

Investment Portfolio Quarterly



Insightful Perspectives

Winter 2011

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None.

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Executive Summary

2011 Winter Outlook

Stewart Hunt — Managing Director, Portfolio Advisory Group

As we begin 2011 it would be safe to say the worries of a ‘double dip’ recession for the North American economy have abated. Equity and bond markets ended the year in positive territory on indications that the U.S. economy is beginning to grow and the employment situation appears to have stabilized. As you read through the Winter IPQ you will see our Scotia Capital Strategist, Economists and Portfolio Advisory Group experts have a positive, yet cautious, approach to the markets in 2011. They anticipate continued economic growth in Canada and the U.S. with the low interest rate environment expected to remain until the U.S. employment situation shows clear signs of improving. They anticipate growing concerns about inflation as the global demand for commodities, particularly from the emerging markets, push input costs higher and create the potential for interest rates to increase. In a perfect world, preparing investment decisions based on our expert’s assumptions would seem relatively easy. However, when we throw the external issues into the mix such as fiscal policy, climate, natural disasters and political unrest the crystal ball becomes cloudy. This is what creates the ‘spice of life’ for investors or as Forrest Gump would say “you never know what you’re going to get”.

Here are some highlights of what our experts anticipate in their 2011 ‘box of chocolates’:

- Scotia Capital Portfolio Strategist Vincent Delisle remains constructive on equities as long as the U.S. employment outlook improves. He is sticking with the dividend and strong balance sheet as key components for specific stock picks, remains overweight Canada, U.S. and Mexico and continues to see emerging markets, particularly the Latin American markets, as investment opportunities.
- Scotia Capital Economists Derek Holt and Gorica Djeric present their debate over the bulls and bears on U.S. growth reflecting their concerns on whether the keys for economic growth can overcome persistent areas of economic weakness.
- With the Canadian dollar having broken through par to the U.S. dollar, U.S. Equity Advisor Paul Danesi recommends investors should be taking advantage of our currency’s strength to buy, by historic standards, cheap U.S. securities. This is also a great opportunity to diversify your equity portfolio by buying companies in sectors where the Canadian market offers limited opportunities. Health care, technology, consumer staples and discretionary are areas of the market investors might consider.
- Joey Mack, Director and manager of our fixed income team, reminds us about what works in the Canadian bond market. Mack recommends always having exposure to fixed income, extending term, and while you might want to be overweight provincial and corporate bonds, don’t forget Government of Canada bonds in the equation. Finally, follow a low cost passive approach that focuses on exposure to the bond universe in Canada and the power of compounding.
- Adam Salahudeen, Director of Taxation Advisory Services, presents a timely piece as we move into tax season, reminding us that tax planning is a year round affair and highlighting when and what tax opportunities we could be focusing on.
- Joel Beriault, our Fund Research Advisor, reminds investors to stay the course, review your investment policy statement, stay invested and be diversified.
- In conclusion, Steve Uzielli provides his quarterly review and commentary on the performance of the Equity Guided Portfolios.

With a new year upon us this is a great time to contact your ScotiaMcLeod advisor and review your investment portfolio.

Stewart Hunt

Portfolio Strategy

Markets Upstaging Sentiment

Vincent Delisle, CFA – Portfolio Strategist, Scotia Capital

Hugo Ste-Marie, CFA – Portfolio Strategist, Scotia Capital

**The following article is a reprint from the publication “Focus 2011 – Seeking Direction in a Global Market: Putting the Pieces Back Together”, released January 11th, 2011.*

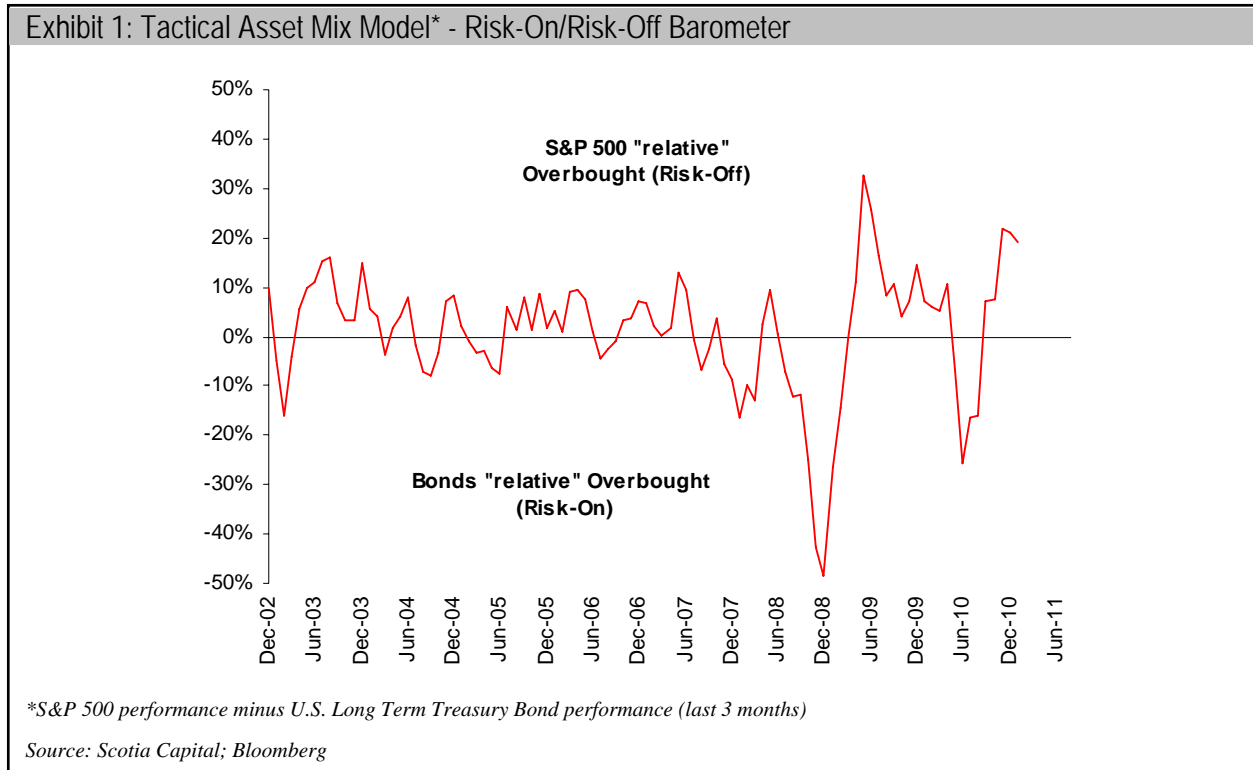
A Quick Recap of 2010 Strategy

Our 2010 investment strategy theme was centered on maintaining an equity over bond preference as long as global economic fundamentals improved. Amidst all the uncertainty and troubling headlines of 2010, world GDP growth did manage to surpass 4%, buoyed by the strength in emerging economies, but with some help from G7 economies as well. Germany is going through its most robust growth period since reunification and the U.S. outlook has been steadily improving since June 2009. In our opinion, double-dip recession fears were dramatically overblown last summer and the U.S. economy ended 2010 with strong momentum. S&P 500 earnings increased 46% in 2010, helping equities (S&P 500 +14.5% total return) outpace long-term bonds (+7.5%). Still, investor sentiment remains muted and growth expectations have been met with elevated pessimism since the recession ended in the second quarter of 2009. Markets have been upstaging sentiment since markets bottomed in the spring of 2009 and this trend could continue in 2011.

From an equity strategy perspective, cyclical sectors looked more attractive in a context of rising corporate profits and they accordingly outperformed in 2010. Globally, diverging monetary policies was the big theme underpinning our NAFTA (United States, Canada, and Mexico) equity preference. The early tightening countries (China, Brazil, and Australia) have visibly underperformed the United States (easing), Canada (neutral), and Mexico (neutral) in the last year and we will be monitoring transitions in monetary policies in 2011 to assess potential change in global leadership.

Since equity markets troughed in March 2009, the main challenge for investors has been navigating through the volatility while sticking to a pro-equity stance. This was especially true in 2010 as markets went from pricing V-shaped recoveries to double-dip recessions. In this context, our tactical asset mix model, the risk-on/risk-off barometer, enabled us to assess the appropriate timing to add risk to our model portfolios. As highlighted in Exhibit 1, the equity/cyclical risk-reward window closed down in April before opening wide again in July. Investor’s risk appetite remains fragile and tactical strategies are likely to pay off again in 2011.

From a valuation standpoint, we prefer equities over bonds for 2011 and are positioned for a 1,325 S&P 500/14,000 TSX and 3.5%+ long-term bond yields. In the near term, however, we expect the cyclical recovery witnessed since August to pause. Equities ended 2010 with a bang and our S&P 500 panic-euphoria model is starting 2011 in euphoria territory, which points to some *contrarian* caution heading into the new year. The next potential game-changer for market leadership will likely be the start of U.S. monetary normalization. When the Federal Reserve starts raising its benchmark rate and talks about unwinding quantitative measures, the ongoing cyclical asset outperformance will be challenged.



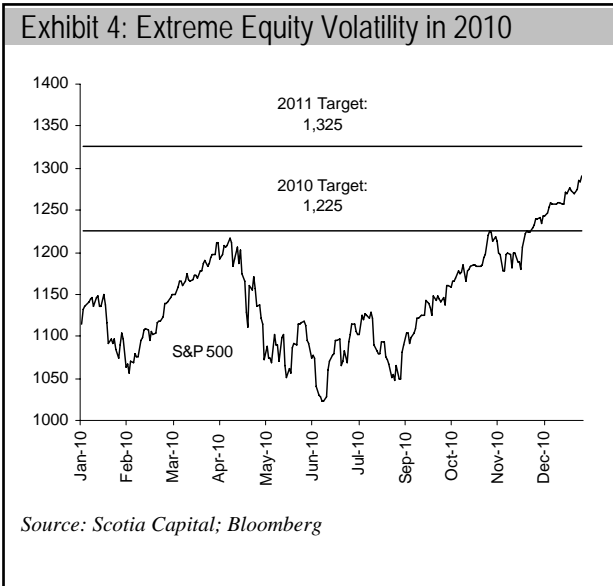
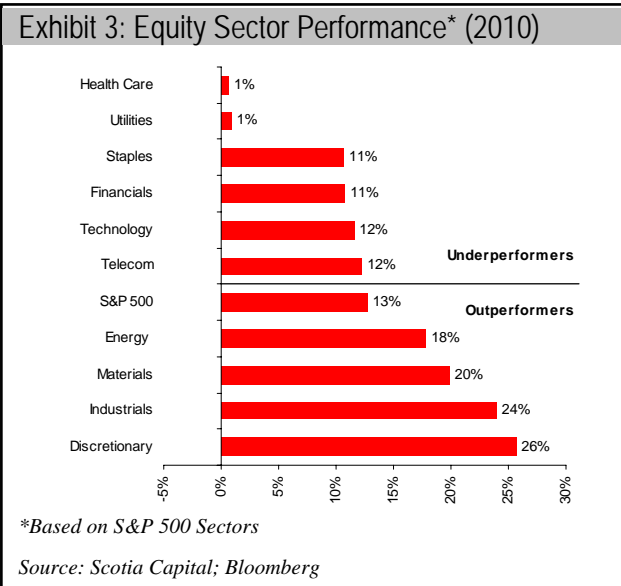
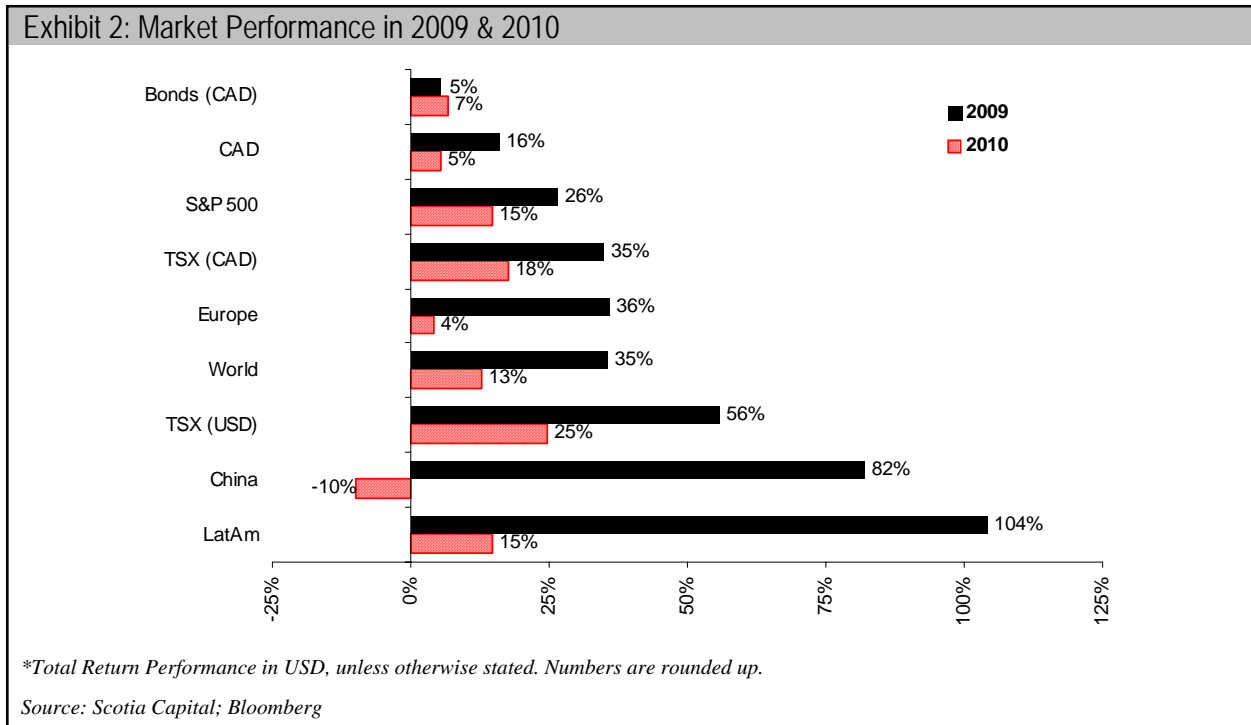
Putting the pieces back together

Although equities have posted two consecutive years of positive returns (S&P 500 +23% in 2009; +12.8% in 2010), the aftermath of the 2008 financial crisis will be felt for many years, most specifically through deleveraging processes. “Austerity” was voted the buzzword of 2010 and the term will be a common fixture for years to come. U.S. consumers (20% of the world economy) have already started a slow deleveraging process and the savings rate has gone from 0% in 2005 to 5.7% in 2010. Consumer debt levels are heading lower as well. Government spending helped avoid a deeper recession in most developed countries, but sovereign debt levels will need to be addressed. Bond vigilantes imposed sanctions in Europe in 2010, but the austerity trend will be felt globally in coming years. 2010 was the year in which debt became a hot topic, especially in the Euro zone. Although the global economy is undergoing a slow and volatile recovery following the 2008 recession, putting the pieces together will be a long process.

Equities slightly edge bonds in 2010....

Global equities posted gains for a second consecutive year in 2010 amidst a constant barrage of economic and geopolitical uncertainty. In our opinion, the last two years have provided investors with further illustration on what drives performance. Markets do not move on good or bad news; they are rather influenced by improving (better) or deteriorating (worse) data. Expectations have been very low since the global recession ended in the summer of 2009 and we believe the macro situation, albeit fragile, has been steadily improving. Heading into 2011, U.S. leading indicators are looking positive and we expect equity performance to benefit from sustained profit growth and a revival in equity appetite.

