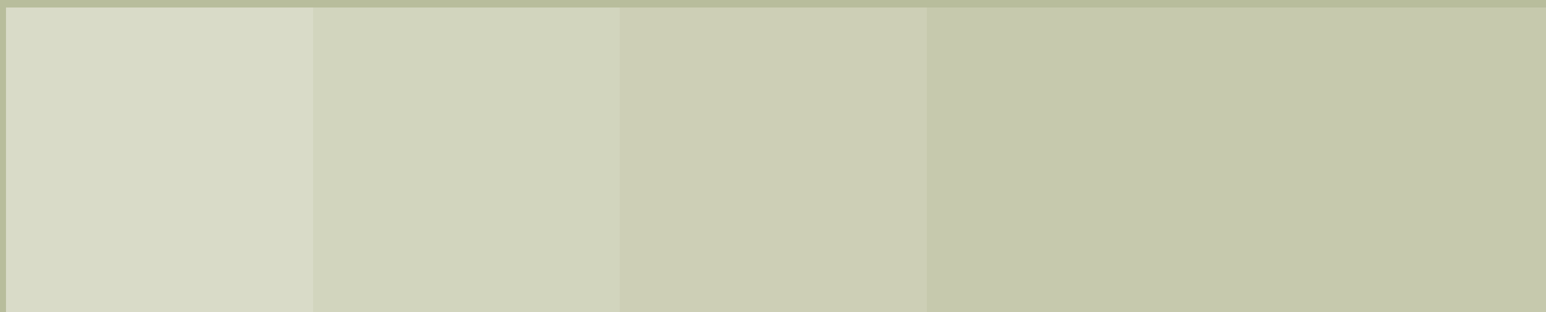
Investment Portfolio Quarterly



Insightful Perspectives

Fall 2004

ScotiaMcLeod™

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Executive Overview

Portfolio Strategy

Frances Horodelski, CFA – Director, Portfolio Advisory Group

"Just as a cautious businessman avoids investing all his capital in one concern, so wisdom would probably admonish us also not to anticipate all our happiness from one quarter alone."

– Sigmund Freud

"The genius of investing is recognizing the direction of a trend – not catching highs and lows"

– Anonymous

The third quarter of 2004 was a tough haul for investors. Equity markets offered up poor returns on average; bonds did the opposite of what would have been expected in a period when the Federal Reserve Board hiked rates three times; oil prices made new highs but inflationary pressures remained muted. As Dr. Freud suggests, a quarter doesn't make a trend, but keeping focused is a challenge.

Our forecasts are essentially unchanged as we look forward to the conclusion of 2004 and into 2005:

- A forecast for higher interest rates.
- An expectation that economic momentum and profitability growth with slow (even more if oil prices stay elevated).
- Bond markets are overvalued based on our valuation work.
- Stocks still offer modest upside potential based on relative value versus fixed income investments and on an absolute basis looking at price/earnings multiples.
- Short term sector bias is towards commodity cyclicals and technology; a sector shift towards a more defensive posture is recommended for 2005.

Recommended Asset Allocation

	Previous	Current
Stocks	60%	55%
Bonds	35%	35%
Cash	5%	10%

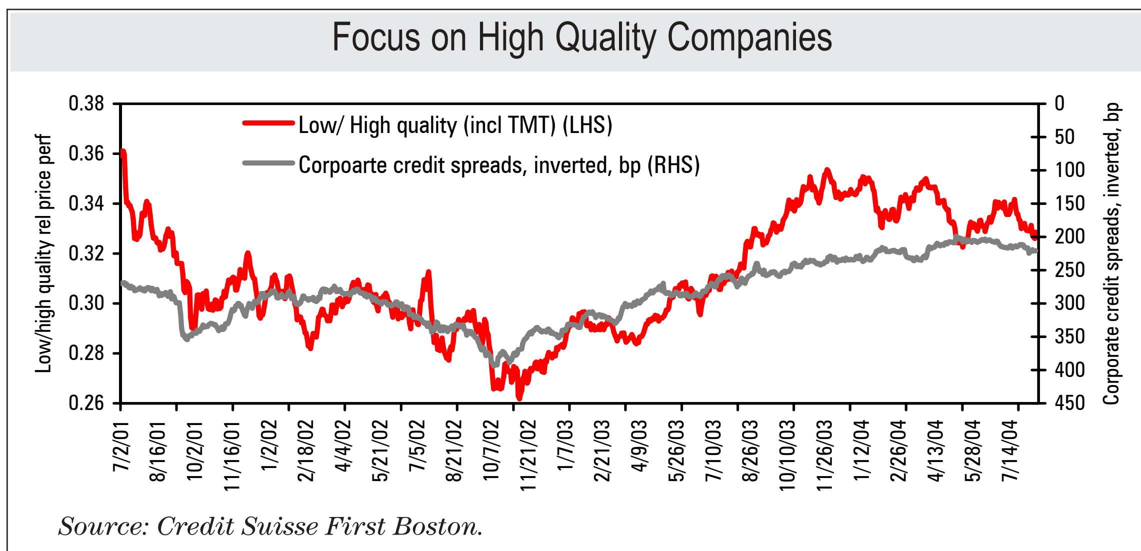
Source: Portfolio Advisory Group.

As we begin the final phase of 2004, it is useful to look back at what we anticipated for this year in January.

We focused on two major themes. The first was that high quality would outperform low quality. As the chart on the next page shows, this indeed has been the case on a trend basis (with lots of variability in between). We continue to believe that as we move into and through 2005, this focus on quality will be an important strategy for investors. It is likely that credit spreads will stabilize and then widen out (after two years of collapsing as risk tolerance has risen but more importantly balance sheets have improved with economic and profitability improvement). It is also likely that the global community will be more focused on some of the global hot spots (Iran, Korea as well as Iraq) and initiatives by the U.S. administration (regardless of who is its leader) to address the imbalances in their system (such as record fiscal and trade deficits).

The second theme was an emphasis on those sectors that would benefit from a steep and stable yield curve. We noted that historically when the difference between short and long term interest rates is wide and has stayed that way for a period of time, the S&P/TSX did well (rising 59% on average during the previous seven cycles when this was the case) and certain sectors

did better than others. That sector emphasis included mining, technology hardware, biotechnology, paper & forest products, banks, software, insurance companies, hospitality and specialty retailing and some of the industrial sectors. We cautioned at the time that both technology and mining were ahead of the historical performance trends and we would await pullbacks before initiating positions. That proved to be a wise move as the commodity sectors (excluding energy), exhibited a significant pullback into the late Spring as did technology. Commodity stocks have snapped back however in recent months. Our view is that technology will do so through the fourth quarter. Indeed, analytical work from Scotia Capital's chief strategist shows that the Nasdaq (as a proxy for technology stocks) is solidly in overweight territory.



Source: Credit Suisse First Boston.

Moving through the end of 2004, we would continue to emphasize our portfolio strategy as outlined in the Summer edition of IPQ namely:

- De-emphasize fixed income investments, shortening term generally (given our outlook for a continued increase in administrated rates to "neutral" by the central banks).
- A focus on the more aggressive sectors of the global economy (including technology, commodities and select industrials) as portfolio managers position for the year-end "beta" trade.
- Have a cash cushion that we would like to increase to 10% to account for the uncertainties we think will be presented in 2005 (including slower economic and profitability momentum).
- Continue to look for quality issues (with a focus on companies that are shareholder friendly through share buybacks and dividend growth initiatives).

This quarter's edition of Investment Portfolio Quarterly provides a series of articles that include:

- Our fixed income view as well as highlights on the core plus portfolio.
- An introduction to our new mutual fund guided portfolios.
- A focus on Canadian and U.S. equity opportunities that emphasize stock selection.
- A review of the all-important income trust category with a focus on the top-picks that are profiled in our recommended list.
- A quarterly review of our equity guided portfolios.
- A feature article on value investing, the strategy behind our managed accounts program, as well as a year-end tax planning article.

Economic Outlook

Traction or Friction

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

Since the start of this year, there has been a steady erosion in the level of optimism with respect to U.S. economic growth prospects, but prior to September the consensus view was still that underlying momentum in the economy was going to remain strong well into 2005. Part and parcel with this view was an expectation that jobs growth in the neighbourhood of 200,000 persons per month would generate enough income growth to keep the consumer sector alive. The slowdown in activity during the summer months has now led to a reassessment of just how much underlying momentum is present and, for the first time in quite a while, some market participants are wondering aloud whether the U.S. might be heading for another downturn. That is indeed an extreme view; however, as oil prices have climbed to record levels, the probabilities of at least a significant slowdown in growth have increased. The Federal Reserve has recently adopted the mantra that the "soft patch" of activity in the third quarter, being caused by the "substantial" increase in energy prices earlier in the year, will give way at some point to a resumption of strong growth. If we really are going to attribute the current malaise to energy, it's worthwhile spending a little time assessing exactly how much of a role this key fundamental is going to play during the remainder of this year and into next.

The Meaning of Oil

The general observation during the latest advance in crude prices has been that the U.S. economy is much less sensitive to energy cost increases than in past cycles, and therefore the effect on growth will be modest. This conclusion falls out of the analysis that the consumption of petroleum fuel products in the U.S. has become increasingly less price elastic. In other words, it takes a larger sustained oil price hike today to cause the same decline in consumption as in the past. Since oil is what we call a "non-discretionary" good, this analysis is intuitive. Individuals still need to drive their cars regardless of the price of gasoline, and homes still need to be heated despite higher fuel oil and natural gas prices. It therefore follows that overall spending patterns will be affected. Since the amount of the household budget going to energy consumption has to increase as prices increase, there are fewer funds available for other purchases. Even for those categories that are more sensitive to interest rates than income, there would be a negative influence from higher energy, and for low- to low-middle class households, higher energy prices act as a regressive tax. If you need proof, just look at Wal-Mart's guidance issued late in the summer.

In addition to the absolute level of energy prices, consumers will also tend to react more negatively the faster prices climb. For example, during the January-May period, crude oil prices advanced by around US$10/bbl (per barrel), or 9.8 cents per day. From the beginning of July to August 20th, crude rose by almost US$14/bbl, but the pace had tripled to 37.5 cents per day. When oil broke US$50/bbl in late September, this represented a less severe US$9.2/bbl increase from the August low, but the pace of increase was almost 44 cents per day. So, while the Federal Reserve looks back at the first half rally in crude oil as being substantial, one has to wonder what description will be applied to the latest advance. Moreover, the first half climb

took place well after the winter heating season and, although higher gasoline prices did eat into summer consumption growth, the impact will be greater this winter (if temperatures are at or below normal) since home energy consumption outstrips gasoline usage. Add in the effects of the recent hurricanes in the South and geopolitical risk, and consumers have the potential of spoiling the party come 2005.

In Canada, we tend to think of rising energy prices as having a net positive impact on economic growth and, in terms of a province like Alberta, this is definitely true. It is not clear, however, that a surge in Alberta's growth will be enough to compensate for weaker growth in central Canada as a result of rising energy costs and possibly weaker U.S. demand. B.C, which has been a solid performer in recent months, also faces a challenge from rising energy prices, split between the pressure on domestic costs, weaker U.S. demand for products, and also the expected hit to Japanese economic growth from higher oil.

