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Executive Summary

2007 Fall Outlook

Stewart Hunt — Managing Director, Portfolio Advisory Group

With the global financial market volatility in July and August it seemed appropriate to focus the theme of the Fall 2007 Investment Portfolio Quarterly (IPQ) around “Risk and Reaching your Goals.”

It is not uncommon for investors to get off the beaten track when it seems all roads are paved with gold. Unfortunately, it usually takes a dramatic event such as the financing failure in the third-party Asset Backed Commercial Paper Market or credit failure in the Sub-Prime Mortgage market to bring everything back to black and white. It is at times like these the value of a financial plan, asset allocation, diversification and realistic return expectations clearly pay dividends in providing investing peace of mind. As Brian Hutchison notes in our feature article, “markets have gone up indeed over the long term, but at times, and sometimes for prolonged periods of time, they go down.” With that in mind we felt that it would be appropriate to write about market risk and reaching your goals. While investing in the markets is a challenge, proper allocation among asset classes and diversification within those asset classes can often lead to a “golden” result.

Here are some of the features in the Fall 2007 Investment Portfolio Quarterly

- Brian Hutchison, in our feature article highlights the value of reducing your investment risk through proper asset allocation across the investment classes of stocks, bonds and cash, including diversification within the classes. In addition, he uses the efficient frontier model to display the relationship between a desired return and the risk you may have to take to achieve that return. Are your return expectations in line with your risk tolerance? Positive performing markets often cloud this observation.
- We are witnessing history by the world’s central banks as they deal with global credit and financing issues. With the Bank of Canada making headlines nearly everyday, Carolyn Tjart reviews the theory and events in Central Bank Monetary Policy in an effort to shed some light on how and why the Bank of Canada and U.S. Federal Reserve have reacted.
- Gareth Watson reviews the Canadian equity market from a sector perspective, providing insights on the Financial and Resource sectors and highlighting the various factors that impact the returns for companies in these markets.
- Paul Danesi provides an excellent commentary on the U.S., offering insights into the U.S. housing and mortgage market and the potential economic slowdown, while highlighting investment opportunities with companies that have international exposure.
- “Like watching paint dry” is how Chris Kennedy describes investing in the bond market. But remember who wins the race between the tortoise and the hare.
- Kevin McMahon makes his first submission to IPQ, highlighting the value of a Mutual Fund portfolio in providing investors with the broadest selection of investments including all the normal asset classes, plus diversification through geography, capitalization and investment style.
- Susan Forint provides readers with an insurance opportunity for mitigating volatility for the long term highlighting the investment benefits, particularly from an after tax perspective of insured annuities, estate reallocation and guaranteed minimum withdrawal benefit products.
- Howard Kabot focuses on gaining investment peace of mind through a financial plan. A builder would never think to construct a house without a plan so why should it be any different when we build towards constructing an investment nest egg for the future.

July and August 2007 were history making in the financial markets but quick action by the world's central banks and a much better prepared investor seem to have weathered the storm. Whenever we experience some market turbulence it is always good to take the time to evaluate how you weathered the storm and, more importantly, to ask if you are prepared for what might happen next. Hopefully, the Fall 2007 edition of IPQ will help you understand "Risk and Reaching your Goals." Now is a great time to contact your ScotiaMcLeod Investment Executive on your financial strategy.

Portfolio Strategy

Market Volatility – A Good Time to Review Your Investment Objective and Risk Tolerance

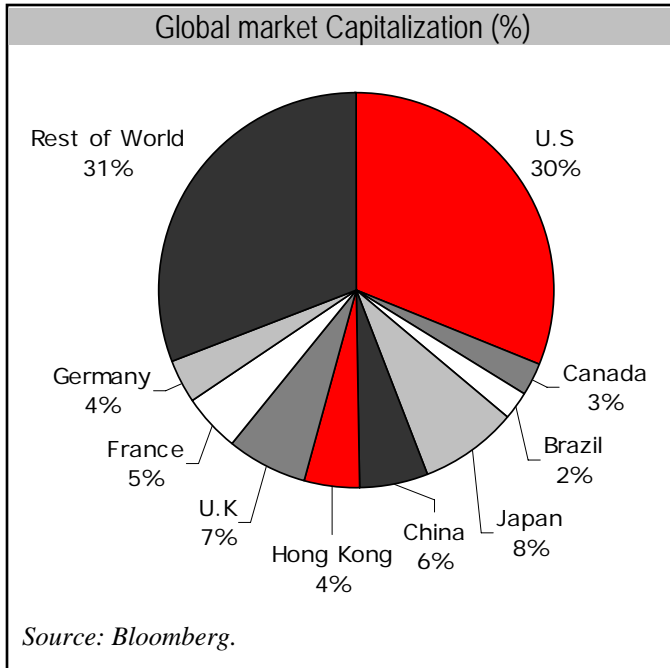
Brian Hutchison, MBA, CFA — Associate Director, Portfolio Advisory Group

If there is something that the last couple of months have reminded us, it is that the equity markets do not go straight up indefinitely. Investors who believed otherwise are now undoubtedly aware of this fallacy. Markets have gone up indeed over the long term, but at times, and sometimes for prolonged periods of time they go down. While we remain fundamentally bullish on the market, we think the market's recent turbulence presents an opportune time for investors to review their asset allocation, the mix between equities, fixed income and cash, to ensure that it falls in line with their investment objectives and risk tolerance.

We often use the word “risk” as a catch all, but risk means different things to different people. In the investing world, some consider risk the possibility of losing ANY money, while for some investors it might include a loss tolerance of up to 10% on their investment. No doubt, you have been at a cocktail party and heard someone bragging about their investment returns. But what many fail to explain is that those returns may have been achieved with a higher level of risk or volatility in their portfolios. While they may be up significantly this year, those returns may not have been as impressive last year or during the technology meltdown. This is why it is important for you to know your risk tolerance and to try to stick within it. We have seen steady gains in the TSX in the last four years, driven primarily by Materials, Energy and Financials. But we need to put the recent returns in context of the long term. In fact, the returns that we have seen over the last 50 years have averaged 6.46%, excluding dividends. This contrasts with the 18.19% that we have seen on a compounded annual growth rate (CAGR) over the last four years ending in 2006.

We mentioned previously that not everybody's risk tolerance is the same. If, for example, you place all of your money in one stock, it stands to reason that you will generally have more risk than someone who owns many stocks. For example, what if suddenly the product your one-company makes becomes obsolete? How would that affect sales and profits? You don't see a big demand for buggy-whips these days, do you? By owning many individual securities you can achieve diversification. But to achieve greater diversification you need to invest in many sectors of the S&P/TSX. Take for example the Materials sub-index of the S&P/TSX. This sector has seen heady gains in the past several years driven by China's seemingly insatiable demand for commodities. Investors that have been in this sector have been amply rewarded but this has not been without risk or volatility. In fact, during the last four years the Materials sector has corrected itself by 10% or more four times, including the recent 16% drop in July and August, 2007. The question investors need to ask themselves is: are you comfortable with this type of volatility? If not, you should perhaps consider alternative sectors or a reduced position.

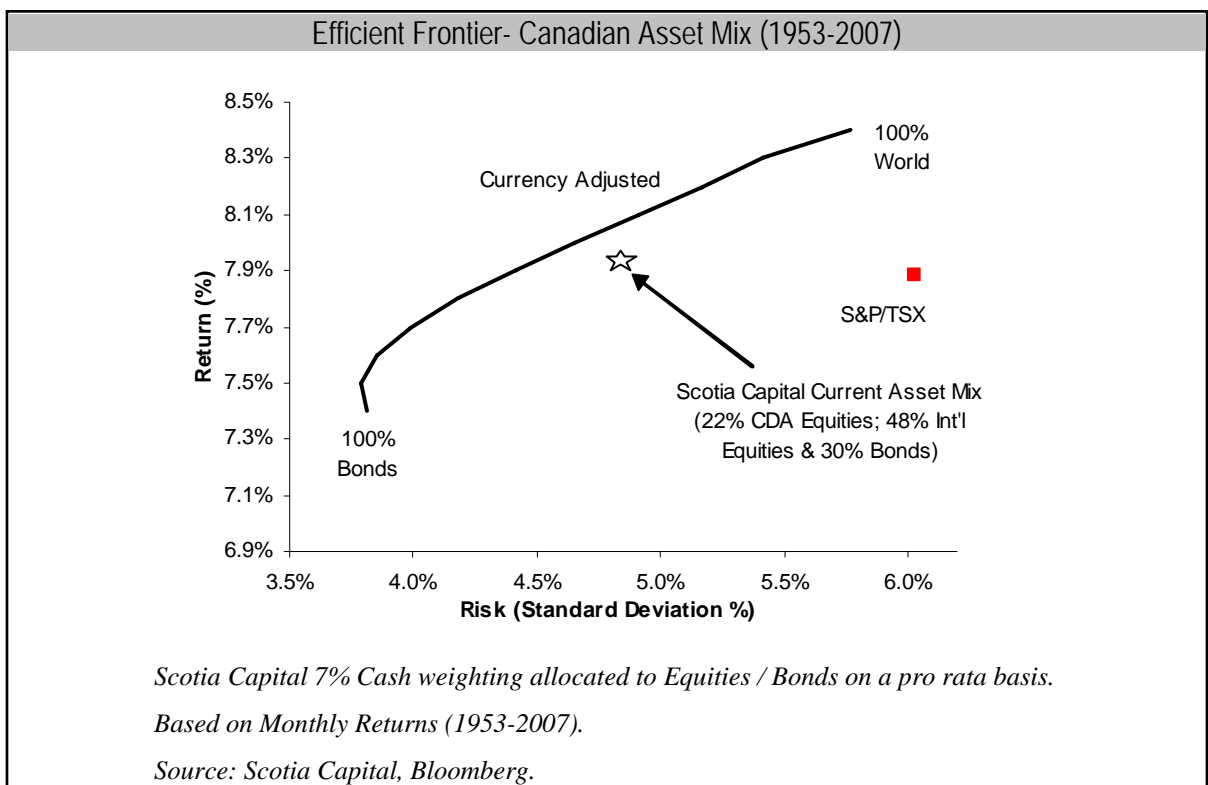
We have discussed diversification in equities as having money invested in multiple stocks and sectors, but it is important to think about foreign equity markets as well. While the majority of us receive our income and incur expenses in Canadian dollars, we need to consider international diversification for our portfolios. Investing solely in one country rarely meets the demands of diversification. In the case of Canada, the market capitalization as a percentage of global market capitalization is only 3%, leaving 97% outside of Canada, as shown in the following chart. Despite this, at the end of 2006, domestic equities represented approximately 62% of total equities held by Canadian institutional and retail investors. Despite the travails of the U.S. dollar or perhaps because of it, now may be a good time to take a look at diversification into the U.S. One reason is that many U.S. companies are multinationals, meaning they have operations in numerous countries around the world. A weaker U.S. dollar makes their earnings worth more when converted back into U.S. dollar terms.



Another benefit of investing in the U.S. is that it offers a somewhat different sector breakdown. If we look at the S&P/TSX Composite it is dominated by the Financials, Energy and Materials. In fact, these three sectors now represent about 75% of the S&P/TSX Composite Index. Let's contrast this to the S&P 500 in the United States where these same three sectors represent about 35%. By investing in the U.S. market you can gain more exposure to sectors such as health care and technology which are much smaller in Canada.

Looking back over the long term, international equities have helped improve the risk-reward profile of investors' portfolios. By risk-reward we mean maximizing the amount of return while minimizing the standard deviation

(volatility) of the portfolio. The efficient frontier, introduced by Nobel Prize winner Harry Markowitz, shows a set of portfolios that yield the maximum rate of return for every given level of risk, or seen the other way around, the minimum risk for every level of return. Risk in this case is measured by standard deviation, a measure of variance. According to the results, the "optimal portfolio" would never include S&P/TSX Composite if we were to use the last 54-years of data as a proxy as illustrated in the following chart. However, we must consider the reality that Canadian investors are going to hold Canadian securities. In fact, recent returns from 1995-2007 show that Canadian equities are on the efficient frontier. So the conclusion that we can draw from this is that international equity portfolio diversification has been important over the long term.



So far we have discussed equities; however, fixed income securities remain an important component of a diversified portfolio. Despite lower yields in recent years, as inflation rates remain relatively tame, investing in fixed income has historically served to reduce the overall risk of your portfolio, as there tends to be less volatility, as seen in the previous chart. Finally, it is important to keep a certain component of your portfolio in cash-type instruments that can be easily accessible when you need them. Not only will you have funds available when the market or a stock that you have been looking to purchase falls but you will also avoid selling a position when it may be inopportune to do so.

While it is easy to be giddy with the returns that the equity markets have dished out in the last four years, one needs to be circumspect to ensure that your current asset allocation not only achieves your financial goals, but lives within your risk tolerance. For a complete review of your asset allocation please contact your ScotiaMcLeod Investment Executive.

Economic Outlook

Economics 101 – Theory and Events in Central Bank Monetary Policy

Carolyn Tjart- Associate, Portfolio Advisory Group

The Role of Monetary Policy

Monetary policy refers to actions undertaken by a central bank, government or monetary authority designed to influence how much money circulates in the economy in order to achieve an economic goal. By managing the supply of money in the economy, monetary officials are able to influence economic growth, inflation, unemployment and a country's exchange rate.

In most nations, central banks have been formed to execute monetary policy. These special institutions operate independent of the government in their home country.

Monetary policy is based on the total supply of money and the price at which it can be borrowed. An expansionary policy describes an environment where the supply of money in the economy is increased, often through lower interest rates, and is used when an economy is in a recession or to combat unemployment. A contractionary policy describes an environment where the money supply is reduced or interest rates are raised, and is used to cool rising inflation or slow economic growth. A neutral policy stance describes a situation where interest rates and/or money supply changes are intended to neither spur growth nor combat inflation.

Tools of the Trade

Various tools are used to control interest rates (the price at which money can be borrowed) and the total supply of money in the economy. These tools include:

- **Open Market Operations** – Adjusting the quantity of money in circulation through buying and selling government securities. If a central bank wishes to lower interest rates, it will purchase securities, thereby increasing the amount of cash in circulation and lowering the cost of credit.
- **Reserve Requirements** – The amount of funds that a deposit institution must hold in their reserves against specific deposit liabilities. By lowering the reserve requirement, more funds are available in the economy to lend out, which lowers the cost of borrowing.
- **Target Interest Rates** – Set by central banks for short-term borrowing. By setting a target where funds can be borrowed or lent out, central banks influence the entire spectrum of interest rates, which in turn affect consumers' spending decisions.
- **Moral Suasion or Open Mouth Operations** – Monetary officials use speaking engagements and announcements to convey their thoughts to the markets on the present and future happenings in an economy.

Monetary Policy in Canada

In Canada, the Bank of Canada (BoC) is the government-owned Crown Corporation charged with the responsibility of enacting monetary policy. Monetary policy in Canada is conducted through the overnight target rate and seeks to maintain a low and relatively stable rate of inflation. By keeping inflation low, stable and predictable, the BoC contributes to solid economic performance and rising living standards for Canadians by avoiding inefficiencies created by inflation.

A key component in implementing monetary policy is the credibility inherent in the central bank's ability to carry out policy actions as announced. Firms and consumers must believe these announcements will reflect future policy; otherwise, they will act in such a way as to create higher prices in the future.