Following blockbuster returns and broad equity gains last year (the MSCI AC World index was up 35% in 2009), 2010 will be remembered as a year of positive performances with notable geographic divergences. The MSCI World index was up 13% in 2010 with Canada (TSX +25%, in US\$), Latin America (+15%), and the S&P 500 (+15%) outpacing China (-10%) and Europe (+4%). Bonds did lag equities last year, but performance was positive, with a gain of 7% for the DEX Canadian Bond Universe index (in C\$). Canadian equities (TSX +18% in C\$) outpaced bonds and cash for a second consecutive year. Cyclical sectors have had the upper hand in 2010, outperforming defensives.



...But volatility remained

Extreme volatility was also a trademark in 2010 and investors were treated to three different leadership cycles in the last 12 months (see Exhibit 4). A sub-par recovery in developed economies, the United States' excessive monetary stimulus campaign, China's tightening bias, and Europe's debt problems explain 2010 market volatility. As we dive into calendar 2011, these items should continue to challenge investor sentiment and trigger sporadic shifts in the risk-on/risk-off mentality. In fact, investors may be more sensitive to perceived disappointments in Q1 since 2010 ended with high optimism levels and overbought equity conditions.

Big picture outlook

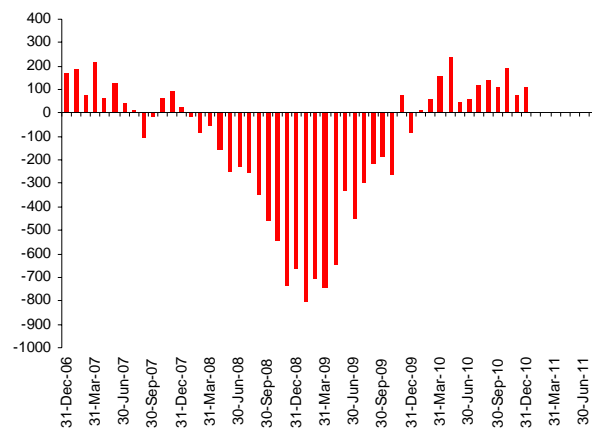
The global recovery is expected to continue in 2011 and world GDP growth should hover near 4% (4.8% in 2010). In developed economies, a slower pace of growth is unlikely to stem inflation fears, but sustained price pressures in emerging markets (EM) – China, India, and Brazil – could trigger further tightening measures. Interest rates should stay low in developed countries and rise in most EMs.

Decoupling monetary policy also points to sustained volatility for currencies and commodities in 2011. Consequently, investment flows should continue to chase higher yielding markets until the Federal Reserve starts raising interest rates, which may not occur before 2012. Although record inflows into emerging markets represent an element of risk, EM valuations remain attractive. Based on 2011 earnings forecasts, the MSCI EM index forward P/E of 11.7 is at a discount to the MSCI AC World's P/E of 12.3.

Our outlook for the U.S. economy remains both conservative and constructive and we expect growth in the 2011/2012 time horizon. Although the U.S. recovery stalled in the spring of 2010, recent statistics point to growth picking up nicely since August. Housing data appears to be stabilizing, ISM indices are hovering above the 55 level, leading indicators are up strongly since September, and private payrolls additions have topped 1.2 million since the start of 2010 (see Exhibit 5). As long as the U.S. economy keeps adding jobs, the double-dip recession scenario remains a low probability outcome. And as long as U.S. GDP growth stays positive, corporate profits should improve, leading to positive equity returns.

China's growth trajectory could be hampered by tighter policy in 2011, translating into volatility for industrial commodities such as oil and copper. Japan's outlook remains challenged by a strong yen, but Germany seems to be successfully weathering the debt storm in Europe. Spain and Portugal could be the European spoilers next year and China's tightening intentions also threaten to dampen fragile risk appetite.

Exhibit 5: U.S. Private Payrolls (000s) Heading in the Right Direction



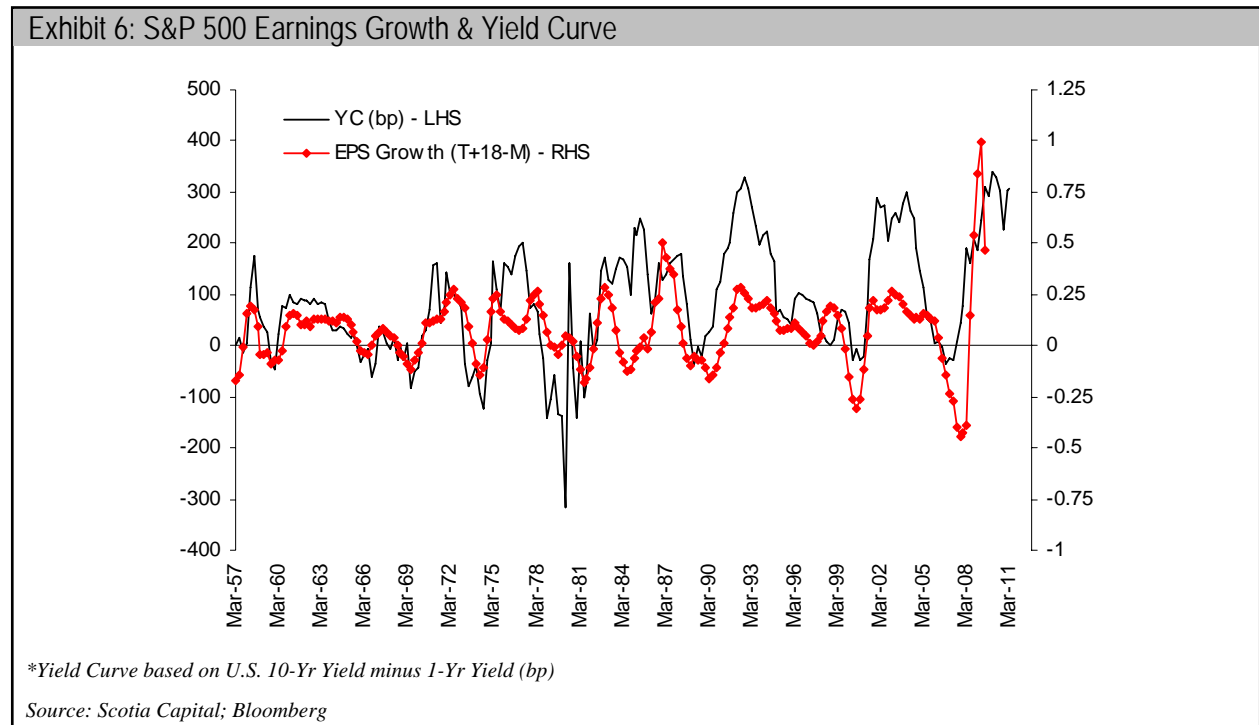
Source: Scotia Capital; Bloomberg

2011 strategy stance

The Federal Reserve recently launched its QE2 program and stimulative monetary conditions should extend throughout 2011 in the United States. The Canadian dollar is expected to strengthen modestly as the Bank of Canada resumes rate hikes in the second half of 2011. Short-term interest rates should stay low, but mean-reverting inflation expectations could push long-term yields higher. We are positioned for U.S. 10-Year yields rising above 3.5% and we expect bond total returns to hover between 2% and 4% in 2011. In our opinion, the risk for bond yields is to the upside if U.S. employment visibility improves. We expect shorter maturities and corporate bonds to outperform.

The 2011 outlook for equities is positive and we expect the S&P 500 to trade in the 1,125-1,325 range. However, investor sentiment will remain vulnerable to myriad challenges and a tactical approach should add value again in 2011. Investors have been through bouts of euphoria and despair in recent months and 2010's volatile equity climate could continue in 2011. In our opinion, the catalyst to sustained improvement in equity sentiment; i.e., a positive reversal in flows that would lift valuations, will materialize when the Fed talks about its exit strategy (rate hikes). In the U.S. mutual fund market, bond flows have reversed and have been negative in the dying weeks of 2010. However, we have yet to witness a positive reversal into U.S. equities.

Our global earnings revisions ratio remains high and we are comfortable with a scenario of sustained profit growth in 2011. A steep U.S. yield curve points to low double-digit profit growth over the next 18 months (see Exhibit 6). Our 2011/2012 earnings estimates stand at \$860/\$925 for the TSX and US\$90/US\$95 for the S&P 500. Our 12-18 month price targets are set at 14,000 for the TSX (15.1x forward P/E) and 1,325 for the S&P 500 (13.9x forward P/E). Based on our revised equity targets, we expect total returns of 10% (TSX +8% in C\$; +12% in US\$, S&P 500 + 8% in C\$; +12% in US\$) in 2011.



From an asset mix perspective, we reiterate our equity over bond preference for 2011. However, the magnitude of our equity overweight recommendation for 2011 is reduced to 58% (was 65% in 2009 and 68% in 2010). Consequently, our Bond suggested weighting increases to 35% (28% in both 2009 and 2010) and Cash settles in at 7%. Globally, Canada, EM (especially LatAm) and the S&P 500 should be preferred to Japan and Europe. In terms of sector strategy, earnings momentum still favours cyclical sectors over defensives heading into 2011. We would overweight Energy, Industrials, and Technology. Risks of additional tightening in China and euro weakness prompt us to start 2011 with a cautious view on Materials. We are raising Financials to overweight to kick off 2011.

Exhibit 7: Scotia Capital Financial Forecasts

Forecasts	2009	2010	2011 E	2012 E
Equity				
S&P/TSX	11,746	13,443	14,000	
EPS	600	700	860	925
S&P 500	1,115	1,258	1,325	
EPS	57.03	83.00	90.00	95.00
Mexico Bolsa	32,120	38,550	41,000	
EPS	1770.24	2,100	2,400	2,600

Source: Scotia Capital estimates

Exhibit 8: Scotia Capital Asset Mix - 2011

	Asset Mix		Change from Focus 2010	Total Return Next 12-M
	Benchmark	Recommended		
Equities	50%	58%	-10%	8-10%
Canada (TSX)	10%	13%		
U.S. (S&P500)	15%	17%		
Int'l (Europe, Japan)	15%	15%		
EM-Asia	6%	6%		
EM-LatAm	4%	7%		
Bonds	45%	35%	+7%	3%
Government	35%	23%		2%
Corporate	10%	12%		4%
Cash (91-D Tbills)	5%	7%	+3%	1%

Source: Scotia Capital estimates

Exhibit 9: Scotia Capital Sector Allocation - 2011

Sector	Recommendation
Energy	Overweight
Materials	Market Weight
Industrials	Overweight
Discretionary	Market Weight
Staples	Underweight
Health Care	Underweight
Financials	Overweight
Technology	Overweight
Telecom	Underweight
Utilities	Underweight

Source: Scotia Capital estimates

10 themes for 2011

The following is a list of guidelines (and reminders) that will influence our strategy in the coming months.

1. The S&P 500 should trade in the 1,125-1,325 range. The risk-on/risk-off mentality kept investors on edge in 2010 and the S&P 500 traded in the 1,025-1,225 range. Looking at bottom-up forecasts for 2011 and 2012, and using the same P/E range, we expect the S&P 500 to trade within the 1,125 and 1,325 levels. We will continue to focus on tactical indicators such as our risk-on/risk-off barometer in order to alter our cyclical exposure.

2. Stay constructive on equities as long as U.S. employment outlook improves. This was our number one asset mix guideline in 2010 and we are sticking to it. If weekly claims fall below the 400,000 “sweet spot” in 2011, the pace of monthly employment growth should accelerate. A pickup in employment is positive for equities, negative for yields, and somewhat supportive for the US\$.

3. Low double-digit earnings growth. Rebounding U.S. leading indicators, high single-digit GDP growth in Emerging Asia, top line expansion, strong operating leverage, share buybacks, and steep yield curves all point to a favourable profit outlook next year. Our global earnings revisions ratio remains high and we are comfortable with a scenario of sustained profit growth in 2011. Cyclical sectors are still posting superior earnings revisions to defensives at this point, and U.S. small cap revisions are also outpacing large cap revisions.

4. Limited P/E expansion. Based on calendar 2011 earnings estimates, the S&P 500 is trading at 13x P/E, two points below its 15x historical average. Sustained bull markets thrive on both EPS and P/E expansion, but until investor sentiment fully recovers from the dreadful secular bear cycle that started in 2000, we see limited contribution coming from valuation expansion for U.S. equities. A reversal in flows would be a catalyst to higher P/Es. In Canada, we could see outright contraction in 2011. The S&P/TSX index is currently trading at a 23% premium to the MSCI AC. There are still many reasons to overweight Canada, but relative valuations are **not** one of them.

5. Stick with the dividend theme. In an environment of low (albeit rising) nominal interest rates and thirst for income (aversion to riskier equities), high-yielding stocks should perform well. With cash balances moving higher, important capital allocation decisions await company boards in coming quarters. Although buybacks and M&A are obvious alternatives for cash redeployment, we believe dividends will become an increasingly attractive option. Dividend increases should also get the best reception from investors with equity sentiment at decade lows, flows searching for comfort (government bonds), and income (corporate bonds and dividends). Moreover, dividends have historically represented a large chunk of equity total returns. Since 1980, roughly 60% of the S&P 500 total return comes from dividends.

6. China policy a bigger risk than U.S. policy. Chinese monetary policy may stay restrictive for most of 2011 and the PBOC could tighten further in order to contain inflation pressures. With inflation running at 4.4% YOY and the PMI index hovering above the 55 level, challenges to the ongoing commodity enthusiasm may be driven more by China than the United States in the first half of 2011.

7. Transitions in monetary policy. De-synchronized monetary policy heavily influenced global leadership in 2010 and we expect it will continue in 2011. China, Brazil, India, and Australia are entering 2011 with a tightening bias, the United States is still in easing mode, and Canada is on the sidelines. The early tightening group underperformed in 2010 and this trend could continue in the early part of next year. By the end of 2011, the early tighteners should move to neutral with the Fed hinting at normalizing its policy (rate hikes). This transition could help stabilize the US\$ and benefit U.S. large caps.

8. NAFTA overweight. Canada, Mexico, and the S&P 500 all outpaced the MSCI World AC index during the “back-to-school” rally and for 2010 as a whole. If U.S. economic worries moderate in coming months, markets that offer proximity to the U.S. recovery should hold their ground. Our global pair-trades entering 2011 are as follows: S&P 500 over China; Canada over Australia; and Mexico over Brazil.

9. Catalyst to narrowing small/large cap valuation spread. Small cap dominance has been ongoing for almost 10 years and the current small cap valuation premium is calling all mean-reversion disciples. Admittedly, the mid-term outlook points to a U.S. large cap resurgence in coming years. In the near term, however, small cap outperformance should last until the Federal Reserve looks to implement its exit strategy. When the Fed starts normalizing interest rates, the 10-year old small cap domination could end.

10. Everybody loves EM. EM economies are posting spectacular GDP growth, and flows are exiting G7 markets for exposure to emerging markets. We believe this is very crowded trade that takes its roots from the notion that developed economies will lag and the US\$ will correct forever. GDP growth in China and Brazil is robust, but those markets have been amongst the worst performing indices in 2010 and have lagged the S&P 500. We prefer the LatAm side of EM for 2011.