A Strong Loonie – A Potential Problem

Canada's bigger threat though comes from the appreciation in the Canadian dollar. At the time of writing, the Loonie had just climbed to within a penny of the 80 US cent threshold and is expected to reach even higher as commodity prices remain firm and the U.S. dollar buckles under the strain of a chronic current account deficit. Currently, the near-term impact of an 80-cent Loonie on overall growth is ambiguous, but it is clear that as the currency travels towards 85 cents and perhaps higher, firms will become increasingly less competitive in the U.S. market, production will be curtailed and employment growth could falter. In recent months, the street has looked to Canada outperforming the U.S. in growth terms which, with the rise in global commodity prices, has resulted in Canada's TSX index outperforming its major U.S. counterparts. Barring a major negative shock to the U.S., a stronger Canadian dollar will ensure that this gap with the U.S. will close.

Weaker growth in the U.S. is expected to cause the Federal Reserve to take a breather from further policy tightening, less than half a year from when it started lifting rates. Market participants are uncertain as to when this pause will begin and how long it will draw on. To the extent that Mr. Greenspan and the FOMC are intent on pushing the official target rate up to its "neutral" level, then it's possible that the tightening will continue through the fourth quarter, leaving fed funds at 2.25%. This is still below what the street (and Fed) feels is "neutral", but economic headwinds at year-end may be sufficient for the Fed to take the foot off the brake pedal nonetheless, especially with core inflation so subdued even in the face of soaring energy prices. The pause would then depend on the duration of weaker growth and how bad things get. The counter view is that the Fed takes short breathers every other meeting beginning with November 10th. Rates still move up, but at a snail's pace, or presumably a pace that the Fed does not feel would turn slower growth into negative growth. There are two things in the Fed's favour right now. Canada's monetary policy outlook will track closely behind the Fed, and even though the Bank of Canada has sounded much more hawkish on rates (bullish on growth), it too will have to reconcile a plan to adjust rates higher with an 11-year high on the Loonie.

Economic and Market Outlook

	2003 Year-end	2004F Year-end	2005F Year-end
Canada			
S&P/TSX Composite Index			
Earnings (C$)	419.00	530.00	580.00
Level	8,221	n.a.	9,000
S&P 500			
Earnings (US$)	54.69	65.75	71.00
Level	1,111.92	n.a.	1,150
Economic Performance			
Real GDP (average annual % change)	2.0	2.75	3.1
Motor Vehicle Sales (average annual, mln units)	1.596	1.530	1.565
Unemployment Rate (%)	7.6	7.2	7.0
Consumer Prices (% change)	2.8	2.1	2.2
Current Account Balance (average annual, C$ bn.)	23.8	38.0	30.0
Yield Curve (%)			
Bank of Canada Overnight Target Rate	2.75	2.75	3.25
2-Year Canada Bond	2.97	3.60	4.10
10-Year Canada Bond	4.80	4.90	5.00
United States			
Economic Performance			
Real GDP (average annual % change)	3.0	4.4	3.0
Motor Vehicle Sales (average annual, mln units)	16.6	16.7	16.7
Unemployment Rate (%)	6.0	5.5	5.2
Consumer Prices (% change)	2.3	2.7	2.4
Current Account Balance (average annual, US$ bn.)	-531	-635	-625
Yield Curve (%)			
Fed Funds Target Rate	1.00	2.00	2.75
2-Year Treasury	1.83	2.75	3.80
10-Year Treasury	4.40	4.30	5.00
Foreign Exchange Forecast			
Canadian Dollar (US¢/C$)	77.04	80.0	83.3
Canadian Dollar (US$/C$)	1.29	1.25	1.20
Yen (¥/US$)	107	105	95
Euro (US$/€)	1.26	1.27	1.35
Sterling (US$/£)	1.79	1.78	1.90
Commodities			
WTI Oil (average annual, US$/bbl)	31.1	39.0	35.0

e: Estimate (Scotia Economics, based on available data)
f: Forecast (Scotia Economics)/Market Forecasts (Scotia Capital).

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

Canadian Equity Outlook

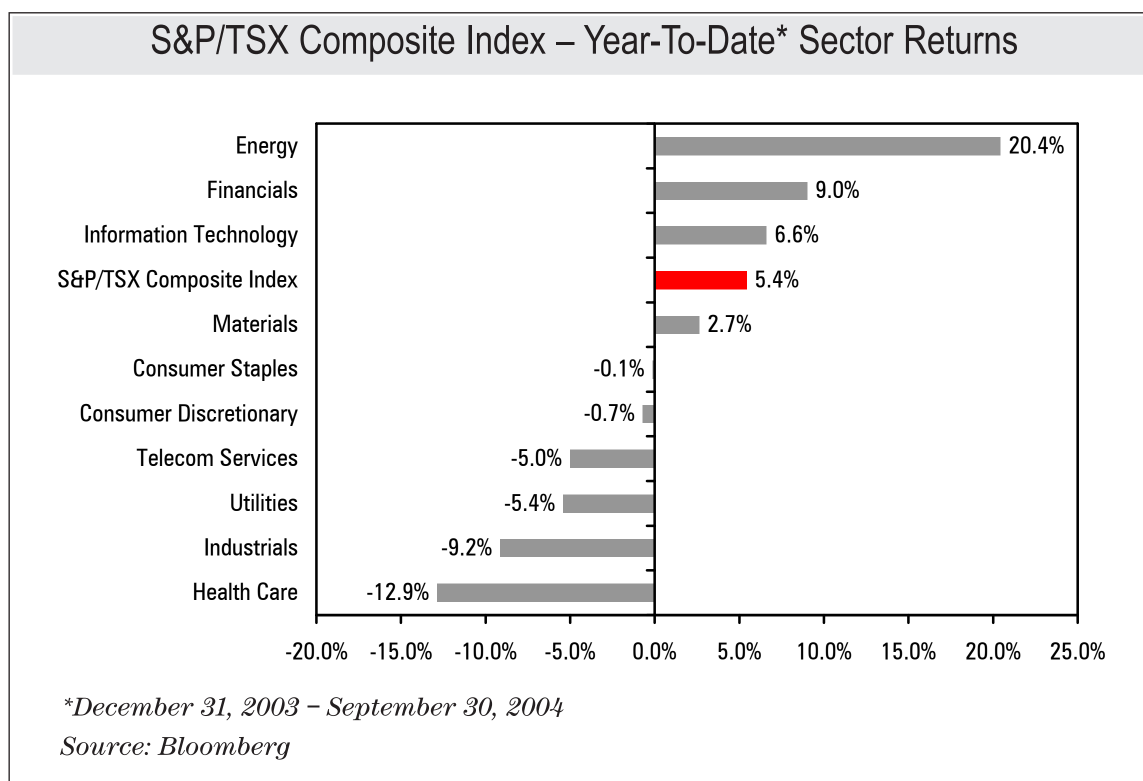
Repositioning for Rising Rates

Paul Danesi – Director, Portfolio Advisory Group

Interest rates are on the rise and it's time for investors that haven't already done so to review and reposition their equity portfolios to take advantage of the climate change. Trends exist where industry sectors tend to behave in a consistent fashion when central banks are shifting to a tighter monetary environment. That is, a rising rate environment is worse/better for some sectors than others. We have identified those sectors that are likely to lead and those most likely to fall behind in the coming months. Within this context we have also provided investors with a handful of stock ideas for their portfolios.

A Quick Look Back

The Canadian equity market has delivered strong relative performance through the first nine months of the year outpacing major U.S. benchmarks. We believe this trend will persist into the New Year. Supporting Canada's strong relative performance year-to-date is an index that is heavily weighted towards the resource and financial services sectors. Together these two groups represent almost 70% of the TSX Composite Index.



**December 31, 2003 – September 30, 2004*

Source: Bloomberg

Despite the growth in technology and service-oriented sectors of the economy, resource industries continue to play a meaningful part in our economic health. Resource companies have exhibited an incredible rebound in profitability as prices for wood products, energy, base and precious metals all surged to recent or record highs. In the same vein, profitability also

remains strong within the Canadian financial services sector. Returns on equity within the banking group are approaching 20% despite large excess capital positions. Banks are also winners in an environment where investor tolerance for risk is low and dividends are cherished. Canadian banks have been raising their dividends every second quarter or so.

Looking forward we believe that current market leaders (energy and financial services) will become market laggards as interest rates continue to work their way higher.

Rising Interest Rates: Risks and Opportunities

While the bond market has largely ignored the rise in interest rates, we have not. We believe that investors should sidestep the debate over when and by how much the Bank of Canada and U.S. Federal Reserve are likely to raise interest rates and simply work off the assumption that rates are likely to move higher in the months ahead. In our opinion, the trend is the more important issue when formulating a strategy for a Canadian equity portfolio. The Bank of Canada believes that inflationary pressures are building in the Canadian marketplace as energy prices rise and the output gap declines (the difference between actual economic output and potential) and will adjust interest rates accordingly.

Historical precedent suggests that during periods when the U.S. Fed is tightening monetary policy, definitive trends of industry sector under/outperformance exist. These historical trends or averages form the foundation for our broader sector recommendations. Cyclical energy, technology, transportation and media stocks outperformed more often than not, while interest sensitive banks and utilities, and gold and auto components underperformed.

That said, no industry group beat or lagged the market in every case. The point being that simply using quantitative historical data may ignore or overlook current macro and industry dynamics that should be considered in our analysis. The recommendations in the table below reflect both. Although the energy sector on average outperforms the market when rates are rising, we believe this is one of the exceptions. We do not believe that energy prices are sustainable at these levels and therefore earnings comparisons will be difficult in the quarters ahead leaving the sector ripe for profit taking.

Sector Allocation

Industry Sector	TSE Weight	Scotia Capital Recommendation
Materials	17.4%	Overweight
Information Technology	6.9%	Overweight
Telecommunications	4.9%	Market Weight
Industrials	5.9%	Market Weight
Consumer Discretionary	6.3%	Market Weight
Health Care	1.7%	Market Weight
Financials	32.8%	Underweight
Utilities	1.4%	Underweight
Consumer Staples	4.3%	Underweight
Energy	18.4%	Underweight

Source: Scotia Capital; Bloomberg.

Stock Picks in Sectors Expected to Outperform

Astral Media Inc. (ACM.A $28.36, 1-Sector Outperform, Target: $35.50): Our recommendation is supported by historical trading patterns, strong underlying fundamentals and attractive valuation. As noted, media stocks have historically outperformed the broader market during periods of rising rates. There is also a persistent seasonality to this sector where the group outperforms in the period of September through March. For those not familiar with the Astral story, the company has an attractive portfolio of 20 specialty and pay-TV licenses including TMN The MovieNetwork, Viewers Choice Pay Per View, Teletoon and the Family Channel. Astral is also a major participant in the Francophone radio market in Quebec. Astral has the highest operating margins in the industry, a debt free balance sheet and generates substantially more cash flow than it uses in its day-to-day operations. The shares trade at only 16 times forecast 2005 earnings.

