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### Industry Update <sup>1</sup>

As sentiments become more positive, sales figures show that investors are beginning to move back into the market. Total net sales in May were \$939.2 million, consisting of \$1.93 billion in long-term fund sales and \$992.9 million in Money Market fund net redemptions. Long-term fund sales were the highest they have been since February 2008.

Domestic Fixed Income led all sales in May with large inflows into Canadian Short-Term Fixed Income funds and Canadian Fixed Income funds at \$609.7 million and \$140.1 million, respectively. Balanced funds also attracted strong sales with \$464.8 million in Domestic Balanced funds and \$386.0 million in Global Balanced funds.

Overall, long-term fund assets have increased by \$21.5 billion in May, \$19.5 billion from market effect and \$1.9 billion from net sales. But the most encouraging news is that for the second month in a row,

| Asset Classes                | Net Sales (\$ millions) |                |                  |
|------------------------------|-------------------------|----------------|------------------|
|                              | May 2009                | April 2009     | YTD              |
| Equity Funds                 | \$13.6                  | (\$442.6)      | (\$2,174.0)      |
| Balanced Funds               | \$850.8                 | \$376.3        | \$1,074.4        |
| Bond Funds                   | \$1,166.5               | \$834.4        | \$3,759.4        |
| Specialty Fund               | (\$98.9)                | (\$121.6)      | (\$429.7)        |
| <b>Total Long-Term Funds</b> | <b>\$1,932.2</b>        | <b>\$646.4</b> | <b>\$2,230.1</b> |
| Short-Term Funds             | (\$992.9)               | (\$276.1)      | \$2,445.7        |
| <b>Total Industry</b>        | <b>\$939.2</b>          | <b>\$370.3</b> | <b>\$4,675.9</b> |

Canadian Money Market funds experienced the highest levels of redemptions at \$1.16 billion, reflecting the trend of investors moving back into the market by investing in long-term funds.

### Introduction to Exchange Traded Funds ("ETFs")

There is a lot of ground to cover with ETFs, more than we can cover in a few pages with this newsletter. With that in mind, this month's newsletter will be approaching the subject of ETFs from a high-level perspective. More specifically, we will discuss the proliferation of ETFs in recent years, and address some common questions about these investment vehicles. From there, we will delve into some of the arguments both in favour of, and against ETFs, followed by our own perspective on the subject, including discussion about strategies in which they can be used.

#### What is an ETF?

An ETF, or Exchange Traded Fund, is effectively a hybrid between a stock and a mutual fund. They trade in the market, on an exchange, similar to how a stock would trade, with intra-day pricing, the ability to trade on margin, as well as order flexibility (i.e. limit orders etc.). But instead of the underlying security being the stock of an individual company, it is normally a diversified basket of securities, usually designed to replicate an index or asset class. In this way, ETF's are more like mutual funds, offering diversified exposure to a given market or asset class.

#### How are ETFs used?

In addition to the two more common strategies that utilize ETFs (outlined later), there are a number of other ways in which ETFs can be used to enhance a portfolio, or at least provide additional flexibility when implementing an investment strategy. Some of these tools and/or strategies include fund or stock complement or replacement, tax loss harvesting, portfolio transition, foreign diversification, as well as strategic and/or tactical asset allocation. In addition to these tools/strategies, ETFs are increasingly being used for hedging purposes. In summary, ETFs have quickly become a popular investment vehicle that can be used for a variety of different purposes, from plain vanilla investing to being a part of more complicated investment strategies.

#### Global proliferation of ETFs

ETFs were introduced to the market in the 1990s. Originally, ETFs were used more as an institutional product that provided an effective tool for pension funds and larger money managers to stay fully invested during periods of asset turnover, or as a replacement and/or

<sup>1</sup> Source: Figures from IFIC

continued...

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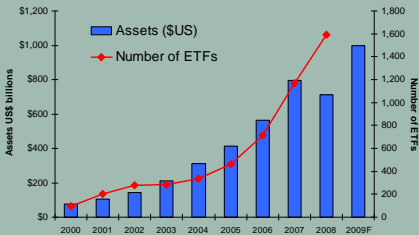
*"Whenever you find yourself on the side of the majority, it is time to pause and reflect."*

Mark Twain -



### Global ETF Growth:

Global ETF Growth



As shown in the figure above, ETF growth globally has been very strong. Over the last 10 years, global ETFs have experienced a compound annual growth rate of approximately 33%. The number of ETFs globally has also experienced staggering growth, with only 92 available in 2000, to approximately 1,590 available today<sup>2</sup>.