Economic Outlook

Debating Points Between Bulls and Bears on U.S. Growth

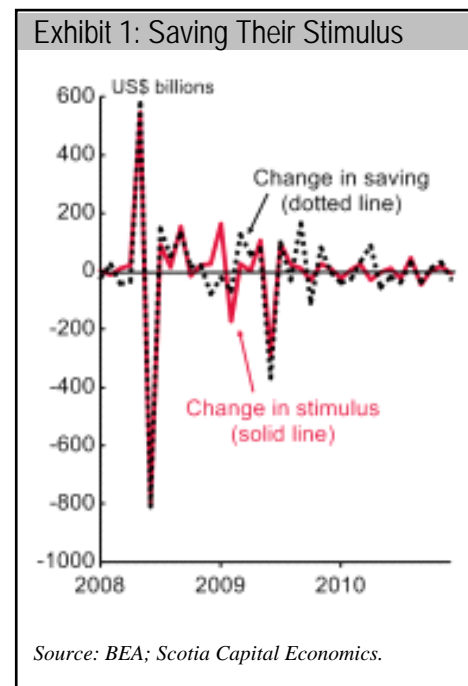
Derek Holt, CFA - Vice-President, Scotia Capital Economics

Gorica Djeric – Financial Markets Analyst, Scotia Capital Economics

While the strongest growth opportunities reside within emerging markets, the one-quarter weighting of the US in world GDP makes US fortunes critically important to assess. To this point, there is a wide variation of forecast opinions on the outlook for the US and global economies over 2011. Scotia Economics sits toward the lower end of evolving forecast opinions at 3.1% compared to the January Consensus Inc low of 2.5% and the high of 3.8% that is now pushing into the over 4% tail. While we don't at all rule out a more impressive performance for the US economy, we are reticent to go with a more bullish forecast at this point given the prevalence of so many persistent unsettled debates. We summarize what we think are some of the major ones below.

1. Will US Consumers Save or Spend Stimulus?

This is perhaps among the most important sources of uncertainty. To date, US consumers have hoarded stimulus offered to them. Witness Exhibit 1 that depicts a one-for-one correlation between changes in monthly saving done by US households, and net monthly changes in stimulus given to households in the form of changes to taxes - like tax cuts or rebate cheques - and direct transfers from governments - like jobless benefit extensions. One of the prime catalysts for upward forecast revisions at many shops was the additional stimulus introduced when President Obama signed into law extensions to jobless benefits, tax cut extensions, and payroll tax cuts. We're asked to believe the literature that speaks to how tax cuts work more powerfully in motivating growth than other forms of stimulus. But the evidence on what people do with such stimulus in a credit-induced recession is very different thus far. That's especially true given that negative real rates are less likely to influence consumers this time around because of today's very different demographics and the hit consumers are still taking to their home values. Our base assumption is that consumers perhaps spend some of the stimulus in driving a modest pace of expansion in consumer spending. More bullish views would attach stronger multipliers to the stimulus.



2. Where Will Consumers Continue To Find Spending Money?

Forget mortgage equity withdrawals in this cycle. That was the surprise factor that kept the last one going so long. But today, US house prices are still 30% lower than at the peak, and Home Equity Lines of Credit (HELOCs) are going nowhere. Thus, with no real housing wealth effect, cash-outs won't be significantly growth supportive. Income gains are also largely absent. The latest nonfarm payrolls report drove that point home, and so did the recent disappointment on jobless claims. Labour market income growth is proxied by growth in hours worked and growth in wages. Total hours worked in the US economy have been largely flat for two months, and are only 0.9% higher than last July. Further, average hourly earnings were only up 0.1% m/m in December, and are 1.8% higher than a year ago.

Some of the funds feeding rising retail sales have been coming from liquidity redeployment. US consumers are recently starting to spend the large amount of stockpiled cash that they put aside during the period of maximum risk aversion (Exhibit 2). In the absence of material job growth, bullish consumer views would argue in favour of more rapid redeployment of such liquidity toward consumption, as well as debt reduction and investment. But there is a limit to how long this can proceed, since it occurs through reductions in the personal saving rate by consuming beyond income gains.

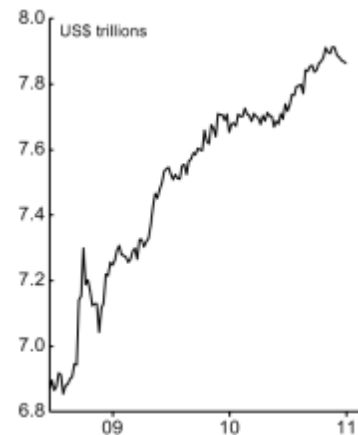
3. A Renewed Or Prolonged Housing Setback?

Housing investment may only be less than 3% of GDP now, but it still plays a vital role in shaping consumer confidence. US home prices are still down 30% from the peak. Whether they rise or fall further is important to judging whether or not consumption may get a hand-up from gradually lessened negative wealth effects on spending. Within Robert Shiller’s December survey of forecasters including ourselves, the most optimistic forecaster assumes cumulative house price gains of nearly 30% by 2015, the most pessimistic is forecasting a further 20% drop, and the median anticipates a cumulative rise of 12%. We sit at 7%. Our assumption is that US shadow housing inventories are so large—and will keep on growing—that this stock of foreclosed but unlisted homes will continue to depress house prices over the longer run. Exhibit 3 depicts the narrow conventional measure of months’ supply that only includes listed product, but then adds back current measures of the shadow inventory that are higher relative to the size of today’s housing market than ever before. The experience of most major global house price corrections is that they take many years to fully run their course. Why raise housing starts when such an inventory overhang exists? Further complicating a housing recovery is that the outlook for bond yields—and hence the critically important 30-year fixed mortgage rate—is bearish in our view due to the long-run outlook for the US fiscal position, and that suggests that buyers will be constrained by rising borrowing costs in taking advantage of depressed house prices.

4. Will Companies Redeploy Their Enormous Cash Hoards?

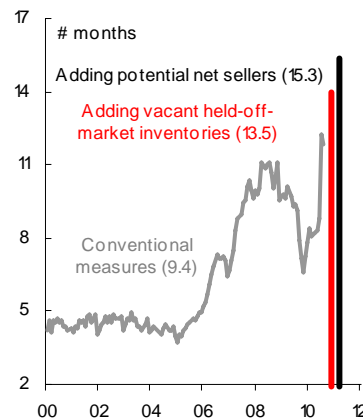
Excess corporate liquidity has never been this high. Exhibit 4 measures the excess level of cash holdings above their long-run average share of total financial assets but expressed in equivalent dollar terms. Bulls are looking forward to aggressive redeployment of such cash positions toward shareholders, hiring, and investment

Exhibit 2: Deposits at U.S. Banks



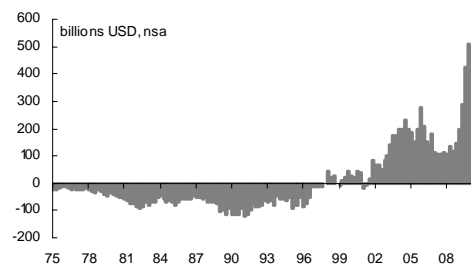
Source: Federal Reserve Board, Scotia Capital Economics

Exhibit 3: Months’ Supply Higher Than Reported



Source: U.S. Census Bureau; Scotia Capital Economics

Exhibit 4: Excess Cash Holdings of U.S. Non-Financial Corporations*



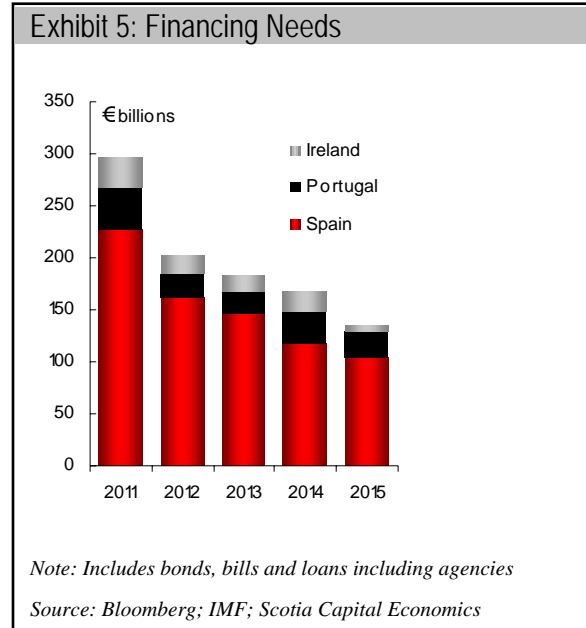
*U.S. non-financial corporations, cash and cash-equivalent holdings, spread between cash-to-asset ratio and the long-term average, expressed in U.S.\$ terms.

Source: FRB; Scotia Capital Economics

activity. Bears think corporate liquidity will remain structurally high for years. We're in the middle, assuming a bit of both, but that ongoing financial market frailties and memory of the credit crunch will have corporations retaining a bias toward preserving liquidity.

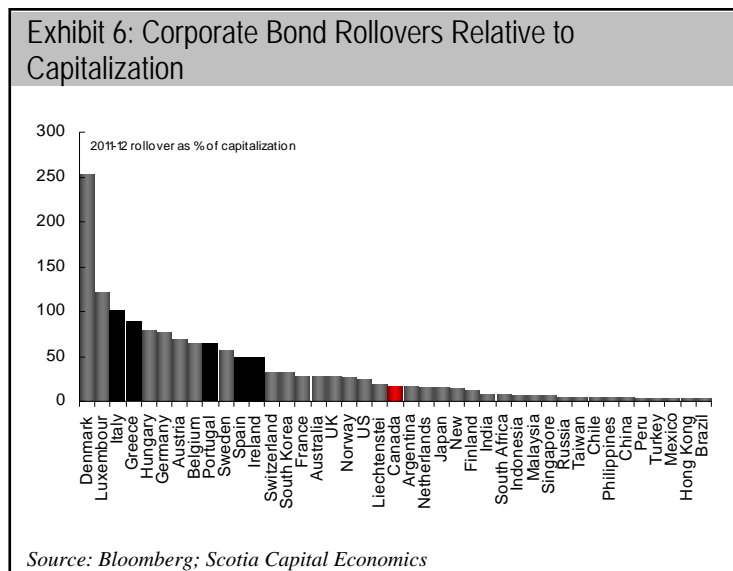
5. Can Markets Handle Rollover Risk?

Perhaps the biggest risk to the outlook is the sheer volume of debt maturing from the peak of the credit cycle that needs to be rolled over into global markets this year. That's true on the sovereign book, across state and local government finances, and at private corporations. Exhibit 5 shows that we expect up to €300 billion in financing needs for just Ireland, Portugal and Spain this year. These beleaguered peripheral economies, however, are only part of a massive global push toward rolling over maturing debt even across major economies. Exhibit 6 demonstrates that Europe also leads the pack in terms of the amount of corporate debt to be rolled over relative to market capitalization. Bulls would argue that the economy can grow fast enough to generate a large enough savings and liquidity buffer to absorb this crunch. We think such forces will be heavily disruptive to global bond markets throughout 2011-12. This is key to the risk trade and hence how supportive financial markets are to the recovery.



6. How Will Markets React To Surpassing The US Debt Ceiling?

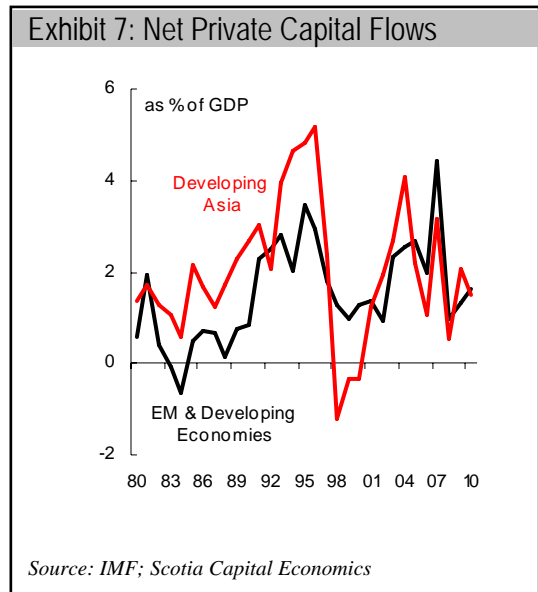
The US government is rapidly approaching its debt ceiling of \$14.3 trillion. It is widely believed that this limit will be reached by Spring, before which Congress will have to approve a higher ceiling or the US government runs sharply disruptive default risk. We are assuming that after horse trading between Republicans and Democrats, Congress will approve a higher ceiling. But with the 2012 Presidential Election in sight, the debate will add to bond market volatility perhaps to the detriment of growth prospects. Longer run, we remain of the view that the US fiscal position is headed down the same path that was once faced by countries like Canada in the 1980s and 1990s. That carries bond bearish



implications that will limit credit affordability and the potential growth of the US economy. The fiscal position is likely to get worse before it stabilizes. We doubt that President Obama's stimulus in the form of payroll tax cuts, extensions to jobless benefits and tax cut extensions will be allowed to expire as planned during a Presidential election year. The stimulus is likely to become quasi-permanent at the expense of the long-run fiscal position and Treasuries. Further, our long-held view that the lagged effects of lower house prices on property tax revenues would ultimately bring state and local government finances forward as a risk to the outlook is on the cusp of materializing.

7. Can Emerging Markets Cope With Capital Inflows?

Surging capital inflows into emerging markets began long before the Fed cut to zero, and longer yet before QE1 and then QE2. Scaled to the size of the developing economies, these capital flows are not disproportionately large (Exhibit 7). In absolute terms, however, they are high and rising. In order to cool inflationary pressures, developing economies are constrained by how far they can tighten monetary policy for fear of attracting even greater capital inflows into economies rife with bottlenecks that could well further ignite inflationary pressures. In order to offset the consequences, it is likely that tighter fiscal policy is required, but this will test the resolve of governments across developing markets with possible implications for the risk trade and hence global growth. We are cautiously optimistic they can adapt to such flows, but view it as a risk to more bullish forecasts.



U.S. Equity Strategy

Time is Right for Investing in the U.S. and Abroad

Paul Danesi, CIM – Director, Portfolio Advisory Group

The Portfolio Advisory Group believes investors should use Canadian dollar strength to build exposure to international markets, both developed and developing. The Canadian equity market lacks depth, offers little exposure to the global economy, and is generally a weak proxy for what would be considered a diversified stock portfolio. The Canadian dollar’s strength against most major currencies over the past year presents an opportunity for investors to diversify their portfolios. Currency movements are notoriously difficult to predict and Canadian dollar strength may not last forever. In the meantime, investors have an attractive currency which they can use to shop for foreign assets. We understand investors are often reluctant to venture into foreign markets however we firmly believe the benefits outweigh the risks in the long run.

