

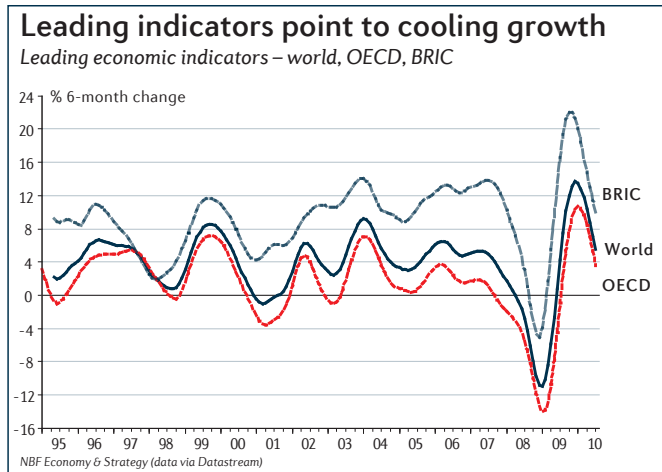
Investment Strategy

October 2010

A foggy patch on the road to recovery

The rise in economic leading indicators has slowed considerably from its 2009 peak, signalling a deceleration of global growth. That being said, it's important to remember that deceleration is not contraction. At this juncture we continue to think that the economic recovery is on track in most of the developed world and that emerging Asia will continue to expand robustly. Monetary policy remains pro-growth, corporate balance sheets are the soundest in a generation, financial stress has abated, commercial banks are finally easing lending standards for commercial and industrial loans, mergers and acquisition activity is picking up and the private sector is hiring, albeit modestly.

On the other hand, recent U.S. developments cannot be ignored. Revisions to the GDP figures of the last three and a half years show more spare capacity and slower inflation than previously assumed. Recent data on housing and capital goods orders have shown uncharacteristic weakness. Though we trace much of the third quarter slowdown in U.S. domestic demand to the unwinding of temporary stimulus, the recovery remains fragile. Authorities must ensure that confidence does not erode and that inflation expectations remain anchored in positive territory



Fiscal policy in the U.S. is a key source of uncertainty. At the time of this writing, the future of the Bush tax cuts introduced in 2001 and set to expire at the end of this year, is still up in the air. Will the current administration maintain them, helping to preserve household disposable income? Will it make adjustments to the tax cuts? Or will it allow them to expire, which will translate into a tax increase for all taxpayers? With the year end just four months away, many U.S. households still do not know the size of the potential hit to their disposable income. The Congressional Budget Office estimates that if the measures expire as scheduled, the aggregate tax increase in 2011 will be \$250 billion, or 1.7% of GDP. The U.S. economy is still too weak to absorb a shock of that magnitude. We expect that politicians will ultimately do the right thing for the economy, but cannot be certain of the timing. A layer of uncertainty should be lifted after the mid-term elections.

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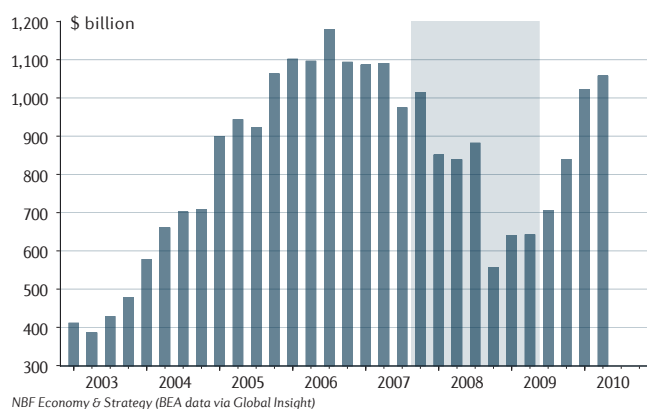
Uncertainty persists, but the news is not all bleak

Even if volatility has abated in recent months, uncertainty among market participants remains high. Nonetheless, with a couple of weeks left in the third quarter, it is good to see that the market has been able to withstand what policy makers have labelled “times of unusual uncertainty”. The S&P/TSX is up over 7% so far in Q3, bringing the year-to-date performance of the Canadian index up to 4.4%. Global market indices are also showing positive momentum this quarter, with emerging markets leading the way. This does not mean that recent uncertainty is being diffused, but instead shows that cyclical and liquidity conditions remain supportive of profit growth.

