net new stores, and expansion of 32 existing locations to be completed before **Target's** expected launch in 2013. **Calloway** trades at an attractive valuation and based on current annual distributions of \$1.55 per unit, the REIT provides a current yield of 6.0%.

In mid February we also made a switch in this portfolio: out of **Fortis Inc. (FTS)** for the same rationale described above in the commentary for the Canadian Core Portfolio, and into **Emera Inc. (EMA)**. **EMA** is an electric utility company which offers diversified energy services in the province of Nova Scotia (through Nova Scotia Power Inc.), and Maine (Bangor Hydro-Electric) including electric power generation, transmission, and distribution. **Emera** also owns and manages electrical utility operations in the Caribbean. Although 2011 is seen by analysts as a transition year for **EMA** to consolidate recent asset purchases, these acquisitions and investments add to the company's rate base and enhance its longer term growth profile. **Emera's** targeted capital structure is 60%/40% debt/equity; the company recently completed a widely anticipated equity issue of approximately \$200 million to fund operations; as the financing was factored into earnings models, there are no material changes to the company's outlook other than the absence going forward of any overhang of a potential equity offering. The company raised their annual dividend by 15% last November, leading to a current dividend yield of 4.1%. **EMA** trades at a discount valuation to its peer group, making the shares particularly attractive given the steady and predictable nature of the company's lower risk regulated earnings.

## Exhibit 2: ScotiaMcLeod Income Plus Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Mar-11	Target Price	Dividend	Yield	Potential ROR
<b>Interest Sensitive:</b>								
Bank of Montreal	BMO	2-SP	Low	\$62.98	\$68.00	\$2.80	4.4%	12%
Bank of Nova Scotia	BNS	2-SP	Low	\$59.49	\$72.00	\$2.08	3.5%	25%
Calloway REIT	CWT.UN	Restricted		\$25.80		\$1.55	6.0%	
Emera Inc.	EMA	2-SP	Low	\$31.69	\$35.00	\$1.30	4.1%	15%
National Bank of Canada	NA	3-SU	Medium	\$78.79	\$90.00	\$2.64	3.4%	18%
Rogers Communications Inc.	RCI.B	2-SP	Medium	\$35.24	\$39.00	\$1.42	4.0%	15%
Royal Bank of Canada	RY	1-SO	Low	\$59.99	\$75.00	\$2.00	3.3%	28%
Sun Life Financial	SLF	1-SO	Low	\$30.47	\$37.00	\$1.44	4.7%	26%
TELUS Corp.	T	2-SP	Medium	\$49.57	\$50.00	\$2.10	4.2%	5%
Toronto Dominion Bank	TD	1-SO	Medium	\$85.80	\$105.00	\$2.64	3.1%	25%
<b>Consumer Products:</b>								
Shaw Communications	SJR.B	1-SO	Low	\$20.44	\$26.00	\$0.92	4.5%	32%
Thomson Reuters Corp.	TRI	1-SO	Low	\$38.05	\$44.00	\$1.18	3.1%	19%
<b>Resource:</b>								
Crescent Point Energy Corp.	CPG	1-SO	Low	\$47.05	\$56.00	\$2.76	5.9%	25%
Enbridge Inc.	ENB	1-SO	Low	\$59.42	\$66.00	\$1.96	3.3%	14%
TransCanada Corp.	TRP	1-SO	Low	\$39.31	\$48.00	\$1.68	4.3%	26%

Source: Scotia Capital; Bloomberg

## ScotiaMcLeod U.S. Core Guided Portfolio

*Stephen Uzielli - Portfolio Manager, Portfolio Advisory Group*

### Performance Update

U.S. equity markets ended the first quarter with an essentially flat month of March, following on the heels of a solid January and February. Investors were suitably encouraged while hoping the old adage “as goes January, so goes the year” would indeed foreshadow a solid year of investment returns, as the first quarter delivered the best such period of performance for U.S. equities since 1998.

U.S. equities were supported by higher than expected Q4 earnings results across most sectors in addition to several encouraging economic data points. In particular, Purchasing Manager Indices looked better in both Europe and the U.S. while crucial employment reports are demonstrating improvement at a faster pace than anticipated. Oil was not the only commodity on the rise during the quarter as inflation is on investors’ minds due to price increases across the whole commodity complex. In fact, rising food prices, (combined with high unemployment), was one of the primary catalysts for the protests in North Africa. The CRB Commodity Price Index, a broad measure of industrial and agricultural commodities, increased 8.0% during the quarter.