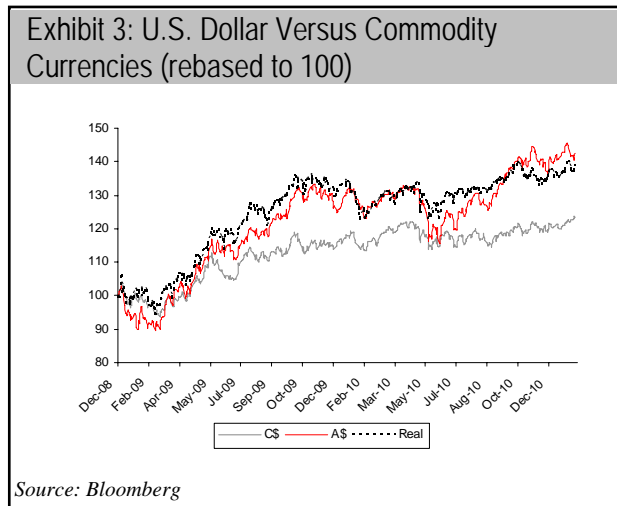
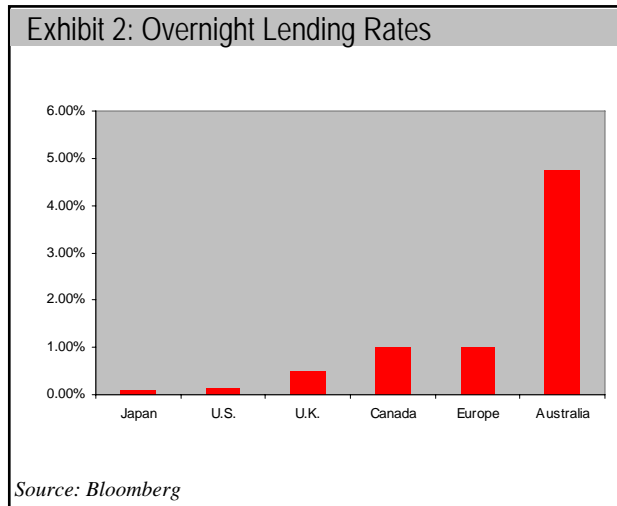
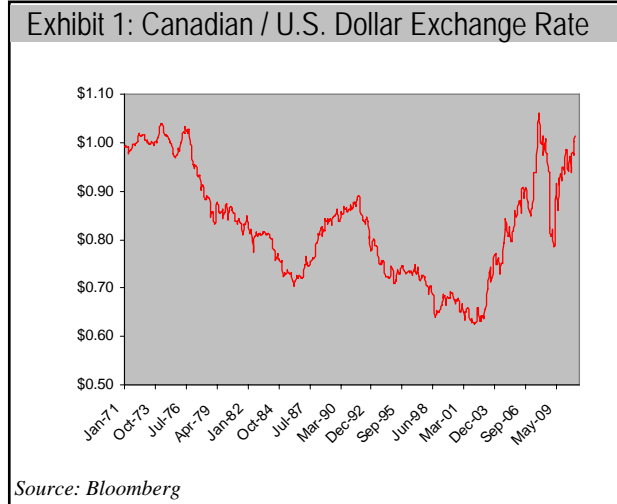
Foreign Currency Fluctuations and U.S. Dollar Weakness: Many Moving Parts

While there is a long list of factors driving capital flows in foreign exchange markets,

- Ongoing global economic recovery
- Strength in commodities markets
- Interest rate differentials and the quest for yield
- Carry trade dynamics
- Growing interest in global currency diversification among central banks
- Intensified government intervention in currency markets

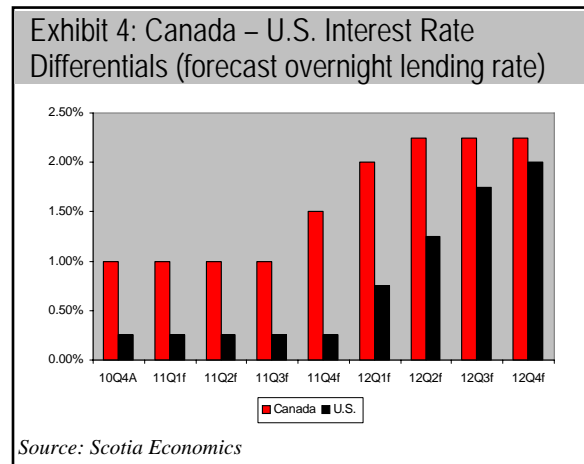
Canadian dollar strength has largely been a function of U.S. dollar weakness.

The U.S. dollar is undergoing a structural decline driven by improving prospects for the global economy, low interest rates, and demand for higher yielding emerging market assets. Improvements in the global economy particularly emerging markets and growing interest rate differentials make the U.S. dollar less attractive. Commodity-based currencies including the Aussie dollar, Brazilian real, and our Canadian “Loonie” have been some of the strongest globally.



The flow of funds out of the U.S. is heightened by interest rate differentials among G20 nations. In December 2008, in response to the housing driven financial crisis, the U.S. Federal Reserve quickly lowered its benchmark Fed Funds Target Rate to 0.25%, where it has remained since. The Fed Funds Target Rate is below that of other central banks with the lone exception being Japan. With financial markets having stabilized and economic growth rebounding, Australia, Canada and a handful of other central banks have begun tightening monetary policy. Scotia Economics does not envision a shift in U.S. policy until the first quarter of 2012, which will only serve to widen the gap.

The U.S. dollar is also being used as a funding currency for carry trades whereby investors capitalize on lower U.S. borrowing rates, and then sell U.S. dollars to invest in higher yielding assets whether bonds or stocks denominated in other currencies, or commodities. The process depresses the value of the borrowed currency, in this case the U.S. dollar. This is essentially what investors were doing for years in Japan. Monetary authorities in Japan slashed interest rates and flooded its system with money back in the 1990s when its real estate and stock market crashed. However, businesses and consumers were reluctant to borrow. Instead, investors borrowed from Japanese banks to fund investment elsewhere.

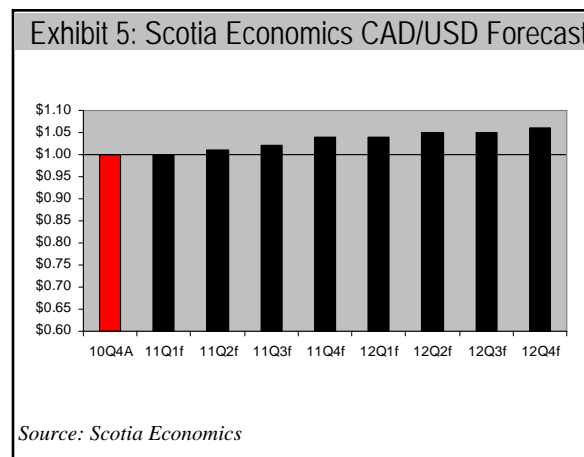


There is a growing crisis of confidence with U.S. economic policies and the country’s deteriorating fiscal situation. The financial crisis has unmasked underlying structural weaknesses in the U.S. economy, most notably American’s propensity to spend beyond their means. This new reality has forced a multi-year period of deleveraging. The U.S. government has thrown more than two trillion dollars at the financial system to stabilize the economy and asset prices, and prevent spiralling debt deflation. More recently, the U.S. Federal Reserve embarked on a second round of quantitative easing with the planned purchase of US\$600 billion worth of government debt. The U.S. is currently running a federal budget deficit in excess of US\$1 trillion. As of December 31, 2010, total public debt outstanding was greater than US\$14 trillion, or 96% of 2010 GDP. Mounting fiscal deficits and escalating public debt are eroding confidence in the dollar. Longer-term investors worry political pressures could hasten the removal of stimulus and create significant inflationary pressures.

Currency Forecast

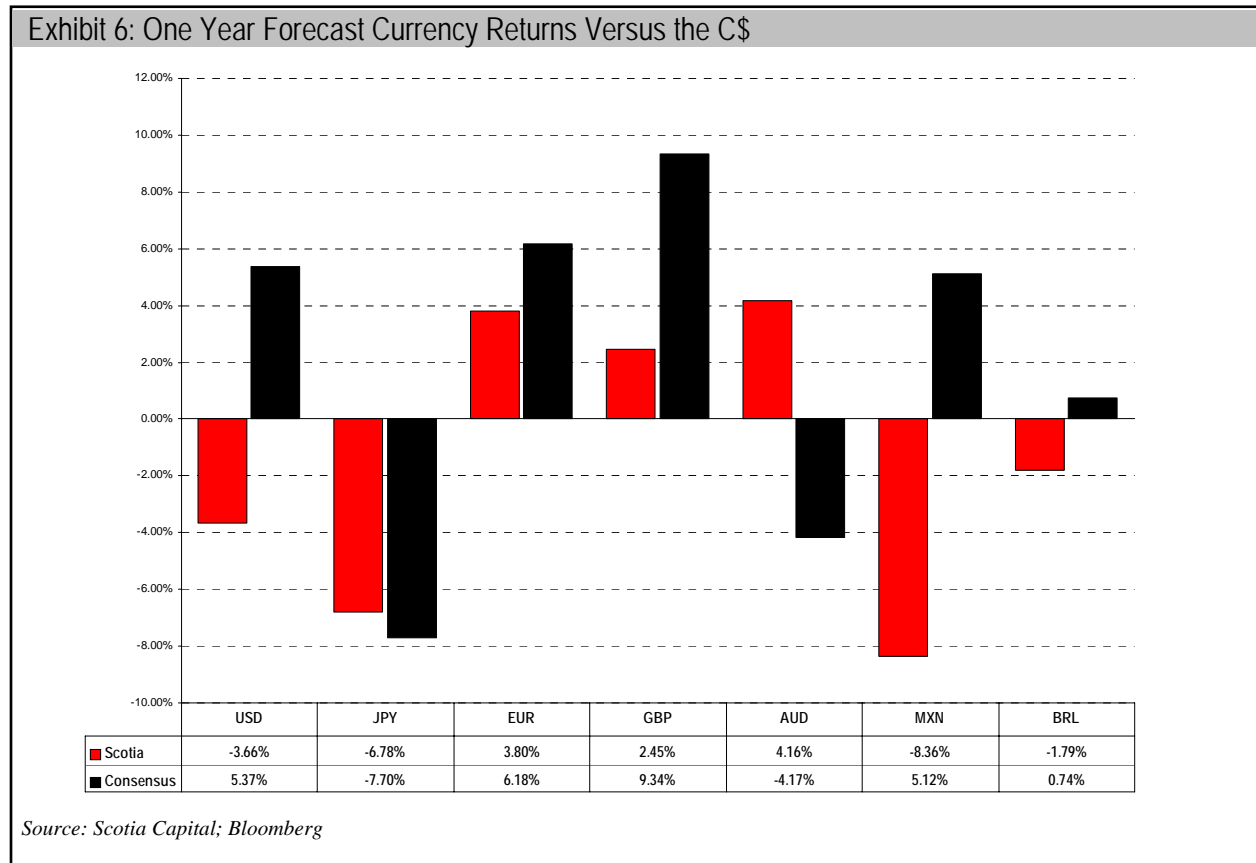
As we begin the year, the Canadian dollar was making an effort to push through parity. In their January outlook, Scotia’s foreign exchange team noted the dollar appears more comfortable at par than at any other time over the past three years.

The overriding theme behind the move remains U.S. dollar weakness reflecting the country’s loose monetary policy, an ongoing deterioration in the country’s fiscal position, and a strong desire to diversify away from the dollar. The U.S. has embarked on a second round of quantitative easing to ward off deflation. Currency is like a commodity, where excess supply puts downward pressure on its price. Periods of risk aversion could drive investors temporarily back to U.S. dollar-denominated assets, but the trend vis-à-vis the Canadian dollar is one of continued weakness.



Traditional drivers of the Canadian dollar are also favourable. Economic fundamentals position Canada ahead of the U.S. with Canadian consumers, housing, and our financial system on more solid footing. The medium-term outlook for commodity prices looks solid. The current consensus forecast for WTI oil calls for the commodity to average U\$87 per barrel in 2011 rising to U\$106 per barrel in 2013, again supportive of our dollar.

The stronger outlook for commodities and foreign investors desire to diversify their currency exposure has been to the benefit of commodity currencies including the Canadian dollar. The chart shows expected one year returns for a number of currencies vis-à-vis the Canadian dollar.



Although downward pressure on the U.S. dollar is likely to persist in the near term, we do not foresee a collapse in the currency. Such a scenario would require the greenback to lose its status as the primary global reserve currency or its ability to function as a global monetary standard, neither of which appears likely. The U.S. dollar remains the most widely used currency for international settlements. Even the “dollar crisis” that led to the collapse of the Bretton Woods system in 1971 did not undermine the dollar’s role as a global monetary standard and reserve currency. The loss of status as either a reserve currency or as a monetary standard would create significant dislocations in the global economy and financial markets.

Conclusion

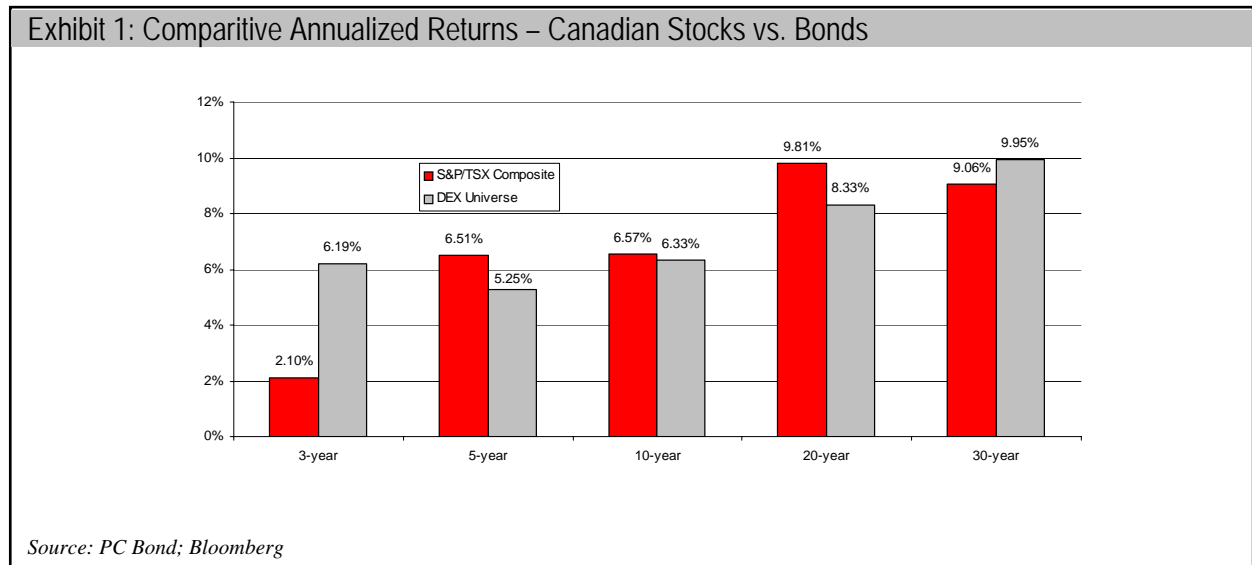
The Portfolio Advisory Group believes investors should consider building exposure to international markets. The strength of our dollar will not last forever and is creating an attractive entry point for long-term investors willing to venture into foreign markets. Clients should speak with their ScotiaMcLeod advisor to determine appropriate asset allocation strategies and security selection. For those still uncomfortable with the idea of foreign currency risk, there are always currency hedged ETFs and mutual funds to consider.