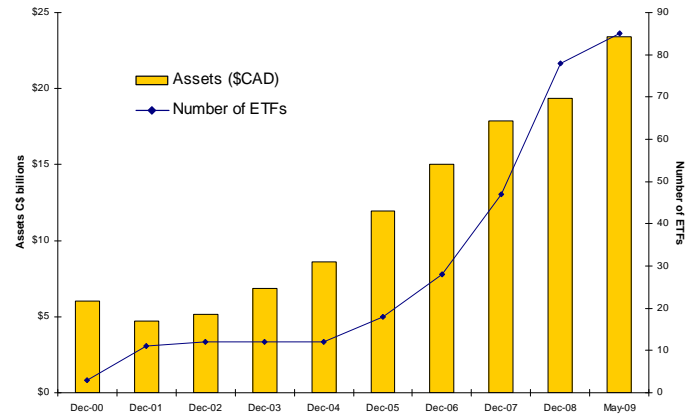
### Introduction to ETFs continued

complement to fund managers. Since that time, ETFs have evolved and now represent a formidable presence in the marketplace with global ETF industry assets at approximately \$634 billion<sup>2</sup>. In Canada, as shown in [Chart 1](#), ETF assets have grown from \$6 billion in 2000 to over \$23 billion 2009<sup>2</sup>, representing an impressive 17.4% compound annual growth rate.

The number of ETFs available has also increased from just three in Canada in 2000, to over 100 today. The users of these instruments have expanded as well, with hedge funds and retail investors comprising a growing segment of the overall market for these products. Today, approximately 80% of ETF trading is institutional, but retail growth is surging with about 60% of inflows coming from retail investors<sup>3</sup>.

Chart 1

Canadian ETF Market

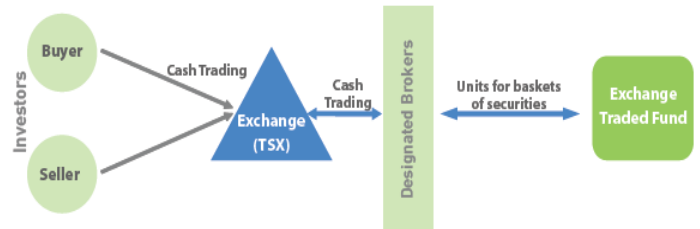


Source: Barclays iShares

### How do ETFs work?

From a high-level perspective, the basic framework of how ETFs work is outlined in [Figure 1](#) (below right). There are effectively two layers of liquidity with ETFs, the first layer is the market supply/demand liquidity, similar to a stock, that occurs between investors/traders. The second layer of liquidity is provided by the "designated broker" or "market maker". The market maker role is a vital component of the operation because they buy and/or sell the underlying basket of securities depending on the direction of purchases or sales in the ETF, and they are also responsible for ensuring the bid/ask spread on the ETFs remain as tight as possible throughout the trading day. The bid/ask spread is equal to the average bid/ask spread of the underlying portfolio of securities, plus a small profit, normally one or two cents on each trade. It is important to note that the bid/ask spread is dependent on the liquidity of the underlying portfolio of securities. For example, the bid/ask spread on a small cap ETF will likely not be as tight as the bid/ask spread on a basket of large cap securities. Ultimately, the "actual" liquidity of an ETF is highly dependent on the liquidity of the underlying basket of securities.

Figure 1: ETF Structure



Source: Claymore Investments Inc.

Now that we've covered some of the basics regarding ETFs, we'll turn our attention to some of the more common arguments both in favour of, and against, ETFs. As with most investment products, there are two sides to every story.

### Arguments *in favour of* ETFs

**Lower cost.** One of the most compelling arguments in favour of ETFs is the lower cost structure when compared to mutual funds. As with all comparisons, it is important to examine this on an individual basis as opposed to making a blanket-statement. There are ETFs that have very low fee structures – in the neighbourhood of 0.15% or less. On the other hand, there are ETFs that have fees much closer to 1.00% or more. The key here is

<sup>2</sup> Source: Barclays iShares

<sup>3</sup> Source: Claymore Investments, Inc.