While still delivering positive absolute returns for the quarter, this portfolio underperformed the S&P500 Index, generating a total return of 4.0% versus the benchmark at 5.9% on a similar basis. All ten major sub-indices moved higher in the quarter while only seven portfolio holdings declined in value. As was the case in the preceding two quarters, the so-called “risk trade” was on again as investors favoured cyclical or more economically sensitive sectors over more defensive investments.

The biggest decliner among portfolio holdings was **Nike Inc. (NKE)** which fell 11% for the quarter but dropped 15% in March after reporting Q3 results light of consensus estimates; revenues rose higher than forecast but gross margins were only slightly below estimates at 45.8% vs. 46%. The earnings miss was attributed to higher costs for cotton, labour, and transportation, and the company indicated this may impact margins for the balance of the year. **NKE** said futures orders (similar to order backlog) increased more than analyst estimates of 8% growth. The company plans to raise prices in Fiscal 2012, which starts in June, to combat rising input costs. We will continue holding the stock as we believe **NKE** will soon be able to pass on their higher costs and restore profit margins. Other shares under selling pressure along with the many other Technology stocks during the quarter included **Intel Corp.**(-4%) and **Microsoft Corp.**(-9%), which fell partially in sympathy with **Cisco Systems**.

Among positive performers during the period, shares of **Marathon Oil** rallied the most, advancing 44% on higher oil prices combined with the plans to split into two companies: one focused on the downstream and refining aspects of the business, in addition to a separate upstream production company. **ExxonMobil Corp.** rallied 15% while reporting excellent Q4 results which caused analysts to raise valuation targets. Shares of **Fluor Corp.**, which generates more than 50% of their revenues from the oil and gas sector, got an 11% lift corresponding to the move in Energy stocks. And finally, shares of **Pfizer** jumped 16% as investors anticipate several catalysts which are expected to support **Pfizer** shares over the next six months including clinical trial results, further evidence of enhanced synergies from the Wyeth acquisition, and speculation of a spin-out of the company’s nutrition business to surface shareholder value.

### Changes

In early February we made a switch in this portfolio, out of **Colgate Palmolive (CL)**, and into **JP Morgan Chase (JPM)** due to sector re-allocation which would shift the portfolio further toward a cyclical over defensive preference. To that end we increased the weight in Financials by one holding, bringing the sector weight to 15%, while reducing our exposure to the defensive Consumer Staple sector down to only one position, representing a 5% weight.

While **Colgate** is undoubtedly a high quality company with strong brands and a solid balance sheet, the intermediate term outlook is cloudy and the shares appeared fully valued. In the absence of any near-term catalysts that might improve the company's prospects or encourage investors to become more enthusiastic, we concluded the stock would likely underperform its brethren in the Consumer Staples sector, and specifically **PepsiCo, Inc.** Although the cyclical bias in our sector allocation is not new, the specific shift in sentiment toward Financials is a change in perspective in response to improving conditions for the sector due to the healthier economic outlook. Both banks and life insurance companies should enjoy enhanced profitability as long term interest rates eventually trend higher and capital markets return to relative stability; dividend increases should also once again be prevalent within the sector as management and regulators become more comfortable that adequate capital levels have been achieved.

We previously held a position in **JP Morgan (JPM)** as the company has long been viewed as one of the best positioned banks in terms of capital levels, profitability, credit quality, and management execution. Although revenue growth may remain challenging for the sector this year, profitability is expected to grow as a result of improving loan growth, better credit spreads, and declining loan loss provisions. **JP Morgan** is a global financial services company, operating in more than 100 countries with a comprehensive product platform which includes asset management, investment banking private & commercial banking, and treasury & securities services. **JPM** appears well positioned relative to its peers due to the strength of their balance sheet and their competitive position. **JPM** was the only major U.S. bank to remain profitable during the financial crisis. As forecast, subsequent to adding the position to the portfolio, the Federal Reserve allowed several banks to reinstate a more traditional dividend policy and **JPM** increased its dividend to \$0.25 per quarter, indicating an annual dividend yield of 2.2%.