Fixed Income Strategy

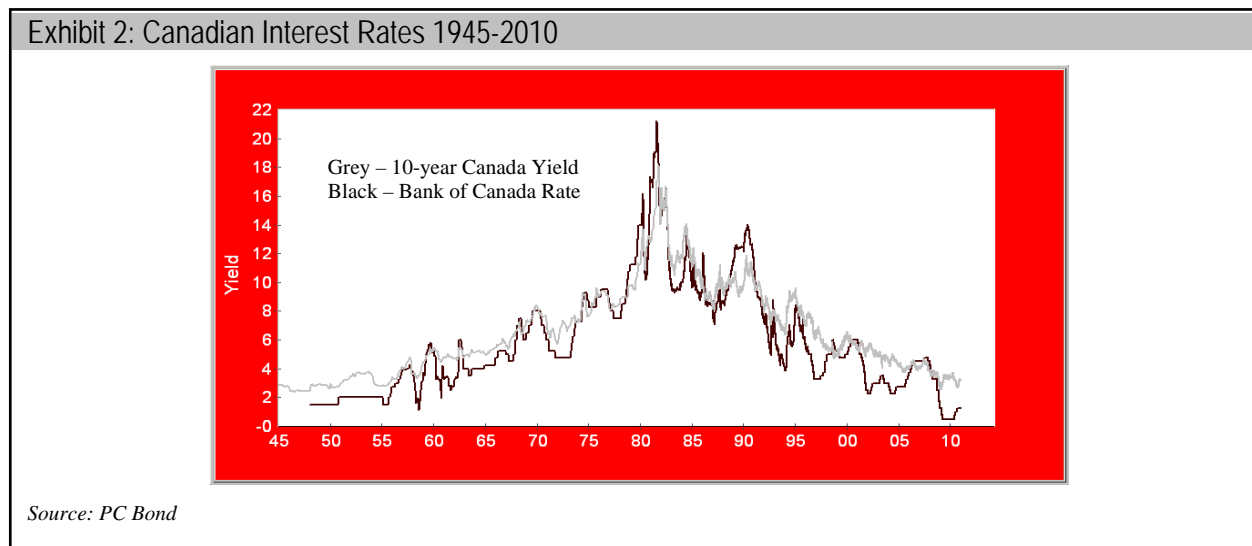
What Works in the Canadian Bond Market

Joey Mack, CFA — Director, Portfolio Advisory Group, Fixed Income

Over the past 30-years, the DEX Universe Bond Index has produced a total return of 1,621%, or 9.95% on an annualized basis. Surprising many investors, this index, which has been comprised of over 70% government bonds, has outperformed the 9.06% annualized total return from the S&P/TSX Composite Index over the same time period. Furthermore, returns have been much less volatile. The standard deviation of returns on Canadian stocks has been 16.78% over this period, whereas the standard deviation of returns on the DEX Universe was only 7.69%.



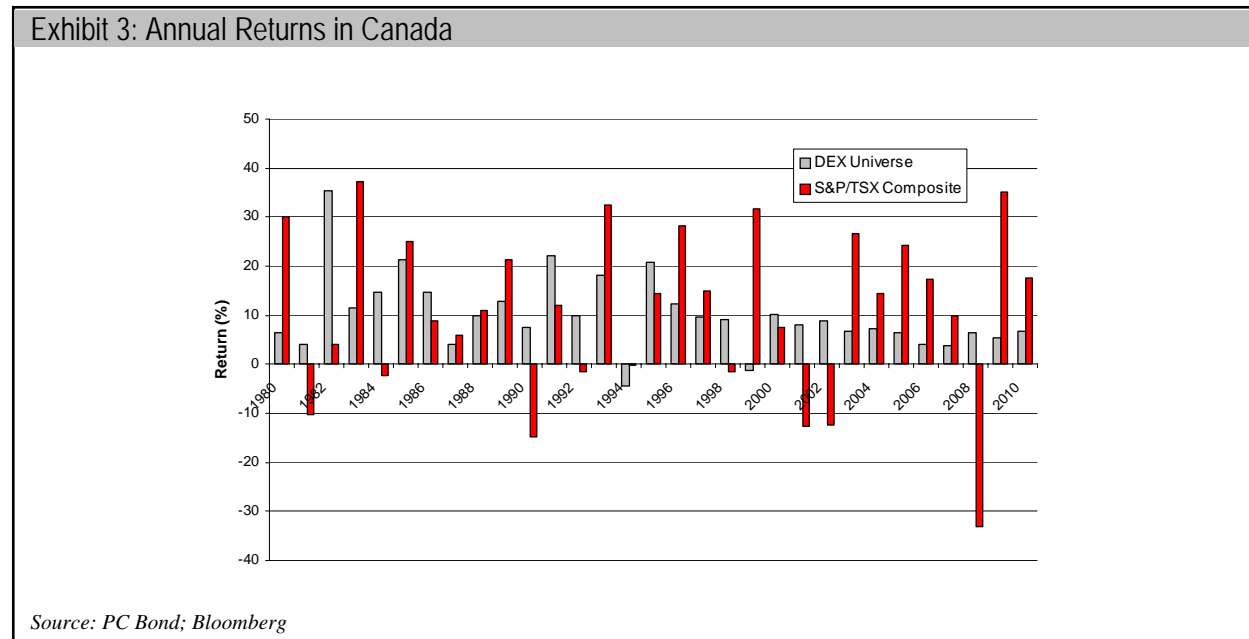
However, these returns come on the back of the greatest bond market rally in recorded financial market history. After peaking at 21.24% in August, 1981, the Bank of Canada rate reached an all time low of 0.5% in 2009. Longer-term bond yields have also fallen significantly, with the 10-year Government of Canada falling from 18.14% in September 1981 to the recent low of 2.53% in March 2009 (the all time recorded low for 10-year Government of Canada bonds was 2.39%, set in June, 1946).



If we look back over the past half century, which also includes the greatest bond bear market in recorded financial market history, the Long Bond Index (the precursor to the current benchmark DEX Universe Index, for which we only have data back to 1980) provided an annualized return of 8.7%, versus 10.1% for the S&P/TSX Composite. Stocks have outperformed bonds, but bonds have still provided substantial returns, and have easily exceed inflation, which averaged 4.15% over the period.

Balance is Key – In Your Life and Your Investments

Nonetheless, bonds have continued to provide great diversification to stock portfolios, with very low correlation – in many years when bonds had outsized returns, this accompanied negative returns in bond markets.



Indeed, a portfolio split evenly between the S&P/TSX Composite Index and the DEX Universe Bond Index would have provided the following returns in comparison to a 100% stock portfolio, and with the following volatility, as measured by the standard deviation of annual returns:

Exhibit 4: Returns vs. Volatility

Returns	Returns			Volatility	Volatility		
	S&P/TSX Composite	DEX Universe	50/50 Split		S&P/TSX Composite	DEX Universe	50/50 Split
3-year	2.10%	6.19%	5.35%	3-year	35.35%	0.69%	17.50%
5-year	6.51%	5.25%	6.68%	5-year	25.42%	1.37%	12.52%
10-year	6.57%	6.33%	7.05%	10-year	21.30%	1.59%	10.36%
20-year	9.81%	8.33%	9.47%	20-year	17.48%	6.38%	9.55%

Source: ScotiaMcLeod

In addition to bonds outperforming stocks for the past three years, a balanced portfolio actually outperformed a 100% stock portfolio over the past 10 years, and did so with half the volatility. Even over the 20-year period, a portfolio split 50% between stocks and bonds, and rebalanced every year, would have provided 97% of the return of a 100% stock portfolio, and with a much less volatile return profile. Hence, with their low volatility, combined with their low correlation, and solid returns, bonds definitively deserve a place in every investor’s portfolio.

However, some sectors are more highly correlated than others. The following table highlights the correlation of the various sectors of the Canadian bond market in comparison to the S&P/TSX Index.

Correlation between bonds and stocks overall is very low, but corporate bond returns are still much more highly correlated to stocks than, for example, Canada bonds, which actually have negative correlation. This continues to argue for including government bonds in portfolios, not just corporate bonds and GICs.

Exhibit 5: Canadian Bond Market Comparison to S&P/TSX Composite

	S&P/TSX Composite
Universe	0.08
Canada	-0.03
Provincial	0.10
Corporate	0.24
Short	-0.03
Mid	0.08
Long	0.14

Source: ScotiaMcLeod

Bond Market Returns

For all investors, it is important to understand what have been the key drivers of returns in bond markets. The following table highlights the returns on the overall market, and key segments of the market, over the past 25 years.

Exhibit 6: Overall Market Returns

	Universe	Short	Mid	Long	Canada	Provincial	Corporate
3-year	6.19%	5.53%	7.45%	6.81%	5.45%	6.06%	7.74%
5-year	5.25%	4.93%	5.94%	5.58%	4.92%	5.35%	5.85%
10-year	6.33%	5.27%	6.82%	7.78%	5.83%	6.76%	6.88%
20-year	8.33%	6.91%	8.67%	10.10%	7.89%	8.87%	8.83%

Source: PC Bond

Over the past 20 years, long-term bonds have outperformed short-term bonds, and provincial and corporate bonds have outperformed government of Canada guarantees. This is not a significant surprise, with the downward move in rates supporting the outperformance of longer maturities, and the additional yield afforded by provincial and corporate bonds driving superior returns. What is somewhat surprising is that the top performing sector over the past 20 years was provincial bonds, not corporate bonds. However, this is primarily the result of the longer average term to maturity of provincial borrowings during the period of declining rates – over shorter time periods, without the significant drop in yields as a tailwind, corporate bonds have indeed outperformed provincials.

This does nonetheless highlight a key error most retail investors in fixed income securities make – although they are inclined to select the additional yield from provincial and corporate bonds, they tend not to invest in maturities over five years. This naturally leads to underperformance – the table highlights how the short index has lagged the performance of the broad market significantly. Further, the short corporate index, which includes all liquid corporate bonds with maturities no greater than five years, posted an average annual total return of 7.41% over the past 20 years, lagging the broad market return of 8.33%.

This is a natural argument for mutual funds – with investors not extending term, but perhaps willing to buy into a professionally managed fund, they may be able to achieve better returns over the long run than they would on their own.

However, the track record of mutual fund managers over the past 20 years does not fully support this view. The following table highlights the returns of the DEX Universe Index in comparison to the average performance of Canadian Fixed Income mutual funds tracked by Morningstar, the performance of the top funds that have been in existence throughout this entire period, as well as the performance of some simple strategies that any individual investor can follow – buying a 5-year or 10-year laddered bond portfolio, or simply buying a 10-year Government of Canada or Province of Ontario bond, and rolling it in to a new 10-year bond every year (a “bullet” strategy).

Exhibit 7: Overall Market Returns

	Universe	Morningstar Canadian Fixed Income	Top Mutual Fund	10-year Ladder	5-year Ladder	Canada Bullet	Ontario Bullet
3-year	6.19%	5.61%	6.65%	6.18%	4.97%	5.52%	5.61%
5-year	5.25%	4.29%	5.31%	5.37%	4.60%	4.91%	4.85%
10-year	6.33%	5.00%	6.24%			5.94%	5.98%
20-year	8.33%	6.40%	8.19%			8.03%	8.15%

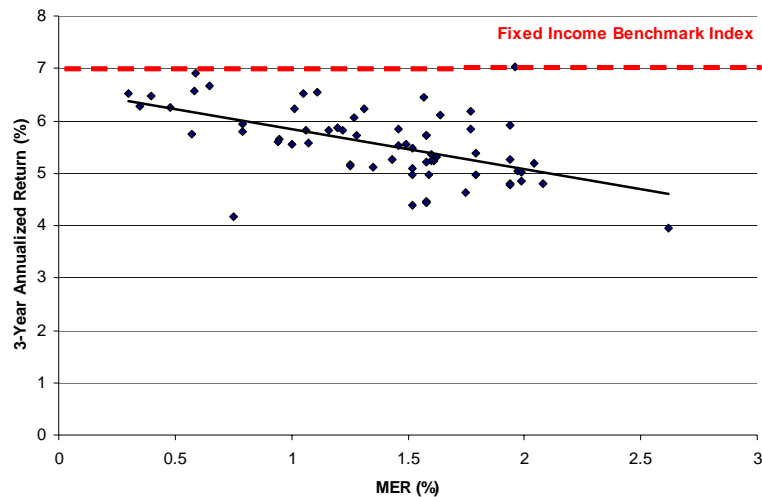
Source: PC Bond; Bloomberg; ScotiaMcLeod

On average, mutual funds have lagged the performance of the DEX Universe by 1.2% over each of these time periods. The key reason? Fees. The average MER of the funds was 1.4%. Although managers have added value, they have not added enough to outperform their benchmark consistently. Even the top performing funds have not been able to overcome their fee hurdle, lagging the DEX Universe Index over longer time periods.

This is most evident in the following chart, which presents the performance of Canadian Bond mutual funds over a three-year period, plotted against their management expense ratios (MER) and compared to the DEX Universe Overall Bond Index.

Passive vs. Active Investing

Exhibit 8: Bond Fund Performance and Management Expense Ratios (MERs) - Data as of June 30, 2010



Source: Globe Investor/PC Bond

The black line is a regression line, a tool used to illustrate relationships and forecast outcomes. This line suggests that a definitive relationship exists: the higher the expense ratio, the lower the expected return. This is intuitive, especially in the current low yield environment.

The dotted line represents the performance of the DEX Universe Bond Index. Of note, only one fund outperformed the index, and only marginally while another fund was able to match the return of the index; in addition, only a few other funds came close to replicating the return of the index – some pursuing active management, some passive indexation strategies.

Outperforming the DEX Universe Bond Index has proven difficult to accomplish. Consistently and accurately predicting the direction of interest rates, the shape of the yield curve, the level of credit spreads, or what instruments will outperform over time, is very difficult.

The relationships shown in the chart above provides the cornerstone of our investment philosophy – a disciplined, low cost, balanced approach not only makes sense but also has proven to be highly successful in generating the consistent returns required from the fixed income portion of a portfolio.

Interestingly, the passive, simple to follow 10-year ladder and bullet portfolios have provided returns that not only compare fairly well versus the DEX Universe Index, but also substantially outperformed the universe of actively managed Canadian fixed income mutual funds. True, these numbers do not include any fees, but based on ScotiaMcLeod's recommended portfolio management fees and/or commission schedule, these strategies should have incurred investment expenses well below the 1.4% MER on the actively managed mutual funds.

Importantly, however, the 5-year ladder did underperform the index, and also slightly underperformed the average mutual fund – further underscoring the need for investors to take a longer-term view towards their investments, and indeed extend term to at least the 10-year time period in order to capture the greater returns available in the marketplace.

Conclusion

Reviewing past performance, both from a return standpoint and in relation to stocks, we have four key recommendations for Canadian investors.

- 1. *Have exposure to fixed income*** – The returns from fixed income in Canada have been substantial, and have not lagged equities to the degree most investors think. We do not believe this relationship will change, and hence, bonds deserve a place in every portfolio. Further, a balanced approach historically has provided comparable returns but much less volatility than a 100% stock portfolio.
- 2. *Extend term*** – Most investors are unwilling to buy bonds with a maturity of more than five years. This has been a dire mistake. Although the current low level of rates may give some investors pause, it is important to remember that equities have also had a period of outsized returns over the past half century, and more muted returns are expected from all asset classes going forward. Furthermore, extending term almost always results in higher yields.
- 3. *Overweight provincials and corporates, but don't exclude Canadas*** – Most individual investors are not actively trading their fixed income positions, and hence do not require the liquidity of government of Canada guarantees. Instead, they should focus on higher yielding provincial and corporate securities. Government of Canada guarantees should not be ignored, however, as they provide stronger performance during periods of equity market weakness.
- 4. *Follow a low cost passive approach*** – The use of low cost ETFs or mutual funds that track the performance of the DEX Universe Index, or following a laddered portfolio approach, will provide investors with solid returns over the long run. These strategies have substantially outperformed actively managed portfolios in the past.

Tax Strategy

Year Round Tax Planning

Adam Salahudeen, L.L.B – Director, Taxation Advisory Services

Nobody likes to spend more time than is necessary thinking about their taxes or for that matter on the often described “mundane” exercise of preparing one’s tax return. However, as a matter of course it is a proven fact that organizing your taxes throughout the year and reviewing on a quarterly basis will allow and enable you to manage your taxes and affairs far more efficiently.