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### Arguments *in favour of* ETFs continued

understanding the underlying basket and/or the structure of the ETF and how difficult it is to maintain as an ETF strategy. For example, an ETF with additional features such as “active” ETFs would have higher fee structures than the plain vanilla versions of ETFs.

**Efficient market theory.** Efficient market theory postulates that all information is known in the markets, so an individual’s (or fund manager’s) ability to outperform the market over time is not possible. If it is not possible for a fund manager to beat the index over the longer term, then why pay the higher fees associated with a mutual fund? This belief is an argument in favour of investing in ETFs where the mandate is to mimic the performance of the index or asset class for a lower cost versus active investing.

**Trading flexibility.** Since ETFs trade similar to a stock, it provides investors with greater flexibility to get in and out of positions at prices that, at least to a certain extent, can be determined by them (i.e. limit orders), as opposed to being limited to a mutual fund’s subscription/redemption schedule.

**Diversification.** Similar to mutual funds, ETFs can offer diversified exposure to markets and/or asset classes as opposed to investing in individual securities. As with mutual funds, ETFs offer a cost-effective way to achieve diversification, which as we all know, provides tremendous benefits to investors when constructing their portfolios.

### Arguments *against* ETFs

**Full market exposure (*whether you like it or not*).** Whereas mutual fund managers are provided some flexibility to position the portfolios they manage, ETFs are generally fully invested with weightings designed to provide replication of the underlying index (or asset class) performance. In other words, your return will be the market’s return. If we look at last year, this means investors in ETFs that tracked the markets uncomfortably found themselves south of -30% versus many mutual funds that saw the storm coming and were able to position their portfolios defensively, and hence, provide downside protection. On the flipside, investors in ETFs will also participate in 100% of the upside of market performance.

**Monitoring and maintenance.** By default, since there is no portfolio manager at the helm of the ETF mandate, managing the risk of the overall investment strategy shifts back to the investor. With mutual funds on the other hand, you have more control over the managers you hire. You can choose to hire more defensive managers, or more aggressive managers, or any combination in between.

**Transaction costs.** We all know that ETFs are a lower cost solution in terms of the MER associated with them (vs. mutual funds), however, depending on how you use them, there are other costs to consider. Since they trade similar to a stock, they are subject to normal trading fees – so if, for example, an investor is attempting to implement a monthly purchase plan, they will incur trading charges each month for every purchase. In these instances, an index mutual fund is the better choice as the trading fees will add up quickly with ETFs.

**Differences between ETFs and ETF providers.** Despite the common notion that “an ETF is an ETF”, this is not the case. There are differences that exist between ETF providers, and it is important to understand what you are buying. One of the more obvious examples are leveraged ETFs versus regular non-leveraged ETFs. Another example is fundamental ETFs or active ETFs versus regular ETFs. Still other examples are hedged versus unhedged ETFs, and for commodity-related products, there are differences in structures and methodology (e.g. rolling futures contracts). In each case, the product can have unique structures and/or characteristics that can have a material impact on what the investor is expecting the ETF to provide to their investment strategy.

### A note on leveraged ETFs

There has been a lot of discussion and negative press on the relative merits of leveraged ETFs lately. Ultimately, if you’re looking for an ETF to provide tight tracking to its benchmark *over a period longer than one day*, then leveraged ETFs are not the solution for you. *The key* continued...

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### A note on leveraged ETFs continued

to these products, as with all investment products, is to understand what you are buying, know how you intend to use them, and ensure the purchase is suitable for your risk tolerance. Leveraged ETFs that are rebalanced *daily* in order to limit risk to capital invested have a resetting compounding effect that magnifies the daily return of the underlying index.