ATI Technologies Inc. (ATY $19.38, 1-Sector Outperform, Target: $29.00): ATI Technologies is a world leader in the graphics processor market. The company's products include visual and graphic processors (semiconductors) that increase the speed and complexity of images that can be displayed on computer monitors, wireless handsets, PDAs and gaming consoles. Solid earnings growth is projected through the end of fiscal 2006, driven by strong PC shipments and new growth opportunities in the consumer electronics segment (game consoles, personal digital assistants, cell phones). The shares trade at a discount to the market, which is impressive for a company forecast to deliver 20% earnings growth. The stock is attractive for risk tolerant investors.

Norske Skog Canada Inc. (NS $4.07, 1-Sector Outperform, Target: $5.85): Norske Skog is one of the largest paper companies on the west coast producing a wide variety of paper grades including newsprint, printing and packaging papers, directory paper, specialty papers and pulp. The paper group has underperformed base metals, chemicals, and other commodity companies over the past year. We believe that paper stocks are poised to rally into 2005. With the exception of newsprint, price increases across most paper grades have been put in place and are sticking.

Three Special Situations

Axcan Pharmaceuticals Inc. (AXP $19.62, 1-Sector Outperform, Target: $28): Axcan is a specialty pharmaceutical company that specializes in the niche market for gastrointestinal drugs. The company's product portfolio is diversified with no single drug accounting for more than 25% of sales. Every drug is exhibiting growth, but it is the company's new Dyspepsia drug ITAX currently in Phase III clinical trials that offers the greatest upside. Management anticipates filing a new drug application for ITAX with the FDA by this time next year and the drug has the potential to double Axcan's revenue line in a few years time. However, it is this same drug that is currently weighing on earnings and the share price. Management now expects earnings to be flat year-over-year due to higher-than-expected costs of running the clinical trials for this new drug. The stock is well off its recent high of $29 per share. We believe that there is attractive upside for patient risk-tolerant investors willing to hold the stock for 12 to 18 months.

Barrick Gold Corp. (ABX $26.60, 2-Sector Perform, Target: $30.50): Barrick is one of the world's largest gold mining companies with projects in the United States, Canada, South America, Australia and Africa. It has an aggressive mine development schedule that could drive annual production from 5 million to 7 million ounces by 2007 while lowering cash costs to under U$200/ounce. Our bullish view on Barrick stems largely from our bearish view on the U.S. dollar and the continued presence of a large geopolitical risk premium. There is a strong inverse relationship between the trade-weighted dollar index and the price of gold. Scotia Economics believes the U.S. dollar will weaken further in 2005 due to that country's growing budget and trade deficits.

Dorel Industries Inc. (DII.B $35.60, 1-Sector Outperform, Target: $45.00): Dorel is a leading manufacturer of bicycles, childcare products, and ready-to-assemble furniture. Safety 1st, Schwinn, Cosco, and GT Mongoose bicycles are just a few of their more popular brands. We recommend the shares for patient value-oriented investors. At its current level investors are paying very little for the acquisition of Pacific Cycle and the shares are trading at only 8.4 times our analyst's 2005 earnings forecast. Rising costs, the source of recent earnings and share price weakness, are being addressed through price increases across a number of product lines. Dorel employs highly innovative product development teams. Over the next year Dorel will introduce 200 new products. Toys "R" Us, a major customer predicts two of Dorel's newer products (motorized ride-on Corvette, Schwinn Stingray bicycle) will be on the top of children's wish lists this holiday season.

The Redemption of Fallen Angels

Andrew Guy, CFA – Associate, Portfolio Advisory Group

The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator' primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices

– Benjamin Graham, The Intelligent Investor

Sometimes it is useful to step back from watching the flashing colours on your screen and go back to first principles on stock valuation. This move is particularly useful if you are looking at an equity that has lost substantial value: a fallen angel.

The quote above is taken from the quintessential book by the quintessential value investor: an investor who made a decent living finding companies that were improperly valued by the market. His focus was on valuing businesses, not stocks. The market (Mr. Market as he liked to call it) provides only the current price at which one can trade ownership interests in those underlying business.

This idea that stocks represent ownership interests in businesses is particularly important when looking at fallen angel companies. Often during the process of the fall from grace, the company will issue new ownership interests (shares) to help finance its liabilities or to cover other cash flow crises. These new shares can have a significant impact on the value of old shares and as a result on the portfolios of the old shareholders.

At this point an example may be useful. Say there is a company that has 1 billion shares outstanding and the market price per share is $25. In addition, the company has $5 billion of debt. At this point, the market is saying that the total value of the company is $30 billion. While, at this point, it is not necessary to say why the company may be worth $30 billion, just realize that the market gives this value through its perception of the future outlook for the company. Now assume that due to any number of reasons (such as terrorism, economic slowdown, commodity prices), the market changes its perception. At some point, perhaps years later, pessimism reigns supreme and the market begins to believe that the company will not be able to pay off its debt. The company decides to meet these concerns by raising cash through a stock offering. Unfortunately, because of the decline in the stock price, an extremely large number of shares will have to be issued. The company decides to raise $2 billion, but the price is $4 and they have to issue 500 million new shares (note that just before the issue the market is saying the company is only worth $9 billion, i.e. $4 billion in equity value plus $5 billion in debt).

	Peak Valuation	Issue at Bottom	Return to Peak
Debt	$5,000	($2,000)	$3,000
# of Shares	1,000	500	1,500
Value Per Share	$25.00	$4.00	$18.00
Total Value of Company	$30,000		$30,000

Source: Portfolio Advisory Group.

If the market's perception should reverse and the total value of the company return to the same level as the previous peak, the new value per share will be only $18.00 due to the 50% increase in the number of shares outstanding. For an individual investor who purchased 100 shares at $25 at the old peak, their share of the company is now only worth $1,800. To get back to break even, the market will have to increase the total value of the company by 35% to $40,500.

So how does the market place a value on a company? Theoretically, the price of a stock, and therefore the value of the company, is equal to the market's perception of the present value of all future cash flows receivable by investors. While few people actually talk about this discounted cash flow measure, at the end of the day, all investors really only care about the cash that they put into their pockets so the theory fits with practice.

Followers of the Ben Graham School of analysis look at the hard assets and liabilities of a company to determine the true value of a company. As a result, they prefer to look at the valuation of a company relative to its book value, which is the value of the company's assets less the value of its liabilities. Another way to look at this equation is to say the book value is the value of the cash flows that can be generated by the assets less the cash flows that the company is required to pay to its creditors.

Assets	Liabilities
= Present Value of cash to be generated by the assets	= Present Value of cash payable to creditors and lenders
	Shareholders Equity = Book Value

Source: Portfolio Advisory Group.

In recent years, a number of former high-flying companies have had to issue shares to cover a real or perceived financial crisis. It is important to realize that a return to the old highs is highly unlikely for their share prices. Nevertheless, there are a number of companies that at one point traded at much higher levels that have some real asset values that exceed the current stock price.

One of the most interesting at the current time is Fairfax Financial (FFH U$130.68; 1-Sector Outperform, Target: U$200). At one point in 1999, the stock price reached $610 on enthusiasm about management's ability to acquire inexpensive property and casualty insurance companies, turn them around and earn superior returns on its investment assets. As it turns out, some of the companies were cheap for good reason and in the past couple of years, the company has had to reorganize its operations.

Nevertheless the company has managed to improve its operations and its profitability, and it trades at a significant discount to its book value while generating an ROE greater than the market. There is some justifiable concern about the impact of the hurricanes on their earnings in the next quarter, but the assets on the balance sheet should ensure that it will weather the storm (excuse the pun). The company recently announced that the claims impact of the four hurricanes will take US$8.75-$9.75 per share from third quarter earnings and, as a result, Scotia Capital expects the company to report a $6 loss in the quarter. Nevertheless, at the end

of the second quarter, the company had investment assets of US$876 per share and 80% of these assets were bonds and cash. In addition, there was US$597 in Accounts Receivable from Reinsurers. Thus, there were US$1,473 per share of fairly liquid assets and these assets covered the primary liability, the Provision for Claims, by 1.4 times. As a result, we have a fairly good confidence level in the book value of US$216. Even after the expected loss in the third quarter, the book value should be about US$200. In Graham terms, at the current price, you're getting a dollar's worth of assets for sixty cents.

Another company trading below its book value that we are currently recommending is Norske Skog Canada (NS $4.07; 1-Sector Outperform, Target: $5.85). It is currently trading at 86% of its $4.66 book value. It is not unusual for cyclicals like Norske to trade near or slightly below book value at the bottom of the cycle, but the book does tend to provide a floor level. It provides a floor because well-maintained factories have a value to purchasers. Norske has invested heavily in modernizing its plants over the past five years and as a result, these assets are believed to be world scale. At the end of the second quarter, Norske had $10.40 of fixed assets on its balance sheet and only $5.43 of long-term debt and other long-term liabilities. As a result, we can have reasonable confidence that there are "real" assets underlying the company's book value.

There are currently a number of other companies covered by Scotia Capital that are trading below book value. The companies covered that are ranked sector perform or sector outperform include Celestica, CP Ships, Tembec, and Martinrea.

At the end of the day, investors want to examine the value of the whole company in which they are investing to determine entry and exit points relative to the value the market is placing on the ownership interest in the company. If you can buy a dollar of real assets for less than a dollar, you should do well in the long term. And in the shorter term, you can leave the daily volatility of stock prices to the speculators.

Income Funds: Getting Down to Business

Blair Wilson – Associate Director, Portfolio Advisory Group

Third Quarter Review

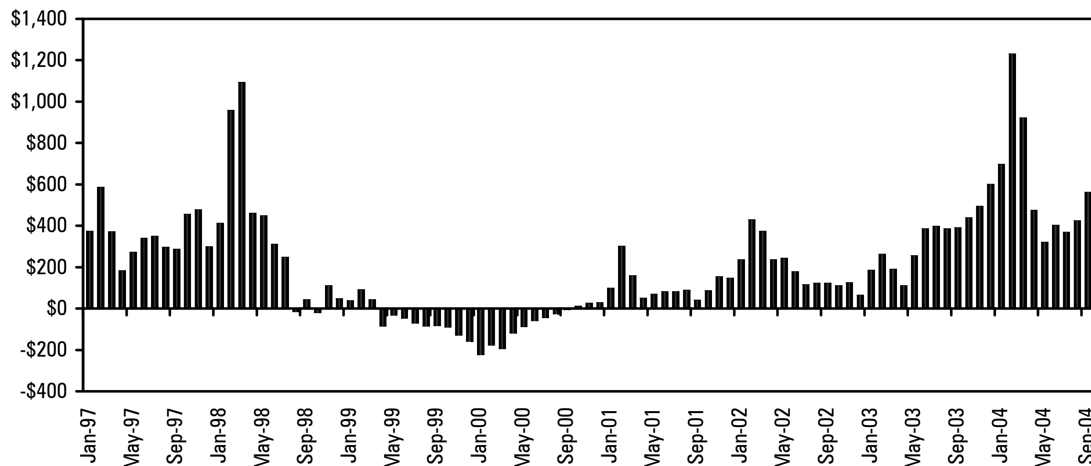
The third quarter was strong for income funds. The Scotia Capital Income Trust Index (SCITI) generated a total return of 10.5% with each sub-sector of the index contributing positive total returns *(see exhibit one for sub-sector performance)*. The overwhelming investor demand for yield continued through the quarter as evidenced by the strong sales of Canadian (open-end) mutual funds *(see exhibit two for this illustration)* that focus on dividend and income-based returns as well as the continued success of closed end funds that invest primarily in income funds. At quarter end, the number of operating business-based income funds was 157 and the market float available to investors was $93.2 billion. The float has more than doubled over the past 12 months due to new and secondary equity issuances as well as price appreciation.