The Transmission Mechanism

The process of setting short-term interest rates results in a complex sequence of events that influences prices, consumer demand, economic output and eventually inflation. To best understand this concept, consider the Canadian economy from September 2004 to June 2006 where the BoC saw inflation pressures rise as global economic growth continued to prove strong. To combat price pressures, the central bank took action to raise their target for the overnight rate. Following the announcement of a rate hike, the actual overnight rate adjusted almost instantaneously, leading to a corresponding increase in long-term interest rates.

The rise in interest rates led to an increase in the cost of borrowing for firms and consumers, designed with the intent of slowing demand for investment goods, residential housing and other big-ticket items which require borrowing. As demand for goods and services slowed, growth in economic output slowed as well.

Ultimately, the BoC's goal was to reduce actual output, to the point where it fell below the potential output of the economy. By doing so, the growth in wage and input prices slows. It is this decline in the growth of firms' costs that tempers inflation pressures by preventing firms from having to increase the price of final goods.

Typically, as interest rates rise relative to those of other countries, money flows into the home country in pursuit of higher yields, causing the currency to appreciate as demand for the currency rises to fund foreign purchases. As the currency appreciates, the price of domestic goods relative to foreign goods increases causing demand for exports (demand by foreigners for domestic products) to decrease and imports (demand by domestic consumers for foreign products) to increase. The rise in Canadian interest rates therefore has been an additional factor supporting strength in the currency over the past several years.

Central Banks in the Spotlight

Monetary policy has been a topic of discussion lately due to the recent events in financial markets. A combination of policy actions have been taken by central banks around the globe to address the recent volatility in financial markets and calm fears over potential fall-out effects of rising delinquencies in the U.S. sub-prime housing sector.

One of the fundamental roles of a central bank is to provide liquidity when financial institutions are faced with markets that have become illiquid. In August, rising sub prime mortgage defaults in the U.S. caused a rise in risk aversion, and many corporate borrowers experienced difficulty issuing new debt. The most extreme case occurred when certain issuers of asset-backed commercial paper (ABCP) were unable to refinance as investors became sceptical of the nature and the value of the underlying assets. These events in August placed upward pressure on overnight borrowing rates between financial institutions, as banks were less willing to lend to each other, negatively impacting market liquidity. So the Bank of Canada, like other central banks, carried out open-market operations with the goal of bringing the actual overnight rate closer to their stated target. The Bank of Canada also temporarily expanded the list of eligible securities that market participants could use as collateral, thereby making it easier to make use of central bank lending facilities. Meanwhile, the U.S. Federal Reserve (Fed) implemented a surprise 0.50% cut to the discount rate (the rate charged to banks on short-term loans from their regional Federal Reserve Bank), thus reducing the penalty of borrowing at the discount window over the overnight rate. These actions were effective in helping to improve liquidity and the functioning of money markets.

To address the mounting risk posed to growth by the ongoing adjustment in the U.S. housing sector, the Fed announced a much anticipated rate cut at their September policy meeting. After holding the fed funds rate steady for 9 consecutive meetings, the Fed switched from “data watching” (inflation bias) to “easing” (growth bias) by implementing their first rate cut since June 2003. The 0.50% cut was intended to help forestall any further deterioration in growth due to recent market events and “promote moderate growth over time.”

Given the impact of slower U.S. growth on the Canadian economy, the BoC is now expected to follow suit with cuts to the overnight target rate.

Impact on Your Portfolio

With the recent Fed easing, we saw the U.S. yield curve steepen as short-term yields fell while longer-term yields rose. This was the market’s response to speculation of higher inflation with the Fed’s focus shifting away from an inflation risk bias to a growth risk bias. Investors viewed the lower cost of credit as inflationary, as money/credit becomes more readily accessible. In recent years, the yield curve flattened as both the U.S. Federal Reserve and the Bank of Canada gained a reputation of acting to keep inflation low.

However, the important question now relates to the future impact of the recent policy action by the Fed on your portfolio. Looking at recent easing cycles in both the U.S. and Canada, equity and bond markets in both countries generally respond favourably to the policy action as indicated by the tables and graphs below. The one exception in equity markets was the easing cycle which began in 2001. This monetary easing coincided with the tech bubble and numerous high profile breaches of accounting standards (Enron, WorldCom, Nortel, and Adelphia) at a time when stocks were significantly overbought. These psychological factors were significant in contributing to the negative returns during this easing cycle, as confidence was lost in financial reporting and equity markets. Correspondingly, bond markets experienced above average returns over this period and outperformed equities, indicative of the markets’ flight to quality response (buying the safety and quality of Government bonds in lieu of riskier assets).

Looking Ahead

While slower economic activity typically results in softer corporate profitability and lower interest rates, these periods have generally been supportive of equity and bond markets. Investors who have put cash to work during slower economic growth periods in the past have generally been rewarded when results are measured over a 1-year time horizon.

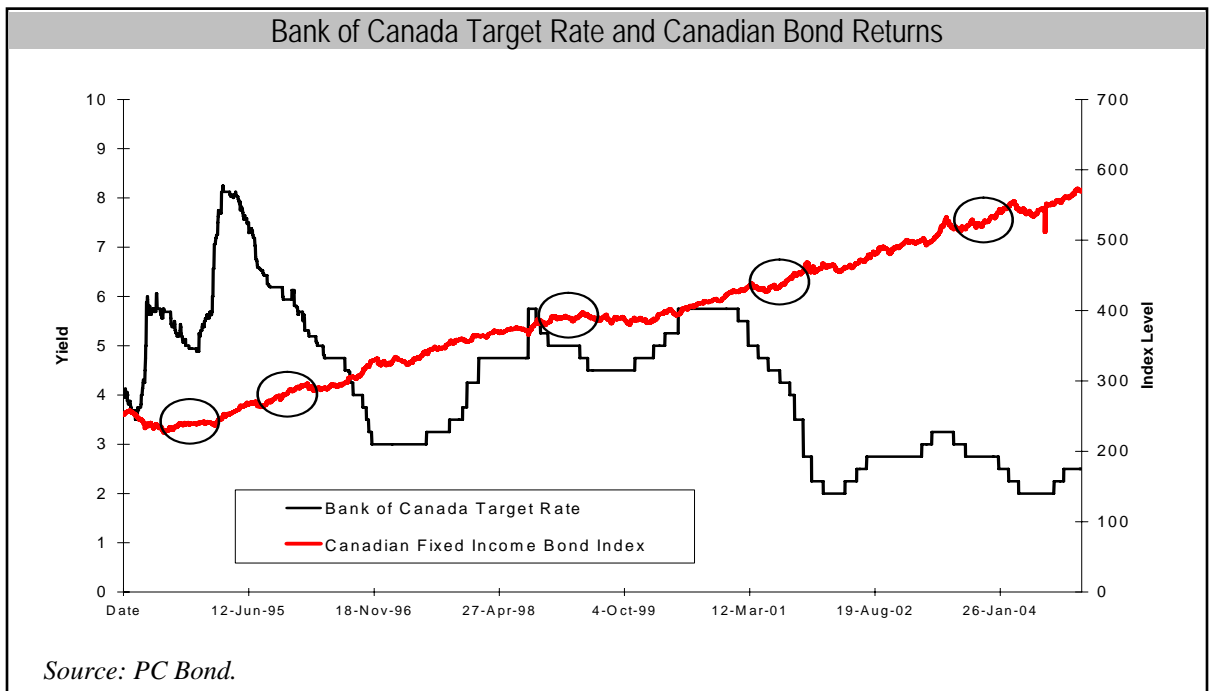
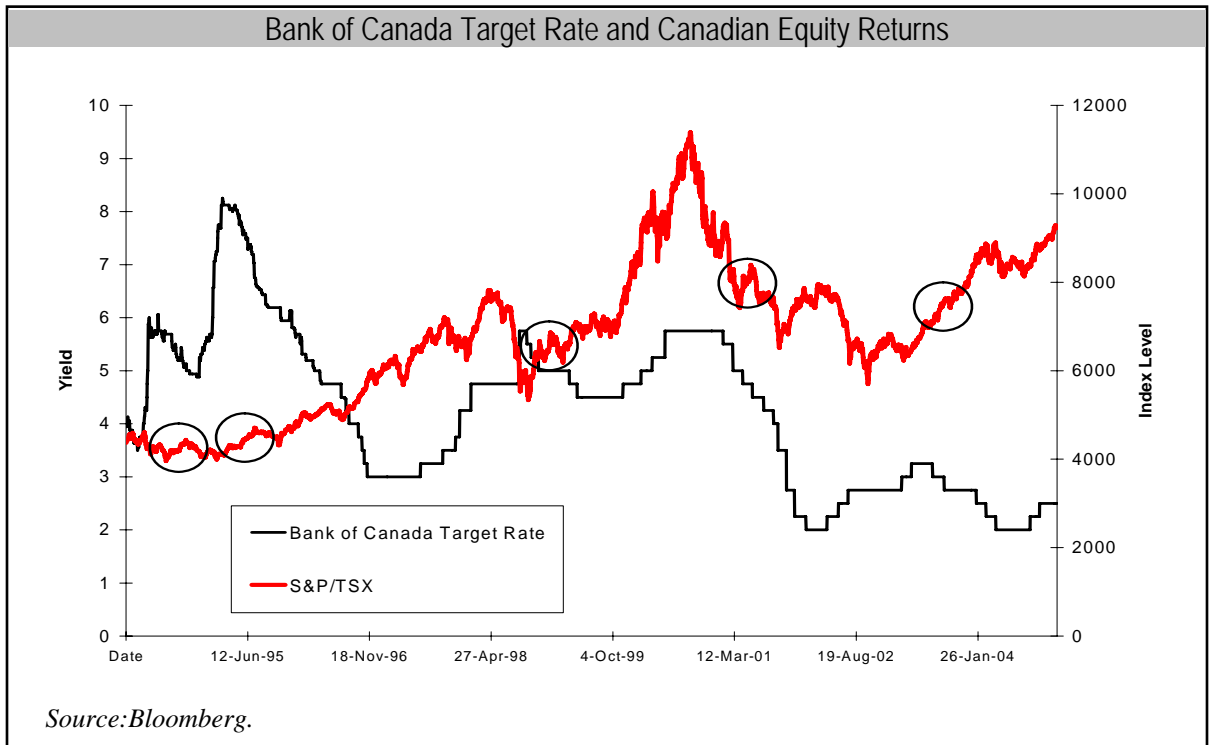
Vincent Delisle, *Director - Equity Research*, notes that the Fed’s 0.50% overnight rate cut and central banks’ liquidity injections have renewed investor optimism. He believes equity valuations remain attractive and reaffirms his equity targets of 1,625 for the S&P 500 and 14,200 for the S&P/TSX, representing modest total return expectations of 6% to 9.4% for U.S. equity and 4% to 8.7% for Canadian equity. Total return expectations for bonds remain in the low single digits over the comparable period with global growth keeping inflation on the radar and pushing long-term bond yields higher. Therefore, equities are expected to outperform bonds over the coming 12-18 months.

*Appendix 1. Summary of 12-month Equity and Fixed Income Index returns in the U.S. and Canada
(Returns measured one year from the beginning of the easing cycle)*

Appendix 1: Easing Cycles in the U.S. and Canada		
U.S.	S&P 500 Equity Returns	U.S. Bond Returns
Start Date	12-Month Return	12-Month Return
6-Jul-95	18.67	3.39
29-Sep-98	20.91	0.03
3-Jan-01	-13.53	7.96
Average	8.68%	3.79%
Canada	S&P/TSX Equity Returns	Canadian Bond Returns
Start Date	12-Month Return	12-Month Return
10-Aug-94	9.62	12.95
8-May-95	20.15	9.77
29-Sep-98	19.38	2.17
23-Jan-01	-18.02	8.38
15-Jul-03	18.00	5.29
Average	9.83%	7.71%

Source: Bloomberg, PC Bond, Lehman Brothers.

Appendix 2. The Bank of Canada Overnight Target Rate relative to Equity and Fixed Income Index Returns (Performance of the index during easing cycles indicated on each graph)



Canadian Equity Strategy

Breaking Down the TSX Index and Understanding its Many Moving Parts

Gareth Watson, CFA — Associate Director, Portfolio Advisory Group

The third quarter of 2007 shall certainly be remembered for the credit problems and liquidity issues that plagued North American equity markets, including Canada's Toronto Stock Exchange. The TSX Composite Index came under pressure during July and August for a number of reasons, including uncertainty as to whether the financial problems we witnessed would develop into broader economic problems. The introduction of this uncertainty led to higher than usual levels of volatility and increased selling, driving the TSX lower. Considering what has occurred over the past three months, we believe it is worthwhile to examine the composition of the TSX and identify key drivers for the most heavily weighted subsectors in Canada in order to give investors some perspective as to why the TSX index declined and where it may go in the future. Our discussion of market drivers is not exhaustive, but we hope to touch on those drivers which have been influential during the third quarter of this year.

As you can see from the table below, the TSX Index is dominated by 3 of 10 subsectors. Financial stocks comprise 30% of the index while resource stocks in the Energy and Materials subsectors comprise another 44%.

TSX Composite Index Sector Weightings	
As of October 2007	
Financials	30.380%
Energy	26.853%
Materials	17.538%
Industrials	5.569%
Telecommunications	5.529%
Consumer Discretionary	5.054%
Technology	4.386%
Consumer Staples	2.602%
Utilities	1.485%
Health Care	0.602%

Source: Bloomberg.

Let us begin our discussion with Financials. For the TSX Index, the Financials subsector is dominated by the 6 major Canadian banks and our country's three largest life insurance companies: Manulife Financial, Sun Life Financial and Great West Lifeco. What helps a financial stock? Looking at the bigger picture, a healthy economy is a good start. When financials operate in areas that are experiencing strong economic growth, they tend to grow and outperform as consumers borrow and spend more money. Financial companies also perform well when the financial system they are a part of operates efficiently. Over the past three months these two drivers have been brought into question as weakness began appearing in the U.S. and as the Bank of Canada intervened and supported the Canadian financial system by providing millions of dollars of borrowing capacity to those who needed it.

Looking forward, investors expect the financial system in this country to stabilize; however, this is not expected to occur overnight and may take a number of months. Furthermore, the jury is still out on the broader economic growth problem in the U.S. Although Canada has posted solid growth numbers recently, primarily due to strength in commodities and the growth of the global economy, there is no doubt that if the U.S. were to go into recession then Canada would see its current economic growth rate decline. A material economic slowdown south of our border could put some pressure on Canadian banks, especially those that have retail banking assets in the U.S. such as TD Bank, Royal Bank and Bank of Montreal. If a recession is averted and the financial system stabilizes, then the outlook for financial stocks in general is positive going forward.

Let us move on to the resource space and discuss Energy and Materials. Energy stocks are normally those affiliated in some way with natural gas and crude oil while Materials stocks include companies involved in the production of things such as base metals (copper, aluminium, zinc, nickel, etc), precious metals (namely gold and silver), steel, and fertilizers. We discuss these two sectors together as they have many similar catalysts including strong global economic growth, supply/demand fundamentals, the U.S. dollar, geopolitical events/risks, weather, labour disruptions, and exploration prospects, to name a few.