Traditionally, year round tax planning has been a front and back loaded strategy throughout the year; that is, there is usually a higher degree of tax planning during the first quarter of the year leading up to the April 30th filing date, and near the end of the year as Canadians rush to planning before the year end of December 31st.

The three key messages that Canadians need to follow in order to manage the tax burden are very simple.

1. Be proactive!
2. Don’t procrastinate!
3. Change the mind-set, take control of your finances and plan accordingly!

Some Interesting Facts

Just before last year’s RRSP contribution deadline passed, there was a study conducted by TNS Canadian Facts for Scotiabank, which asked investment decision-makers how they would allocate a hypothetical \$1,000 tax refund and found that the typical person would allot about a third of their refund to pay off debt, while an equal proportion (33 per cent) would be put into a savings account or into investments.

The emphasis placed on debt repayment as well as building up one’s savings and investments pointed to an overall desire on the part of Canadians to attempt to rebalance their personal balance sheet as the economy slowly continues to improve. Depositing one’s tax refund in an RRSP for tax deferral on income in the year ahead is a tried and tested strategy.

Regarding the upcoming tax season, the study also found that many Canadians are turning their attention to their tax returns and the tax credits available to them:

- Four out of five of those surveyed indicate they have or plan to take advantage of available tax credits this year.
- The charitable tax credit is the most widely used (49 percent) followed by the home renovation tax credit (38 percent) and the medical expenses tax credit (36 percent).

Another strategy noted was an attempt to optimize both savings and investments by allocating a portion of your refund to a Tax-Free Savings Account (TFSA). This way, you can invest after-tax dollars to earn tax-free growth throughout your lifetime and also have the flexibility to withdraw funds at any time without penalty.

Year Round Strategies

Taking Advantage of Available Deductions & Tax Credits

To that end, one of the first steps in building a proper tax preparation plan, is to be aware of all available deductions and tax credits. Canadians should try to be mindful of any changes to relevant tax legislation as it can in some instances have a positive effect on the savings opportunities available to them.

Know What Credits and Deductions You are Eligible For

Non-refundable tax credits are a known means of reducing your taxes owing. By adding a checklist of all available deductions and tax credits to your plan and combined with proper research, Canadians can reduce their taxes owing and put more dollars back into their wallet.

A brief list of some of the tax credits that one should be considering taking advantage of in preparing a 2010 tax return are:

- The Children's Fitness Tax Credit. For children under the age of sixteen, the government of Canada allows a non-refundable tax credit of up to \$500 per year/child. This is based on eligible fitness expenses paid by parents to register a child in a prescribed program.
- Charitable Tax Credit
- Student Tuition
- Public Transit Tax Credit
- First Time Homebuyers' Tax Credit

With regard to deductions, one of the most widely used eligible deductions claimed by Canadians is moving expenses; The general rule is that when an individual moves from one city to another, the issue that often arises is whether related moving expenses are deductible for tax purposes.

In order for moving expenses to be deductible, the expenses must be "moving expenses." The move must be an "eligible relocation." An eligible relocation is defined to be a relocation that enabled the taxpayer to:

1. Carry on a business or to be employed at a new location in Canada; or
2. Be a student in full-time attendance enrolled in a program at a post-secondary level at a location of a university, college or other educational institution.

Both the old and the new residences must be in Canada. The distance between the old residence and the new residence must be at least 40 kilometres. Once it has been determined that an eligible relocation has occurred, the next point is whether the expenses paid are moving expenses for tax purposes.

Expenses included in the definition of moving expenses are:

1. Travel costs, including a reasonable amount for meals and lodging;
2. The cost of transporting or storing household effects;
3. The cost of meals and lodging for a period not exceeding 15 days;
4. The cost of cancelling a lease;

ECO Grants and Rebates

Furthermore, Canadians would do well to know that the Federal Government has offered many grants and rebates for improving the energy efficiency of their home and for when they purchased fuel efficient vehicles. There are also many incentives provided at the provincial level as well that you may be eligible to taking advantage of for your 2010 tax return.

Lastly, let's turn our attention once again to the concept of receiving a tax refund. Did you know that your tax refund represents an interest free loan that you have given to the government?

Plan on Not Receiving a Refund for 2012

Did you know that if you make regular RRSP contributions throughout the year, you can reduce your taxes immediately, rather than having to wait until you file your tax return? This can be done by simply filing a request to reduce tax deductions at source (T1213) with the Canada Revenue Agency and you are closer to seeing more money in your wallet come paycheque time. These extra funds will make it easier for you to maximize your RRSP contribution target throughout the year, instead of having to scramble at the last minute, as most Canadians tend to do.

In order for you to have your source deductions reduced, you must file a Form T1213, Request to Reduce Tax Deductions at Source with the Canada Revenue Agency.

Note: You must file this form every year on an ongoing basis. You can submit this form with your tax return if you are owed a refund, or if you enclose a payment for the whole amount you owe to the CRA. Otherwise, you must wait until you have paid your account in full before you can file.

Here's how you file the request to reduce source deductions and what you will need to provide the CRA. Provide proof that you have set up a pre-authorized contribution plan for your RRSP and contact your bank/broker and ask to set up a "pre-authorized contribution plan" (PAC) for your RRSP. With a PAC in place, your banker/broker will be able to automatically withdraw your RRSP contribution from your bank/brokerage account each month. It is very important to set up an actual PAC simply because you will have to submit a copy of your signed PAC along with your T1213 to CRA when you ask to have your tax deductions reduced.

Contact information for your employer's payroll administrator: When you fill out the T1213 you will be asked to provide contact information of your employer's payroll administrator. This is the person in accounting or human resources who is responsible for withholding source deductions and remitting them to the CRA. You will need to provide the name, telephone, and fax number for this individual as CRA will need to contact them directly once they've decided to authorize your reduction of taxes at source.

Furthermore, you must provide all relevant information as it relates to your tax return information. Make sure you don't forget to have child care or support payments attached as proof of your expenses or your support order. If you have made charitable donations you will need to attach copies of your receipts. If you have interest or carrying charges you will need a statement from the lender confirming the purpose of the loan and the amount of interest paid.

You're almost there. Once you've set up your regular RRSP contribution, paid any outstanding taxes, and gathered all of the requisite information simply mail in or fax your form T1213 to a CRA office nearest you. To find a tax centre near you, visit the CRA's tax service office contact page and search in your province.

The commentary and/or information provided herein should not be construed as legal or tax advice. Clients are strongly encouraged to seek the expertise of independent professionals, such as tax, legal and accounting experts prior to the final implementation of any strategy. Only after a diligent analysis of the client's needs, objectives and financial position and tolerance for risk can an appropriate recommendation be made.

Mutual Funds

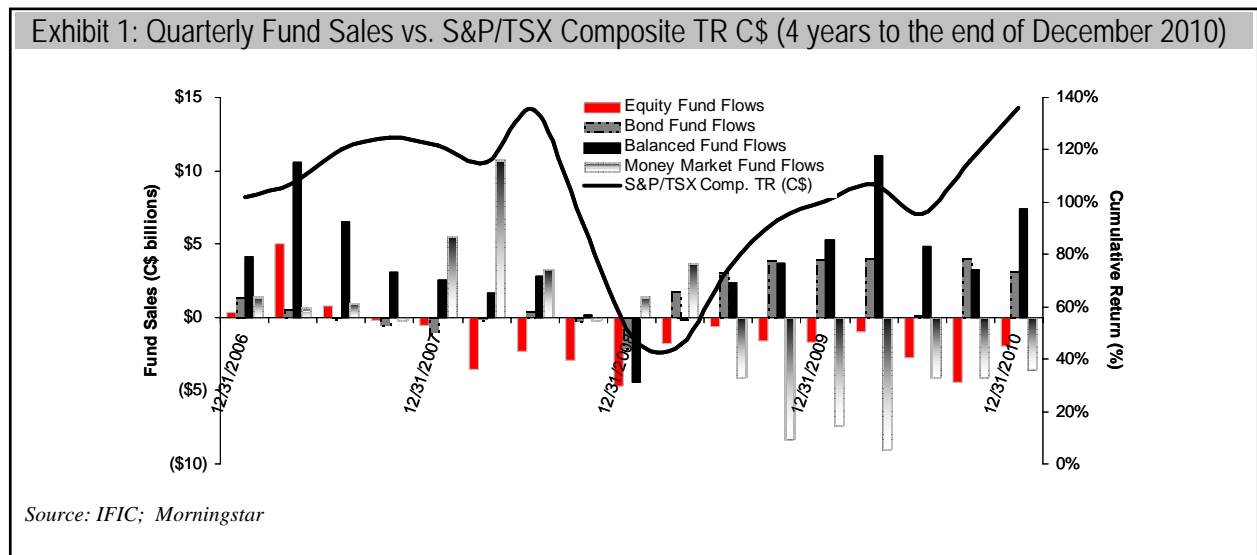
Staying the Course in 2011

Joel Beriault– Associate, Portfolio Advisory Group, Mutual Fund Research

2010 proved to be another interesting year. European debt problems along with sub-par growth in developed countries all contributed to volatility in markets around the globe. In spite of these factors, most world equity markets ended the year on a positive note. The S&P/TSX Composite Total Return Index was up 17.61% for the year, and the S&P500 Total Return Index finished the year with a return of 15.06% (all figures in local currency).

Despite positive returns in major markets, investors continue to be deeply affected by the volatility, as evident in retail mutual fund flows in 2010. At first look, month to month net redemptions in money market funds appear to be a positive sign. However, when we dig a little deeper, we can see that investors had not yet committed to pure equity funds as the majority of the money market proceeds went into high interest savings accounts, balanced funds and fixed income funds. Fear remains the main driver of investor decisions.

From Exhibit 1, referring to the market return (solid line) we can see the S&P/TSX continuing its upward trend since hitting a low point in March of 2009. We can also see a trend of outflows from equities and money market funds in favour of balanced and bond funds. In 2010, equity funds experienced minimal net new sales only for the first two months of the year. In the first quarter of the year, balanced funds accounted for approximately 75% of the net new sales followed by bonds funds at 25%. In the second and third quarters, the trend continued with balanced funds accounting for over 97% and 46% respectively of the new net sales. Additionally, in the first two quarters of 2010, money market funds experienced net redemptions of \$11B compared to net sales of \$10.5B for high interest savings accounts. As a result, we continue to see a consistency with historical patterns - as we are well into the recovery phase, we continued to see inflows towards low yielding investments followed by balanced funds and fixed income funds. This trend indicates investors are still clearly hesitant to purchase equity funds. It is evident investors continue to bet against the market, but sound investment principles still apply – stay invested, stay diversified, and ensure investor’s goals and objectives are in line with their risk tolerance.



Volatility and sub-par growth are expected to continue into 2011. Vincent Delisle, Portfolio Strategist of Scotia Capital stated that if extreme volatility has been a trademark in 2010, a “sub-par recovery in developed economies, the U.S.’s excessive monetary stimulus campaign, China’s tightening bias and Europe’s debt problems” are all themes that will contribute to the continuity of market volatility heading into 2011. In this environment, we feel choosing the *right* professional money manager is more important

than ever. With attractive investment opportunities more difficult to come by, we believe the talent and experience of the fund managers on the ScotiaMcLeod Mutual Fund Recommended List provide investors with a selection of fund managers we believe have the propensity to outperform on a risk-adjusted basis over time based on their disciplined investment processes.

In this edition of IPQ, we will review some of the key themes from 2010, and look ahead to what we expect for 2011 before delving into a few ideas on how to position your portfolios in the coming year.

Themes from 2010

Equity Mutual Fund Categories Leading the Pack in Returns. For a second consecutive year, most major world equity markets have been positive. This in turn favoured equity focused mutual fund mandates. In 2010, the top performing mutual fund categories had primarily equity mandates continuing the trend from 2009. The *Precious Metals* category, mainly led by the surge of gold and silver prices, led the way in 2010 followed by the *Natural Resources* category. Another theme in 2010 was the surge of small cap companies – the results apparent in small to mid cap mandates accounting for 4 out of the top 10 performing mutual fund categories.

Fear and Anxiety. If in 2009, investors were baffled regarding the direction to take with their investments, much of the same behaviour was apparent in 2010. Government stimulus packages were put into motion which has helped to spur activity; however, there are several questions that remain. Although stock market volatility was expected to persist in 2010, major stock markets were up for the second straight year. So what is preventing investors from reinvesting in equities? For one, the media is quick to highlight every small piece of negative news regarding the economy thereby spreading the fear. Emotions continue to play into financial decisions and amplify the negative perceptions of the economy. As a result, many investors succumb to the short-term pressures and deviate from their long-term investment strategies. In the past, the average investor was more likely to base their investment decisions on rational expectations of the market performance when establishing their investment goals. Today, because the recession did a lot of damage to the psychology, investors no longer talk about their expectations of their investments long-term growth potential but rather they have been reacting more emotionally and instinctively to the short-term ups and downs of the market.

The Search for Higher Yielding “Safe” Investments. Notwithstanding the positive returns of global markets, investors seemed to have lost some confidence in the stock markets in 2010. Over the 12 months ending November 2010, more than two-thirds of new net sales went to balanced funds and the remaining sales directed mainly towards fixed income funds. At the same time, equity funds experienced more than \$6.5B in net redemptions and almost \$20B was redeemed from money market funds as investors searching for slightly higher yielding “safer” money favoured “High Interest Savings Accounts”. Don’t let the name fool you. “High” interest savings accounts are currently yielding anywhere between 1.0% to 1.5% - after inflation the returns can be close to or less than zero percent. Obviously investors seem to follow the perceived safe approach and stayed out of equity funds. Expectations have been low since the end of the recession and investors are waiting for clear indications that the global economy is improving and markets can sustain consistent growth.

Looking Ahead to 2011

There is still a widespread misconception among investors that the health of the economy is directly related to the performance of the stock market. In fact, there is little evidence that the stock market causes the economy to rise or fall. The direction of the market is rather dependent on individual’s collective anticipation of what is about to happen in the economy. The stock market does not directly affect the economy yet investors continue to base their investment decisions on (in most cases) the health of their local economies. There are two major drawbacks from this practice: 1) investors do not believe it is possible to get good returns on their equity investments when the economy is growing at a slower pace and as a result continue to shy away from equity funds until the economy improves thereby foregoing potentially attractive returns and 2) they tend to generalize the poor health of their domestic economy to the entire world economies.