Exhibit 1 – Trust Sub-Sector Performance

Date	Overall	Energy	Real Estate	Consumer	Utils & Infra	Power	Industrials	Resource
Q3/04	10.5%	15.4%	5.9%	2.6%	7.9%	6.1%	9.2%	17.7%
Year-to-Date	25.0%	36.2%	14.6%	11.6%	16.4%	7.8%	25.2%	43.9%

Source: Scotia Capital.

Exhibit 2 – Net Sales – Dividend & Income Funds (millions of dollars)



Source: Investment Funds Institute of Canada.

Uncertainty surrounding the outlook for the North American economic expansion and the direction of interest rates has meant that investors have been cautious toward committing money to equities however low bond yields have offered little (and insufficient in many cases) potential returns. Therefore, the benefits of investing in income funds including a regular cash

stream with possible price appreciation have made sense to many investors. As well the possibility of an increase in institutional interest in income funds is also drawing closer. On May 12, 2004, the province of Alberta's legislature passed the *Income Trusts Liability Act* into law. This statutory protection has been sought to put income fund holders on equal footing with shareholders of corporations and should lead to the consideration of re-including income funds in the S&P/TSX index. The issue falls within provincial jurisdiction however so each Canadian province is required to pass its own legislative changes. The process has begun in Ontario and could be passed into law in December 2004. The passing of these laws would be expected to result in rising institutional interest due to possible index inclusion, which would require the participation of index funds, and/or by certain types of funds that have been reluctant to own income funds to date without the explicit protection. Third, soaring oil prices have created a backdrop for strong royalty trust returns (up 15.4% during the third quarter). We maintain a cautious stance toward the royalty trust group that makes up 35% of the SCITI, because of valuation concerns. Scotia Capital has recently increased its forecast for average oil and natural gas prices for 2004 and 2005 to US$39.50 per bbl and US$38.80 per bbl and has introduced an estimate of US$36.30 for 2006. This revised price deck would be expected to support current distribution levels through the end of 2005 however the Price to NAV (P/NAV) valuations that the royalty trusts are trading at are considered to be relatively high. Using the new price forecasts and assuming a reversion to a long-term oil price of US$30 per bbl after 2006, Scotia's royalty trust analyst indicates that the average P/NAV is approximately 185%.

Returns have been fantastic for income funds over the past three years in an environment that has favoured the fundamentals for the underlying businesses. Above we highlighted the favourable impacts of rising energy commodity prices rates for oil and gas-based royalty trusts. As well, declining interest rates have attracted investment dollars to the whole area (Power Trusts, REITs and Business Trusts alike) allowing highly successful levels of equity issuance by income funds requiring capital to make acquisitions to support their businesses. Lower interest rates have also meant that debt service costs have been low. In a rising rate environment this could be a hindering factor for various funds with floating rate obligations or who wish to finance future acquisitions through the use of debt. It is also clear to us that a more challenging business environment is on the horizon which will test income fund management teams. We doubt that investors will be able to participate in a "rising tide lifting all ships" type of market for too much longer. Income funds that have cut distributions due to deteriorating cash flow margins because of tougher business conditions or business profiles that were ill-suited to the income fund structure have been met with ruthless selling and significantly negative investment returns over the past nine months.

A Focus on Business Trusts

With the aid of Michael Morden, one of Scotia Capital's business trust analysts, we have identified some basic screening rules to use in conjunction with valuation metrics when considering the inclusion of this group of funds to the PAG Recommended List for Income Trusts. We suggest that a basic starting point for general "screening" for the investment prospects of individual names may be through identifying trusts with: 1) **sustainable or growing distributions**, which are byproducts of **low payout ratios** (the lower the payout

ratio, the greater the probability that distributions are not only sustainable, but also likely to increase). Payout ratios average 90%-95% for the group, so this gives a good gauge of the distribution increase potential for funds with low payout ratios; 2) **Distributable Cash Growth** (available for payout) in the range of 4-6% annually; and 3) **Manageable Debt Levels** (measured by debt/cash flow ratio, which over time ought to be approximately 2 times). All of these measures should be taken in the context of the trusts' currently offered cash-on-cash yields and the expectations for interest rate changes.

Taking these items into consideration, Scotia Capital carries 1-Sector Outperform recommendations on the following Consumer and/or Industrial related income trusts: Arctic Glacier Income Fund (AG.UN), Cineplex Galaxy Income Fund (CGX.UN), Davis & Henderson Income Fund (DHF.UN), Transforce Income Fund (TIF.UN) and Yellow Pages Income Fund (YLO.UN). While not all of these trusts meet each criteria, there are reasons for not doing so and the numbers can also indicate the future business plans of the operating trusts. The three business trusts on the PAG Recommended List include Yellow Pages, Cineplex Galaxy and TransForce. Scotia Capital research indicates that Yellow Pages carries a debt/cash flow ratio of 3x, which may appear high, however, due to the business's high EBITDA margin (estimated to be 58-59% in 2004 and 2005), the trust generates more than sufficient free cash flow to cover its debt service obligations. We also note that the trust's payout ratio is low at 90%, which also offers an element of financial flexibility. In Cineplex Galaxy's case, its balance sheet is strong (1.7x debt/cash flow) and its payout ratio (92%) meets the criteria although the expected EBITDA growth is at the low end of the preferred range (at 4%). We believe the EBITDA growth expectations are conservative which may be exceeded in light of the line-up of movies scheduled for release in 2005-06 and the trends of movie-going that continue to support strong profitability. TransForce meets the screening criteria and is also benefiting from the strong trucking environment.

Income Trust Recommended List

Trust	Price (30-Sep-04)	Market Cap (000)	Pre-Tax Yield 2004	Pre-Tax Yield 2005	Forecast Distribution* 2004	Forecast Distribution* 2005	2004E Taxation Dividend	2004E Taxation Income	2004E Taxation Deferred	NAV Value	Price/ NAV	1-Year Target	ROR	Analyst's Rating**	Risk	Stability S&P	Stability DBRS
Power Income Funds																	
TransAlta Power (TPW.UN)	$8.85	$625.70	8.8%	8.8%	$0.78	$0.78	0.0%	5.0%	95.0%	-	-	$9.25	13.3%	2-SP	Low	SR-1 (negative)	STA-2 (mid)
TransAlta Power (TPW.UN)	$33.40	$1,583.16	7.5%	7.5%	$2.52	$2.52	0.0%	65.0%	35.0%	-	-	$33.00	6.3%	1-SO	Low	SR-1 (stable)	STA-1 (low)
REITS																	
Allied Properties REIT (AP.UN)	$12.70	$129.54	8.9%	9.3%	$1.13	$1.18	0.0%	35.0%	65.0%	$11.00	115.5%	$12.65	8.5%	1-SO	High	N/A	N/A
Boardwalk REIT (BEI.UN)	$17.00	$904.40	5.3%	7.3%	$0.90	$1.24	0.0%	30.0%	70.0%	$16.00	106.3%	$16.90	4.7%	1-SO	Medium	N/A	N/A
RioCan REIT (REI.UN)	$16.50	$2,973.30	7.2%	7.5%	$1.19	$1.24	0.0%	52.0%	48.0%	$14.15	116.6%	$15.60	1.8%	1-SO	Low	SR-2 (stable)	STA-2 (Low)
Infrastructure Income Funds																	
Consumers' Waterheater Income Fund (CWI.UN)	$14.34	$709.83	7.5%	7.5%	$1.07	$1.07	0.0%	100.0%	0.0%	-	-	$13.50	1.6%	2-SP	Low	SR-2 (stable)	STA-2 (Mid)
Fort Chicago Energy Prtnrs. (FCE.UN)	$10.40	$1,084.72	8.0%	8.0%	$0.83	$0.83	0.0%	0.0%	100.0%	-	-	$10.25	6.5%	1-SO	Medium	N/A	STA-2 (Low)
Inter Pipeline (IPL.UN)	$8.21	$1,455.63	8.9%	9.1%	$0.73	$0.75	0.0%	58.0%	42.0%	-	-	$8.00	6.3%	1-SO	Medium	SR-3 (positive)	STA-3 (Low)
Consumer Funds																	
Cineplex Galaxy Inc. Fund (CGX.UN)	$12.70	$604.52	9.1%	9.4%	$1.15	$1.20	80.0%	20.0%	0.0%	-	-	$12.00	3.5%	1-SO	High	N/A	N/A
Industrial Funds																	
Transforce Income Fund (TIF.UN)	$11.83	$605.70	9.8%	10.7%	$1.16	$1.26	0.0%	97.0%	3.0%	-	-	$11.65	8.3%	1-SO	High	N/A	N/A
Yellow Pages Inc. Fund (YLO.UN)	$12.11	$4,156.15	7.7%	8.2%	$0.93	$0.99	25.0%	75.0%	0.0%	-	-	$13.00	15.0%	1-SO	Low	SR-2 (Stable)	STA-1 (low)
Oil & Gas Royalty Trust Units																	
Bonavista Energy Trust (BNP.UN)	$25.89	$2,060.84	11.6%	11.6%	$3.00	$3.00	0.0%	96.0%	4.0%	$13.51	191.6%	$26.00	12.0%	1-SO	High	N/A	N/A

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

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

Please contact your Investment Advisor for further detailed information.

Source: Scotia Capital; ScotiaMcLeod Portfolio Advisory Group.

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Equity Guided Portfolios: Canadian Core Portfolio

Paul Danesi – Director, Portfolio Advisory Group

North American equity markets exhibited significant volatility in the third quarter with the TSX Composite Index trading in a range of nearly 7% from peak to trough. Five of the 10 TSX industry sectors finished the quarter higher with energy and materials stocks outperforming the broader market. High beta technology names suffered on the back of disappointing financial results.

On a total return basis, the Canadian Core portfolio underperformed the TSX Total Return Index in the third quarter. For the three-month period ended September 30, 2004, the Portfolio generated a total return of 0.2% compared with a return of 1.9% for our benchmark. While the Canadian Core Portfolio has underperformed the market in recent months we have a high degree of conviction in the medium to long-term outlook for this portfolio.

September 15, 2004 was the fifth anniversary of the Canadian Core Guided Portfolio. Over the last five years we have built and maintained a substantial performance gap between the portfolio and the broader market. Since inception (September 15, 1999) the portfolio has provided investors with a total return of 48.5% versus 33.1% for the TSX Total Return Index.