Recent focus for Energy equities has been placed on economic growth, inventory levels and the U.S. dollar. The U.S. is the world's largest consumer of crude oil and since we've seen a lot of recent uncertainty concerning U.S. economic growth, some investors are wondering if future oil demand could possibly decline. A U.S. recession would certainly slow U.S. demand, but if recent credit/liquidity problems prove to be only financial and not economic, then we may see energy demand from the U.S. remain consistent. However, natural gas has been a focus in the U.S. not because of economic growth concerns, but because U.S. inventory levels are quite high, thus placing downward pressure on natural gas prices for most of 2007. We believe a very cold winter is required to get natural gas prices moving higher and due to the difficulty of predicting weather patterns, we shall leave those forecasts to the meteorologists. Even though there has been little change in supply/demand fundamentals for both crude oil and natural gas over the past couple of months, we have seen prices for these commodities appreciate likely due to recent weakness for the U.S. dollar. U.S. dollar strength/weakness will continue to be a catalyst of interest going forward for commodities in general as the Federal Reserve could continue to cut interest rates during the remainder of 2007 and into 2008. When the U.S. dollar weakens, prices tend to increase for U.S. consumers relative to consumers in other countries since it now requires more U.S. dollars to make a purchase than in the past when the U.S. dollar was stronger. Therefore, since many commodity prices are quoted in U.S. dollars, you have seen those prices increase for U.S. consumers as the U.S. dollar has declined in value.

As mentioned, Materials stocks have similar drivers to the Energy subsector. Over the past three months global economic growth has been the driver of focus for Materials as the growth of many emerging markets such as China has resulted in record high base metals prices and increased demand. When credit and liquidity problems first emerged in July there was an immediate knee jerk reaction by the market to sell Materials' stocks in expectation that any U.S. economic slowdown could filter through to other countries and thus depress global economic growth. Although we are seeing a slowdown in the United States and were actually witnessing it even before the summer's credit woes, we have yet to see a material impact on global growth and thus stocks in the base metal and fertilizer space have recouped a large portion of their summer losses.

It is at this stage though that we must highlight the precious metal component of the Materials sector as it is the "odd one out" amongst resource investments for the simple reason that gold and silver producers tend to outperform during times of economic weakness or market uncertainty. For the most part this is where the differences in drivers between precious metals and other resources end. The other drivers listed above, such as supply/demand fundamentals, inventories, exploration and the U.S. dollar apply as much to precious metals as they do to other resources. In fact, the combination of U.S. economic weakness, investor uncertainty, lower U.S. interest rates, a weaker U.S. dollar, strong seasonal demand and a challenging production growth environment for many precious metal companies has created a perfect storm for gold prices during the second half of the year and gold equities have reacted accordingly. If these drivers persist, the outlook for precious metal prices remains strong.

We will not address the remaining subsectors individually in this piece due to their low weightings but we will address two more "categories" of stocks which may be important going forward.

Even with the increased volatility of the markets during the summer we were recommending investors focus on what we call "defensive" stocks. These are companies which provide essential products and services to the public whether or not we are in a time of strong economic growth or a recession. Examples of such stocks include utilities (power providers), drugstores or telecommunications

companies. No matter what the economy is doing you need to power your house, you need your prescription drugs, and you need to use the phone. These types of stocks tend to have consistent returns and performance and thus help to “defend” the performance of a portfolio. One driver which is common amongst all defensive stocks is that they tend to outperform the market during times of economic and market uncertainty. However, defensive stocks can also be influenced by other differentiating catalysts depending on their operating industry. For example, regulatory rate decisions are drivers for electric utilities and not for drug stores, while demographics are a driver for drug stores, but not for electric utilities. Economic weakness is the tie that binds defensive stocks together, but amongst these stocks many different drivers exist. Defensive stocks are commonly found amongst the Consumer Staple, Utilities, Telecommunications and Health Care sectors.

Finally, we shall touch upon those stocks we label as “interest sensitive.” These stocks are also sometimes labelled as high dividend yielding stocks. As the title denotes, interest sensitive equities are those which are sensitive to movements in interest rates. When interest rates increase, interest sensitive stocks become less attractive on a relative valuation basis and vice versa. We mention interest sensitive stocks in particular because Scotia Economics has recently changed its interest rate forecast in Canada and is now expecting 50 basis points worth of cuts over the next 6 months. Whether this forecast change becomes reality will likely depend highly on where inflation is headed in our country. If inflation starts to creep higher, then such rate cuts may not occur; however, if inflation stays in check around 2.0% per year, then the Bank of Canada may have some flexibility in cutting rates especially if a persistently higher Canadian dollar starts to have a material impact on economic growth. Many investors would argue that the Bank of Canada should only worry about inflation and let market forces determine the value of the Canadian dollar relative to other currencies. However, if a higher loonie chokes economic growth, monetary policy may have to intervene even if it does result in higher inflation. This is a difficult balancing act that Governor David Dodge and the Bank of Canada will have to control over the next couple of quarters.

No matter what the rationale for such a move, if interest rates are cut by the Bank of Canada then interest sensitive stocks will benefit. The main reason why these stocks tend to appreciate with rate cuts is that their dividend yields become more attractive on a relative basis to interest rates. We must emphasize that rate cuts do not change the risk profiles of particular investments, but investors may be more willing to look at a stock that yields 4.5% than a bond that yields 4.25% for income purposes, especially when tax considerations are taken into account. When the gap between interest rates and dividend yields narrows, dividend yielding stocks tend to appreciate in value.

As aforementioned, our discussion in this piece of the many moving parts to the TSX Index was not exhaustive, but it is our hope that this discussion provided insight and answered questions that investors may have had concerning the performance of the Canadian equity markets over the summer and the performance drivers looking forward as we quickly approach the end of another calendar year.

U.S. and International Strategy

Volatility and a Loss of Transparency?

Paul Danesi — Director, Portfolio Advisory Group

As we ended the quarter, the U.S. equity market soared back towards its record high blissfully ignoring one of the largest credit events in more than a generation. Was all of the volatility in financial markets in the past two months much ado about nothing, or is there real cause for concern?

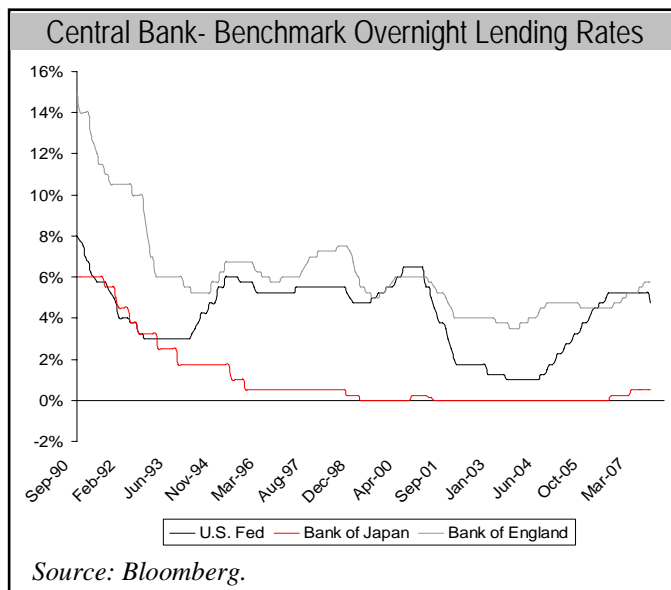
Certainly things are not all doom and gloom. Corporate profitability and balance sheets are strong. The global economy continues to grow at a healthy pace and a weak U.S. dollar is leading to very strong export growth. Valuations also do not appear excessive.

What then caused the volatility we saw in global financial markets during the summer and where are we headed in the months ahead?

Historical Perspective: The Root of the Problem

The root of the problem in global financial markets today really began a few years ago. The cause of the current financial crisis can generally be summed up as sloppy regulatory oversight and a relaxation of normal underwriting standards during what was a period of abnormally low interest rates. With the global economy awash in excess liquidity asset bubbles began to emerge.

In reaction to financial turbulence earlier in the decade, the U.S. Federal Reserve slashed its overnight lending rate to 1% as the U.S. economy quickly headed toward recession. The Bank of Japan has also been pumping out cheap money in an effort to revive its economy. In the U.S., low interest rates fuelled a boom in the housing market and consumer spending. Massive trade surpluses developed with their trading partners creating excess reserves that were invested in U.S. Treasury Bonds and other sovereign debt. The recycling of excess savings helped drive down long-term interest rates around the globe even though central banks were beginning to raise policy rates. Credit spreads, which are measures of the market's assessment of risk, narrowed as investors intensified their search for yield and better returns.

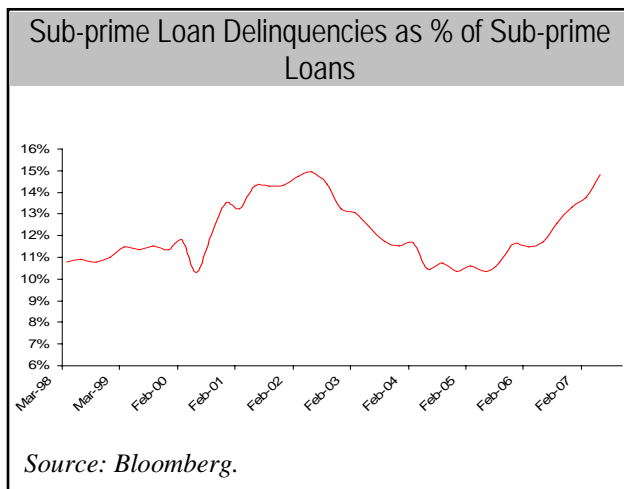
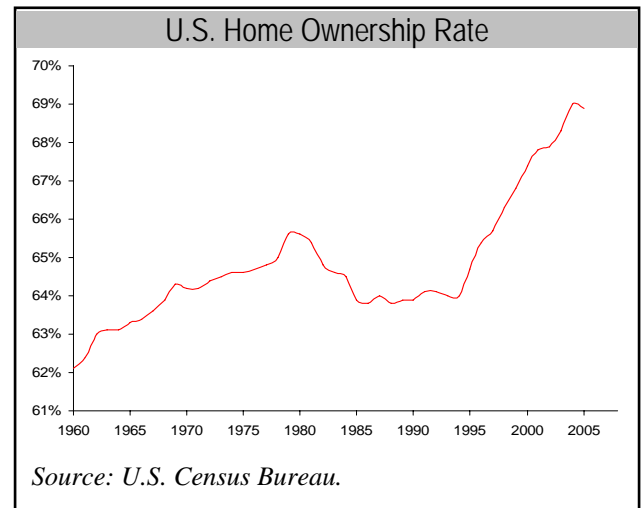
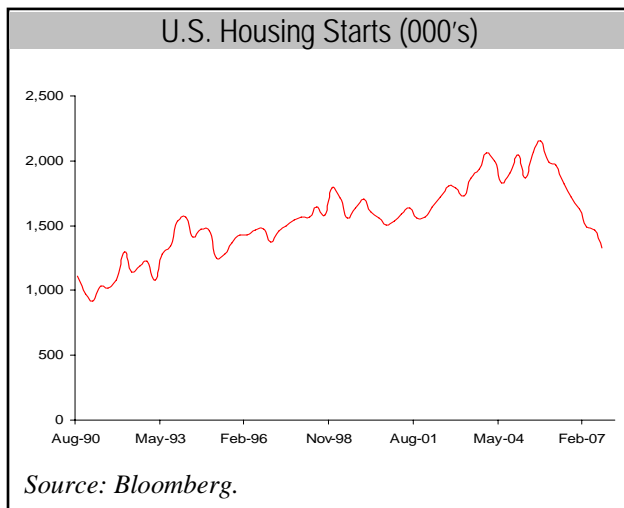


Around the same time, lending and underwriting standards had been relaxed as financial institutions around the globe competed for new business. Financial institutions were willing to take on more risk in their retail and wholesale banking operations to capture new business. In an environment where a flat yield curve and competition reduced margins, financial institutions responded by increasing volumes. U.S. banks underwrote mortgages for both credible and questionable credit, packaged the loans into mortgage backed securities and helped finance highly levered hedge funds to purchase these securities. This allowed the banking sector to originate new loans while remaining well capitalized. All of that excess liquidity helped drive U.S. home sales and prices as well as other assets to record highs.

U.S. Housing: From Boom to Bust

Low interest rates and easy access to credit fuelled a boom in the U.S. housing market from 2002 through early 2006. Existing and new homes sales eclipsed previous records and in 2006 home ownership was at an all time high. The problem was many of these first time homeowners (sub-prime borrowers) really couldn't afford their homes. Predatory lending practices, especially among the mono-line mortgage companies, lured consumers with initial teaser rates into adjustable rate mortgages. By the end of 2006 there were nearly 8 million sub-prime mortgages with a total value of U\$1.4 trillion outstanding. As reset dates are hit, new tighter lending restrictions, higher interest rates, and declining homes prices are limiting homeowners' ability to pay the fully amortizing rates or refinance. The Center for Responsible Lending estimates that 30% of these loans may end in foreclosure, adding potentially another 2 million homes to the market which is already over supplied. The National Association of Realtors reports that the existing supply of single-family homes for resale hit 4.6 million in July, or 9.2 months of supply - a 16 year high that is about to move higher.

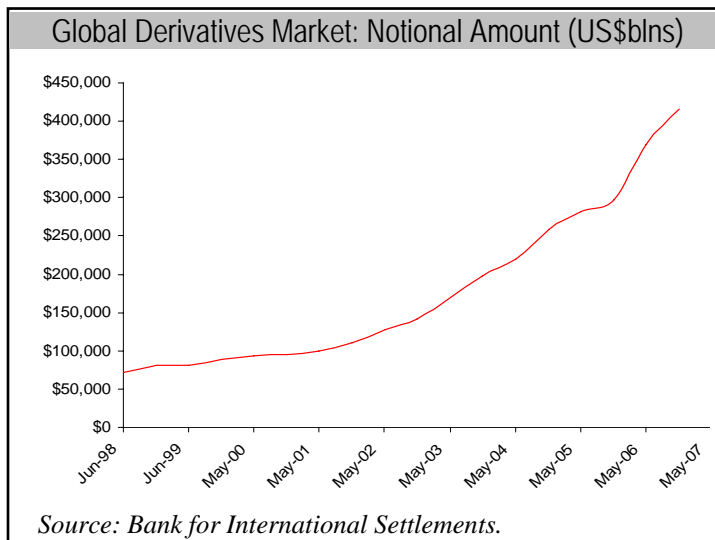
What began as a "sub-prime" issue has worked its way into other segments of the U.S. mortgage market, including Alt-A and Jumbos, and can be viewed as the root cause behind the recent credit crunch. U.S. home prices are falling year-over-year for the first time in decades as the U.S. housing market goes from boom to bust.



Derivatives: A Lack of Transparency

Many of those questionable “sub-prime” mortgages were packaged into derivative financial instruments called mortgage back securities (MBS) and quickly moved off balance sheet. Derivatives are financial contracts the value of which depends on the value of the underlying instrument which could be mortgages, commodities, bonds, equities, currencies or even other derivatives. Credit Default Swaps (CDS), Collateralized Debt Obligations (CDO), options, and futures are common forms of derivatives.

The global derivatives market has grown rapidly in the past 10 years. According to the Bank for International Settlements, derivatives contracts based on bonds (Credit Default Swaps) went from US\$6 trillion in December 2004 to US\$29 trillion in December 2006, while the notional value of the entire over-the-counter derivatives market ballooned from US\$258 trillion to US\$415 trillion dollars. Interest rate swaps account for US\$230 trillion.