**Volatility plays a critical role with these ETFs, as illustrated in Table 1.**

Table 1. For illustrative purposes only. Source: Horizons BetaPro

| ONE YEAR BENCHMARK PERFORMANCE | 2X ONE YEAR BENCHMARK PERFORMANCE | BENCHMARK VOLATILITY |        |        |        |
|--------------------------------|-----------------------------------|----------------------|--------|--------|--------|
|                                |                                   | 0%                   | 25%    | 50%    | 75%    |
| -40%                           | -80%                              | -64.0%               | -66.2% | -72.0% | -79.5% |
| -20%                           | -40%                              | -36.0%               | -39.9% | -50.2% | -63.5% |
| 0%                             | 0%                                | 0.0%                 | -6.1%  | -22.1% | -43.0% |
| 20%                            | 40%                               | 44.0%                | 35.3%  | 12.1%  | -18.0% |
| 40%                            | 80%                               | 96.0%                | 84.1%  | 52.6%  | 11.7%  |

The example above illustrates the estimated fund return over one year for a Horizon BetaPro Bull+ ETF. The fund objective is to seek daily results, before fees and expenses, that correspond to twice (200%) the daily performance of a benchmark.

As we can see in the table, periods of high volatility of the underlying benchmark can have a significant negative impact on an investment. Alternatively, periods of low benchmark volatility can have a positive impact. In summary, leveraged ETFs require an increased level of due diligence and ongoing attention (i.e. monitoring) on the part of investors.

**Investors are strongly urged to speak to a financial professional before attempting to invest in leveraged ETFs. The performance of these instruments may vary widely from their intended benchmarks if held for longer than one day.**

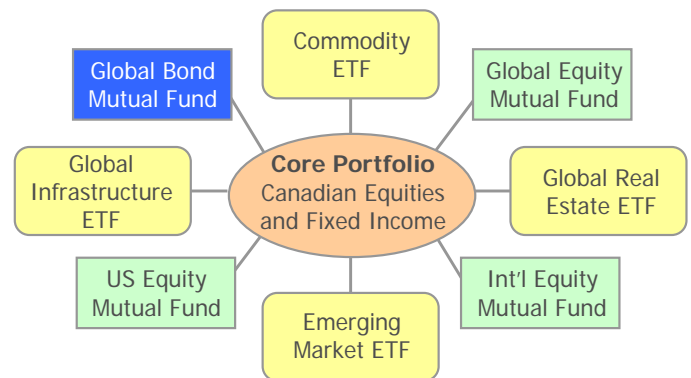
### Our view on ETFs vs. mutual funds

**It's not a competition.** The bottom line here is that fund companies will often argue that mutual funds are a better solution than ETFs, and ETF providers will often argue that ETFs are a better solution than mutual funds. Both sides will provide compelling evidence that supports their own purposes. From our perspective, it is not a competition. We feel both ETFs and mutual funds are useful, the question becomes *how* they are used. In the next section, we explore a couple of ways in which ETFs and mutual funds can be used in combination to produce broadly diversified, cost-effective portfolios.

### Strategies using ETFs

**Core + Satellite approach.** One of the more common challenges faced by investors is attaining an appropriate level of diversification, particularly in trying to gain exposure to difficult-to-access markets or asset classes. Referring to Figure 2 below, we illustrate a simplified example of a diversified portfolio using equities, mutual funds and ETFs. In the example, we have a core portfolio comprised of individual Canadian equity and fixed income positions, combined with a layer of selected mutual funds covering global bonds, as well as global, international, and U.S. equities, and an additional layer of ETFs that include niche or otherwise difficult to access markets and/or asset classes. In this example, we highlight global infrastructure, global real estate, emerging markets and commodity ETFs. There are many different combinations of assets that can be used here, but the point remains the same, ETFs can provide a cost-effective way to assist investors in broadening the scope of their portfolios. This approach is appealing for a couple of other reasons: 1) "Stock picking" and "accessibility" can be challenging in these areas (e.g. emerging markets; infrastructure), and 2) Limited selection for mutual funds in niche areas such as global infrastructure and/or real estate make ETFs a valuable tool to enhance diversification in a portfolio.

Figure 2: Core (stocks, bonds) + Satellite (mutual funds and ETFs)



continued...