During the second quarter we made two changes to the portfolio: 1) we switched from Molson Inc. to Inco Ltd. and 2) from Finning International Inc. to ATI Technologies Inc.

Our decision to include Inco in the portfolio was based on the belief that nickel prices would stay at higher levels for a longer period of time than the market was anticipating. The physical nickel market remains extremely tight with strong demand from China being met my tight inventories and limited new supply. At U$7.00/lb, the price of nickel is well above the cycle low of U$2.00/lb and Inco's cost of production at U$2.40/lb.

ATI Technologies Inc. is a leader in graphics processing technology for personal computers and consumer electronic devices. The company's products include visual and graphic processors (semiconductors) that increase the speed and complexity of images that can be displayed on computer monitors, wireless handsets, PDAs and gaming consoles. Graphics processors also improve the resolution and colour definition providing a richer visual experience for the user. The company offers excellent earnings growth prospects at a reasonable price.

Canadian Core Equity Guided Portfolio

Company	Symbol	Price (30-Sep-04)	Target Price	Dividend	Dividend Yield
Interest Sensitive *(TSX Weight 39%, Portfolio Weight 33%)*					
BCE Inc.	BCE	$27.25	$37.00	$1.20	4.4%
Bank of Montreal	BMO	$55.30	$66.00	$1.76	3.1%
Enbridge Inc.	ENB	$52.75	$56.00	$1.83	3.5%
Manulife Financial Corp.	MFC	$55.40	$60.00	$1.04	1.9%
Power Corp.	POW	$28.90	$35.00	$0.58	2.6%
Toronto-Dominion Bank	TD	$46.09	$56.00	$1.44	3.1%
Consumer Products *(TSX Weight 12%, Portfolio Weight 28%)*					
Astral Media Inc.	ACM.A	$28.36	$35.50	$0.15	0.5%
Dorel Industries Inc.**	DII.B	$35.60	$44.50	$0.00	0.0%
Loblaw Companies Ltd.	L	$64.75	$72.00	$0.76	1.2%
MDS Inc.	MDS	$19.38	$26.00	$0.13	0.7%
Thomson Corp.* **	TOC	$43.89	$51.00	$1.01	2.3%
Industrial Products *(TSX Weight 13%, Portfolio Weight 20%)*					
ATI Technologies Inc.**	ATY	$19.38	$30.00	$0.00	0.0%
CP Rail Ltd.	CP	$32.69	$36.00	$0.53	1.6%
Cognos Inc.**	CSN	$45.12	$50.00	$0.00	0.0%
Resource *(TSX Weight 36%, Portfolio Weight 19%)*					
Inco Ltd.**	N	$49.40	$50.25	$0.00	0.0%
Norske Skog Canada Inc.	NS	$4.07	$5.85	$0.00	0.0%

* *Quarterly dividend is U$0.19.*
** *Companies report in U.S. dollars. Target prices are converted from US$ to C$ using current exchange rate.*

Source: Scotia Capital.

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Equity Guided Portfolios: Canadian Income Plus Guided Portfolio

Andrew Guy, CFA – Associate, Portfolio Advisory Group

Investment Objective

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

Selection Criteria

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

Performance Update

During the third quarter of 2004, the Income Plus Guided Portfolio generated a total return of 5.3 %, which outperformed the S&P/TSX. The broader index was up 1.9%. The third quarter was a challenging period for the market as a whole as economic uncertainty weighed heavily on expectations for the future. As a result, the more defensive interest sensitive sectors received a bid.

The Income Plus portfolio continues to benefit from its exposure to the TSX Financial Services sector. Third quarter earnings for the banks were strong. As a result, TD Bank along with Enbridge and Power Financial, was among the strongest performing names in the portfolio. Only TransAlta and Sun Life underperformed the index during the quarter.

The Financials have also been the strongest contributors to year-to-date performance. Earnings growth has outweighed the negative pressure of higher anticipated interest rates that has put pressure on the prices of the other interest sensitives in the portfolio. In addition, each of the companies added this year (Atco, RioCan and Thomson) have contributed positively to the performance.

For the first nine months, the portfolio has returned 6.8%, which is in line with the return on the broader S&P/TSX Composite. The Utilities and Telecom sectors continue to be amongst the weakest performing sectors while Financial Services is one of the best performing sectors.

Changes

During the third quarter we made one change to the Income Plus portfolio. We added Thomson Corp. to the portfolio late in August. Thomson was added to diversify the economic exposure of the portfolio. Its stock price is less sensitive to interest rates and its financial results are expected to perform well as the US/global economy continues to improve.

Canadian Income Plus Guided Portfolio

Company	Symbol	Price (30-Sep-04)	Target Price	Dividend	Dividend Yield
ATCO	ACO.X	$50.00	$57.00	$1.40	2.8%
BCE Inc.	BCE	$27.25	$37.00	$1.24	4.6%
CIBC Inc.	CM	$67.67	$84.00	$2.40	3.5%
Enbridge Inc.	ENB	$52.75	$56.00	$1.83	3.5%
Fortis	FTS	$61.25	$64.00	$2.16	3.5%
Power Financial Corp.	PWF	$29.57	$34.00	$0.73	2.5%
RioCan REIT	REI.UN	$16.50	$15.60	$1.20	7.3%
Sun Life Financial	SLF	$38.19	$41.00	$0.88	2.3%
Thomson Corp.	TOC	$43.89	$51.00	$1.00	2.3%
TransAlta Corp.	TA	$16.49	$20.00	$1.00	6.1%
TD Bank	TD	$46.09	$56.00	$1.44	3.1%

Source: Scotia Capital estimates.

U.S. Equity Outlook

Equity Guided Portfolios: U.S. Core Portfolio

Frances Horodelski, CFA – Director, Portfolio Advisory Group

Despite the underwhelming performance of U.S. equities during the summer months, the U.S. Core Guided Portfolio put in another period of outperformance versus the S&P 500 during the quarter ended September. For the third quarter, the portfolio provided a 2% total return versus the S&P 500's decline of 1.9%. On a year to date basis, the portfolio widened its outperformance to 460 basis points, ending the nine months higher by 6.2% versus the market's gain of 1.6%. Of the 15 companies in the portfolio, 12 presented positive performance during September (led by Raytheon and Intuit). On the year, the performance has been assisted by Raytheon, GlobalSantaFe and newly added Intuit but hampered by our healthcare exposure, namely Pfizer and Amgen.

During the quarter, we made a number of changes including the removal of Microsoft and the addition of Intuit and Disney – two companies we saw as undervalued relative to the growth potential we anticipate over the next year.

Our removal of Microsoft reflected a number of issues both fundamental and technical. We note for Canadian investors that the upcoming $3 special dividend offers a potential negative tax issue. It is important to remember that the dividend will be fully taxed as income. Consequently, post distribution, it is likely that the economic position for a Canadian investor in Microsoft (valuation considerations aside) will be worse than pre-distribution. The shares should drop by the value of the dividend, but on an after-tax basis, investors will hold less than the $3 cash distribution. We would encourage investors to review their own particular tax position well before the December 2nd pay date to ensure that they are not penalized by holding the shares.

Elsewhere in the portfolio, target prices were raised on Walgreen and Clorox; dividends were boosted at Kraft Foods (+14%), Walgreen (+22%) and Diageo (+14%). We continue to anticipate distribution hikes from Pfizer and General Electric later this year.

In the fourth quarter, we would anticipate the portfolio's relative performance to sag somewhat reflecting normal seasonal and cyclical biases which support an emphasis on higher risk technology and commodity basic investments. Our diversified approach to the U.S. equity markets has served us well and we will continue to manage the portfolio to ensure that we provide the appropriate combination of companies that complement a Canadian investment portfolio.

U.S. Core Equity Guided Portfolio

Company	Symbol	Price (30-Sep-04)	Target Price	Dividend	Dividend Yield
Interest Sensitive *(S&P 500 Weighting 27.3%)*					
Allstate Financial	ALL	$47.99	$55.00	$1.12	2.3%
JP Morgan	JPM	$39.73	$50.00	$1.36	3.4%
Consumer Products *(S&P 500 Weighting 34.7%)*					
Amgen	AMGN	$56.81	$77.00	$0.00	0.0%
Clorox	CLX	$53.30	$59.00	$1.08	2.0%
Diageo	DEO	$50.43	$60.50	$1.99	3.9%
Kraft Foods	KFT	$31.72	$34.00	$0.82	2.6%
Pfizer	PFE	$30.60	$42.00	$0.68	2.2%
Walgreen	WAG	$35.83	$44.00	$0.21	0.6%
Walt Disney	DIS	$22.55	$40.00	$0.21	0.9%
Industrial Products *(S&P 500 Weighting 27.6%)*					
Deere	DE	$64.55	$85.00	$1.12	1.7%
General Electric	GE	$33.58	$38.00	$0.80	2.4%
Intuit	INTU	$45.40	$56.00	$0.00	0.0%
Raytheon	RTN	$37.98	$36.00	$0.80	2.1%
Resource *(S&P 500 Weighting 10.4%)*					
GlobalSantaFe	GSF	$30.65	$34.00	$0.20	0.7%
PPG Industries	PPG	$61.28	$77.00	$1.80	2.9%
S&P 500		*1114.58*	*1150*	*$19.91*	*1.8%*

Source: Scotia Capital; Credit Suisse First Boston.

Fixed Income Outlook

Great Expectations

Kevin Martin, CFA – Associate, Portfolio Advisory Group

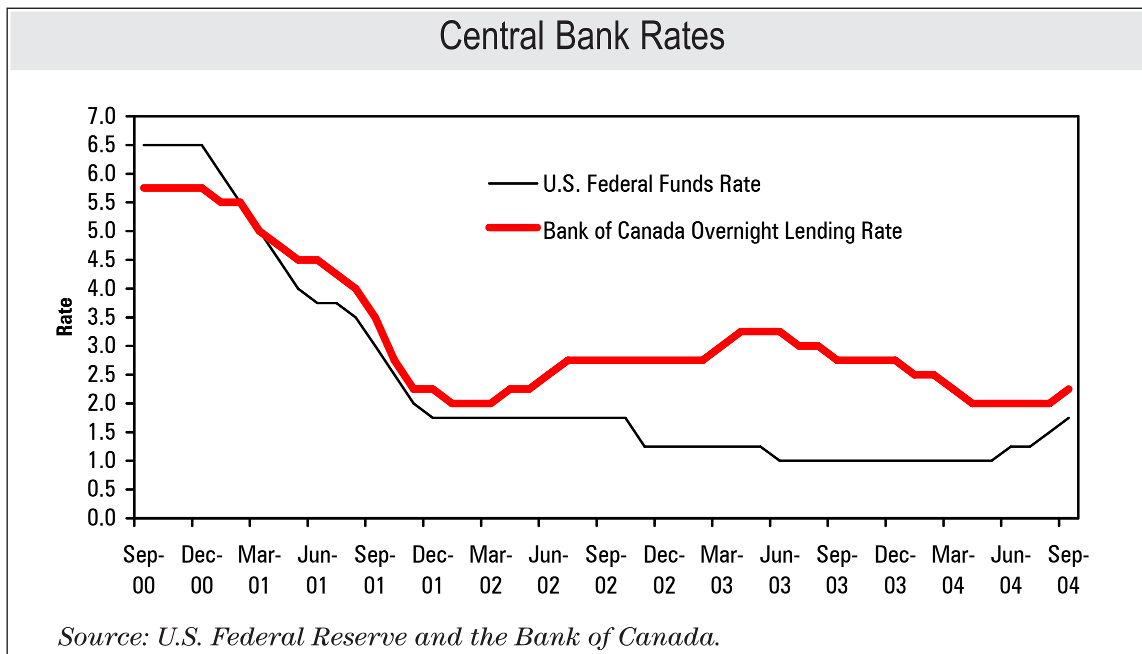
Expectations regarding central bank monetary policy, inflation, and the general health of the economy typically play a major role in the valuation of bond prices and in the shape of the overall yield curve. The relationship between these expectations and bond valuations has been particularly evident in 2004 as a) central banks have started to move away from an historically accommodative monetary policy stance; b) inflation expectations have changed from a disinflation bias to a reflation bias; and c) conflicting signs of U.S. economic strength and weakness have altered economic growth expectations during the year. Consequently, bond yields have shifted over the first three quarters of 2004 to adjust to these changing expectations.