In mid March we executed a trade in this portfolio in which we sold **Cisco Systems Inc. (CSCO)** and replaced it with a new position in the shares of **Apple Inc.** Q2 results provided the third quarter in a row of disappointing guidance from **CSCO** management; previously we were willing to accept that management was merely being conservative and that the issues the company faced were more macro in nature. Increasingly however we came to believe that some of **CSCO's** challenges are more company-specific and that management had used up much of their credibility with analysts; **CSCO** has turned into a "show-me" story which will take several quarters to regain investors' confidence. We think the stock will likely continue to underperform and switched into another Technology name which offers more predictable earnings growth and upside potential: **Apple Inc.**

**Apple Inc. (AAPL)** is one of the world's largest makers of personal computers and related peripherals, mobile communications, and consumer products, such as the *Mac* family of computers, *iPod* digital music player, the *iPad* tablet, and the *iPhone* smartphone, for sale primarily to the business, creative, education, government, and consumer markets. **Apple** operates an online store as well as over 300 retail outlets, in the United States, Canada, and overseas. **Apple** benefits by having product offerings across multiple market segments, some of which they invented, or re-invented themselves, like the *iPad* tablet. **Apple** has a clean balance sheet with no debt and currently sits on approximately \$64 per share of cash, representing ~18% of the share price, and despite the stock's strong share price performance, continues to trade at an attractive valuation. Subsequent to our adding **AAPL** to the portfolio, Credit Suisse launched research coverage of the stock with an Outperform recommendation and a \$500 target price.

## Exhibit 3: ScotiaMcLeod U.S. Core Guided Portfolio

Sector	Symbol	Rating	Risk Ranking	Price 31-Mar-11	Target Price	Dividend	Dividend Yield	Potential ROR
<b>Interest Sensitive:</b>								
AT&T Inc.*	T	Restricted	Low	\$30.61	\$32.00	\$1.72	5.6%	10%
JP Morgan Chase & Co.	JPM	Outperform	Medium	\$46.10	\$58.00	\$1.00	2.2%	28%
MetLife, Inc.	MET	Outperform	Medium	\$44.73	\$52.00	\$0.74	1.7%	18%
State Street Corp	STT	Outperform	Low	\$44.94	\$53.00	\$0.72	1.6%	20%
<b>Consumer Products:</b>								
McDonald's Corp	MCD	Outperform	Low	\$76.09	\$89.00	\$2.44	3.2%	20%
McKesson Corporation	MCK	Outperform	Low	\$79.05	\$89.00	\$0.72	0.9%	13%
Nike Inc.*	NKE	Not Rated	Medium	\$75.70	\$93.00	\$1.24	1.6%	24%
PepsiCo, Inc	PEP	Neutral	Low	\$64.41	\$69.00	\$1.92	3.0%	10%
Pfizer Inc.	PFE	Outperform	Low	\$20.31	\$23.00	\$0.80	3.9%	17%
<b>Industrial Products:</b>								
Apple Inc.	AAPL	Outperform	Medium	\$348.51	\$500.00	\$0.00	0.0%	43%
Fluor Corp.	FLR	Outperform	Low	\$73.66	\$84.00	\$0.50	0.7%	15%
Intel Corp.	INTC	Outperform	Low	\$20.18	\$28.00	\$0.73	3.6%	42%
Microsoft Corp	MSFT	Outperform	Medium	\$25.39	\$36.00	\$0.64	2.5%	44%
Oracle Corp	ORCL	Outperform	Low	\$33.43	\$42.00	\$0.24	0.7%	26%
United Technologies Corp	UTX	Outperform	Low	\$84.65	\$92.00	\$1.92	2.3%	11%
Waste Management Inc.	WM	Neutral	Medium	\$37.34	\$36.00	\$1.36	3.6%	0%
<b>Resource:</b>								
ExxonMobil Corp.	XOM	Neutral	Low	\$84.13	\$95.00	\$1.76	2.1%	15%
Freeport McMoRan Copper	FCX	Outperform	Medium	\$55.55	\$75.00	\$1.00	1.8%	37%
Marathon Oil Corp.	MRO	Outperform	Medium	\$53.31	\$65.00	\$1.00	1.9%	24%
Occidental Petroleum	OXY	Neutral	Medium	\$104.49	\$128.00	\$1.84	1.8%	24%

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

Source: Scotia Capital Credit Suisse; Bloomberg; Value Line

# ScotiaMcLeod North American Core Guided Portfolio

*Stephen Uzielli - Portfolio Manager, Portfolio Advisory Group*

## Performance Update

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

The North American Core Guided Portfolio generated a total return of 1.6% during the quarter, underperforming the hybrid benchmark North American index which advanced 4.6% on the same basis, largely as a result of several holdings which suffered particularly damaging declines during the period. The U.S. dollar declined against the Canadian dollar during the first quarter as the Canadian currency got a boost from the strength in oil prices. Ultimately the U.S. dollar fell 2.4% against the loonie which had the effect of reducing the positive performance contributed by U.S. portfolio holdings during the period after allowing for currency translation.