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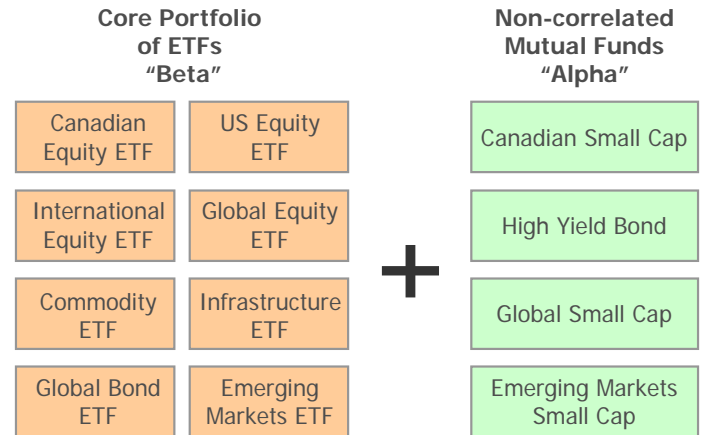


### Strategies using ETFs continued

**Separating “Beta” and “Alpha”.** Another investment strategy using ETFs that has been more prevalent with institutional investors is using ETFs as part of the core portfolio to get passive market returns, also known as “Beta”, while relying on selected mandates that cover niche investment strategies and have a low correlation to the general market for “Alpha” generation – which can also be referred to as “active” management. For retail investors, this can be accomplished by using ETFs (passive returns) and mutual funds (active returns). As

Figure 3 shows, this approach basically flips the previous strategy around to have ETFs as the core portfolio to generate the market, or passive returns, while using selected mutual funds to represent niche strategies that have a low correlation to the “Beta” part of the portfolio, and that add value based on the unique skill-set of the mutual fund manager. These mandates would generally include more concentrated portfolios that focus on niche markets, and we would generally

Figure 3: Beta (ETFs) + Alpha (non-correlated mutual funds)



expect these funds to have a unique profile where the manager has shown an ability to consistently generate excess risk-adjusted returns versus their benchmark.

In general terms, the theory behind this strategy relates to efficient market hypothesis, and how over the long-term active managers will generally not outperform the market. So instead of paying higher fees for actively managed funds that are highly correlated to the index, the idea is to build a portfolio of “indices” (in this case, ETFs) to capture passive returns (Beta portion), and supplement the portfolio with actively managed niche and/or highly uncorrelated funds to capture Alpha.

There are many investment strategies out there that can add value. Obviously, it is important for investors to understand the strategies in which they are investing, so the choice of what strategy to use comes down to the comfort level of the individual investor.

### Summary:

**Since this issue of *Fund Research Monthly* was more of a high-level subject discussion about ETFs as opposed to a specific investment theme, we are not providing any specific recommendations.** Instead, the page that follows provides a short summary of the main ETF providers in Canada. We have provided web links for each ETF provider profiled should you wish to pursue more information about these firms.

In summary, ETFs can be a valuable tool for investors in their investment strategies and portfolio construction efforts. The key with these products, as with all products, is to know and understand what you are buying. There are a number of questions you should ask before making the decision to purchase ETFs - here are a few to get you started:

- What is the objective of the ETF? What is it designed to do?
- Are there any unusual features of the ETF that require further investigation? (such as leverage, hedged vs. unhedged, active features, etc.)
- How are the features designed to work? Have they been working? (i.e. has the ETF performed in the way it was intended to perform?)
- Given underlying assets and/or features of the ETF, is the fee structure reasonable?
- Is the ETF appropriate for the investment strategy involved? Is it appropriate for your own risk tolerance level?

Should you have questions or would like additional research, please speak to your advisor.

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### Important Disclaimer:

ETF provider profiles (at right) have been provided for information purposes only, and as such, should not be construed as an endorsement by the ScotiaMcLeod Fund Research Group for any products offered by these firms.

### Notes and definitions:

**Barclays Global Investors ("BGI")** created the index strategy in 1971, and is the largest institutional asset manager in Canada.

On June 17, 2009, Barclays announced the acceptance of BlackRock's offer to buy its fund management arm BGI. The \$13.5 billion deal must be approved by Barclays shareholders at a general meeting scheduled for August 2009.

**Research Affiliates Fundamental Indexing ("RAFI")** is an indexing method employed to eliminate the performance "drag" that the cap-weighted method can experience. Cap-weighting over-weights the overpriced shares in the index, while under-weighting the underpriced shares.