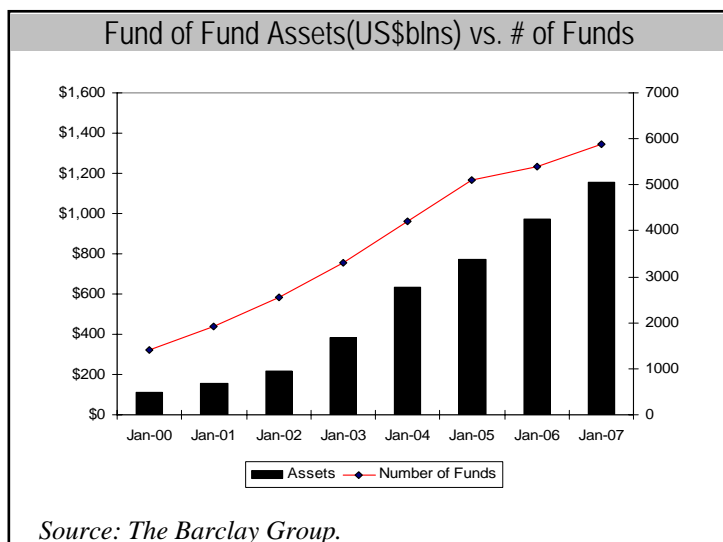
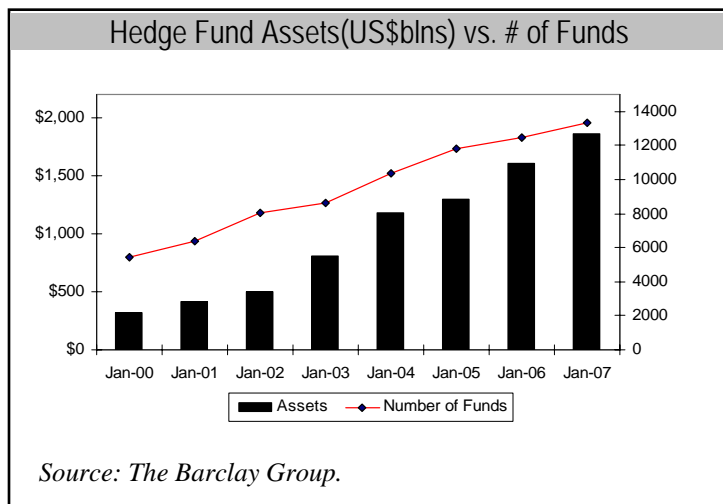


While derivatives offer many benefits, they also have the effect of reducing the transparency in the financial system. Assets have moved from the banks balance sheets, where they can be easily monitored, to other financial institutions and hedge funds where they can not. Another problem is derivative products have become so complex (derivatives whose value are based on other derivatives) that even the most sophisticated investors do not fully understand the risks or pricing structures. Many of these securities were issued investment grade credit ratings, but did those ratings accurately reflect the risks?

The contentious issue surrounding derivatives is whether or not they have effectively dispersed risk around the globe or raised the risks of a widespread meltdown in the financial system. Do derivatives “increase the resilience” of financial markets as suggested by Federal Reserve Chairman Ben Bernanke, or are they “financial weapons of mass destruction” as Warren Buffett refers to them?

Hedge Funds: Known Unknowns

Major financial institutions are the largest participants in the derivatives market. However, hedge funds have been playing an increasingly important role, particularly in the booming credit derivatives market. According to The Barclay Group, hedge funds manage an estimated US\$1.91 trillion globally with market exposure being multiples of that with the use of leverage. The fund of fund industry represents another US\$1.2 trillion. Their diversified investment strategies and low correlation to traditional asset classes created appeal as an “alternative” asset class for retail and institutional investors.



Hedge funds are similar to mutual funds in that investments are pooled and professionally managed. However, they employ more diversified investment strategies and offer very little transparency. Unlike mutual funds, hedge funds are not required to register with the Securities and Exchange Commission (SEC). In addition, hedge funds are not required to make periodic reports under the Securities Exchange Act.

Hedge funds are big business. In the U.S., they account for approximately 5% of investable assets. According to Greenwich Associates, "In several individual products, hedge funds provide so much liquidity that one could say that certain markets could not function efficiently without them." Hedge funds accounted for 30% of all stock trading volume in the U.S in 2006 and 25% of all U.S. fixed income trading. Hedge funds now generate 45% of annual trading volume in emerging market bonds, 47% of annual volume in distressed debt, about one-third in leveraged loans. Hedge funds accounted for more than 55% of all credit derivatives trading volume in 2006. The relative importance of the hedge fund industry to financial markets became more obvious this past summer.

Market Volatility: Who's to Blame?

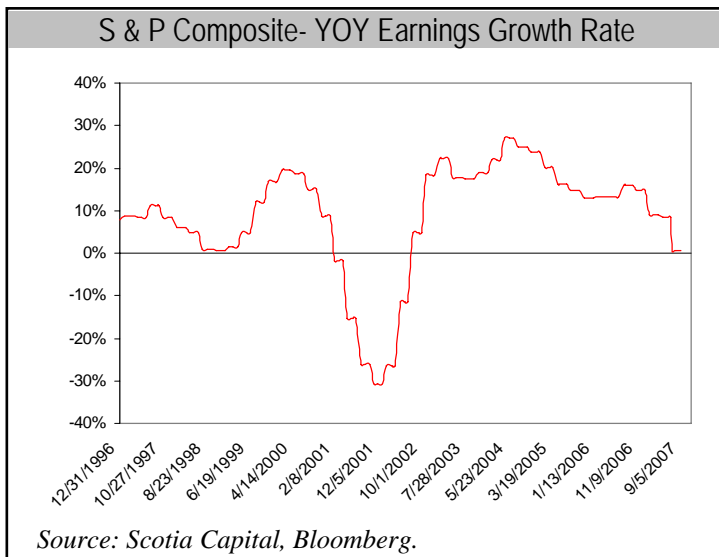
The event that triggered the recent spike in volatility in financial markets appears to be the collapse of two large Bear Stearns hedge funds, both of which had exposure to sub-prime mortgages. That event in turn caused a re-pricing of risk and an unwinding of levered positions by other hedge funds. Credit spreads were not appropriately reflecting risk and began to widen out, equities sold off, and the credit market seized up. There was a massive flight to quality as investors shunned risky assets in favour of short-term government T-bills. A study conducted by Goldman Sachs of nearly 700 hedge funds with nearly US\$1 trillion of assets supports the argument that they were the primary cause behind the sell off in August that saw the S&P 500 fall almost 10%.

Back to the Future: More Known Unknowns

The financial system appears to be slowly working its way through the recent credit crunch. Unfortunately for all of those troubled U.S. homeowners, a cut in the U.S. overnight lending rate and a modest federal bailout program are unlikely to have much of an effect on the housing market. Many of the existing adjustable rate mortgage resets are priced off of the London Interbank Rate (LIBOR) which has climbed since the crisis began. This serves to increase refinancing costs, not lower them. The U.S. consumer has shown tremendous resiliency, but will it last as housing prices continue to fall? The question then becomes, will the downturn in U.S. housing impact consumer spending, which accounts for 71% of U.S. GDP? U.S. economic activity is bound to slow, just how much we do not know. The U.S. economy's growing reliance on service industries as opposed to manufacturing can in fact be regarded as positive as it should reduce volatility throughout a business cycle. As for the global economy, it should be able to withstand a slowing in U.S. activity as it did earlier this year.

Corporate earnings growth is likely to slow further as profits for financial services companies are revised lower. Profit growth could turn negative in Q3 and this could serve to put a cap on further gains in the U.S. equity market. A weak U.S. dollar is supporting a strong rebound in U.S. export growth, but there are potential problems that stem from a weaker greenback, notably inflation and foreign demand for U.S. Treasury securities.

As we write this article, we've just received the U.S. employment data for the month of September. The surprising element of this report was the sharp upward revision to August's payroll numbers (from a loss of 4,000 jobs to the creation of 89,000). The original figure was viewed by many as the trigger event that supported the Fed's reduction in its overnight lending rate. The revision brings into question whether or not the Fed acted prematurely in lowering interest rates. If the economy is weathering the downturn in U.S. housing, that 50 basis point cut will need to be reversed, sooner rather than later.



How Should You Be Positioning Your Portfolios?

The bottom line is U.S. economic activity is likely to lag growth in developing regions for the foreseeable future. Hence, portfolios should be positioned to participate in stronger growth in international markets.

Use foreign equity mutual funds, Exchange Traded Funds (ETFs), American Depository Receipts (ADRs), and U.S. multinationals to build exposure.

Strong global growth and a weak U.S. dollar will likely fuel inflation. Massive construction projects in emerging markets are also fuelling demand for industrial commodities. Ensure you have some exposure to a broad range of commodities including base metals, energy, agribusiness, and gold. Top picks: BHP Billiton, Freeport McMoRan Copper & Gold, Bunge Inc.,

PowerShares Commodity DB Commodity Index Fund, and Market Vectors Agribusiness ETF.

With oil prices hovering near record highs, strong cash flows support robust drilling activity. The deepwater drillers look particularly attractive as do the oil services companies. Top picks: Transocean Inc., Diamond Offshore Drilling and Halliburton Co.

Technology appears to be reasserting itself in a leadership role in the market. It is the driving force behind globalization. Technology facilitates productivity, growth, education, communication, and investments. IT systems also support the global communication required for outsourcing, trading and processing. Top picks include: Cisco Systems Inc., Apple Inc., eBay Inc., and Oracle Corp.

Purchasing power of consumers in emerging markets is growing rapidly as is the population of the global middle class. Basic consumer products that we take for granted are becoming affordable for many people around the world. Top picks: Proctor & Gamble, Pepsi Inc., and Luxxotica Group Spa.

There is tremendous value surfacing in financials, but we remain cautious on the group as a whole. For the time being we would avoid investment banks and financial institutions that are overly reliant on wholesale banking operations. However, we are buyers of U.S. banks with strong retail banking and wealth management operations such as Bank of America and Wachovia and insurance companies such as Metlife Inc.

Among U.S. companies with a domestic orientation we prefer the defensive consumer staples, utilities and telecommunication sectors. Top picks: CVS Corp., AT&T, and Edison International.

Fixed Income Strategy

Like Watching Paint Dry: A New Spin on Bonds and the Certainty they Offer.

Chris Kennedy — CFA, Portfolio Advisory Group

Bond traders may want a word in edgewise for what I am about to write, but this article is not aimed at bond traders. It is aimed at our clients. Besides, I think the following sums up the heart of the message I want to deliver.

I believe, as the average investor, you could spend your whole life mastering the concepts of bond trading, but the returns you would produce would be marginal at best compared to putting that same effort into equity trading.

Rocket Science? Certainly not, but this statement is designed to help develop your expectations, the central theme of this article. Once yours are in the right place with your investments, you can worry less about gains and losses and more about getting on with living your life. So if the central theme is expectations, here is the one I want to help you develop: If bonds in general are going to return less than equities in this day and age, the amount of time you spend learning about and worrying about investing in them should be less than equities as well. You see, bond *trading* is difficult. However, bond *investing* is easy, and I want to show you how.

Summer of 2007

In times like the summer of 2007, investors big and small received a rude awakening. It is times like this that parts of the market we were absolutely sure of, suddenly come into question. For instance, until this summer we were sure of the following:

- The credibility of our rating agencies;
- The constant availability of Government backed T-Bills;
- The Canadian dollar below par.

So when the market turns our assumed surety upside-down, it's time for investors to get *Back to Basics*. It's time for you to re-evaluate your investment plans and make sure they are built to withstand change, even the unexpected. But how does one build such a plan? Has anyone consistently predicted the direction of interest rates or foreign exchange over time? Are models built by hedge fund geniuses bullet-proof? According to this past summer, apparently not. So believe me when I say, the only way to have a plan that keeps you prepared for the unknown is to diversify. ***The only assured way of consistently weathering the ups and downs in the market is to spread out those eggs.***

Don't worry. We're not going to re-explain the theory of diversification or the efficient frontier or even asset allocation models. What I want to describe is how bonds can be used in a very simple way, to bolster the strength of your investment plan and give you the piece of mind to sleep at night. Ultimately, when used correctly in a balanced portfolio, bonds will significantly increase *your wealth*.

The Difference

Let's first look quickly at how investing in bonds is different than investing in equities. We will not use charts and tables just yet; we'll revert to the old fashioned language moniker called the analogy. This one is a sports analogy, and believe me if I could write one involving hockey I would, but I just can't seem to find one as clear and simple as this baseball example.

Think of investing in equities like being a batter in baseball. But let's assume there is no infield or outfield – just you hitting the ball. When the pitch comes, the chance of hitting is there and if you really get a hold of it, you could blast a home run. However, if you miss, and the chances are certainly there, you'll get a strike. Get enough strikes and you'll be *out of the game*.

Contrast this with investing in bonds. Think of investing in bonds like being in that same game, but this time you've got a large red oversized plastic bat and a beach ball as the ball. Got the visual? Now the chances of hitting the ball are almost certain, assuming the pitcher throws it over the plate. But you also know with relative certainty the ball isn't going to go nearly as far. So what are you trading? Distance for certainty of hitting – but ultimately, *staying in the game*.

Now I realize the mention of bond investing usually invokes blank looks or glazed over eyes from many clients. Bonds aren't very glamorous; they're not even extremely interesting to the average investor. This may be true, but I counter with this:

Yes people have said investing in bonds can be like watching paint dry... But what is it about paint that you most certainly want it to do? Dry. Knowing with certainty that it will allows you to stop watching and move on to more important things.

Once again we are back to the central theme that disciplined investing should include setting reasonable expectations. Why do people watch so much? Is there not a way we can invest in bonds knowing with certainty they are doing what we want, adding to *our wealth*? Yes there is.