In addition to **Cisco Systems** which dropped significantly before we exited the position, other big decliners during the period included **Nike Inc**, **Microsoft Corp.**, **Teck Resources**, and **Research In Motion** which got hit almost 9% subsequent to adding it to the portfolio. The top performing holdings were found among several sectors and included: **Royal Bank**; **TD Bank**; **Pfizer Inc.**, **CN Rail**, **Fluor Corp.**, and **Suncor Energy**.

## Changes

In early February we also made changes in this portfolio. Not only did we trade out of **Colgate Palmolive (CL)** and into **JP Morgan Chase (JPM)** for the same rationale described previously, but we also switched the position in **Rogers Communications (RCLB)** into another Energy holding: **Crescent Point Energy (CPG)**. In order to further align the sector allocation in this portfolio, we reduced exposure to Telecommunication Services by one holding, and added to the weight in Energy. The portfolio had two positions in the Telecom sector and we elected to sell **Rogers Communications** while continuing to hold **AT&T Inc.** which we believe offers superior total return potential in the intermediate term. Although **Rogers** offers the most upside among Canadian wireless players, the next few quarters are likely to remain challenging due to the intensity of the current competitive landscape. **AT&T** shares trade at an attractive valuation and the stock currently provides a 5.6% dividend yield, as compared to **Rogers** at 4.0%.

We like **Crescent Point Energy Corp.** due to the company’s impressive track record of building shareholder value through a strategy focused on acquiring, developing, and exploiting large resource plays; management continues to execute and the stock has been a solid performer while offering a current yield of 5.9%. **CPG** is acknowledged as a leader in the energy patch for its disciplined strategy and focused, high-quality reserve base that allows for low risk and predictable production growth. 2011 production forecast is split 90% light & medium oil, 10% natural gas. On a Price/Cash Flow basis, **CPG** has historically traded at a premium to the peer group but we continue believe the premium valuation is justified by the proven track record, significant growth potential, and compelling dividend yield.

As in the U.S. Core Portfolio, in mid March we also made changes in this portfolio; not only did we trade out of **Cisco Systems** and into **Apple Inc.** for the same rationale described in the section on the U.S. Core Portfolio, but we also further shifted sector emphasis by switching the position in **Talisman Energy (TLM)** into an additional Technology holding: **Research In Motion (RIM)**. With the addition of **JP Morgan** in early February, the North American Core Portfolio was already overweight Financials, with four bank holdings in total; however, there was room to add an additional holding in the Technology sector in keeping with the recommended sector allocation. As a result, we increased our weight in Technology by one holding, bringing the sector weight to 16%, while reducing our exposure to the Energy sector down to five (equal weighted) positions, representing a total sector weight of 20%, equal to the benchmark weight. **Talisman Energy Inc.** had been a holding in this portfolio since its inception in May, 2007; given our more positive disposition toward the other energy producers held in the portfolio, we elected to sell the position in **Talisman**.

**RIM** has been a holding in the Canadian Core Guided Portfolio since August, 2009 and remains the only truly investment grade Canadian Technology investment available to investors. The next big catalyst for the stock is the launch of their new *PlayBook* tablet device, their response to **Apple's iPad**. **Apple** virtually invented the category last year with a much-coveted consumer device, and **RIM** plans to compete in this market with a device that is expected to have certain appeal with consumers, especially existing *Blackberry* users; however, the *PlayBook* is also expected to make significant inroads in the enterprise or business market, which is **RIM's** historical market niche. **Apple** is still expected to be the dominant player in this new tablet space; nevertheless, it is expected to be an enormous market with room for multiple players. Industry consultants are now predicting as many as 100 different tablet devices available by the end of this calendar year. We believe **RIM** will be able to capture significant share as a result of enhanced functionality in addition to important distribution relationships with telecom carriers globally. **RIM** has a very solid balance sheet with US\$5.15 per share (almost 10% of the share price) in net cash and no net debt.