RAFI attempts to eliminate the "drag" by weighting stocks by non-price measures of firm size including book value of equity, and the 5-year averages of total cash flow, total sales, and gross dividends paid.

**Exchange Traded Notes ("ETNs")** are unsecured debt securities that are linked to the performance of an index or asset class.

### ETF Providers

#### Barclays iShares

(<http://ca.ishares.com>)



iShares ETFs are investment vehicles that track the performance of specific indexes. iShares are the direct product of an asset management firm (BGI) who created the first indexing strategy 40 years ago. In Canada, the first Canadian iShares fund was launched in 1999 (XIU-T), and with more than \$9 billion in assets, is one of the largest funds in Canada. iShares has a wide variety of ETFs available in Canada with representation including market indices, sectors, styles, fixed income, specialty, and international mandates.

#### AUM:

Global: US\$400 billion  
(Canada: C\$20.3 billion)

#### ETFs available:

Global: 385  
(Canada: 30)

#### What makes them unique:

- Have ETFs that are currency hedged
- Jantzi Social Index Fund (XEN)
- Launch of two new ETFs (June 24) CDN MSCI Emerging Markets and CDN MSCI World Index.

#### Claymore Investments, Inc.

([www.claymoreinvestments.ca](http://www.claymoreinvestments.ca))



Claymore Investments, Inc. is a privately held company that offers investment solutions for institutions, advisors, and retail investors including a variety of ETFs, closed-end funds and institutional funds. One of the key differentiators of Claymore ETFs is its focus on "fundamental" ETF solutions that avoid some of the common pitfalls of cap-weighted indexing solutions.

#### AUM:

Global: US\$13 billion  
(Canada: C\$2.3 billion)

#### ETFs available:

Global: 56  
(Canada: 23)

#### What makes them unique:

- RAFI Approach used to determine stock weighting in each Fund which uses four fundamental factors including total cash flow, total sales, gross dividends and book equity value
- PACC plan and DRIP options
- Global Real Estate ETF used in our Guided Portfolios to add diversification

#### Invesco Powershares

([www.powershares.com](http://www.powershares.com))



Founded in 2003, Invesco Powershares Capital Management LLC (formerly PowerShares Capital Management LLC) was created with a vision of delivering investment performance through the ETF structure. With an extensive line-up of ETFs and ETNs, Invesco PowerShares have experienced significant growth since 2003. On the ETF side, for Canadian investors, Invesco PowerShares ETFs can be purchased from a U.S. exchange, but do not currently trade on a Canadian exchange. On the ETN side, there are six products offering 2x exposure that are cross-listed in the U.S. and Canada.

#### AUM:

Global: US\$28.6 billion  
(Canada: N/A)

#### ETFs/ETNs available:

Global: 135 ETFs/19 ETNs  
(Canada: 6 cross-listed ETNs)

#### What makes them unique:

- Invesco Powershares offers both Exchange Traded Notes (ETNs) and Exchange Traded Funds (ETFs)
- Deutsche Bank bears the issuer risk for ETN business
- Currently Powershares ETFs are available via U.S. exchanges only

#### Horizons BetaPro ETFs

([www.hbpetfs.com](http://www.hbpetfs.com))



Managed by BetaPro Management Inc., HBP ETFs allow investors to profit or protect in bull and bear markets. BetaPro is an associate of Jovian Capital Corporation (TSX: 'JOV'), a publicly traded management and holding company with interests in a variety of financial service firms specializing in wealth and asset management.

#### AUM:

Global: N/A  
Canada: C\$2.2 billion

#### ETFs available:

Global: N/A  
Canada: 33

#### What makes them unique:

- Offer leveraged and inverse leveraged ETFs (with daily rebalancing) for a variety of underlying indices and commodities
- Offer ETF products that provide 1x inverse exposure (with daily rebalancing)
- Have ETFs that are currency hedged
- Launching a series of unlevered commodity ETFs in June 2009

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Graphs and performance data are used only to illustrate the effects of the compound growth rate and are not intended to reflect future values of any fund or returns on investment of any fund.

Regulatory restrictions prohibit the disclosure of performance information for funds that have a history of less than 12 consecutive months.

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*The supervisors of the Portfolio Advisory Group own securities of the following companies. None.*