Investing in Bonds

Let me clarify what I mean by investing in fixed income, namely bonds. By investing I mean the exact opposite of trading in and out of bond positions, playing the curve, playing the sector or playing foreign exchange. I refer to buying and holding bonds until maturity. Now we are at the point where I need you the client to make a few assumptions for this article to continue to make sense. For this illustration to work, you need to assume the following when you invest in bonds:

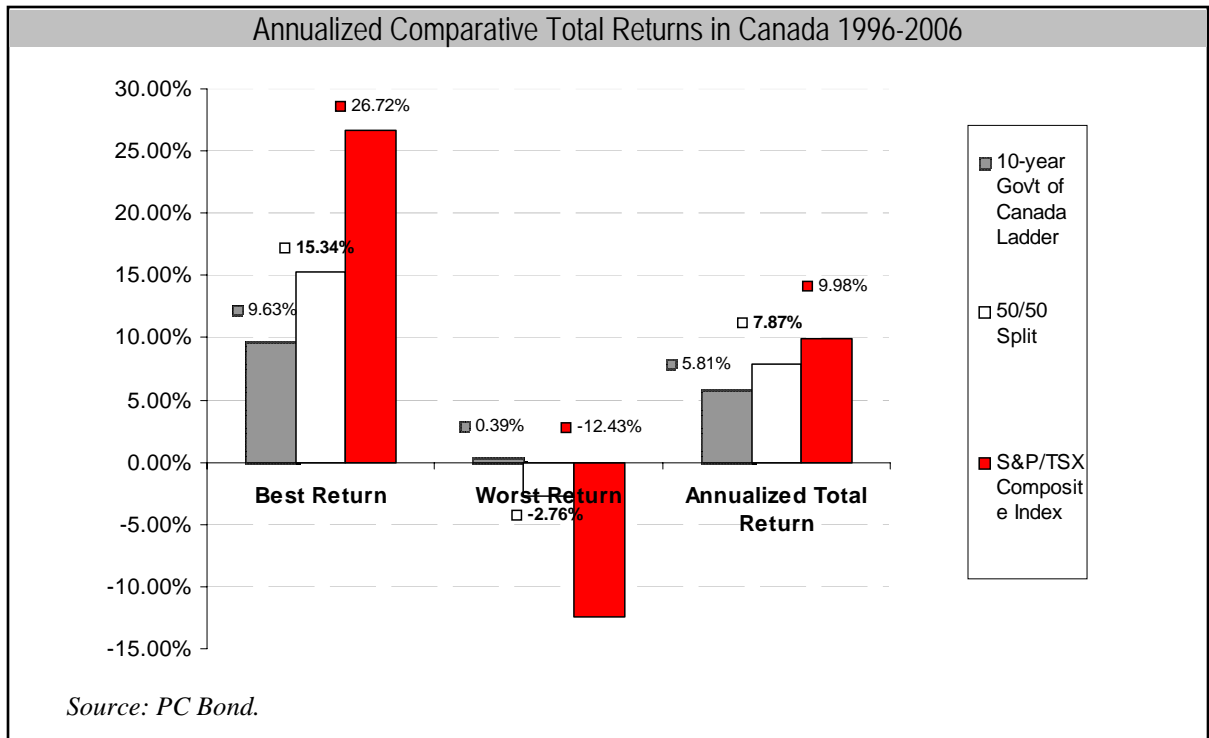
- You will follow a passive investment style, consisting of buying and holding bonds until maturity. In doing so, while following assumption 2 below, you lock in the return you expect to get upon maturity and therefore remove one of the major stresses inherent in investing – worrying about fluctuations in value and the fate of *your wealth*.
- You will invest in high quality credit names, such as Government backed or high grade corporate bonds. This removes the worry the paint may not dry.

With those assumptions in place we can now look at some of the benefits of investing in bonds. What exactly happens when you spread out those eggs?

The Technical Stuff

Let's look at some visuals. The following bar chart shows total returns from 1996 to 2006 of three separate hypothetical portfolios using different asset allocation mixes.

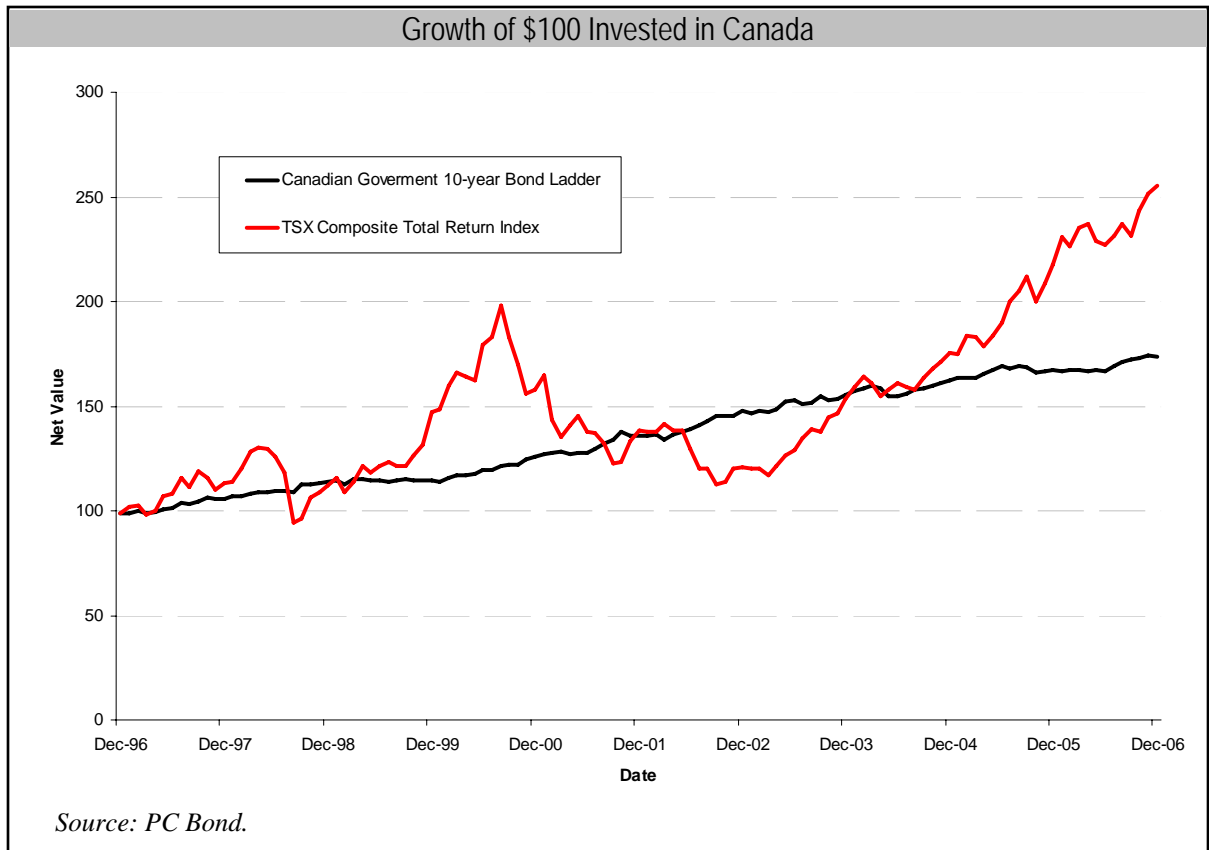
- The first is 100% equity (S&P/TSX Composite)
- The second is 100% fixed income, represented by Canadian Government rolling 10-year ladder
- The third is a 50/50% mix of each



As you can see, the 100% equity portfolio has significantly out performed the 100% fixed income, (in line with our expectations), but it hasn't done so without the addition of risk, and therefore increased magnitude of loss. However, the 50/50 blended portfolio has generated significant returns comparable to the 100% equity portfolio (78% of the annualized return) but at a fraction of the volatility (22% of the worst return).

The point is that using a buy and hold bond strategy to supplement your equity investments greatly reduces negative downside returns, but doesn't retract nearly as much from the upside positive returns. Why is this? The key reason is that investing in bonds greatly increases the chances of getting back the capital you have invested, along with interest. *There is a firm maturity date for each bond.* Each time this happens, you reinvest with a larger amount of capital, and therefore you truly grow *your wealth*.

The following graph also illustrates investing in 100% equity versus 100% fixed income. This graph tracks the growth of \$100 invested from 1996-2006 in both a rolling 10-year Government of Canada bond ladder, and the equity benchmark S&P/TSX Composite.



The visual is clear. Equity returns are higher, but not without periods of significant and consistent negative returns. The fixed income bond ladder, with lower total returns, continues to move higher with consistency. No two years in a row show a downturn. Baseballs versus beach balls. Now that is something you can count on with certainty - that's how you grow *your wealth*.

So now that you may be interested in what bonds have to offer, what exactly is this foolproof, simple strategy for investing in bonds that I have been using in the illustrations above? What is the simplest way to get this level of certainty and therefore staying in the game? The answer is of course the bond ladder.

The bond ladder is the understated workhorse of the investment strategy family. I believe the bond ladder is the simplest, most dependable strategy for two major reasons. The optics it demonstrates and the benefits it holds. First, the optics:

- Bond ladders are transparent and easy to understand. You start by buying a specific number of bonds (depending on your time horizon), each with a longer final maturity date. Common staggering is 1 year between each maturity.
- Bond ladders are easy to set up and easy to administer. You hold each bond until maturity (passive strategy). As each matures, you simply re-invest in the long end of the portfolio by buying another bond at the top of the ladder. In the simplest of ladders, there will be only one trade a year.
- Bond ladders create firm expectations. With a buy and hold strategy, the final return (yield to maturity) for each bond is known and locked in at the time of purchase (assuming high credit quality).
- Bond ladders are flexible. Although all bond ladders essentially work the same, you can alter the holdings and structure to meet various needs. For instance, you can alter the time horizon, the number of bonds in each period, and the bond sectors represented (i.e. provincial, national and corporate).

Bond ladders also offer a range of benefits:

- Safety of Principal
- High Average Yield & Income
- Potential Tax Efficiency
- Smoother Level of Income and Returns
- Diversification
- Low Cost

Each of the above points can be expanded on thoroughly, but we do not have the room to do so in this article. The point of this article was to demystify some of the stigmas surrounding bonds, and show that when the market begins throwing curve balls, it's time to reassess your strategy and reassess your expectations. Once you do so, it's easy to see that bonds can help supplement your overall portfolio, growing *your wealth*, without requiring a lot of effort. In essence:

Passively investing in bonds is rarely going to return more than 5.0% in this day and age. So don't use more than 5.0% of your brain learning about or worrying about doing so!

Where to Go From Here:

If you are interested in learning more about bond laddering and other fixed income strategies, we encourage you to contact your ScotiaMcLeod Investment Executive.

Fixed Income Strategy

The ABC's of ABCP: an Update on the Canadian Asset Backed Commercial Paper Market

Joey Mack, CFA — Director, Portfolio Advisory Group

Asset-backed securities are securities collateralized by underlying assets. They are created by forming a collection or pool of credit card receivables, automobile loans, or other debt obligations, and selling "shares" or participation certificates in the pool. Credit enhancement is provided by letters of credit, recourse to the issuer, over-collateralization, or senior/subordinated issuance.

In the Canadian marketplace, a significant portion of asset backed securities are issued as commercial paper. Commercial Paper is a short-term, unsecured debt instrument used to borrow money to finance credit, inventories, or investments. Issue terms range from under three months to one year with most corporate paper trading in \$1,000 multiples. Commercial Paper ranks senior to common stock, equal or senior to unsecured long term debt, and junior to secured debt.

As with conventional commercial paper, asset backed commercial paper (ABCP) issue terms typically range from under three months to one year, with most trading in \$1,000 multiples. Generally, ABCP is of high quality, rated AAA or R1-H. According to Dominion Bond Rating Service (DBRS), the benchmark credit rating provider in the Canadian money market, short-term debt rated R-1 (high) is of the highest credit quality, and indicates an entity possessing unquestioned ability to repay current liabilities as they fall due. Entities rated in this category normally maintain strong liquidity positions, conservative debt levels, and profitability that is both stable and above average. Given the extremely tough definition DBRS has established for an R-1 (high), few entities are strong enough to achieve this rating.

ABCP issuers include the Canadian banks, who package their own assets and sell them off as asset-backed securities, as well as several third-party multi-sellers, which purchase assets from third parties and package them into a conduit, with funding from commercial paper and term debt issuance. All of these R-1 (high) ABCP issues offered investors a higher yield in comparison to Banker's Acceptances for accepting ownership of financial assets rather than the obligation of an ongoing concern. Due to the high quality and attractive yield, the ABCP market in Canada has grown in size to over \$120 billion, with paper currently widely held by a variety of investors.

Most ABCP conduits issue two series of commercial paper: non-extendible ABCP, which benefit from market disruption-based (MDE) liquidity support, and extendible ABCP, which do not benefit from liquidity support and are extendible in circumstances of market disruption. If extended, the extendible CP rolls at one month CDOR (Canadian Deposit Offering Rate) plus 100-130 basis points, depending on the issuer and rating. The extendible feature creates uncertainty about the timing of principal payment of the CP notes.

According to DBRS, MDE liquidity facilities protect ABCP holders where there is a general market disruption and an ABCP Issuer is unable to sell new liquidity-backed notes in the general market to retire the existing liquidity-backed notes. It is important to note that MDE liquidity facilities do not constitute a guarantee of payment for the liquidity-backed notes and that liquidity facilities are only available upon the satisfaction of certain pre-conditions. Typical pre-conditions include the following: (1) the ABCP Issuer is not in default to the applicable liquidity provider; (2) the rating of the liquidity-backed notes is confirmed by DBRS at R-1 (high); and (3) the definition of a "market disruption event" is met.

On Monday, August 13, 2007, a number of third-party multi-seller Canadian ABCP issuers announced that as a result of unfavourable conditions in the marketplace, they had been unable to place new ABCP to fund the repayment of previously issued ABCP maturing on that day.

One of the key triggers of this disruption has been rising concerns in the credit/lending market, especially over exposure to U.S. sub-prime mortgages, which have been experiencing rising defaults. This exposure created greater uncertainty over the value of the underlying assets, and given the lack of transparency over the nature of the underlying assets, investors chose to move to the sidelines in an ongoing flight to quality.

As a result of this market disruption, ABCP issuers have extended the term of any extendible ABCP, and have also issued notices requesting funding under liquidity facilities that support the liquidity-backed ABCP.

Following these announcements, DBRS issued a press release stating they have been closely monitoring the credit quality of the affected underlying assets in the third-party multi-seller Canadian-based ABCP Issuers that it rates. Consistent with standards that have been in place since the inception of the Canadian ABCP market, in order for an R-1 (high) rating to be maintained, the asset must be at the AAA or senior-AAA level in terms of credit quality, and liquidity must be provided. On August 14, 2007, DBRS confirmed the applicable outstanding ratings on the basis of the underlying credit quality of the assets held by the ABCP Issuers. DBRS provided these confirmations as it was of the opinion that the assets held by the Issuers requesting ratings confirmations continue to perform in a manner that is consistent with the ratings that were originally assigned.

However, as of the close of business on August 14, 2007, certain ABCP Issuers that had delivered a funding request under MDE liquidity facilities for maturing ABCP were denied funding. This was based on apparent disagreements over the obligation to fund, which in turn raised the possibility of events of default.

This resulted in ABN AMRO, Barclays Capital, Caisse de dépôt et placement du Québec, Desjardins Group, Deutsche Bank, HSBC, PSP Investments, Merrill Lynch, National Bank and UBS meeting on August 16 in Montréal to work out a solution to the liquidity problem affecting Canadian ABCP market. This led to a long term proposal that set out the following:

1. All outstanding Third Party ABCP, including extendible Third Party ABCP, will be converted into term floating rate notes (FRNs) maturing no earlier than the scheduled termination date of the corresponding underlying assets.
2. Existing liquidity facilities will therefore not be necessary and will be cancelled and all outstanding liquidity calls will be revoked.
3. Interest on the FRNs will be payable monthly or quarterly, as the case may be, to match the fixed payment dates under the underlying assets.
4. Margin provisions will be revised to create renewed stability, thereby reducing the likelihood of near-term margin calls.

According to the press release, the institutional investors who are signatories of this proposal are confident that they have the support of the sponsors of the Third Party ABCP conduits and of investors. The signatories are also confident that additional market participants will confirm their agreement with these arrangements. Implementation, however, will require note holder meetings and may require court applications. Although this was initially expected to be completed in mid-October, this has since been extended until mid-December.

In the interim, holders of Third Party ABCP in the group above have agreed to continue to roll their Third Party ABCP, and encourage all other holders to do the same. The counterparties have also agreed to not pursue any existing margin calls or make any further margin calls, and the conduits have agreed to not pursue liquidity calls. The group above is also encouraging all other market participants, including note trustees, to take all actions to implement the long term proposal and to refrain from taking any actions that will hinder the implementation of the long term proposals.