Subsequent to adding **RIM** to the portfolio and as noted above, the stock dropped in response to disappointing guidance for the current quarter when announcing their year-end results. We remain confident in the pending *PlayBook* product launch and believe the current valuation is too low relative to the forecast earnings growth rate.

## Exhibit 4: ScotiaMcLeod North American Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Mar-11	Target Price	Dividend	Dividend Yield	Potential ROR
<b>Financials:</b>								
Bank of Nova Scotia	BNS	2-SP	Low	\$59.49	\$72.00	\$2.08	3.5%	25%
Brookfield Asset Management	BAM/A	1-SO	Low	\$31.51	\$35.50	\$0.50	1.6%	14%
JP Morgan Chase & Co.	JPM	Outperform	Medium	\$46.10	\$58.00	\$1.00	2.2%	28%
Royal Bank of Canada	RY	1-SO	Low	\$59.99	\$75.00	\$2.00	3.3%	28%
Sun Life Financial	SLF	1-SO	Low	\$30.47	\$37.00	\$1.44	4.7%	26%
Toronto Dominion Bank	TD	1-SO	Low	\$85.80	\$105.00	\$2.64	3.1%	25%
<b>Telecommunication Services</b>								
AT&T Inc.*	T	Restricted	Low	\$30.61	\$32.00	\$1.72	5.6%	10%
<b>Consumer Discretionary</b>								
McDonald's Corp	MCD	Outperform	Low	\$76.09	\$89.00	\$2.44	3.2%	20%
Nike Inc.*	NKE	Not Rated	Medium	\$75.70	\$93.00	\$1.24	1.6%	24%
<b>Consumer Staples</b>								
PepsiCo, Inc.	PEP	Neutral	Low	\$64.41	\$69.00	\$1.92	3.0%	10%
<b>Health Care</b>								
Pfizer Inc.	PFE	Outperform	Low	\$20.31	\$23.00	\$0.80	3.9%	17%
<b>Industrials</b>								
Canadian National Railway	CNR	1-SO	Medium	\$73.15	\$80.00	\$1.30	1.8%	11%
Fluor Corp.	FLR	Outperform	Low	\$73.66	\$84.00	\$0.50	0.7%	15%
United Technologies Corp	UTX	Outperform	Low	\$84.65	\$92.00	\$1.92	2.3%	11%
<b>Information Technology</b>								
Apple Inc.	AAPL	Outperform	Medium	\$348.51	\$500.00	\$0.00	0.0%	43%
Microsoft Corp.	MSFT	Outperform	Medium	\$25.39	\$36.00	\$0.64	2.5%	44%
Oracle Corp	ORCL	Outperform	Low	\$33.43	\$42.00	\$0.24	0.7%	26%
Research In Motion	RIM	1-SO	Medium	\$54.83	\$99.00	\$0.00	0.0%	81%
<b>Energy</b>								
Canadian Natural Resources	CNQ	1-SO	Medium	\$47.94	\$49.00	\$0.36	0.8%	3%
Crescent Point Energy Corp.	CPG	1-SO	High	\$47.05	\$56.00	\$2.76	5.9%	25%
Occidental Petroleum	OXY	Neutral	Medium	\$104.49	\$128.00	\$1.84	1.8%	24%
Suncor Energy	SU	2-SP	Medium	\$43.48	\$46.00	\$0.40	0.9%	7%
TransCanada Corporation	TRP	1-SO	Low	\$39.31	\$48.00	\$1.68	4.3%	26%
<b>Materials</b>								
Barrick Gold	ABX	1-SO	Medium	\$50.39	\$84.00	\$0.47	0.9%	68%
Teck Resources Ltd.**	TCK/B	Not Rated	High	\$51.39	\$69.00	\$0.60	1.2%	35%

\*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

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 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&PTX60 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.