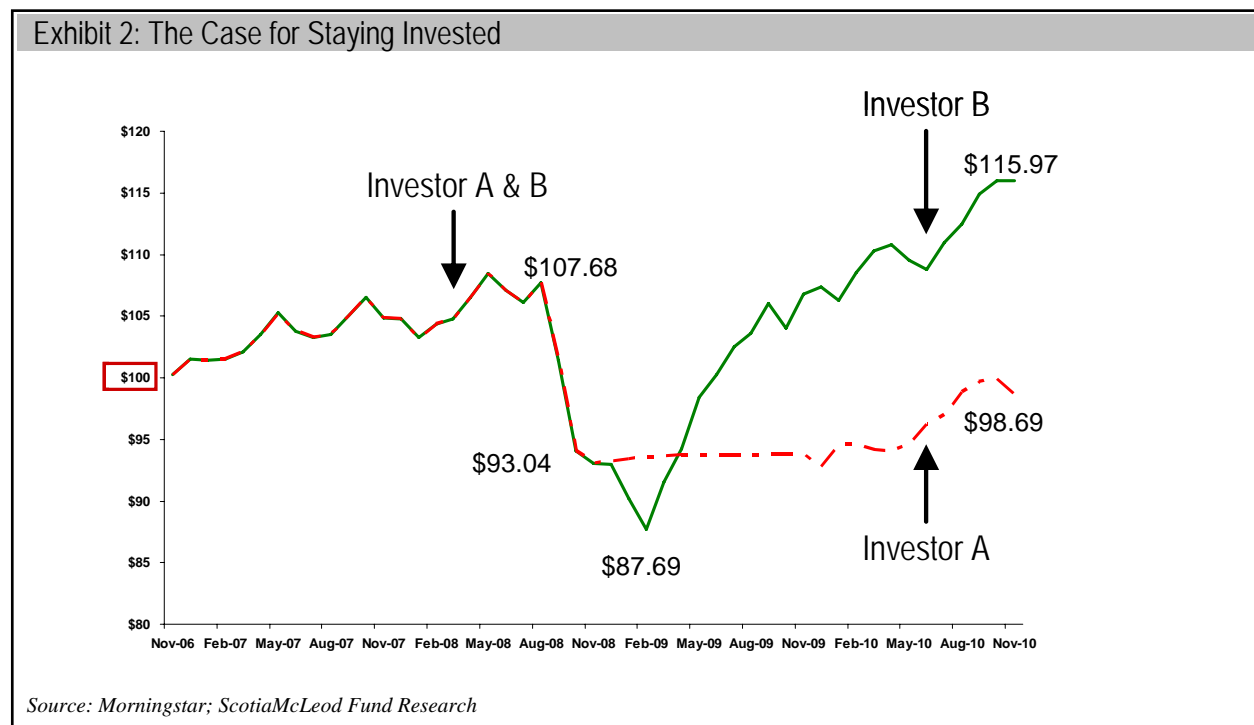
We continue to hear about investors who were not prepared to deal with the volatility experienced since the recession. The danger with this loss of confidence by the investors is the risk of not meeting their investment objectives or goals. With a large cohort of investors in or near their baby-boom years, it's a good time to sit down and re-evaluate their investment parameters. One caveat to this statement is that many investors may have to revisit their investment objectives and risk tolerance levels to ensure they are aligned. Ultimately, investors need to be reminded about basic investment principals such as being diversified, staying invested and being disciplined in the execution of an investment strategy.

Strategy Ideas for 2011

So what does all of this mean as we move forward into 2011? How should investors be positioning their portfolios? As investors, it is important to understand and be conscious of the behaviour of the equity markets in the short term however confusing the markets can be, however also to keep in mind are the longer-term investment objectives. We suggest investors keep their investment goals simple and focus on the things they can control such as ensuring they are at the right risk level.

Review Your Investment Policy Statement “IPS”. One major challenge for investors is to not react emotionally when stock markets exhibit short-term volatility. One common reaction is to either chase appetizing equity returns when the markets are up or alternatively invest in what is perceived as “safer” investments such as money market funds. Unfortunately safe investments pay interest income and interest rates are still close to the historical lows. One disastrous consequence of this “emotional” investing can be investment objectives not being met. To prevent a disconnect between investment goals and risk tolerance versus current investment holdings, it is essential to review and update if required investor’s IPS on a regular basis.

Stay invested. We understand the urge to try and time the market. The prospect of being “right” on timing the market can be very rewarding. It’s no secret however, that no one can consistently time the market, and realistically, it very seldom happens. So as challenging as it is to stick to the principle of staying invested, it is vitally important to do so in combination with executing a disciplined, unemotional investment strategy. We highlight a fairly simple example in Exhibit 2 below.



Both Investor A and Investor B were invested in the same balanced fund prior to the market downturn. However, like so many investors did near the market bottom, Investor A sold out of the balanced fund at the end of 2008 and went into a money market fund. Feeling more confident the same investor switched their investments into a bond fund at the end of 2009. Investor B, on the other hand, remained invested in the fund. As you can see in the chart, while Investor B's holdings were affected by the market downturn, by not panicking and continuing to stay the course, Investor B was able to participate and benefit from the market rebound. While Investor A's initial move to a money market fund avoided the remaining downside that Investor B experienced, Investor A's portfolio did not benefit from the market recovery and continues to earn near zero returns.

Investors must realize the risk and opportunity costs of sitting on the sidelines in cash-like investments waiting for the ever-elusive "opportunity to get back in". In most instances, the opportunity to get back in has long since past – as evidenced by the significant increase in equity fund purchases while markets are at or near the top. By waiting on the sidelines, investors can miss long periods of sustained recovery which will make it extremely difficult for their portfolio to meet their long-term objectives.

The importance of global diversification. Historically, equities have been an effective inflation hedge. The case for global diversification is as strong as ever. Most major equity indexes have rebounded from their lows in early 2009 and provide great buying opportunities for investors. On one hand, many of the largest corporations of the world are based and trade in Japan or Europe but mostly in the U.S. In fact, close to 30 per cent of the world's top companies in terms of market capitalization reside in the U.S. Furthermore, a large majority of these firms are multi-nationals (for example Coca-Cola, Microsoft, Walmart, etc.) and are expanding to take advantage of the emerging countries' growing demand. On the other hand, it is important not to neglect the equity markets in the more dynamic economies around the world. Emerging market economies in 2011 are expected to continue strongly; supported largely by a growing middle-class, increasing domestic demand and rising infrastructure investments. In addition, most governments and consumers from emerging countries are not as leveraged as their developed countries counterparts which should add to the positive conditions.

Summary

As much as we'd like to speculate what will happen in 2011, no one really knows. Whether up, down, sideways or a combination of all three, it is more important than ever to find Portfolio Managers that can find value regardless of the direction of the market. In terms of portfolio positioning, we will always go back to the sound investment principles that we have discussed in this newsletter – be diversified, stay invested, and stick to a disciplined investment strategy that fits your objectives and risk tolerance levels. It's not exciting or sexy, but it works.

Given the challenges of the last couple of years, it may be worth re-visiting your investment objectives and risk tolerances with the intention of either reaffirming if you still have the right strategy that matches your objectives and risk tolerance level, or perhaps make a few adjustments as necessary. Given the events of the last few years, many investors have been completely turned off of the market, and may have learned their risk tolerance levels were not as aggressive as they once thought. Please consult your ScotiaMcLeod advisor to assist you in the planning and execution of your investment strategies and objectives.

For conservative income-oriented investors, opportunities we like are Income-Oriented funds, such as the Dynamic Strategic Yield (recently added to the 2011 ScotiaMcLeod Mutual Fund Recommended List) and CI Signature Income and Growth Funds. As part of a diversified portfolio, these funds are relatively low volatility solutions focused on sourcing the best yield opportunities.

For more aggressive investors with longer time horizons, you may want to consider greater emphasis on global and/or emerging market opportunities such as the Hartford Global Leaders Fund, AGF Emerging Markets and Dynamic Far East Value Funds, again, as part of a diversified portfolio.

In each case, the ScotiaMcLeod Mutual Fund Recommended List is a great resource for well-managed funds that we feel have the ability to outperform over time. The Guided Portfolios, which are diversified portfolios comprised of funds from the Recommended List is another great resource for investors to use.

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 a dedicated Portfolio Manager with oversight from 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 through holding a portfolio of stocks comprised of industry leaders with unique franchises and strong management teams, combined with an attractive trend in profitability.

ScotiaMcLeod Canadian Core Guided Portfolio

Performance Update

Building on the momentum which began in late August, Canadian equities delivered solid returns in the fourth quarter in the wake of indications from the U.S. Federal Reserve that their next monetary policy move likely included another round of quantitative easing. Investors interpreted this pending policy initiative as supportive of higher prices for all assets including commodities and equities; combined with largely positive Q3 earnings announcements, this resulted in higher stock prices. Although the trend for equity markets was largely positive during the quarter, the upward move did pause somewhat during November as concerns surrounding the sovereign debt crisis in Europe, and specifically the necessity of a financial aid package for Ireland, led to swings in market sentiment, impacting global equities in addition to credit, currency, and commodity markets. Ultimately the Fed confirmed its intention to pursue a \$600 billion asset repurchase program, (otherwise known as quantitative easing or “QE2”), in an effort to bolster the economic recovery and perhaps more importantly, combat the growing risk of deflation, leading to a very strong equity market in December.

One of the policy objectives of quantitative easing was to lower long-term interest rates in an effort to promote economic growth. Ironically, although rates did decline in anticipation of the new policy initiative, once enacted, bond yields began to rise again. The back up saw the yield on 10-year US Treasuries increase from a low of 2.38% in October to 3.29% at year-end. Higher interest rates tend to be a positive catalyst for the life insurance stocks, not only regarding profitability, but also for share price performance. This partially explains the rally in lifeco shares during the quarter as **Manulife Financial** rebounded due to its higher leverage to interest rate changes in addition to its previous steep share price decline. Among portfolio holdings, **Great West Lifeco** shares jumped 4%, while **Sun Life Financial** advanced 12%.

The Canadian Core Guided Portfolio generated a total return of 11.3% during the quarter, outperforming the benchmark S&PTSX60 Index which advanced 8.3% on the same basis. For all of 2010, the portfolio advanced 14.4%, outperforming the benchmark which was up 13.8%. Nine of ten sectors posted positive returns during the quarter with greater gains found among more cyclically oriented sectors. The strength in commodity prices supported significant outperformance within the Materials and Energy sectors. Gold bullion futures closed at an all-time high of US\$1421/oz., advancing almost 9%, while the S&PTSX Gold Index increased 7% for the quarter and shares of portfolio holding **Barrick Gold** moved higher by 12%. As mentioned, most commodities advanced as the CRB Commodity Price Index, a broader measure of industrial and agricultural commodities, rallied 16% during the period, following an 11% increase in the prior quarter. Crude oil futures moved higher by 14% in the quarter, while copper futures jumped 22%, closing at a record US\$4.45/lb. For the second quarter in a row, shares of **Teck Resources** and **Talisman Energy** were among the top performing holdings, advancing 46% and 23% respectively. In addition to the strength in copper, **Teck's** advance also came in reaction to the increase in the price of coal due to supply shortages resulting from flooding in Australia, a dominant supplier of coal used for steel making. The flooding, and consequently the supply disruption for coal, is expected to impact coal markets through 2011. Other top performing resource holdings during the quarter included **Canadian Natural Resources** which climbed 25%, and fertilizer play **Agrium Inc.**, which moved higher by 19%.

Despite declining in the month of December, **Research In Motion** shares advanced almost 16% during the quarter on improving investor sentiment, strong corporate earnings, and the anticipated launch of the new “Blackberry Playbook” tablet device designed to compete with **Apple’s** “iPad”; the new product is expected to be released in February. Only four holdings declined in value during the quarter, with the only move of consequence being **Rogers Communications** which fell over 10% in the period; the bulk of the share price decline occurred after the company reported disappointing Q3 earnings results which demonstrated evidence of current competitive pressures in the wireless business.

For 2011 we expect equity markets to trend higher; however, similar to the choppy nature of the economic recovery, we anticipate stock prices will continue the uneven trading pattern observed over the past two years. Given the equity market rally experienced since late August, much of the earnings growth anticipated in 2011 may be priced in already and we remain mindful of the threat of a modest pullback in stock prices. Although numerous obstacles continue to serve as potential risks to the market’s positive momentum, most of these negative factors have been known by the market for some time and are not new. The positive influence of strong corporate earnings, healthy balance sheets, and reasonable valuations are supportive of equities. From current levels we would expect modest capital appreciation over the coming year. Stocks are likely to remain rangebound, trading within a broad price band, exhibiting a series of higher lows, and higher highs. This potential for ongoing volatility, combined with a low interest rate environment supports the dividend investment theme that provided a counter force to the cyclical strength exhibited during 2010.

Changes

Late in the quarter we switched holdings in the Energy sector: selling the position in **Nexen Inc.** and buying units of **ARC Energy Trust**. **Nexen** has been a holding in this portfolio for several years and its performance has been nothing short of disappointing. Although the company’s valuation invariably appears to be cheap relative to its peers, and has during the holding period shown signs of promise in terms of growth potential, the company has consistently failed to execute on their strategies, and thus disappointed investors, justifying the discount valuation in the process. Although it is impossible to predict when the company might turn things around and begin to live up to expectations on a sustained basis, we believe the market will be slow to reward the stock with multiple expansion in the short term. We believe investors are better served by holding a different Energy stock with a proven track record of growth and management execution, hence the switch out of **Nexen Inc.** into **ARC Energy Trust**.

ARC Energy Trust, (effective January 1, 2011 the Trust converted to a dividend paying corporation, operating as **ARC Resources Ltd.**), is an oil and production company, with a focus in Western Canada. **ARC’s** operations include production generated either through acquisition or development of the company’s own resource-play opportunities. Future growth prospects include the development of conventional oil and natural gas production from their significant land positions and long-life reserve base, as well as the potential to add production through acquisition as “value-added” opportunities become available. The current asset portfolio is reasonably balanced with production in 2010 expected to be leveraged 57% to natural gas.

ARC is a defensive investment within the Energy sector by virtue of its attractive and sustainable current dividend yield, and offers a measure of share price support and protection for investors during periods of energy and stock market volatility. As of the third quarter, **ARC** holds approximately \$2.4 billion of tax pools and the company does not expect to be taxable until 2014. The current management team has largely been in place for approximately ten years and has earned a reputation for solid execution, on both acquisitions but also operational and capital efficiency. The company’s balance sheet is solid with 2010 estimated debt/cash flow at 1.4x, forecast to decline to 1.0x in 2011.

Exhibit 1: ScotiaMcLeod Canadian Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Dec-10	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
Bank of Nova Scotia	BNS	2-SP	Low	\$57.10	\$72.00	\$1.96	3.4%	30%
Brookfield Asset Management	BAM	2-SP	Low	\$33.21	\$35.75	\$0.52	1.6%	9%
Fortis Inc.	FTS	3-SU	Low	\$33.98	\$34.50	\$1.16	3.4%	5%
Great West Lifeco	GWO	3-SU	Medium	\$26.40	\$28.00	\$1.23	4.7%	11%
Rogers Communications	RCI.B	2-SP	Low	\$34.60	\$39.00	\$1.42	4.1%	17%
Royal Bank of Canada	RY	2-SP	Low	\$52.24	\$65.00	\$2.00	3.8%	28%
Sun Life Financial	SLF	1-SO	Medium	\$30.11	\$37.00	\$1.44	4.8%	28%
Toronto Dominion Bank	TD	1-SO	Low	\$74.25	\$100.00	\$2.44	3.3%	38%
Consumer Products:								
Thomson Reuters Corporation	TRI	1-SO	Low	\$37.24	\$45.00	\$1.22	3.3%	24%
Industrial Products:								
Canadian National Railway	CNR	1-SO	Medium	\$66.35	\$80.00	\$1.30	2.0%	23%
Research In Motion	RIM	1-SO	Medium	\$58.07	\$130.00	\$0.00	0.0%	124%
Resource:								
Agrium Inc.	AGU	1-SO	High	\$91.50	\$111.00	\$0.11	0.1%	21%
Arc Resources Ltd.	ARX	1-SO	High	\$25.41	\$28.00	\$1.20	4.7%	15%
Barrick Gold	ABX	1-SO	Medium	\$53.12	\$78.00	\$0.47	0.9%	48%
Canadian Natural Resources	CNQ	2-SP	Medium	\$44.35	\$44.00	\$0.30	0.7%	0%
Crescent Point Energy Corp.	CPG	1-SO	High	\$44.19	\$47.00	\$2.76	6.2%	13%
Suncor Energy	SU	2-SP	Medium	\$38.28	\$41.00	\$0.40	1.0%	8%
Talisman Energy	TLM	8-CS	Medium	\$22.12	\$25.00	\$0.25	1.1%	14%
Teck Resources Ltd.*	TCK.B	Not Rated	n/a	\$61.79	\$70.00	\$0.60	1.0%	14%
TransCanada Corp.	TRP	1-SO	Low	\$37.99	\$48.00	\$1.68	4.4%	31%

*Currently Scotia Capital does not provide research coverage - target price based on consensus data.