DBRS subsequently has placed these issuers Under Review with Developing Implications. In the press release, DBRS noted that these ABCP issuers contain a wide variety of assets; for example, CDOs, mortgages, lines of credit and auto loan receivables. According to DBRS, the unprecedented declaration of a market disruption by certain issuer sponsors, combined with certain liquidity draw requests that may not have been met, has left these ABCP issuers with strong underlying assets from a credit perspective (generally of credit quality consistent with the ratings originally assigned to such assets), but without an ability to continue to fund these assets. If such a situation were to continue beyond prescribed grace periods, the underlying assets would be liquidated and, depending on the individual issuer, it is likely that note holders would experience a loss. Due to global credit markets that have, in recent weeks, exhibited extreme levels of volatility, some of the underlying assets, although strong from a credit perspective, could fetch significantly less than par.

Currently, there remains uncertainty in the market segment. The terms, credit quality, and market liquidity of the potential new batch of floating rate note securities are uncertain, and information disclosure by issuers has yet to be addressed. In addition, we are uncertain over the ability of certain investors holding ABCP to hold these new securities instead, and what market impact that will have. In the interim, ABCP scheduled to mature is not being paid, but so far no events of default have been declared.

Income Trust Strategy

REITs and Sub-prime Mortgages

Katie Tabesh, CA — Equity Advisor, Portfolio Advisory Group

Volatility in the broader equity markets certainly did not spare the income trust sector. In fact, income trusts underperformed equities during both the third quarter and on a year-to-date basis. While year-to-date performance of the Scotia Capital Income Trust Index (SCITI) rests in positive territory, with every sub-index contributing to the gain, the third quarter's performance was definitely lackluster.

During the third quarter the SCITI posted a loss of 2.5%, while the S&P/TSX recovered from its August lows and posted an impressive total return of 2%. As the breakdown of sector performance indicates, the underperformance of the SCITI was primarily driven by weakness in the Energy sector (which currently comprises approximately 41.2% of the market capitalization of the SCITI), and to a lesser extent the Industrial sector (15.6% weight). On the energy front, a large overhang in natural gas storage levels and an increase in liquefied natural gas imports continued to depress natural gas prices. Coupled with the ever strengthening Canadian dollar, this resulted in weakness throughout the Royalty Trust sector. The Industrial sector of the SCITI is also impacted by weakness in natural gas, considering the large number of energy service companies in this space. By comparison, gains in the TSX were primarily driven by the strength in base metal prices and precious metals given the composite's heavy weighting towards Materials.

Total Return Indices							
	SCITI Overall	S&P/TSX Composite	S&P/TSX Capped REIT				
Q3 2007:	-2.51%	1.98%	0.22%				
YTD	8.12%	11.20%	3.15%				
Segment	Consumer	Energy	Industrial	Power	Real Estate	Resource	Utils & Infra
Q3 2007:	0.52%	-3.49%	-9.13%	-1.56%	0.40%	3.82%	3.87%
YTD	18.00%	3.61%	4.73%	1.80%	4.51%	42.27%	17.92%
Weight	12.80%	41.23%	15.57%	3.16%	13.43%	5.56%	8.25%

Source: Scotia Capital, Bloomberg.

Sub-primes Got You Down?

No doubt the big news in the quarter was the re-pricing of risk, as evident by the widening of credit spreads. Simply put, risk was brought back into the market following sub-prime concerns south of the border, which caused liquidity to dry up in both debt and equity markets. This increase in risk aversion caused the number of leveraged buyouts to significantly decline, pending deals to breakdown or get completed at lower prices, and resulted in investors questioning a number of pending transactions. Specific to the income trust sector, the number of trusts tapping the capital markets to raise cash and the flow of M&A transactions significantly declined. As a result, trusts trading with M&A premiums, including Real Estate Investment Trusts (REITs), had their valuations pared back.

The third quarter proved to be particularly challenging for the REITs. While the sector has somewhat recovered from the lows of August 2007, it has been a tough year to date. The weakness in the sector has been primarily driven by the reversal of the bond market (rising bond yields), increased investor focus on risk, and a potential tapering off in a relatively robust M&A market. However, it seems as though sub-prime worries found their way to the Canadian REIT sector, further depressing valuations.

While Canadian REITs have little or no exposure at all to sub-prime, they have been the victim of investor confusion. Perhaps a distinction between the different types of REITs will help clear up some of this confusion. Equity REITs are tax efficient investment vehicles that invest in income-producing real estate and distribute most of their income as distribution to unit holders. These are the types of REITs under the Scotia Capital coverage universe. In fact, all Canadian REITs trading on the Toronto Stock Exchange fall under this category. It is possible for these REITs to have an immaterial exposure (if any) to U.S. sub-prime mortgages only through short-term investments in mortgage backed securities.

Mortgage REITs are a U.S. phenomena and a subset of REITs that invest in loans secured by real estate, including residential and commercial mortgages and mortgage backed securities. In fact, it's mortgage REITs that have received most of the media attention with regards to sub-prime. Several mortgage lenders, including two mortgage REITs, American Home Mortgage Investment Corp and New Century Financial Corp, have filed for bankruptcy in the U.S.

What is Sub-prime Anyway?

By now investors should be quite familiar with "sub-prime" mortgages, maybe even a little sick and tired of the term. While sub-prime woes are rooted in the U.S. residential housing sector, we have witnessed consequences on a global scale. Sub-prime concerns first made headlines in March after New Century Financial Corp, one of the largest originators of sub-prime mortgages, disclosed it was being investigated by the Securities Exchange Commission, its lenders would not provide further financing, and the company would not be able to meet repayment demands by its creditors.

A sub-prime loan is a type of loan offered to prospective homebuyers with poor credit histories and therefore do not qualify for a prime conforming loan. The sub-prime mortgage market is typically the last resort of financing and is intended to allow the borrower to build equity and improve their credit rating, allowing them to refinance at a better rate. Sub-prime lending is risky for both lenders and borrowers considering the combination of high interest rates, poor credit history, and the questionable financial situations often associated with sub-prime applicants.

The controversy surrounding sub-prime lending expanded as a result of ongoing lending and credit crisis both in the sub-prime industry and in the greater financial markets. As a result, a large number of borrowers have been forced to default and several major sub-prime lenders have filed for bankruptcy. The breakdown of sub-prime lending practices in the U.S. has had a direct financial impact on the originators of these mortgages, and has indirectly impacted the balance sheets and trading revenues of financial institutions through exposure to mortgage financial products such as collateralized mortgage backed securities.

So are Canadian REITs Exposed at All?

The sub-prime issue has indirectly impacted the Canadian REIT sector through the financial market's re-pricing of risk as evident by the widening credit spreads. While sub-prime mortgages are on U.S. residential real estate properties, the credit spreads adversely affect all real estate classes. The widening of credit spreads affects Canadian REITs in two ways. First, tighter lending standards will likely translate into lower access to debt. This specifically impacts smaller REITs that rely on acquisitions to fund growth. Secondly, and probably the most obvious, widening of credit spreads means higher cost of borrowing.

Investment Strategy

Investors should keep in mind that REIT fundamentals have not changed, and that the issues facing the U.S. housing sector are separate from the issues facing the Canadian REITs. Although it is increasingly difficult to call the bottom of the recent REIT sell-off considering recent market volatility, we are approaching value territories. The Scotia Capital Real Estate and REIT team believes that "the sharp decline in the REIT sector's price to net asset value ratio is now flashing a green signal" and as such they have become more bullish on future return prospects for the Canadian REIT sector.

While the Portfolio Advisory Group expects the current volatility in equity and debt markets to persist as the underlying issues that led to the credit/liquidity crunch have not yet been resolved, we believe the REIT sector has now entered calmer waters. Please contact your ScotiaMcLeod Investment Executive for specific recommendations in the REIT sector and on other income trusts.

Insurance

Mitigating Volatility for the Long Term

Susan Forint, — Manager, Insurance

Asset allocation is often credited as a more important decision than the particular choice of investment product. When developing strategies to balance your investments across high and low risk options that are in line with your long-term objectives, why not consider insurance solutions as a way to round out your conservative investments? Insurance, as an integral component of a balanced financial plan, can be utilized in many ways to protect investors from market volatility, diversify their holdings, and create additional tax efficiencies within their portfolios.

Insured Annuities

As discussed in the Summer 2007 issue of IPQ, the Insured Annuity strategy is a popular alternative to other fixed-interest investments. An Insured Annuity provides regular, guaranteed payments for the rest of your life, with a return of principal upon death. In essence it creates the same end result as a GIC investment, where the individual earns interest each year, while preserving the GIC capital for their heirs. The tax efficiency of this strategy often delivers a much higher net yield than traditional conservative investments, making it an attractive strategy for diversifying and enhancing your fixed income portfolio.

Estate Reallocation

To further enhance the ultimate benefit of fixed income investing, you should consider additional strategies that can help you minimize tax and maximize the amount of wealth that you transfer to the next generation. Once again, life insurance offers a unique solution. When you invest in a Universal Life or Whole Life plan, your policy grows on a tax-deferred basis during your lifetime (just like inside a typical RRSP), and the death benefit that’s owed to your beneficiaries is paid out tax-free.

Comparing Two Estates		
The following illustrates how an estate reallocation strategy can help maximize the value of an estate reallocation of \$50,000 per year for a 10-year period.		
	GIC (4%)	Estate Reallocation Strategy
Base Insurance Death Benefit	\$0	\$1,000,000
Estate Value* at age 85	\$917,542	\$2,013,254
Internal Rate of Return	2.40%	5.56%
Assumes 55 year old couple, non-smoking at 40% tax rate. Rates and death benefit will vary based on personal situation. Insurance assumptions – Universal Life, increasing death benefit, level cost of insurance, and a 3% annual rate of return on account value		
* Value payable at death.		
<i>Source: Manulife Financial – InnoVision.</i>		

In essence, these insurance policies permit you to reallocate conservatively invested assets that are currently fully taxable (such as GICs, bonds or cash) into a more tax-efficient asset class. You benefit from continual insurance protection, a reduction in your ongoing tax liabilities, and the potential to significantly increase the after-tax value of your estate.

In the previous example this couple would more than double their money after 30 years. The internal rate of return is an after-tax number, so in order to match that estate value they would have to find a GIC that consistently provides a 9.27% rate of return. Essentially, the funds accumulate within a separate asset class, providing diversification as well as additional protection throughout all those years (and would continue to grow and ultimately pay out directly to beneficiaries) making this a very viable alternative for a part of a fixed income portfolio.

Guaranteed Minimum Withdrawal Benefit

Guaranteed Minimum Withdrawal Benefit (GMWB) products have been available in Canada from Manulife Financial for just over a year and from CI Investments for almost six months. The success of this product proves that investors planning for retirement are looking for a secure, income generating investment option that allows for potential market gains. Essentially a segregated fund with principal protection, GMWBs differ from principal protected fixed-income products in that every three years the base amount on which the income payments are calculated can potentially grow if the market has seen an increase. If, however, the market sees a downturn, the base amount can never be lower than the originally invested capital.

Until now, the revenue stream had only been guaranteed for a fixed time period – usually 20 years. Manulife has recently made some modifications to GIF Select with IncomePlus, including extending the guarantee period for life beginning at age 65. This creates another alternative for people looking to create guaranteed lifetime income to ensure they don't outlive their capital. In addition, Manulife has also extended the 5% bonus you can add to your guaranteed income balance from the traditional 10 years bonus period to the now 15 year bonus period, providing no withdrawals are made. This bonus is an attractive feature to the product and one of the reasons why Manulife has had so much success. These changes make this product ideal for those as young as 50 to make this vehicle an element of their retirement plan.

Long Term Protection from Volatility

Although market risk cannot be completely eliminated, the exposure to volatility can certainly be reduced by carefully diversifying across asset classes. Just as bonds or GICs can add an element of fixed-income security to your portfolio, insurance solutions can enhance your income, as well as the ultimate value of your investments, through unique tax advantages. Insurance is not just about protecting your family; it's a powerful financial tool that can be an important component of your asset allocation.

All insurance products are sold through ScotiaMcLeod Financial Services Inc., the insurance subsidiary of Scotia Capital Inc., a member of the Scotiabank Group. When discussing life insurance products, ScotiaMcLeod Investment Executives are acting as Life Underwriters (Financial Security Advisors in Quebec) representing ScotiaMcLeod Financial Services Inc.

The Manufacturers Life Insurance Company is the issuer and guarantor of the GIF Select contract, which offers the IncomePlus benefit.

Sun Life Assurance Company of Canada, a member of the Sun Life Financial group of companies, is the sole issuer of the individual variable annuity contract providing for investment in SunWise Elite segregated funds.

Financial Planning

We All Need Peace of Mind

Howard Kabot, — National Director, Financial Planning

Do you have a financial plan? Do you even need a financial plan? When asked these two questions, a majority of respondents will respond with a “no” to the first and an “I don’t know” to the second. The latter response is not hard to understand. The truth of the matter is that in a lot of cases, people aren’t quite sure what value they will get from the plan. I would like to suggest that there is only one; peace of mind. Sure, there are many issues that a financial plan will address and for which answers should be provided but the truth of the matter is that a financial plan serves one purpose and one purpose only and that is to provide peace of mind. Not surprisingly, financial planning is not usually thought of in this way but peace of mind is precisely what is achieved by a thorough and well thought through financial plan.

Achieving peace of mind (from a planning perspective) means that your financial goals and objectives have been analysed and that strategies are in place to ensure that you will meet them. These strategies can examine (but are not limited to) retirement, estate, tax and investment issues which, when presented in a holistic manner, provide a powerful document that in turn provides peace of mind that your financial and perhaps even your life goals can be achieved.

Peace of mind is particularly relevant when thinking of financial markets. If there is one thing that can cause stress it is the volatility that comes with investing. We’re taught that over the long run a well balanced portfolio will mitigate risk and reduce volatility. But an investment strategy is nothing without being put into the context of being able to satisfy your long-term goals and objectives.

One of those goals may be to retire comfortably. Not surprisingly, there are many risks that exist that could negatively affect the quality of our retirement years. I’ve already mentioned the volatility of financial markets and to this I will add inflation, i.e. how will your retirement years be affected by 3% inflation vs. 2%; longevity, i.e. are you going to outlast your money; and health, i.e. will you or your spouse need long-term care? These variables have the potential to wreak havoc with your retirement plan. The solution is to build a financial plan that can properly evaluate the degree to which your plan can deal with these stresses.

For example, a thorough analysis will take into account all sources of both incomes and expenses. All potential retirement income will be included including amounts projected to come from your retirement assets. An integral part of the analysis will include sensitivity around the appropriate rate of return that should be expected. The focus however from a planning perspective is not on getting the highest rate of return possible but on getting the appropriate rate of return to meet your goals and objectives. Quite often it turns out that the rate of return needed to provide peace of mind is much less than first thought. A lower rate of return means less risk and therefore less volatility. Peace of mind will come from knowing that goals are achievable without having to take unnecessary risk.

A holistic plan will also attempt to provide peace of mind from a qualitative perspective. Using retirement again as an example, the focus will shift from the quantitative to issues around transitioning from a “work only” phase to a new phase of life. This type of planning requires that thought be given to what the next state of life may look like and will ask you to consider retirement as a multi-stage journey where any number of opportunities may exist. A peace of mind exercise to be sure.