**As per the quantitative screen conducted using data from March 31, 2011, we present the holdings for the new ScotiaMcLeod Canadian Quant Guided Portfolio:**

## Exhibit 5: ScotiaMcLeod Canadian Quant Guided Portfolio

Company	Symbol	Quant Rank	Price 31-Mar-11	Dividend	Dividend Yield	Risk Ranking
Rogers Communications Inc.	RCI.B	1	\$35.24	\$1.42	4.0%	Medium
Yellow Media Inc.	YLO	2	\$5.52	\$0.65	11.8%	Medium
Shaw Communications	SJR.B	3	\$20.44	\$0.92	4.5%	Medium
Sun Life Financial	SLF	4	\$30.47	\$1.44	4.7%	Medium
First Quantum Minerals	FM	5	\$125.42	\$1.21	1.0%	High
TELUS Corp.	T	6	\$49.57	\$2.10	4.2%	Medium
Suncor Energy Inc.	SU	7	\$43.48	\$0.40	0.9%	Medium
Canadian Imperial Bank of Commerce	CM	8	\$83.60	\$3.48	4.2%	Low
Power Corp.	POW	9	\$28.73	\$1.16	4.0%	Low
National Bank of Canada	NA	10	\$78.79	\$2.64	3.4%	Low
Agnico-Eagle Mines Ltd.	AEM	11	\$64.45	\$0.63	1.0%	High
Canadian Oil Sands Ltd.	COS	12	\$32.67	\$0.80	2.4%	High
Potash Corp. of Saskatchewan	POT	13	\$57.18	\$0.27	0.5%	High
Bank of Montreal	BMO	14	\$62.98	\$2.80	4.4%	Low
Husky Energy Inc.	HSE	15	\$29.46	\$1.20	4.1%	Medium

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

*Source: Scotia Capital; Bloomberg; ScotiaMcLeod*

# 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.

## Performance Update

The ScotiaMcLeod Core-Plus Portfolio Fixed Income Guided Portfolio returned 0.44% for the first quarter that ended on March 31st, 2011. The portfolio outperformed the DEX Universe Bond Index, which returned a -0.27% over the same period. The reasons for the outperformance of the Portfolio, as compared to the Index, are primarily due to sector allocation, the length of term of the Portfolio and the decision to invest in the high yield space as one of the active strategies.

The best performing sector in the first quarter of 2011 has been the corporate sector, with the DEX Corporate Index returning 0.33% thus far. The short end of the yield curve has been the best performing area of the yield curve this year with the DEX Short Term Index returning 0.26% for the quarter. The combination of short term investments and being overweight the corporate sector were two of the key reasons why the Core-Plus Portfolio outperformed the Index for the quarter.

The key reason for the DEX Universe Index generating a negative return for the quarter was due to rising longer-term yields. The DEX Long-Term Index returned a -1.35% for the quarter as investors began to focus on possible interest rate hikes later in the year. Better economic data, stronger stock markets and better sentiment helped fuel the notion that inflation might become a concern in the future and that central banks would need to increase interest rates in order to keep inflation contained. These factors were the primary reasons why the long end of the yield curve sold off during the first quarter. The lack of any investments in the long-end of the yield curve helped the Core-Plus Portfolio avoid the downdraft and was another factor that helped the Portfolio outperform the Index for the quarter.

There were no changes made to the Portfolio for the quarter.

## Current Active Strategies

Active trades were implemented to add value and to try to outperform the Index. The two active strategies generated a combined return of 2.22% for the quarter.

The first position invested in a Laurentian Bank Fixed Floater with a coupon of 3.70% and is callable on November 2, 2015. This position was aided by the rally in short-term corporate paper. The return from this active strategy has tailed off in recent weeks and may be replaced if an opportunity presents itself in the short term.

The second active position, the iShares US High Yield Bond Index Exchange Traded Fund hedged against the Canadian dollar (XHY on the TSX) performed extremely well as investors searched for higher yields. 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. The investment generated a 3.23% return in the first quarter.

These two positions continue to be reviewed as market conditions change and evaluated against other fixed income alternatives.

Exhibit 1: ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio					
Issuer Name	Coupon	Maturity or Call Date	Current Weighting	Total Return for Q1 2011	Total Return Year To Date
<b>Core Positions</b>					
Export Development Corp.	5.750%	Jun 1, 2011	6.4%	0.34%	0.34%
Canada	5.000%	Jun 1, 2014	6.7%	-0.05%	-0.05%
CMHC	4.350%	Feb 1, 2017	6.8%	-0.44%	-0.44%
Canada RRB	3.000%	Dec 1, 2036	5.5%	0.49%	0.49%
Royal Bank Fixed Floater	5.450%	Nov 4, 2013	6.9%	0.46%	0.46%
Canadian Tire Corp	4.950%	Jun 1, 2015	7.1%	0.25%	0.25%
Telus Corporation	5.050%	Jul 23, 2020	7.2%	0.12%	0.12%
Metro Toronto	5.600%	Dec 18, 2018	7.4%	-0.38%	-0.38%
Manitoba	5.250%	Dec 3, 2012	6.7%	0.38%	0.38%
Saskatchewan	4.500%	Aug 23, 2016	6.9%	-0.29%	-0.29%
Quebec	4.500%	Dec 1, 2019	7.2%	-0.64%	-0.64%
<b>Active Positions</b>					
Laurentian Bank of Canada Fixed Floater	3.700%	Nov 2, 2015	9.7%	1.16%	1.16%
iShares US High Yield Bond Index ETF			10.1%	3.23%	3.23%
Cash			5.3%	0.00%	0.00%
<b>Returns for the ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio</b>			<b>100.0%</b>	<b>0.44%</b>	<b>0.44%</b>
<b>Returns for the DEX Universe Bond Index</b>				<b>-0.27%</b>	<b>-0.27%</b>