Bond yields dropped (prices moved higher) during the first quarter with North American central banks maintaining an extremely accommodative monetary policy. The U.S. Federal Reserve signaled it would remain patient in removing monetary policy accommodation while the Bank of Canada was still cutting interest rates. Additionally, inflation was declining and economic growth remained sluggish. Bond yields hit their lowest point of the year to date in mid-March.

Bond yields then rose sharply (prices lower) in the second quarter. The sell-off was attributed to a series of strong U.S. employment numbers that resulted in higher expectations for economic growth. Additionally, a spike in U.S. inflation data resulted in higher inflation expectations and a change in tone from the U.S. Federal Reserve resulted in expectations of future interest rate hikes. Bond yields hit their highest point of the year to date in mid June as traders quickly began pricing in a series of interest rate hikes in 2004 and 2005 in both the U.S. and Canada. The Fed made the first move at the end of June raising the Federal Funds rate by 25 basis points for the first time in four years.

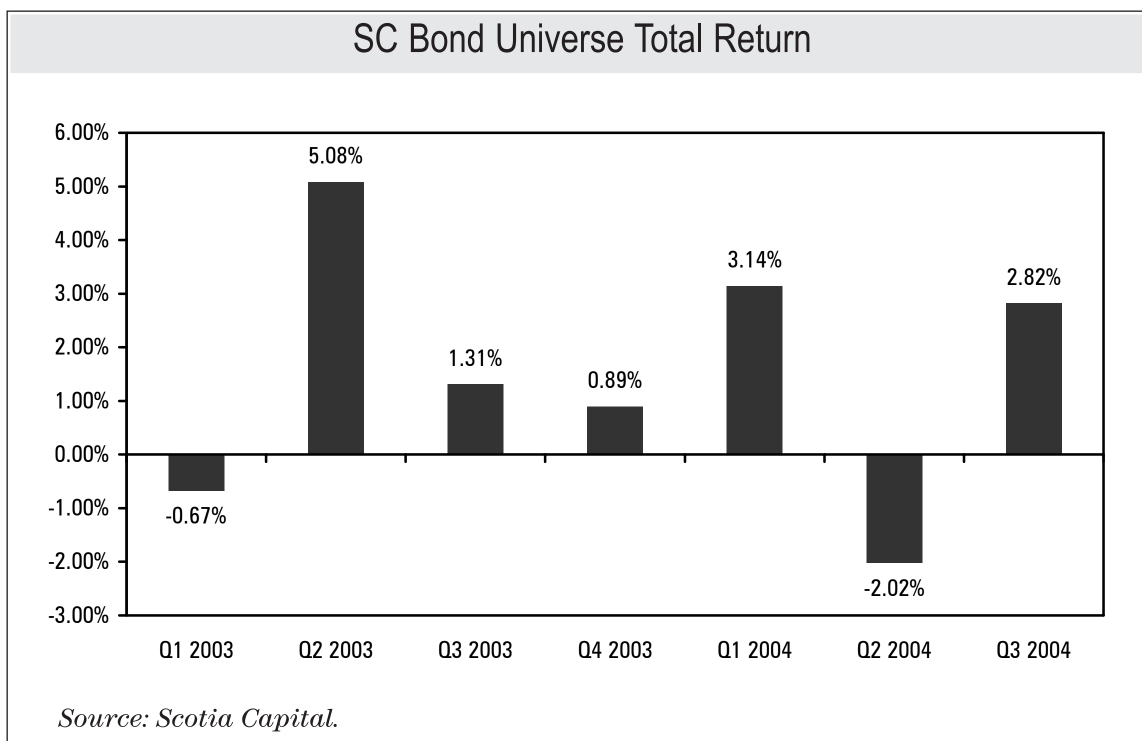
Expectations began changing again in the third quarter amid record high oil prices, a pullback in inflation data, and signs that the U.S. economy was slowing down. Bond yields dropped gradually over the third quarter to levels not seen since the first quarter as traders began removing many of the future rate hikes that had been previously priced into the yield curve. Against this background, North American central banks continued to make a case for the need to remove accommodative monetary policy. The Fed proceeded to raise the U.S. Federal Funds rate by 25 basis points in August and again in September taking the U.S. lending rate to 1.75% by the end of the quarter. The Bank of Canada followed suit in September, raising interest rates by 25 basis points and bringing the Canadian overnight lending rate to 2.25%.

The chart below illustrates recent monetary policy action by both the Bank of Canada and the U.S. Federal Reserve Bank.



Source: U.S. Federal Reserve and the Bank of Canada.

Despite the environment of higher short-term interest rates, bond prices responded impressively over the summer months. The Scotia Capital Bond Universe Index had a total return of 2.82% in the third quarter binging the total return for the first three quarters of 2004 to 3.91%.



Source: Scotia Capital.

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Implications

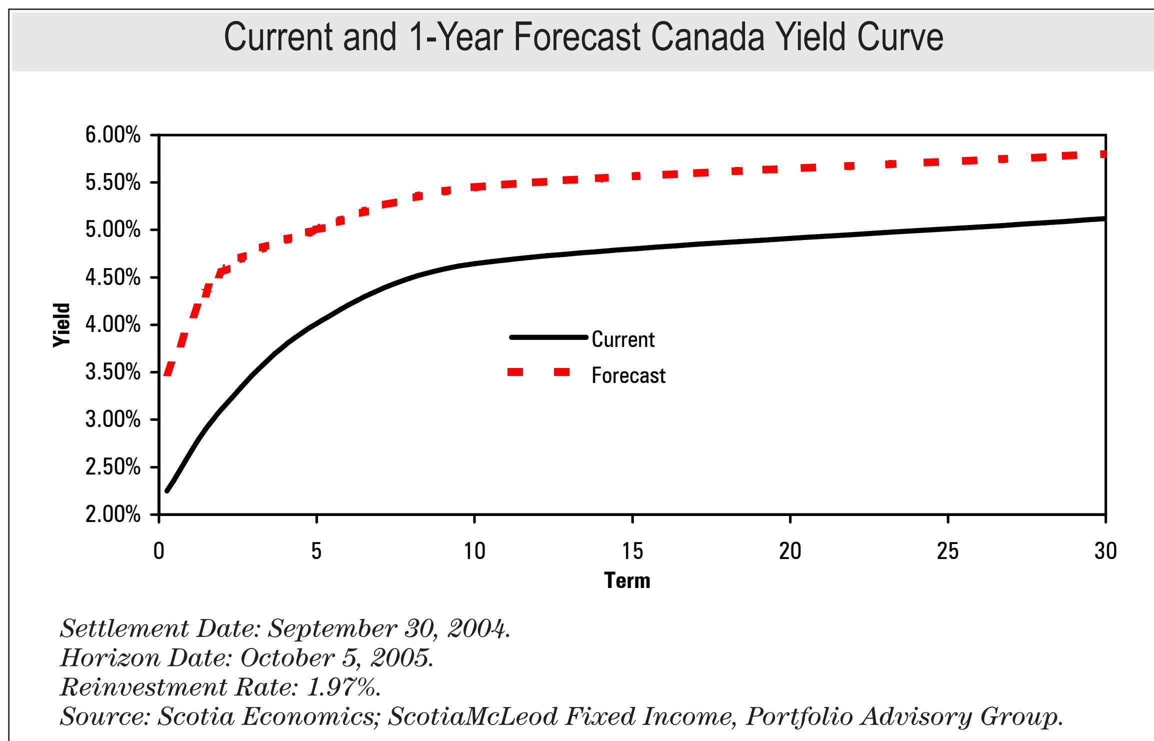
Monetary policy, economic growth and inflation expectations will continue to guide bond markets as we move through the final quarter of 2004 and begin to look towards 2005.

Inflation expectations will primarily drive the valuation of long maturity bonds going forward. We would argue that the market is currently pricing in an overly optimistic view on inflation. We believe it is only a matter of time before high energy costs lead to considerably higher inflation levels. Indeed, the spot price of WTI crude rose by 34% in the third quarter alone and is up 53% during the first three quarters of 2004. Any spike in inflation would be negative for the long end of the yield curve. Such a spike would lead to higher yields as the market will demand a larger risk premium for bonds with longer maturities.

Future rate hike expectations will continue to drive short maturity bond valuations for the remainder of the year. Both the Fed and the Bank of Canada have indicated the need for further interest rate increases to reduce monetary stimulus. However, any changes in the message coming from either of the central banks regarding monetary policy will have a direct affect on short maturity bond prices as the market adjusts its expectations of future rate tightening.