Mutual Fund Diversification

There is A Lot More to It than You Think

Kevin McMahon, — Manager, Mutual Fund Research

Mutual funds pool money from many different individual investors and invest the money according to the fund's stated objectives. There are many benefits to investing in mutual funds. They offer flexibility to meet your needs and goals. Investors range in age as well as risk tolerance, so whether it is financing your children's education or planning your retirement, there is a large universe of funds available with different characteristics for you to choose from. Mutual funds save you time and give you access to professional money management. There are literally thousands of individual investment choices out there and building a proper investment portfolio takes considerable time and effort. Professional money managers are devoted to this task and have far greater resources and commitment than the average investor. Most mutual funds are priced daily and thus highly liquid, making them very easy and inexpensive to buy or sell. Probably the biggest advantage to investing in mutual funds is diversification. Diversification lowers risk by spreading your money across a range of different investments. Simply put, it is about "not putting all your eggs in one basket."

*So, if I want to own a specific Canadian company **and** lower my risk, all I need to do is purchase a mutual fund which holds this company and I will reap the benefits of diversification, correct?*

Well, it is a good start, but that is just the beginning. There is a lot more to it than you think.

Similar to individual securities, mutual funds are subject to different risk factors, such as exchange rates, interest rates, economic conditions, inflation and company specific events. In the example above, we sought out diversification by investing in a Canadian Equity mutual fund. As opposed to owning the individual security, we would be far better protected should anything adverse happen to this company, causing the stock price to drop. Unfortunately, it is not uncommon for all the stocks of a certain asset class to rise or fall at the same time. This is why it is important to diversify across the various asset classes, as they move in different directions and by different amounts at different times. As an example, Emerging Markets Equity was the best performing asset class over the last 3 years (2004-2006), but was the worst in 1997, 1998 and 2000. This is an extreme example, but it does show that a consistently top performing asset class does not exist.

Diversification by geography is important as well. All too often, investors have a "home country" bias, investing almost exclusively in the stocks and bonds of the country they live in. Canada represents around 3% of the world's equity market. By limiting your investments to Canada, you are limiting your potential for higher return and lower risk. Consider diversification across industry. Various industries behave differently during the various phases of the business cycle. To compete globally, companies are forced to expand outside their own borders. It is not uncommon to see the stock price of local oil producers in Canada drop as the oil industry slumps in Asia. There are many different industry groups to choose from, including: Precious Metals, Financial Services, Real Estate, Health Care and Science & Technology.

Diversification across market capitalization or "market cap" is important as well. Traditionally, the equity market categorizes a company by its size, namely large, medium or small-cap. Capitalization is determined by multiplying the number of outstanding company shares by the share price. While large-cap equities are considered lower risk when compared to small-cap equities, the latter offer higher return potential. Look to diversify your portfolio with mutual funds that specialize in the three capitalization groups.

Understand as well that not all "cap" funds are the same, and this is why diversification by style is important. Mutual funds portfolio managers are usually classified by their style of investing, which include buzz words such as Value, Growth, Momentum, or GARP (Growth at a Reasonable Price).

This is not limited to equity investing, as fixed income portfolio managers have their own styles as well: Duration, Credit Selection and Sector Allocation. Similar to everything discussed so far, different styles can be in favour (or out) at different times. If we take this one step further, diversification within style can have significant benefits. Let's take a look at the Canadian Large Cap Value space. Generally, portfolio managers in this space are looking to purchase stocks at prices below, what they believe to be, their true value. The hope is that when everybody else realizes this, investors will flock to the market, drive the price up and the portfolio managers will sell at a profit. But, do all Canadian Large Cap Value equity managers think the same? No. If this were true, all their funds would be identical. Portfolio managers can vary in different ways. The models and their inputs they create to value securities can differ. Some run concentrated portfolios while others hold many different names. Some are more "benchmark aware", while others run portfolios that look very different from the benchmark. Portfolio managers differ in their price sensitivity; some will sell winners early, while others will "let winners run." As you can see, same "styles" can result in very different portfolios.

The case for diversification is pretty evident. Without the power to predict the future, nobody can consistently know what individual stock, mutual fund, asset class or industry will be the next "hot market." Building a portfolio of mutual funds, diversified by asset class, geography, industry, capitalization, and style will help lower volatility and protect you from large swings in the market. Is diversification an easy task for the individual investor? No. But with a little homework and the right advice, it is possible. Speak to your ScotiaMcLeod Investment Executive about the ScotiaMcLeod Mutual Fund Guided Portfolios. These portfolios offer between a 30/70 Equity/Fixed Income split to 100% Equity and are designed to lower volatility and diversify across asset class, geography, industry and management style.

Equity Guided Portfolios

Stephen Uzielli- Portfolio Manager, Portfolio Advisory Group

The Equity Guided Portfolios are models designed to provide investors with a convenient way of investing directly in individual holdings and building diversified portfolios composed of equity securities. The portfolios are actively managed by the Investment Committee of the ScotiaMcLeod Portfolio Advisory Group. Each portfolio has a specific mandate but they all have the common objective of providing investors with a consistent long-term rate of return by holding a portfolio of stocks comprised of industry leaders with unique franchises and strong management teams, combined with an attractive trend in profitability.

Equities have been increasingly volatile in recent months with markets that rise and fall, both from one day to the next, and frequently several times in the same day. We expect that trend to continue for the foreseeable future as investors gain greater understanding and appreciation of the increasing risk in the marketplace. It tests our patience, but we must remain calm in the face of these conditions, and not let emotions dictate our investment decisions.

What is apparent is that as we anticipate slowing economic growth and decelerating, yet still growing corporate earnings, equity investors should moderate their return expectations. The last several years of double-digit investment returns will likely prove to be an anomaly in historical terms. We encourage investors to focus on their strategic investment plan, developed in concert with their ScotiaMcLeod Investment Executive, and maintain a disciplined investment philosophy that ignores market gyrations and focuses on the long term. Consider incorporating the Guided Portfolios as part of your asset allocation and long-term investment plan.

ScotiaMcLeod Canadian Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

There were three distinct stages of activity in capital markets in the third quarter, but volatility is the common thread that tied the whole period together. In the first stage, equity indices hit all-time highs, powered by a positive economic backdrop, solid earnings growth and continued Mergers and Acquisition (M&A activity). However, after peaking in mid July, the market began its second stage, retreating lower, driven by rising concerns around sub-prime lending and other credit problems faced by the financial system. August saw the onset of a full credit crisis spawned by the slump in U.S. housing and mortgage lending woes, leading to a re-pricing of investment risk by investors. Canadian markets experienced their own credit issues surrounding the asset-backed commercial paper marketplace. Global equity markets were in the midst of a major correction when the Federal Reserve (Fed) stepped in to cut the discount rate by 50 basis points, thus providing short-term confidence, rallying markets, and beginning the third stage in the odyssey. A subsequent rate cut by the Fed in mid September supported markets further, leading equity indices around the world back toward their previous highs.

Only four sectors in the Canadian equity market delivered positive performance last quarter, led by Information Technology, Materials, and followed to a lesser extent by Utilities and Financials. Defensive sectors like Consumer stocks, Telecommunication Services, and Health Care were weaker relative performers. The Canadian Core Guided Portfolio performed in line with its benchmark, the S&P TSX 60 Index, during the period as both increased 2.7% on total return basis. The portfolio continues to outperform on a year to date basis as well.

Despite our underweight position in Material stocks in the portfolio, our stock selections in that sector were the biggest contributors to performance in the period. The holding in **Alcan Inc.** generated a total return of 15.4% before we eliminated the position near the end of September and the significant move in gold bullion contributed to the 29.0% move in **Barrick Gold** during the quarter. **Shoppers Drug Mart** shares also demonstrated strength with a 10.2% move higher. On the downside, the stock of **TELUS Corp.** declined 9.8% over the period as it became apparent that the company would not be pursuing a takeover or merger with **BCE Inc.**

We remain cautious regarding the short-term outlook due to risks in the financial system and the U.S. economy that may cause ongoing volatility. Caution during this current environment is the prudent course and we would still hold some cash in equity portfolios with a view to adding exposure at lower prices and when we have more confidence that risk is appropriately priced into the market. We continue to believe that the negative influences that have weighed on the market will ultimately be superseded by underlying strength in the global economy which will support rising corporate profitability. We believe that the U.S. and Canada will avoid a recession and that equities will resume their upward trend.

Changes

As documented in the previous edition of the Investment Portfolio Quarterly, at the beginning of the quarter we added two Resource positions: **Nexen Inc.** and **Teck Cominco Limited** to the portfolio. The combined effect of adding these stocks without eliminating any other positions reduced the weights and emphasis of the other holdings. We remain underweight in both Energy and Materials while maintaining an overweight position in Financials, Telecommunication Services, and Industrials. Late in the quarter we made a switch out of **Alcan** and into **Agrium Inc.** **Alcan** stock fell from its highs as a result of the advance in the value of the Canadian dollar. We removed the position in **Alcan** due to the very narrow spread remaining between the share price and the cash take-over offer by **Rio Tinto PLC**. When the **Rio Tinto** bid was announced in mid-July, it translated to \$106 Canadian dollars; given the move in the currency toward parity in September, the value of the bid declined by \$5 Canadian in the intervening period.

Agrium Inc. is an integrated North and South American wholesale retail company producing and marketing products along the agricultural value chain from seed to fertilizer. The fundamentals and investment outlook for the fertilizer industry are positive due to low crop inventories around the globe, drought conditions in Australia and Europe impeding production and resulting in record high crop prices, and growing demand for inputs to biofuels production. Increased demand for ethanol and corn that is the primary feedstock for biofuel production has led to a massive change in the way farmers utilize their fields. This 'perfect storm' of events leading to strong industry characteristics has evolved over many years and conditions are unlikely to correct or reverse over a short period of time.

Canadian Core Guided Portfolio					
Company	Symbol	Price 28-Sep-07	Target Price	Dividend	Dividend Yield
Interest Sensitive:					
AGF Management Limited	AGF.B	\$33.40	\$45.00	\$0.80	2.4%
Canadian Imperial Bank of Commerce	CM	\$99.36	\$115.00	\$3.48	3.5%
Manulife Financial	MFC	\$41.01	\$44.00	\$0.88	2.1%
Power Financial Corp	PWF	\$41.50	\$45.00	\$1.16	2.8%
Rogers Communications	RCI.B	\$45.28	\$60.00	\$0.50	1.1%
Royal Bank of Canada	RY	\$55.05	\$75.00	\$2.00	3.6%
Sun Life Financial	SLF	\$52.20	\$58.00	\$1.36	2.6%
TELUS Corp.	T	\$57.50	\$64.00	\$1.50	2.6%
Toronto-Dominion Bank	TD	\$76.30	\$90.00	\$2.28	3.0%
Consumer Products:					
Shoppers Drug Mart	SC	\$54.38	\$62.50	\$0.64	1.2%
Yellow Pages Income Fund	YLO.UN	\$13.58	\$16.25	\$1.09	8.0%
Industrial Products:					
Canadian National Railway*	CNR	\$56.76	\$72.00	\$0.84	1.5%
Resource:					
Agrium Inc.	AGU	\$54.18	\$67.00	\$0.11	0.2%
Barrick Gold	ABX	\$39.95	\$55.00	\$0.30	0.8%
Enbridge Inc.	ENB	\$36.44	\$41.00	\$1.23	3.4%
Nexen Inc.	NXY	\$30.39	\$44.00	\$0.10	0.3%
Petro-Canada	PCA	\$57.07	\$69.00	\$0.52	0.9%
Suncor Energy	SU	\$94.46	\$119.00	\$0.40	0.4%
Talisman Energy	TLM	\$19.53	\$26.00	\$0.18	0.9%
Teck Cominco Inc.	TCK.B	\$47.22	\$49.00	\$1.00	2.1%

*Scotia Capital does not currently provide research coverage, target price based on consensus data
Source: Scotia Capital, Bloomberg.

ScotiaMcLeod Income Plus Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

In addition to credit quality concerns driving Financial stocks lower in July, they were under the additional pressure of ongoing investor anxiety stemming from the rising interest rate environment at the time. Early in the quarter there was an expectation of further interest rate increases by the Bank of Canada; as an indication of the volatility experienced over the duration of the period, the market began anticipating rate cuts in Canada by mid September.

The volatility in August saw a flight to quality that drove investors toward defensive, dividend paying stocks in the Canadian market, yet income oriented equities still declined in August. September brought another month of market uncertainty, but ultimately led higher yielding stocks into higher territory.

By the end of the period, this portfolio had remained flat with the previous quarter-end while the benchmark Dow Jones Canada Dividend Index generated a modest 0.8% total return. The best performers were found among Financial stocks as **TD Bank** increased 4.7% and shares of **CIBC** climbed 3.55%; both companies reported their third quarter financial results that were better than analysts anticipated. **Sun Life Financial** and **Power Financial** increased 2.8% and 2.6% respectively. These gains were offset by negative returns provided by **Telus Corp.**, **Husky Energy**, and **Thomson Corp.**

Changes

No changes were made to the composition of the ScotiaMcLeod Canadian Income Plus Guided Portfolio during the quarter. The current mix of conservative investment positions continues to offer well diversified exposure to all broad economic sectors and is consistent with the defensively oriented mandate of the portfolio. While tilted toward income generation, this portfolio seeks a balance between growth, income and total return. The current yield of the Income Plus portfolio is 3.7%.

Canadian Income Plus Guided Portfolio					
Company	Symbol	Price 28-Sep-07	Target Price	Dividend Dividend	Dividend Yield
Interest Sensitive:					
BCE Inc.	BCE	\$39.90	\$42.75	\$1.46	3.7%
Calloway REIT	CWT.UN	\$24.79	\$28.40	\$1.55	6.2%
Canadian Imperial Bank of Commerce	CM	\$99.36	\$115.00	\$3.48	3.5%
Power Financial Corp.	PWF	\$41.50	\$45.00	\$1.16	2.8%
Royal Bank of Canada	RY	\$55.05	\$75.00	\$2.00	3.6%
Sun Life Financial	SLF	\$52.20	\$58.00	\$1.36	2.6%
TELUS Corp.	T	\$57.50	\$64.00	\$1.50	2.6%
Toronto-Dominion Bank	TD	\$76.30	\$90.00	\$2.28	3.0%
Consumer Products:					
Thomson Corporation	TOC	\$41.66	\$52.00	\$0.98	2.4%
Yellow Pages Income Fund	YLO.UN	\$13.58	\$16.25	\$1.09	8.0%
Resource:					
Enbridge Inc.	ENB	\$36.44	\$41.00	\$1.23	3.4%
Husky Energy Inc.	HSE	\$41.45	\$48.00	\$1.00	2.4%
TransCanada Corp.	TRP	\$36.47	\$41.00	\$1.36	3.7%

Source: Scotia Capital, Bloomberg.

ScotiaMcLeod U.S. Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

The sub-prime mortgage issue was particularly influential in the U.S. equity market last quarter. In fact, statistically it is a much larger feature of the commercial and investment banking business in that market than in Canada as real estate loans now represent 55% of outstanding loans in the U.S. versus approximately 42% in Canada. Sub-prime lending by large financial institutions is much more prevalent in the U.S. than in Canada as well. As a result, the negative impact of declines in the overweighted Financial sector significantly outpaced strong price improvement among Industrial, Energy, and Information Technology stocks.

Issues impacting global credit markets led to incredible volatility in U.S. equities during the quarter. Aided by a second rate cut by the Fed on September 18, the benchmark S&P 500 ended in positive territory, increasing 2.0% for the three month period, while the U.S. Core Portfolio improved by 2.3% despite our defensive orientation.