Source: ScotiaMcLeod Portfolio Advisory Group

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

**Bank of Montreal, Bank of Nova Scotia, Rogers Communications Inc., Royal Bank of Canada, Sun Life Financial Inc., Toronto-Dominion Bank, Thomson Reuters Corporation, Canadian National Railway Company, SNC-Lavalin Group Inc., Barrick Gold Corporation, Canadian Natural Resources Limited, Crescent Point Energy Corp., Suncor Energy Inc., Talisman Energy Inc., Teck Resources Limited, TransCanada Corporation, TELUS Corporation, Enbridge Inc., Power Corporation of Canada, AT&T Inc, Intel Corp, United Technologies Corp,**

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

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Sylvia Chrominska, Group Head of Global Human Resources and Communications for The Bank of Nova Scotia, is on the Board of Directors of Emera Inc. **Emera Incorporated**

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Scotia Capital USA Inc. had a non-investment banking securities-related services client relationship during the past 12 months. **Research In Motion Limited**

The issuer paid a portion of the travel-related expenses incurred by the Fundamental Research Analyst/Associate to visit material operations of the following issuer(s): **Agnico-Eagle Mines Limited, Agrium Inc., Barrick Gold Corporation**

Scotia Capital Restriction **Bank of Nova Scotia**

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The Fundamental Research Analyst/Associate has visited material operations of the following issuer(s): **Agnico-Eagle Mines Limited, Barrick Gold Corporation, Canadian National Railway Company, Genworth MI Canada Inc., Research In Motion Limited, Rogers Communications Inc., Shaw Communications Inc., Sun Life Financial Inc., TELUS Corporation, Thomson Reuters Corporation, Yellow Media Inc.**

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This issuer owns 5% or more of the total issued share capital of the Bank of Nova Scotia. **Royal Bank of Canada, Toronto-Dominion Bank**

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<b>Comparative Canadian Bank Information</b>				
<b>Bank</b>	<b>Symbol</b>	<b>Scotia Capital Recommendation</b>	<b>Risk Rating</b>	<b>1 Yr Target</b>
<b>Bank of Montreal</b>	<b>BMO</b>	<b>2-Sector Perform</b>	<b>Low</b>	<b>\$68.00</b>
<b>Bank of Nova Scotia</b>	<b>BNS</b>	<b>2-Sector Perform</b>	<b>Low</b>	<b>\$72.00</b>
<b>CIBC</b>	<b>CM</b>	<b>1-Sector Outperform</b>	<b>Low</b>	<b>\$105.00</b>
<b>National Bank</b>	<b>NA</b>	<b>3-Sector Underperform</b>	<b>Low</b>	<b>\$90.00</b>
<b>Royal Bank</b>	<b>RY</b>	<b>1-Sector Outperform</b>	<b>Low</b>	<b>\$75.00</b>
<b>Toronto-Dominion Bank</b>	<b>TD</b>	<b>1-Sector Outperform</b>	<b>Low</b>	<b>\$105.00</b>

## ScotiaMcLeod

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CALGARY  
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COMOX II  
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MONTRÉAL  
Capital Branch  
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NEW LISKEARD  
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(905) 377-6301  
OAKVILLE – Kerr St.  
(905) 842-9000  
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QUEBEC – Rive-Sud  
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THUNDER BAY  
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11th Floor  
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TORONTO – Scotia Plaza  
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15th Floor  
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Group  
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VANCOUVER – North  
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VANCOUVER – West  
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YARMOUTH  
(902) 742-0040