This summer’s earning season was generally positive, especially for both Canadian and the U.S. markets. Q2 earnings for the S&P/TSX rose 47.4% compared to one-year earlier, with sales increasing 16.4%. In the U.S. the S&P 500 index registered a 54.2% year-over-year advance in earnings per share in Q2, with revenues increasing 12%. Importantly, this increase was widespread across sectors in both countries. Looking forward, it will be difficult for revenues to keep growing at double-digit

U.S.: profits continue to improve

Q2 domestic profit of non financial corporations, national-accounts basis



rates as we enter 2011. However, the extent of the deceleration in earnings growth will depend on the size of any additional fiscal and/or monetary stimulus aimed at spurring U.S. domestic demand.

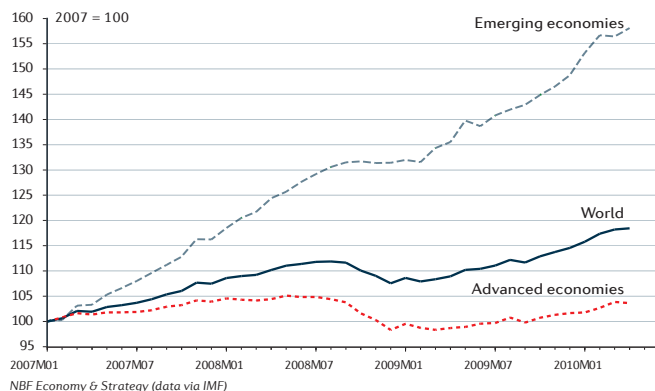
A new source of consumption

Emerging markets continue to outpace the rest of the world. Their growth is buoyed by the increasing weight consumers in these countries represent in terms of total global demand. Over the last three years retail sales have grown less than 5% in the developed economies, but have skyrocketed 60% in the

emerging world. Emerging economies now account for more than 30% of global retail sales. These economies continue to move away from export-led business models, and their decoupling from the developed economies is likely to become even more apparent in the coming quarters. According to

World: A new source of consumption

Retail sales



the International Monetary Fund (IMF), output in emerging and developing economies should grow by 6.5% in 2011, compared to 2.4% for the advanced economies.

Bond markets have provided investors with solid returns over the past few months. The 10-year U.S. treasury yield has fallen by approximately 140 basis points since the European sovereign debt problems emerged in April 2010. Investment grade corporate bonds have followed the same course, with the lowest average monthly yield since 2004 reached in August of this year. In the current environment of very tame inflation, an abrupt upward spike in bond yields is not likely. The U.S. labour market will obviously remain a major factor in the outlook for the economy, inflation and global bond yields.

When we weigh possible outcomes for equity markets in the light of our assumptions for the next few months, we see pros and cons offsetting each other.

Foggy Patch? Drive carefully and switch on the fog lights!

We hit our first patch of fog on the road to recovery last quarter as investors focused on the European sovereign debt crisis at the expense of positive news emanating from many other areas of the global economy. While the sovereign debt-related difficulties of the Euro-zone have faded into the background, this quarter it is the softer economic data from south of the border that is capturing the headlines rather than the good news on the earnings front. But pushing our automotive metaphor further, a bit of fog merely prompts us to slow down a bit... not pull of the highway altogether.

We had adopted an overweight position in equities in June 2009, and maintained it until June 2010, at which point we trimmed our exposure to stocks back in the face of the uncertainty from across the Atlantic. This rebalancing left us with an equity position that was very close to neutral. At this point, we continue to see market risks and rewards largely offsetting each other, and are maintaining this equity weighting largely unchanged.

On the geographic front, we continue to prefer North America, and particularly Canada, at the expense of Europe and the Far East. We also still think that attractive opportunities are to be found in emerging markets because of the increasing role these countries will be playing in the global economy. Part of our strategy of driving more carefully involves moving to a slightly more defensive stance in terms of sector weightings. We

have increased our exposure to telecommunications, utilities and consumer products while still remaining slightly underweight these sectors. At this point we retain a small overweight in commodities on the premise that the global economy will expand by more than 3.5% in the coming year.

For the fixed income component of our reference portfolio, in anticipation of a flight to quality in reaction to the European sovereign debt crisis we had reduced our underweight position in federal bonds a little last quarter, cutting back on our provincial and corporate bond holdings while still remaining overweight in these asset classes. While provincial spreads have narrowed considerably from

levels reached in early 2009, we think that at current level they are fairly priced given the financial situations of our provinces. Spreads are not expected to narrow much in coming months but in an environment of relatively low interest rates we do not want to give up the yield pick-up over Government of Canada bonds they currently provide. Given our view that the Canadian economic expansion will continue and a double-dip will be avoided in the U.S., we are also maintaining a positive bias in favour of corporate bonds. Currently we prefer to express our view about the likely direction of interest rates by maintaining a duration that is close to neutral.