A combination of stock selection and sector allocation contributed to the positive relative performance. The best performing holding in the portfolio was **Cisco Systems** which jumped 19.0% after announcing better than expected Q4 earnings results. **Oracle Corp.** also climbed an impressive 9.8% as the Technology sector is viewed as mostly immune to the current credit issues. Shares of recently added **Microsoft Corp.** and **MetLife Inc.** were also up 5.1% and 9.3% respectively since being inserted in the portfolio during the quarter. Other contributors were **United Technologies Corp.** which rallied 13.5% and drugstore operator **CVS Caremark Corp.** that moved up 8.7%. All these gains were offset to a great degree by weakness among Financials like **Lehman Brothers**, **Allstate**, and **JP Morgan** which dropped 17.2%, 7.0%, and 5.4% respectively on credit related concerns.

In addition to questions surrounding the impact of weak job data, we remain particularly concerned about the ongoing impact of sub-prime and related housing issues and their potential impact on consumer confidence and therefore spending. U.S. mortgage foreclosures have reached highs and, perhaps not surprisingly, delinquency rates on mortgages are tracking higher as well. Countering these negative signals, one silver lining resulting from the poor employment growth is that any increase in unemployment would help delay potential wage inflation. In search of guidance, the market will stay particularly focused on third quarter earnings reports and economic data being released over the next several months.

Changes

As mentioned last quarter, the addition of Consumer Discretionary company **Nike Inc.** to the portfolio in early July maintained the defensive orientation in the portfolio with an overweight position in Financials, Telecommunication Services, and Industrials, and underweight Resource stocks.

In August we announced two changes in the portfolio: a switch out of **Wells Fargo** and into **MetLife Inc.**, and out of **Motorola** into **Microsoft Corp.** In light of the ongoing turbulence in capital markets resulting from concerns around sub-prime issues, we decided to alter the composition of holdings in the Financial sector of the portfolio. By taking profits in **Wells Fargo**, we reduced the emphasis in the portfolio on credit markets while maintaining the overweight sector weighting. **MetLife, Inc.** is one of the largest insurance and financial service companies in the U.S. with a global reach and high brand recognition. The stock offers steady earnings growth, a conservative balance sheet and although the company's investment portfolio has some exposure to mortgage-backed securities, sub-prime exposure is minimal.

The holding in **Motorola** provided ongoing disappointments, both corporately and as an investment. Motivated by the belief that the company was having difficulty executing their strategy at the same time that their competitive position was weakening, we sold the position and replaced it with **Microsoft Corp.** This is a company that enjoys a unique asset in its customer base that includes over one billion Windows user providing a platform upon which to build and sell products and services for existing consumers. The company is in the process of launching and deploying one of the strongest pipelines of new product releases in recent years that should re-accelerate revenue and earnings growth for the next few years. The stock is appropriate for conservative investors looking for technology exposure, consistent earnings growth, and an attractive valuation.

U.S. Core Guided Portfolio					
Sector	Symbol	Price 28-Sep-07	Target Price	Dividend	Dividend Yield
Interest Sensitive:					
AT&T Inc.	T	\$42.31	\$46.00	\$1.42	3.4%
Allstate Corp	ALL	\$57.19	\$68.00	\$1.52	2.7%
Bank of America*	BAC	\$50.27	\$58.00	\$2.56	5.1%
Edison International	EIX	\$55.45	\$66.00	\$1.16	2.1%
JP Morgan Chase	JPM	\$45.82	\$65.00	\$1.52	3.3%
Lehman Brothers	LEH	\$61.73	\$90.00	\$0.60	1.0%
MetLife, Inc.	MET	\$69.73	\$75.00	\$0.59	0.8%
Consumer Products:					
CVS Caremark Corp	CVS	\$39.63	\$44.00	\$0.24	0.6%
Eli Lilly	LLY	\$56.93	\$62.00	\$1.70	3.0%
Nike Inc.	NKE	\$58.66	\$65.00	\$0.74	1.3%
Wal Mart Stores	WMT	\$43.65	\$55.00	\$0.88	2.0%
Walt Disney	DIS	\$34.39	\$38.00	\$0.31	0.9%
WellPoint Inc	WLP	\$78.92	\$82.00	\$0.00	0.0%
Industrial Products:					
Caterpillar Inc	CAT	\$78.43	\$90.00	\$1.44	1.8%
Cisco Systems	CSCO	\$33.13	\$38.00	\$0.00	0.0%
Microsoft Corp	MOT	\$29.46	\$35.00	\$0.44	1.5%
Oracle Corp	ORCL	\$21.65	\$26.00	\$0.00	0.0%
United Parcel Services Inc	UPS	\$75.10	\$92.00	\$1.68	2.2%
United Technologies Corp	UTX	\$80.48	\$84.00	\$1.28	1.6%
Resource:					
Transocean Inc.	RIG	\$113.05	\$120.00	\$0.00	0.0%
*Credit Suisse does not currently provide research coverage, target price based on consensus data					
Source: Scotia Capital, Credit Suisse, Bloomberg.					

ScotiaMcLeod North American Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

The recently launched ScotiaMcLeod North American Core Guided Portfolio is designed for growth investors seeking consistent long-term rates of return from a portfolio of high quality Canadian and U.S. companies. This portfolio is comprised of North American companies offering market leadership, unique franchises and a strong management team combined with an attractive trend in profitability. Stocks are selected from the universe of positions held in the ScotiaMcLeod Canadian and U.S. Core Guided Portfolios.

The current portfolio holds 25 equal-weighted (4%) positions and its composition is tilted defensively, in a similar fashion to the two Core Portfolios; thus it holds overweight positions in Financials, Telecommunication Services, Consumer Staples, and Industrials, while being underweight in the Energy and Materials sectors. Country allocation within the portfolio is determined in a bottom-up, stock-specific fashion as opposed to making any particular country “call.” Generally speaking, but not exclusively, Resource holdings will likely come from the Canadian universe, and Health Care, Information Technology, and Consumer stocks will usually be drawn from the U.S.

Probably the security with the biggest impact on the North American Portfolio since its inception has been the Canadian dollar and its value relative to the U.S. dollar. The Canadian currency hit parity at the end of the quarter largely due to record prices for the key Canadian exports oil, gold, and wheat. Another influencing factor is the anticipated decline in short-term interest rates in the U.S., thus pushing its currency lower against all global currencies. Since inception, the U.S. dollar has declined 6.9% against the Canadian dollar, and 6.1% in the third quarter alone.

Our expectation is that parity is not sustainable longer term, and thus future performance in this hybrid portfolio of U.S. and Canadian equity holdings should not be significantly impaired as a result of currency translation. In fact it would be fair to say that U.S. stocks, and arguably all products in the U.S. are currently “on sale” in Canadian dollar terms.

Changes

We made two switches in the portfolio during the quarter. In the first change we reduced the magnitude of the overweight position in the Financial sector and increased exposure to Information Technology. By eliminating the holding in **Wells Fargo**, we reduced the emphasis in the portfolio on credit markets while still maintaining the overweight sector weighting. We redeployed the proceeds from **Wells Fargo** into a position in **Microsoft Corp.** More details on these changes can be found in the commentary for the U.S. portfolio.

The second switch was a move out of **Alcan Inc.** and into **Teck Cominco Inc.** (see the comments on the **Alcan** sale in the Canadian Core commentary). **Teck Cominco Inc.** is a diversified mining company and the world’s no. 2 zinc miner and no. 2 metallurgical coal producer. Although not yet widely understood by investors, **Teck Cominco** now has greater earnings leverage to copper than zinc. The company also produces significant levels of lead, gold, other specialty metals, and also has investments in several oil sands projects.

North American Core Guided Portfolio					
Company	Symbol	Price 28-Sep-07	Target Price	Dividend	Dividend Yield
Financials:					
Allstate Corp	ALL US	\$57.19	\$68.00	\$1.52	2.7%
Bank of America**	BAC US	\$50.27	\$58.00	\$2.56	5.1%
JP Morgan Chase & Co	JPM US	\$45.82	\$65.00	\$1.52	3.3%
Manulife Financial	MFC	\$41.01	\$44.00	\$0.88	2.1%
Royal Bank of Canada	RY	\$55.05	\$75.00	\$2.00	3.6%
Sun Life Financial	SLF	\$52.20	\$58.00	\$1.36	2.6%
Toronto-Dominion Bank	TD	\$76.30	\$90.00	\$2.28	3.0%
Telecommunication Services					
Rogers Communications	RCI/B	\$45.28	\$60.00	\$0.50	1.1%
TELUS Corp.	T	\$57.50	\$64.00	\$1.50	2.6%
Utilities					
Edison International	EIX US	\$55.45	\$66.00	\$1.16	2.1%
Consumer Discretionary					
Walt Disney	DIS US	\$34.39	\$38.00	\$0.31	0.9%
Consumer Staples					
CVS Corp	CVS US	\$39.63	\$44.00	\$0.24	0.6%
Shoppers Drug Mart	SC	\$54.38	\$62.50	\$0.64	1.2%
Health Care					
Eli Lilly & Co	LLY US	\$56.93	\$62.00	\$1.70	3.0%
Industrials					
Canadian National Railway*	CNR	\$56.76	\$65.00	\$0.84	1.5%
United Technologies Corp	UTX US	\$80.48	\$84.00	\$1.28	1.6%
Information Technology					
Cisco Systems	CSCO US	\$33.13	\$38.00	\$0.00	0.0%
Microsoft Corp.	MSFT US	\$29.46	\$35.00	\$0.44	1.5%
Oracle Corp	ORCL US	\$21.65	\$26.00	\$0.00	0.0%
Energy					
Enbridge Inc.	ENB	\$36.44	\$41.00	\$1.23	3.4%
Petro-Canada	PCA	\$57.07	\$69.00	\$0.52	0.9%
Suncor Energy	SU	\$94.46	\$119.00	\$0.40	0.4%
Talisman Energy	TLM	\$19.53	\$26.00	\$0.18	0.9%
Materials					
Barrick Gold	ABX	\$39.95	\$55.00	\$0.30	0.8%
Teck Cominco Inc.	TCK/B	\$47.22	\$49.00	\$1.00	2.1%
* ScotiaMcLeod does not currently provide research coverage - target price based on consensus data					
**Credit Suisse does not currently provide research coverage - target price based on consensus data					
Source: Scotia Capital; Credit Suisse, Bloomberg.					

ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio

Chris Kennedy, CFA — Associate, Portfolio Advisory Group

Investment Objective

The ScotiaMcLeod Core-Plus Fixed Income Guided Portfolio is designed and managed for our 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 portfolio's benchmark, the Canadian Universe Bond Index. Typically, this rate of return is not achieved every year but rather it is the desired average performance over the longer-term time horizon. Approximately 75% of the portfolio is placed in a 10-year laddered bond portfolio and 5% is placed in inflation-protected instruments, comprising the core holdings of the portfolio. The remaining 20% of the portfolio is focused on active value added trade strategies that attempt to help the portfolio outperform the benchmark.

Current Active Strategies

On August 15th, we sold the active portion of the portfolio that was invested in the German Government 3.0% coupon due March 14, 2008. The decision to unwind this position rested ultimately on our view that upside returns in Euro denominated currency bonds versus what could be received in similar term Canadian denominated bonds did not justify the foreign exchange risk inherent in holding this position. Two months later we see this was the correct call to remove the position, and minimize our losses as the Canadian dollar for the remainder of the summer continued to rise until it reached recent cycle highs against the Euro and a 30-year high against the U.S. dollar.

On the back of concerns in the credit and lending markets, initiated by rising sub-prime mortgage defaults, we had seen credit spreads (pick up in yield over a comparable Government of Canada benchmark) widen for most corporate paper. This created opportunities for active accounts. However, as we were expecting further volatility in the financial issue names going forward, we decided to stay short on the yield curve. Therefore, with the proceeds of the German bond sale, we purchased a short maturity Bank of Nova Scotia Deposit Note 3.722% due November 5, 2007.

Performance Update

The Core-Plus Portfolio over the past quarter has returned a positive 1.65%, slightly underperforming its benchmark, the Canadian Universe Bond Index, which returned a positive 1.70% over the same period. The main reason for this underperformance can be attributed to the portfolio's 20% active position held in the corporate sector over this time period. Through the summer, as the credit and liquidity crunch intensified, investors fled out of corporate bonds and into the safety of Government backed securities – deemed the “flight to quality” trade. The corporate sector was the worst performing sector at 0.33% versus the Canadian and Provincial sectors which returned a much higher 2.21% and 1.95% respectively, for the quarter.

The chart below highlights our active trade choices versus the return of the index over the corresponding period. It is these active positions through which we attempt to outperform the benchmark. However, last quarter, the majority of the active positions did not outperform the benchmark, as we, like many portfolio managers, were caught in the credit crunch of the summer.

Active Trade Relative Performance			
Name	Total Return 06/29/07-08/15/07	Total Return 06/29/07-09/28/07	Total Return 08/15/07-09/28/07
German Government 3.00% 03/14/08	1.10%		
Bank of Montreal 4.30% 09/04/09		1.37%	
Bank of Nova Scotia 3.722% 11/05/07			0.55%
Canadian Overall Bond Index	0.68%	1.70%	1.01%
Difference	0.42%	-0.33%	-0.46%

Source: PC Bond.

It was the “Core” portion of the Core-Plus portfolio, the 10-year passive laddered holdings that helped maintain the returns roughly in line with the benchmark, as can be seen from the numbers below.

Active Trade Relative Performance					
Issuer Name	Coupon	Maturity Date	Weighting*	Rate of Return*	Benchmark
Core Positions					
CMHC	5.30	3-Dec-07	7.5%	1.20	
Bank of Nova Scotia	4.30	22-Aug-08	7.5%	1.22	
New Brunswick	5.25	2-Jun-09	7.5%	1.80	
Bell Canada	5.50	12-Aug-10	7.5%	1.97	
Export Development Corp.	5.75	1-Jun-11	7.5%	2.20	
Manitoba	5.25	3-Dec-12	7.5%	2.40	
Royal Bank	5.45	4-Nov-13	7.5%	0.80	
Canada	5.00	1-Jun-14	7.5%	2.82	
Candian Tire Corp	4.95	1-Jun-15	7.5%	0.78	
Saskatchewan	4.50	23-Aug-16	7.5%	2.31	
Canada RRB	3.00	1-Dec-36	5.0%	1.09	
Active Positions					
Bank of Montreal	4.30	4-Sep-09	10.0%	1.37	
Bank of Nova Scotia**	3.722	5-Nov-07	10.0%	0.55	
Total				1.65%***	1.70%

*For quarter ending September 28, 2007
 **Position since August 15, 2007
 *** Includes active trade returns since June 29, 2007

Source: ScotiaMcLeod Portfolio Advisory Group.

Notes

The author(s) of the report own(s) securities of the following companies. Manulife Financial Corporation, Rogers Communications Inc., Royal Bank of Canada, Sun Life Financial Inc., TELUS Corporation, Toronto-Dominion Bank, Shoppers Drug Mart Corporation, Yellow Pages Income Fund, Canadian National Railway Company, Enbridge Inc., Petro-Canada, Suncor Energy Inc., Teck Cominco Ltd., Talisman Energy Inc., BCE Inc., The Thomson Corporation, TransCanada Corporation, Wal-Mart Stores Inc, Caterpillar Inc, United Parcel Service Inc, United Technologies Corp

The supervisors of the Portfolio Advisory Group own securities of the following companies. Manulife Financial Corporation, TELUS Corporation, Canadian National Railway Company, Petro-Canada Scotia Capital is a member of the Canadian Investor Protection Fund (CIPF).

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