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As a new year begins to unfold, it's an appropriate time to look ahead at some of the issues that will affect us as investors. All too familiar with the markets' turbulence over recent months, this issue of *Exchange* focuses on three essential areas to help you work closely with your ScotiaMcLeod advisor to develop an investment strategy suited to your own situation.

Investors must, as always, watch the balance between equities and fixed income investments in their portfolio. We also need to review our RRSPs, seeing how those measure up against some traditional truths. Finally, we need to reassess whether it is better to invest inside or outside of an RRSP, given the changes in capital gains announced in the mini-budget before the last federal election.

TO OUR CLIENTS

This is a time of new beginnings, as we all look ahead with renewed purpose and anticipation. It is a time when all is possible. It is a time when we build on the past, to strengthen our future.

Allow us to take this moment to say thank you for the opportunity to work together. And more importantly, for the trust you have placed in our hands. We are reminded that trust is a fragile gift, one that can only be earned. So we appreciate that we must continue to work hard on our behalf.

From our family to yours, we wish you all the best in the days ahead, as we give shape to 2002.

Sincerely,
ScotiaMcLeod

The RRSP Debate: Does the RRSP Still Make Sense?

Marianna Paltanen, CFP • Wealth Planning Consultant
Andrea M. Matthew • Assistant Product Manager, Registered Products

Since the October 2000 mini-budget cut the capital gains inclusion – the amount of a capital gain that is taxable – to 50%, investors have been debating whether to invest inside or outside an RRSP. The reason lies in the way money in RRSPs is taxed. Capital gains outside an RRSP get preferential tax treatment while the gains inside an RRSP when withdrawn are taxed as ordinary income.

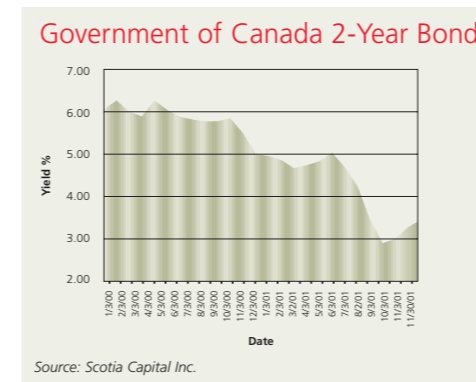
For example, if your marginal tax rate is 46% and you have \$1,000 in capital gains in your RRSP, your tax bill is \$460 when the money is withdrawn. If we compare the same \$1,000 of capital gain in a non-registered portfolio with a 50% inclusion rate, the tax would be \$230 (\$1,000 x 50% x 46%). The non-registered portfolio, therefore, comes out ahead by \$230.

Start RRSP contributions as early as possible. Consider a 45-year-old who earns \$125,000 annually and plans on retiring at age 60. In order to have an after-tax income of \$75,000 he will require approximately \$2,000,000 at retirement.

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American interest rates would fall to historic lows.

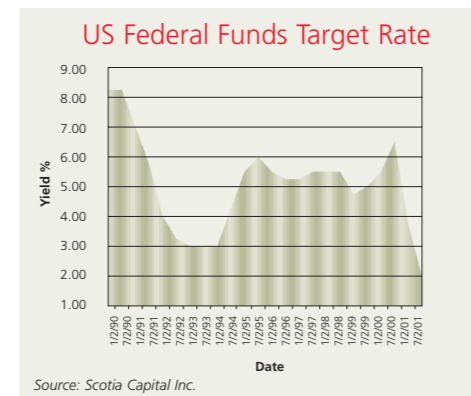
Many things have contributed to the continuing interest rate decline in recent months. In response to the terrorist attacks on September 11, the governments and central banks of the world's major economies have all increased spending and eased credit conditions to restore investor confidence. In the U.S., the government approved a U.S.\$100 billion economic stimulus package; the Treasury Department eliminated the issuance of 30-year bonds, in order to push long term borrowing costs lower; and the central bank cut interest rates.



The combined actions of the U.S. government and the Federal Reserve demonstrate how serious they are to restore the economy and investor confidence. In addition, the union of twenty of the world's developed nations to combat terrorist activities and the success in Afghanistan have provided investors with some comfort to focus on their investments.

All of the pieces are in place for the North American economy to rebound. While interest rates reached historic lows and the returns on bond holdings increased, returns on the equity markets reached their lowest level of the year on September 21. Over the next year we anticipate the returns on equities to outperform bonds as the economy grows and fears of potential inflation increase the possibility that interest rates will move higher.