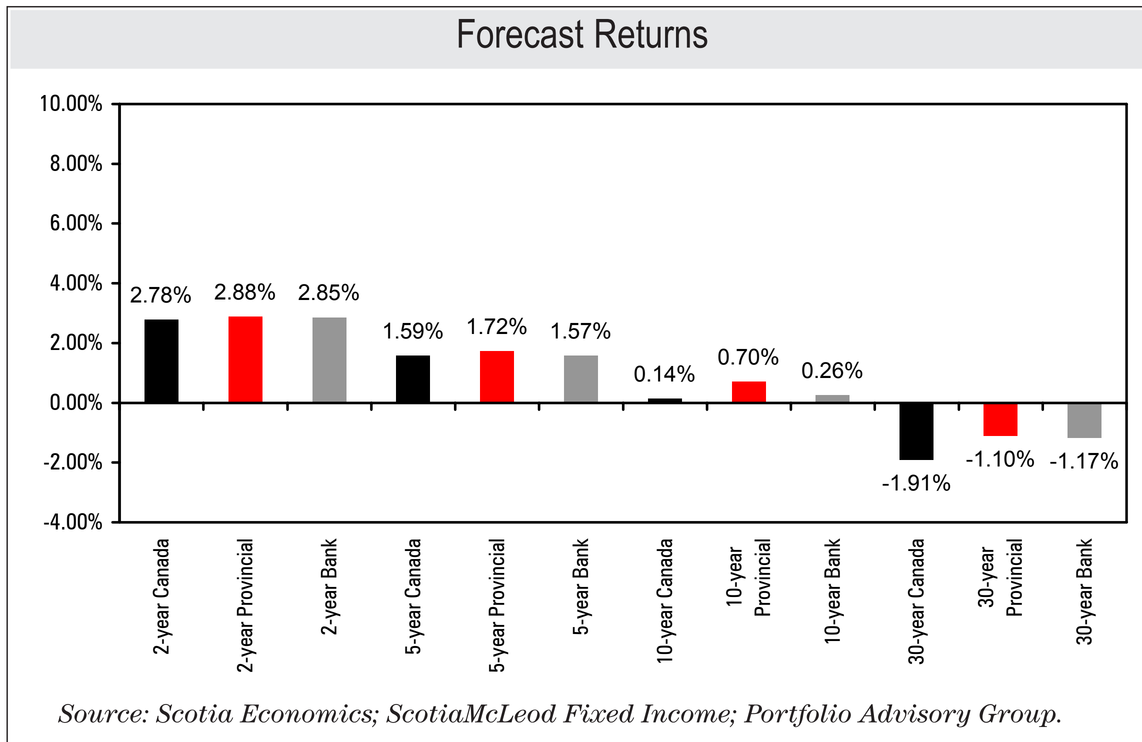
Scotia Economics is forecasting 50 additional basis points of rate tightening by both central banks in the remainder of 2004 which would bring the Fed funds rate to 2.25% and the Bank of Canada Overnight Lending Rate to 2.75% at year-end. Further monetary policy tightening is expected in 2005 and Scotia is forecasting a 3.25% Fed funds rate and a 3.50% Bank of Canada Overnight Lending Rate by year-end 2005.

The chart below projects the forecast Canada yield curve one year forward (dotted line) versus the current Canada yield curve (solid line). The forecast calls for a continued increase in yields over the next year and further flattening of the yield curve.



Settlement Date: September 30, 2004.
Horizon Date: October 5, 2005.
Reinvestment Rate: 1.97%.
Source: Scotia Economics; ScotiaMcLeod Fixed Income, Portfolio Advisory Group.

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



Source: Scotia Economics; ScotiaMcLeod Fixed Income; Portfolio Advisory Group.

Gains over the next year are likely to be limited to the short end of the yield curve. We are forecasting long maturity yields to move high enough that they offset coupon payments and result in negative returns over the near term.

In this environment we recommend that passive fixed income investors use a laddered bond strategy. A laddered bond portfolio is a selection of several fixed income securities, each with a successively longer term to maturity. The portfolio is structured so that a portion will mature each year. To maintain the ladder, money that comes in from maturing bonds is re-invested out at the long end of the portfolio (the top of the ladder) at what are hopefully higher yields. The ladder strategy offers the passive investor an opportunity to take advantage of a steep yield curve by increasing returns over current money market instruments.

For active fixed income investors, we recommend keeping bond duration short. We do not believe the yield pick-up in bond maturities greater than 10 years is enough to offset the price depreciation risks associated with these long maturity bonds. Investors should also focus on products that have the potential for increasing coupon payments over time such as step-up coupon bonds and floating rate bonds. Additionally, we continue to believe in the long term benefits of inflation-protection that are offered by Government of Canada Real Return Bonds.

Fixed Income Guided Portfolios: Core-Plus Portfolio

Kevin Martin, CFA – Associate, Portfolio Advisory Group

Investment Objective

The Core-Plus Fixed Income Guided Portfolio is designed and managed for clients with a moderate to higher risk investment profile, whose investment horizon and objectives focus on both current income and a reasonable level of returns to protect against future inflation. Based on these criteria, the portfolio's objective is to meet or exceed the performance of the Scotia Capital Universe Bond Index. Typically, this rate of return is not achieved every year but rather it is the desired average rate of return over the long-term time horizon. Approximately 75% of the portfolio is placed in a laddered bond portfolio and 5% is placed in inflation-protected instruments. These two positions make up the core holdings of the portfolio. The balance of 20% is then focused on active strategies that are geared towards moderate to high-risk investors.

Current Active Strategies

The active strategy portion of the Core-Plus Portfolio currently includes a four-year Province of Ontario New Zealand dollar denominated bond position. New Zealand dollar denominated bonds offer a substantial yield pick-up over comparable maturity Canada bonds. For example, the benchmark New Zealand Government five-year bond currently yields 211 basis points (or 2.11%) more than a comparable five-year Government of Canada bond. Additionally, we believe there is the potential for significant appreciation in the New Zealand dollar versus the Canadian dollar. The second active strategy position consists of one-month Bankers Acceptance paper. This position is simply a proxy for cash as we wait for another buying opportunity to emerge in the bond market.

Performance Update

The Core-Plus Portfolio had a total return of 3.77% for the nine months ending September 30, 2004, under performing the SC Universe's 3.91% return. Since its inception date of September 30, 2003 the Core-Plus portfolio has had a total return of 5.19% outperforming the SC Universe's 4.83% return. The portfolio's term to maturity is quite short relative to the SC Universe causing it to lag the Universe's performance during the rally in long maturity bond prices in the third quarter.

Active strategies in the third quarter included a position in four-year Japanese Yen denominated bonds and an overweight position in 10-year Government of Canada bonds.

Core-Plus Fixed Income Guided Portfolio (as at September 30, 2004)

Issuer Name	Coupon	Maturity Date	Weighting
Core Positions			
Canada	4.250	01-Dec-04	7%
Canada Real Return Bond	3.000	01-Dec-36	5%
CMHC	5.300	03-Dec-07	7%
Export Development Corp.	5.750	01-Jun-11	8%
Bank of Nova Scotia	4.295	22-Aug-08	7%
Bell Canada	5.500	12-Aug-10	7%
DaimlerChrysler Can Fin	4.650	11-Aug-05	7%
Royal Bank Of Canada	5.450	04-Nov-13	7%
Manitoba	5.250	03-Dec-12	7%
New Brunswick	5.250	02-Jun-09	7%
Ontario	3.500	08-Sep-06	7%
Active Positions			
BNS Bankers Acceptance	0.000	20-Oct-04	14%
Ontario (New Zealand $)	5.750	03-Mar-08	9%

Source: ScotiaMcLeod Portfolio Advisory Group.

Mutual Fund Strategy

Mutual Fund Guided Portfolios

Jennifer Gilbert – Associate Director Mutual Funds

The task of sifting through the vast number of available Canadian mutual funds in order to identify investment-worthy options can be a daunting one. Add to that the need to construct portfolios with the characteristics most likely to help you achieve your future goals, and the process becomes even more challenging. Unfortunately for many investors this important decision often consists of fund selection based solely upon the most recent hot performance numbers and an arbitrary grouping of funds that can expose us to various unintended risks.

At ScotiaMcLeod we recognize that your future is much too important to be left chance. That is why we have developed a tool to provide definitive investment direction, while at the same time offering you both the control and flexibility you need to best service the unique needs of your financial plan.

What are Mutual Fund Guided Portfolios and How are They Designed?

Mutual Fund Guided Portfolios are designed to bring an element of structure and discipline to the portfolio construction process. Each Portfolio is designed based on modern portfolio theory and supported by the ScotiaMcLeod Mutual Fund Recommended List. The objective of the Portfolios is to enhance the level of portfolio management and structure that goes into the investment process.

The portfolios are constructed using a long-term outlook, focused on risk control with the goal of reducing volatility. How do we do this? By offering diversification across fund managers, geographic regions and by remaining investment style neutral.

We created the portfolios to represent efficient combinations of investment assets based on seven asset allocation models within two pre-set asset sizes, for a total of 14 unique Mutual Fund Guided Portfolios. The seven asset allocations models are based on forecasts for market returns, market volatility and market correlations established by a committee of professionals from Scotia Capital and Northern Trust Global Advisors.

How are Underlying Funds Selected?

Fund selection starts with the Mutual Fund Recommended List. This will ensure that only thoroughly researched funds from some of the world's premier asset management companies will make it into your Mutual Fund Guided Portfolio.

Many of the Portfolios feature different fund selections to address different investment objectives and risk targets. This was done to accommodate the needs of a broad cross section of investors. The total number of underlying funds will also differ ranging from 8 to 13 depending on the Portfolio selected.

How are Mutual Fund Guided Portfolios Monitored?

Mutual Fund Guided Portfolios will benefit from the same research and due diligence that is the foundation of the Mutual Fund Recommended List. ScotiaMcLeod fund analysts continually monitor and evaluate the investment-worthiness and performance of each of the underlying mutual funds in the Portfolios. Areas of focus include factors such as manager and investment team changes, consistency of investment style and fund mandate, portfolio concentration and investment costs. Additionally, the performance and characteristics for each Portfolio will be monitored to maintain risk within reasonable parameters. Finally, any material changes to long-term market forecasts will be reflected in the program's asset allocations.

How to Use Mutual Fund Guided Portfolios?

Mutual Fund Guided Portfolios are easy to use and implement with the assistance of your advisor. View them as a holistic approach to your investment decision or simply choose with your advisor to combine specific asset classes and geographical regions in combination with other existing investment products to create a fully diversified personalized portfolio solution.

We will feature each of the portfolios individually over subsequent quarterly issues.

Feature Portfolio:

Investible Assets of $50,000 – $150,000

Portfolio 50% Equity 50% Fixed Income:

The portfolio's primary objective is to obtain long-term capital growth while also providing a significant amount of interest income.