From recovery to expansion

Real GDP growth slowed from 5.8% in Q1 to 2% in Q2. Most of the deceleration, however, was due to a jump in imports: domestic demand expanded at a vigorous 3.5% clip. The level of real GDP now stands above its pre-recession peak, meaning that Canada has moved from recovery to expansion in the span of just a year. Against this backdrop, the Bank of Canada (BoC) raised its overnight rate by 25 basis points for the third consecutive time in as many meetings on September 8, to 1.0%. While our central bank recognizes that the recent softness in U.S. economic data will translate into a somewhat slower pace of expansion for Canadian exports, it nonetheless sees the recent sharp

decline in global bond yields as supportive of solid domestic consumption growth and business investment in the coming months. In light of the continuing strength of the domestic economy – both production and employment are above pre-recession levels – the most likely course of action for the Bank of Canada is to continue raising its policy rate in small increments through the end of the year. Despite further tightening, interest rates will remain well below the levels normally associated with a restrictive policy. We still see Canadian economy expanding by more than 3% in 2010.

Income Portfolio

Investor Profile: You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is very low.

Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	10%	10%	0
Fixed-income (duration: 5.9 years) ¹	60% to 100%	70%	69%	0
Canadian equities		10%	11%	+ 1
U.S. equities	0% to 30%	5%	5%	- 1
Foreign equities		5%	5%	0

Conservative Portfolio

Investor Profile: On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.

Cash equivalents	0% to 15%	5%	5%	0
Fixed-income (duration: 5.9 years) ¹	50% to 80%	60%	60%	0
Canadian equities		20%	22%	+ 1
U.S. equities	20% to 45%	7,5%	8%	- 1
Foreign equities		7,5%	5%	0

Balanced Portfolio

Investor Profile: You give equal weight to income and capital growth. You can tolerate moderate volatility to ensure the growth of your capital, but you prefer having a portfolio with a significant exposure to fixed-income securities for reasons of stability. Your tolerance for risk is average.

Cash equivalents	0% to 20%	5%	6%	0
Fixed-income (duration: 5.9 years) ¹	30% to 65%	45%	45%	0
Canadian equities		25%	27%	0
U.S. equities	30% to 65%	10%	11%	0
Foreign equities		10%	6%	0
Alternative investments ²	0% to 15%	5%	5%	0

Growth Portfolio

Investor Profile: Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.

Cash equivalents	0% to 25%	0%	2%	0
Fixed-income (duration: 5.9 years) ¹	25% to 45%	35%	33%	0
Canadian equities		25%	28%	0
U.S. equities	40% to 75%	15%	17%	0
Foreign equities		15%	10%	0
Alternative investments ²	0% to 20%	10%	10%	0

Maximum Growth

Investor Profile: You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is very high.

Cash equivalents	0% to 30%	0%	5%	0
Fixed-income (duration: 5.9 years) ¹	0% to 30%	20%	17%	0
Canadian equities		25%	27%	0
U.S. equities	55% to 100%	20%	21%	0
Foreign equities		20%	15%	0
Alternative investments ²	0% to 25%	15%	15%	0

1) Includes conventional and real return bonds. Benchmark = 75% DEX Universe Index, 25% SC RRB Index.

2) Includes hedge funds and real estate. Benchmark = 50% Tremont Hedge Fund Index, 50% S&P TSX Cap REIT Index.

	Forecast			Rate %	December 2010		December 2011		S&P / TSX Sector Rotation
	2009	2010	2011		Canada	U.S.	Canada	U.S.	
Gross Domestic Product %				Short-term rate (T-Bills, 91-Day)	1.43	0.17	1.92	1.17	Overweight (slight)
Canada	(2.5)	3.2	2.0	10-year bond yields	3.08	2.89	3.75	3.73	Energy Materials
U.S.	(2.6)	2.7	2.3	30-year bond yields	3.64	3.89	4.11	4.53	Underweight (slight)
Inflation %									Consumer Staples Utilities
Canada	0.3	1.8	2.3	Canadian dollar	U.S.\$1.00		U.S.\$0.96		
U.S.	(0.3)	1.6	1.9						

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