With the RRSP season upon us, this is an ideal time to review the asset allocation in your investment portfolio. Investors are encouraged to increase their equity exposure and reduce their fixed income holdings in line with their risk tolerance and financial objectives. ■



Our last two major economic downturns were remembered for the high interest rates associated with them, making this current slowdown one that's unprecedented as interest rates throughout 2001 fell lower and lower. We believe the stage is set for a quicker recovery given the central banks' proactive stance to stimulate the economy through reduced interest rates. And with interest rates unable to drop much further, the comparative strength of bonds and equities appear ready to shift.

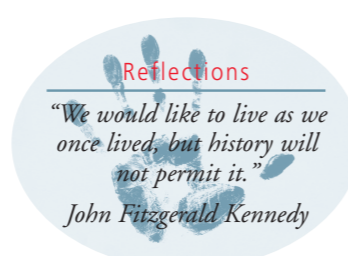
Are Markets Poised for a Rebound?

Stewart Hunt, Director • Fixed Income

On January 3, 2001 the U.S. Federal Open Market Committee surprised the bond and equity markets when it unexpectedly cut its federal funds target rate by 50 basis points, or half of a percent. U.S. Federal Reserve Chairman Alan Greenspan expressed concern that the economy was headed for a downturn. Since the third day of 2001, the Federal Reserve has cut interest rates by 4.75 percentage points and the federal funds target rate has reached 1.75%, a level not seen in 40 years. The Bank of Canada has joined the U.S. central bank and reduced its rates by 3.5 percentage points, taking Canada's target overnight rate to 2.25%.

As a result, on November 7, 2001 the yield on a two-year Government of Canada bond reached a record low of 2.65% and the yield on a two-year United States Treasury note reached a record low of 2.30%. Contrast that with May 2000 when the yield on a two-year Government of Canada bond was 6.35% and on a two-year United States Treasury note 6.9%. Few would have anticipated back in May 2000 that over the next 18 months North

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As a result, some people are concluding that it makes sense to stop contributing to an RRSP and instead redirect that money towards a non-registered equity investment. The problem with this solution is that an investor will not normally hold a portfolio comprised of only capital gains but one that produces interest and dividend income as well. That type of portfolio would be subject to tax at different rates – not just purely capital gains.

Chances are you may have accumulated unused RRSP contribution room.

By not putting away the \$13,500 allowable for 2001 you will be forgoing \$62,923 in future income, assuming you will retire in 20 years and that you can earn 8% on your contribution each year.

There is, therefore, no strategy that applies to everyone. You have to consider other factors such as your investing behaviour, closeness to retirement and your tax rate when the RRSP is withdrawn. The younger you are, the more advantageous the magic of tax-free compounding in an RRSP will be, assuming the RRSP remains in place.

For example, if you invest \$5,000 in an RRSP and it earns 10% for 10 years, your investment will grow to almost \$13,000 (Table 1). If you then collapse the plan and your marginal rate is 46%, you will have approximately \$7,000 at the end of the 10-year period.

Year	Age	Annual Contribution	Deferred Growth	Market Value
2001	40	\$0	\$500	\$5,500
2002	41	\$0	\$550	\$6,050
2003	42	\$0	\$605	\$6,655
2004	43	\$0	\$665	\$7,320
2005	44	\$0	\$732	\$8,053
2006	45	\$0	\$805	\$8,858
2007	46	\$0	\$886	\$9,744
2008	47	\$0	\$974	\$10,718
2009	48	\$0	\$1,072	\$11,790
2010	49	\$0	\$1,179	\$12,969
Total			\$7,969	\$12,969

Initial investment at the beginning of 2001 is \$5,000.

Since you received a \$2,300 tax refund by contributing to your RRSP, your net investment is actually \$2,700. Now, if that \$2,700 is invested outside your RRSP for 10 years at 10% in something that garners capital gains only and is taxed at the 50% inclusion rate with a 46% marginal tax rate, you will have approximately \$5,700 after 10 years (Table 2).

End of Year	Income Earned	After-Tax Income Earned	Deferred Growth	Market Value
2001	270	208	0	2,908
2002	291	224	0	3,132
2003	313	241	0	3,373
2004	337	260	0	3,633
2005	363	280	0	3,912
2006	391	301	0	4,214
2007	421	324	0	4,538
2008	454	349	0	4,888
2009	489	376	0	5,264
2010	526	405	0	5,669

Initial investment at the beginning of 2001 is \$2,700 invested at 10%, earning capital gains only. Growth taxed at 46%.

In this example, the amount of time that your RRSP remained in place – 10 years – provided the best outcome. However, if you were to

Spreading total income over both a high and lower income earner results in lower taxes than if the same RRSP funds were taxed solely in the hands of the higher income spouse. A \$1,000,000 RRSP would have an after-tax payout of \$53,779 while two RRSPs of \$500,000 would have an after-tax payout of \$30,793 – a saving of \$7,807.

immediately collapse your plan prior to the 10-year period you would have to pay tax on the contribution and on the accumulated earnings so the investment outside your RRSP may prove to be a better strategy.