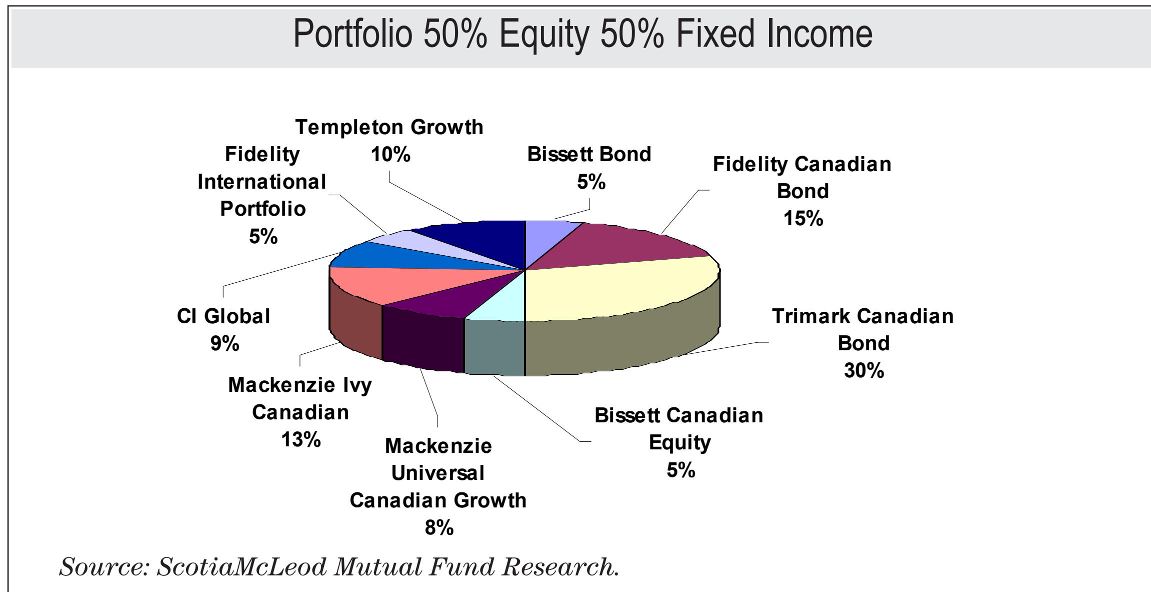
Portfolio Details and Investment Strategy

The portfolio seeks to achieve its objective through a balanced allocation to both fixed income and equity mutual funds. The portfolio's 50% fixed income weighting will be represented by a diverse set of fixed income strategies designed to generate steady income flows. The remaining 50% weighting is allocated to equity funds that invest across a range of companies with varying market capitalizations operating in a broad spectrum of industries. The portfolio is diversified by geographic region, investment style and market capitalization.

Portfolio Positioning

The funds in which the portfolio will invest as well as their target weightings within the portfolio are as follows:

Portfolio 50% Equity 50% Fixed Income



Source: ScotiaMcLeod Mutual Fund Research.

Portfolio Suitability

This portfolio may be suitable for investors who:

- wish to build a portfolio focused equally on interest income generation and long-term capital appreciation
- can accept a moderate level of investment risk
- are investing for at least 3 to 5 years.

Blended MER

1.97% – Based on Series A funds and represents the weighted-average of all underlying fund MERs in the portfolio.

What Are the Risks of Investing in this Portfolio?

Mutual Fund Guided Portfolios represent investments in the underlying funds and will exhibit the same risks as the underlying funds based upon their proportionate representations.

For more detailed information please contact your advisor.

Year End Financial Planning

– And Don't Forget the Charities

Howard Kabot – National Director, Wealth Planning

It's that time of year again. The days are getting shorter, the weather is getting colder and oh yes, there is only a small amount of time left to get our tax affairs in order for the 2004 tax year. While it is common to focus on those same issues that arise year in and year out (tax loss selling, paying deductible amounts by year end, etc) the overall exercise can be made even more worthwhile if others can benefit as well. So in addition to those "regular" strategies, this article will also provide insight into strategies for charitable giving.

First Things First

Tax Loss Selling

Primary among most investor's tax minimization strategies is tax loss selling. This annual ritual involves selling off those positions you no longer have faith in knowing that the loss will be used first to offset any gains you have had this year. Once you have netted out your losses and gains for this year, you then have the opportunity to carry your losses back three years or forward indefinitely. Keep in mind that with tax loss selling your year-end trades must settle by December 31st. This can be a little tricky given the Christmas and Boxing day holidays and the fact that trades will settle in three days. The settlement date is what is used for tax purposes. For the 2004 tax year, trades must be made on the Toronto Stock Exchange by Friday, December 24th and New York Stock Exchange by Tuesday December 28th. Don't forget that capital losses apply to bonds as well. In particular, if you buy a bond at a premium and hold it to maturity, the premium amount is considered a loss for tax purposes.

Give the Loss to the Kids

While tax loss selling involves actually disposing of those shares no longer deemed worthy of keeping, gifting or selling a losing position to your child, provides a different angle on the same strategy. The superficial loss rules prevent an individual from claiming a loss on shares reacquired by a spouse or a controlled company, but not to shares reacquired by a child. So, in gifting to the child, the loss can be claimed while the shares remain in the family. If the shares subsequently rise in value, the gain would be the child's.

Spousal Loans Are Still Worthwhile

Its still not too late to consider making a loan your spouse, if they are in a lower income bracket than yourself. While the benefit won't be as large as it could have been had this strategy been pursued earlier in the year, you will be set up nicely for the 2005 tax year. To benefit from a spousal loan, the higher income spouse loans the lower income spouse an amount at a prescribed rate set be the Canadian Customs and Revenue Agency (CCRA). For the fourth quarter of 2004, the rate was set at 3%. The spouse receiving the loan is able to invest the money and report the income as his/her own but must pay the interest on the loan back to the spouse from whom the loan was received. The spouse who made the loan must make sure to report the interest on his/her tax return.

Avoid Year-End Mutual Fund Purchases

The concern here is to avoid purchasing those mutual funds that make year-end distributions. If you decide to purchase a unit of a fund near the end of the year, you will receive a distribution and will be taxed as a result, even though you effectively have not earned a return on your investment.

Pay For Your Deductions

There are many items that if paid by year-end are tax deductible or will give you a tax credit. Charitable donations for instance, have to be made by year-end as do investment counsel fees, union dues, professional fees, political contributions, alimony and maintenance amounts and safety deposit fees.

If You Turn 69 This Year

If you turn 69 this year you have to convert your RRSP to a Registered Retirement Income Fund or to an annuity. This means that you will no longer be able to make RRSP contributions. However there is one more RRSP contribution strategy you can follow. First we'll assume that you worked this year and therefore have RRSP room to be used next year. But there is a problem. Your RRSP has to be wound up this year which means that it would be impossible to make your RRSP contribution next year. The only way around this dilemma is to make the RRSP contribution this year while the RRSP is still open. The problem with doing this is that the contribution is considered an overcontribution and therefore subject to a 1% penalty per month. However come January of 2005, the contribution is no longer considered an overcontribution and the penalty no longer exists. You therefore end up with a deductible contribution, which (on $15,500) will generate a tax refund of $7,190 (in Ontario). Keep in mind that you still have to pay the $145 penalty. Not a bad trade off.

Give to Charitable Causes

If you want to be able to claim a charitable donation credit for 2004, then the contribution must be made by the end of this year. The most common way for many of us to do this is through cash contributions. However there are many alternatives that are just as beneficial if not more. The donation of stocks, bonds, etc. is just one example. From a tax perspective, the gift is considered a deemed disposition for tax purposes. However since the intended recipient is a charity, the capital gains inclusion rate is reduced to half the regular amount (from 50% to 25%). For someone in the top tax bracket, this means that the normal tax rate of 21.5% (in Ontario) on capital gains, is reduced to 10.75%. Furthermore, the charity will issue the tax receipt for the full value of the donated property. In many cases the resulting credit will more than offset the tax liability on the deemed disposition to the extent that the excess credit would be used to offset tax payable from other sources.

Another option is to use life insurance. This can be accomplished in a number of ways. One option is to purchase a policy on your own life and then gift it to the charity which then becomes the owner of the policy. In this case you would continue to pay the premiums on the policy and would therefore receive a donation receipt each year for the premiums paid. You could also consider donating a life insurance policy that you already own. In this case you would have to be able to establish the cost base of the policy (term, whole life or universal life) and would have to report a capital gain on the disposition but would also get a tax credit for the cash value of the policy.

Managed Asset Group

Making the Most of Portfolio Optimization

Erin Griffiths MBA – Senior Group Manager, Fee Based Programs

op'ti'mi'za'tion – working to achieve the most favourable balance between risk and return.

Regardless of your unique investment goals or objectives for your portfolio, achieving the most favourable balance between risk and return is the outcome that most investors strive for. The challenge, of course, is how to achieve this outcome. The markets can be complicated and unpredictable and there are a number of varying opinions on the most effective investment strategy for a portfolio.

Northern Trust Global Advisors, the investment management consultant for the Summit and Pinnacle Programs, has developed a highly disciplined process that is designed to help you achieve the best risk/reward results for your portfolio.

The Portfolio Construction Process

When it comes to the portfolio construction process, Northern Trust draws on modern portfolio theory and sophisticated portfolio construction tools to achieve multi-level diversification by asset class, market capitalization, country and investment style.

Asset allocation is determined using a combination of factors – forecast market returns, market correlations and market volatility. The goal here is to arrive at an asset allocation that will maximize an investor's potential return for their stated risk tolerance.

The asset allocation optimization process is also driven by scenario analysis, to determine what combination of asset classes is likely to provide the best pattern of excess return and reduced risk under varying conditions – be it a rising interest rate environment, a period of high inflation, volatility in the currency markets or a recession.

In addition to asset allocation, Northern Trust also focuses on market capitalization, regional diversification and investment style – optimizing portfolios based on each of these factors.

The goal of the optimization is to manage unintended portfolio bets and create more consistent performance. As Andrew Smith, Vice President, Northern Trust Global Advisors points out:

"A portfolio is really a composite of asset class, capitalization, geographic and style bets. The impact of these aggregate bets often determines more of a portfolio's performance than the stocks or bonds held within. Unsuccessful and unintended bets are among the primary reasons why investors underperform. A sound investment process provides a framework to identify and manage portfolio bets."

For Northern Trust, this process involves both quantitative and qualitative analysis, particularly at the money manager level.

How Money Managers are Selected

Northern Trust has the global capacity to research, compare and select money managers through its offices in Toronto, Stamford, Chicago, San Francisco and London. They track over 5,000 money managers in select investment specialties, recommending fewer than 200 to their clients.

Money managers selected for the Summit and Pinnacle Programs are subjected to an indepth selection methodology that includes both qualitative and quantitative analysis. Key points of focus include investment process, stock selection and risk management skills, performance, quality of the firm and key personnel.

Money managers who are ultimately selected must also undergo a disciplined, ongoing evaluation process that includes on-site due diligence visits, extensive interviews, and independent analysis of portfolios and performance, including their market capitalization, regional diversification and investment style.

There is also a definitive effort to create style neutrality in a portfolio. Investment style is defined as the way in which a money manager selects securities for a portfolio. In general equity managers fall into two broad categories – value and growth. Value managers look for quality companies that are undervalued or out of favour. These are companies that tend to have low Price-To-Earnings, Price-To-Book and Price-To-Cash Flow ratios. Growth managers, on the other hand, tend to focus on companies that are growing earnings, reinvesting in capital expenditure, and have high returns on equity. They also tend to have high Price-To-Earnings, Price-To-Book and Price-To-Cash Flow ratios.

The important thing to understand is that managers frequently behave differently based on their style attributes with very distinct cycles of outperformance and underperformance versus the broad market.

To reduce this volatility and add return through security selection, money managers with different investment styles are recommended is the Summit and Pinnacle Program to allow for effective portfolio optimization. Growth and value managers, for example, are balanced so as to avoid the uncertain return patterns and the extra volatility associated with overweighting any one investment style.

In addition to investment style, Northern Trust also pays careful attention to overall capitalization and country weightings in a portfolio to eliminate unintended bets that can rob performance.

To find out more about Northern Trust's portfolio construction and money manager selection process or the benefits of portfolio optimization in the Summit and Pinnacle Programs, please contact your advisor.

Notes

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