RRSP CHECKLIST FOR 2002

- Make your maximum RRSP contribution before the deadline.
- Consider an RRSP catch-up loan.
- Take advantage of global diversification.
- Don't forget about non-cash, RRSP eligible contributions.
- Split income through spousal RRSP plans.
- Consolidate your investments.
- Review your asset allocation with your ScotiaMcLeod advisor.

Contributing early, regularly, and as much as possible to your RRSP ensures that you are on track to meet your retirement objectives.

The best decision clearly depends upon an individual's circumstances. Even though the capital gains inclusion is lower and may continue to drop, you should not stop contributing to an RRSP. Instead, it may be prudent to follow a strategy whereby fixed income investments are held inside RRSPs and equities outside RRSPs. Ensure that

Those who wait to contribute to their RRSP lose out: To accumulate \$1,000,000 at age 65, a 20-year-old has to put in only \$6,000 for seven years at 8% while a 31-year-old must deposit \$6,000 for 34 years.

your retirement needs are met through RRSP

contributions in order to take advantage of the tax break up front, the tax-free compounding and the tax deferral that an RRSP provides. And remember to consider investing outside your RRSP with equity investments that produce dividends and capital gains to take advantage of the preferential tax treatment. ■

Along with a clear RRSP strategy, deciding on a suitable mix among the major asset classes is key. While the past year has been challenging for most investors, there are signs that suggest we may have passed through a transition point in the markets, as equities appear to be bouncing back. That will lead many of us to recalibrate our investment portfolio to take advantage of the economic climate ahead.

Portfolio Watch: A Time to Rebalance

Frances Horodelski, CFA • Director, Portfolio Advisory Group

In reviewing the first year of the 21st Century, September 11 obviously stands out. This year will always be remembered for the horrific events of that date and the impact on the American (and by extension, our own) view of the world and our place in it. Looking forward, the incidents of 2001 and the beginning of the new year presents an ideal time for review as well as for response to those circumstances and a plan for the future.

There were few forecasts at the beginning of 2001 that prepared investors for the dramatic political events that unfolded nor for the volatility of market returns they experienced. While terrorist actions, by definition, are unpredictable, most investors were also sobered by the depth and length of the bear market. The significant contraction in the value of high-profile technology companies as well as the collapse of the share prices of companies that had once been considered the bluest of blue chips repeatedly caused headaches for investors and headlines for newspapers.

Looking forward, our quantitative strategy group's analysis suggests a changing direction for market valuation and for how investors allocate between the major investable asset classes.

After two decades of expanding price/earnings multiples, we may be entering a period where economic activity and resulting corporate profitability is more important than expanding

price/earnings ratios when considering the valuation of equities. If that is the case – and if indeed our forecast for relatively slow, nominal economic growth comes to pass – investment returns may well be lower than those of the recent past and more consistent with the long term average. These lower return expectations will encourage investors to pay stricter attention to the asset allocation decision as well as to sector selection within each asset class.

Second, despite the still negative trends in the global economy, we are confident that expansionary monetary and fiscal policies in North America will result in economic recovery some time during 2002. Already there have been some modest signals that economic activity is deteriorating at a slower pace and indeed may be stabilizing.

While it is too early to call the recovery, it is important to remember that equity prices take into account changes in economic activity and profitability some nine to 12 months ahead of the event. We believe that improving share prices at the end of 2001 were providing the early indication that 2002 will be a better year.

Our bias for the upcoming year is to favour equities over bonds. Valuations relative to earnings growth expectations are attractive and the last year of cost cutting and streamlining in many sectors should provide an attractive payoff when the economy does improve.

Third, the prospect of lower overall investment returns is another reason that a diversified, disciplined portfolio approach to investing will go a long way



to enhancing investment returns. We recommend investors pay strict attention to the amount of wealth allocated amongst the various asset classes as well as to specific sectors and companies.

Rebalancing to realign those positions back to target levels can help protect a portfolio from dramatic swings. As we found last year, a portfolio balanced between stocks and bonds at the beginning of 2001 was better positioned than one solely committed to equities. In 2002, realigning that same portfolio to increase equity and decrease bond exposure to a more even keel should also provide a better return.

There are no words to put to rest the tragedy of 2001. But as investors, we can gain comfort from the resiliency of the financial markets as well as from the words of Confucius: "Our greatest glory is not in never falling, but in rising every time we fall." ■