Source: Scotia Capital; Bloomberg.

ScotiaMcLeod Canadian Income Plus Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

As a result of the strength exhibited by the heavily weighted resource stocks during the fourth quarter, the Financial sector lagged the broader market and as a result, dividend stocks as measured by the Dow Jones Canada Select Dividend Index also materially underperformed. Due to the high weighting of Financials within the benchmark (60%), and the relative underweight position in the Income Plus Portfolio (47%), the portfolio might have been expected to outperform as well; however, declines in several non-financial holdings contributed to overall underperformance of the portfolio during the period. The portfolio generated a total return of 2.8% for the quarter while the benchmark increased 4.4% on the same basis. For all of 2010, the portfolio was up 12.3% versus 13.3% for the benchmark.

Financial stocks delivered a mixed performance during the quarter as life insurance shares, as described in the commentary for the Canadian Core Portfolio, advanced due to changes in capital markets, but also on better than expected third quarter earnings reports. Bank earnings however provided varied results with **Bank of Nova Scotia** and **National Bank** both exceeding expectations, with their respective stocks advancing 4% and 6% in response, while **Bank of Montreal** and **Royal Bank** each disappointed investors with their earnings report and their stocks declined 3% and 2% in reaction.

Following a very strong move higher in the previous quarter, shares of **Shaw Communications** dropped 6% on news regarding senior management changes and uncertainty surrounding the company's plans for rolling out their wireless business. The top performing holding during the period was **Crescent Point Energy** which jumped almost 17% on the strength in oil prices and in recognition of management successfully executing on their strategy.

Changes

No changes were made to the Canadian Income Plus Guided Portfolio during the fourth quarter. We will continue to monitor all current holdings to ensure that they represent the best potential return available within the eligible investment universe of companies. We seek to make investments in companies that demonstrate a combination of both above-average income and growth characteristics. The current yield of the portfolio as of the end of the quarter is 4.1%.

Exhibit 2: ScotiaMcLeod Income Plus Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Dec-10	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
Bank of Montreal	BMO	2-SP	Low	\$57.48	\$68.00	\$2.80	4.9%	23%
Bank of Nova Scotia	BNS	2-SP	Low	\$57.10	\$72.00	\$1.96	3.4%	30%
Fortis Inc.	FTS	1-SO	Low	\$33.98	\$34.50	\$1.16	3.4%	5%
Great West Lifeco	GWO	3-SU	Medium	\$26.40	\$28.00	\$1.23	4.7%	11%
National Bank of Canada	NA	1-SO	Medium	\$68.52	\$90.00	\$2.64	3.9%	35%
Rogers Communications Inc.	RCI.B	2-SP	Medium	\$34.60	\$39.00	\$1.42	4.1%	17%
Sun Life Financial	SLF	1-SO	Medium	\$30.11	\$37.00	\$1.44	4.8%	28%
Toronto Dominion Bank	TD	1-SO	Low	\$74.25	\$100.00	\$2.44	3.3%	38%
TELUS Corp.	T	2-SP	Medium	\$45.48	\$50.00	\$2.10	4.6%	15%
Toronto Dominion Bank	TD	1-SO	Medium	\$74.25	\$100.00	\$2.44	3.3%	38%
Consumer Products:								
Shaw Communications	SJR.B	1-SO	Low	\$21.35	\$26.00	\$0.92	4.3%	26%
Thomson Reuters Corp.	TRI	1-SO	Low	\$37.24	\$45.00	\$1.22	3.3%	24%
Resource:								
Crescent Point Energy Corp.	CPG	1-SO	Low	\$44.19	\$49.00	\$2.76	6.2%	17%
Enbridge Inc.	ENB	1-SO	Low	\$56.27	\$66.00	\$1.96	3.5%	21%
TransCanada Corp.	TRP	1-SO	Low	\$37.99	\$48.00	\$1.68	4.4%	31%

Source: Scotia Capital; Bloomberg.

ScotiaMcLeod U.S. Core Guided Portfolio

Stephen Uzielli - Portfolio Manager, Portfolio Advisory Group

Performance Update

U.S. equity markets ended 2010 with a positive fourth quarter characterized by a weak November sandwiched between a solid October and the best December performance for the benchmark S&P500 Index since 1991. Investors appeared to be willing to overlook the many risks that threaten a sustainable economic expansion and were more inclined to look “across the valley” of economic recession as most economic data shows signs of improvement. In a demonstration of the market’s enthusiasm, U.S. equity markets along with the MSCI World Index closed the year at their highest levels since the demise of Lehman Brothers in September of 2008.

In addition to the monetary policy moves made by the U.S. Federal Reserve during the quarter, U.S. mid-term elections at the beginning of November saw the Democrats hold on to leadership of the Senate while losing control in the House of Representatives, leading to a potentially “gridlocked” Congress which could severely hamper the Obama administration’s efforts to advance new policy and regulatory initiatives. Despite these issues however, investors were encouraged during the period by another season of better than expected earnings results for the third quarter and expectations for increased holiday spending which enhanced the traditionally positive December performance.

For the quarter, this portfolio exceeded the performance of the S&P500 Index, generating a total return of 13.1% versus the benchmark at 10.8% on a similar basis. For all of 2010, the portfolio advanced 17.0%, outperforming the benchmark which was up 15.1%. Nine out of ten major sub-indices moved higher in the quarter while all but one of the portfolio holdings also generated positive returns. Similar to the previous quarter, the so-called “risk trade” was back on again for most of the quarter as investors favoured cyclical or more economically sensitive sectors over more defensive investments. Also in a repeat of the third quarter, the top performing portfolio holding for the period was **Freeport McMoRan Copper & Gold** which advanced 41% in synch with the price increase in its key sources of revenue, namely copper and gold. Similarly, Energy stocks also performed well with shares of **ExxonMobil Corp.** and **Occidental Petroleum** advancing 18% and 25% respectively. **Fluor Corp.** shares suffered a big drop in October but rallied in November and December, resulting in a 34% total increase for the quarter. Although trading has been volatile, the stock tends to move in tandem with Energy stocks; a number of analysts suggest the company is at an inflection point for winning new contract awards. With 51% of revenue generated outside the U.S., **Fluor** also benefits from recent weakness in the U.S. dollar.

The only holding to post a decline during the period was **Cisco Systems** which fell 8% for the quarter, having recovered somewhat from lower levels, after reporting a solid Q1 but providing guidance for Q2 and the full fiscal year suggesting revenue growth below expectations; the company cited weak demand from public sector clients as well as short-term challenges in Europe. This is the second quarter in a row that **Cisco** management delivered negative guidance and we suspect the company is being overly conservative in its outlook, a trait they have demonstrated previously.

Changes

In November we made a switch in this portfolio: out of **Wal-Mart Stores (WMT)**, and into **PepsiCo, Inc.** **WMT** had been a holding in this portfolio since 2005 and during that time frame outperformed the broader market index. During 2008 and the global recession, consumers and investors flocked to **Wal-Mart** and the company’s shares were one of the best performing stocks among S&P500 constituents. Recently however, the stock has underperformed the market and the Consumer Staples sub-sector due to a deteriorating outlook for the company. Despite all the positive defensive characteristics that have made **WMT** such an attractive investment vehicle over the years, it has become evident of late that it will be progressively more difficult for the company to sustain historical growth rates due to a more competitive retailing environment and the sheer size of **WMT** as an enterprise. As **WMT**’s growth rate has slowed over the past few years, so too has the multiple of earnings that investors are prepared to pay for **WMT**

shares, hence the multiple compression observed, both in relative and absolute terms. **WMT** shares appear to be fairly valued in this context and thus we were compelled to sell our holding and switch into another Consumer Staple stalwart **PepsiCo, Inc.**

PepsiCo, Inc. (PEP) is the number 2 carbonated soft-drink maker in the world with operations all over the globe, selling a wide range of food and beverage products in over 200 countries. In 2010 the company acquired its two largest bottlers giving the company control over most of its North American bottling and distribution volume. The acquisition of the company's two major bottlers has already generated both top line and bottom line improvements due to substantive cost savings. Owning bottling operations gives management better operating control and should enhance profitability. **PEP** reported Q3 earnings in early October, in line with expectations while generating 15% year over year growth, and guiding toward 11-13% growth for all of 2010. **PEP** shares trade at a significant discount to rival **Coca Cola** while earnings are growing at a faster pace. It is currently one of the least expensive consumer oriented stocks in the U.S. market. **PEP** trades at a 3.0% dividend yield and the five year dividend growth rate is 13.7% per annum.

Exhibit 3: ScotiaMcLeod U.S. Core Guided Portfolio

Sector	Symbol	Rating	Risk Ranking	Price 31-Dec-10	Target Price	Dividend	Dividend Yield	Potential ROR
Interest Sensitive:								
AT&T Inc.	T	Outperform	Low	\$29.38	\$35.00	\$1.72	5.9%	25%
MetLife, Inc.	MET	Outperform	Medium	\$44.44	\$52.00	\$0.74	1.7%	19%
State Street Corp	STT	Outperform	Low	\$46.34	\$53.00	\$0.04	0.1%	14%
Consumer Products:								
Colgate-Palmolive Co.	CL	Neutral	Medium	\$80.37	\$80.00	\$2.12	2.6%	2%
McDonald's Corp	MCD	Outperform	Low	\$76.76	\$87.00	\$2.44	3.2%	17%
McKesson Corporation	MCK	Outperform	Low	\$70.38	\$89.00	\$0.72	1.0%	27%
Nike Inc.	NKE	Outperform	Medium	\$85.42	\$100.00	\$1.24	1.5%	19%
PepsiCo, Inc	PEP	Outperform	Low	\$65.33	\$76.00	\$1.92	2.9%	19%
Pfizer Inc.	PFE	Outperform	Low	\$17.51	\$21.00	\$0.80	4.6%	25%
Industrial Products:								
Cisco Systems	CSCO	Outperform	Low	\$20.23	\$24.00	\$0.00	0.0%	19%
Fluor Corp.	FLR	Outperform	Low	\$66.26	\$84.00	\$0.50	0.8%	28%
Intel Corp.	INTC	Outperform	Low	\$21.03	\$28.00	\$0.73	3.4%	37%
Microsoft Corp	MSFT	Outperform	Medium	\$27.91	\$36.00	\$0.64	2.3%	31%
Oracle Corp	ORCL	Outperform	Low	\$31.30	\$38.00	\$0.20	0.6%	22%
United Technologies Corp	UTX	Outperform	Low	\$78.72	\$92.00	\$1.70	2.2%	19%
Waste Management Inc.	WM	Neutral	Medium	\$36.87	\$36.00	\$1.36	3.7%	1%
Resource:								
ExxonMobil Corp.	XOM	Neutral	Low	\$73.12	\$84.00	\$1.76	2.4%	17%
Freeport McMoRan Copper	FCX	Outperform	Medium	\$120.09	\$75.00	\$1.00	0.8%	-37%
Marathon Oil Corp.	MRO	Outperform	Medium	\$37.03	\$57.00	\$1.00	2.7%	57%
Occidental Petroleum	OXY	Neutral	Medium	\$98.10	\$104.00	\$1.84	1.9%	8%

Source: Scotia Capital Credit Suisse; Bloomberg; Value Line

ScotiaMcLeod North American Core Guided Portfolio

Stephen Uzielli-Portfolio Manager, Portfolio Advisory Group

Performance Update

The ScotiaMcLeod North American Core Guided Portfolio is suitable for growth investors seeking consistent long-term rates of return from a portfolio of high quality Canadian and U.S. companies. The current portfolio holds 25 equal-weighted (4%) positions. 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 United States. Performance of the portfolio is measured against a North American Index which is a composite benchmark equally weighted between the S&PTSX 60 Index (50%) and the S&P500 Index (50%), translated into Canadian dollars.

The North American Core Guided Portfolio generated a total return of 8.8% during the quarter, outperforming the hybrid benchmark North American index which advanced 7.6% on the same basis. For all of 2010, the portfolio advanced 10.8%, slightly lagging the benchmark which was up 11.1%.

The U.S. dollar declined against most global currencies including the Canadian dollar during the fourth quarter, ultimately falling 3.4% against the loonie which had the effect of reducing the positive performance contributed by U.S. portfolio holdings during the period after allowing for currency translation. In local currency terms, Canadian holdings performed in line with U.S. holdings, increasing on average approximately 10% during the period. Only five holdings declined during the quarter with **Rogers Communications** and **Cisco Systems** posting the only negative moves of consequence. The top performing holdings were mostly found within the more cyclical sectors, including: **Fluor Corp**; **Oracle Corp.**; **Canadian Natural Resources**; **Occidental Petroleum**; **Talisman Energy**; and **Teck Resources**.

Changes

During the quarter we also made the same switch among Consumer Staples holdings in this portfolio that we described above in the commentary regarding the U.S. Core Portfolio. We switched the position in **Wal-Mart Stores** into **PepsiCo Inc.** on the same rationale.

Exhibit 4: ScotiaMcLeod North American Core Guided Portfolio

Company	Symbol	Rating	Risk Ranking	Price 31-Dec-10	Target Price	Dividend	Dividend Yield	Potential ROR
Financials:								
Bank of Nova Scotia	BNS	2-SP	Low	\$57.10	\$72.00	\$1.96	3.4%	30%
Brookfield Asset Management	BAM/A	2-SP	Low	\$33.20	\$35.75	\$0.52	1.6%	9%
Royal Bank of Canada	RY	2-SP	Low	\$52.24	\$65.00	\$2.00	3.8%	28%
Sun Life Financial	SLF	1-SO	Medium	\$30.11	\$37.00	\$1.44	4.8%	28%
Toronto Dominion Bank	TD	1-SO	Low	\$74.25	\$100.00	\$2.44	3.3%	38%
Telecommunication Services								
AT&T Inc.	T	Outperform	Low	\$29.38	\$35.00	\$1.72	5.9%	25%
Rogers Communications	RCI/B	2-SP	Low	\$34.60	\$39.00	\$1.42	4.1%	17%
Consumer Discretionary								
McDonald's Corp	MCD	Outperform	Low	\$76.76	\$87.00	\$2.44	3.2%	17%
Nike Inc.	NKE	Outperform	Medium	\$85.42	\$100.00	\$1.24	1.5%	19%
Consumer Staples								
Colgate-Palmolive	CL	Neutral	Medium	\$80.37	\$80.00	\$2.12	2.6%	2%
PepsiCo, Inc.	PEP	Outperform	Low	\$65.33	\$76.00	\$1.92	2.9%	19%
Health Care								
Pfizer Inc.	PFE	Outperform	Low	\$17.51	\$21.00	\$0.80	4.6%	25%
Industrials								
Canadian National Railway	CNR	1-SO	Medium	\$66.35	\$80.00	\$1.30	2.0%	23%
Fluor Corp.	FLR	Outperform	Low	\$66.26	\$84.00	\$0.50	0.8%	28%
United Technologies Corp	UTX	Outperform	Low	\$78.72	\$92.00	\$1.70	2.2%	19%
Information Technology								
Cisco Systems	CSCO	Outperform	Low	\$20.23	\$24.00	\$0.00	0.0%	19%
Microsoft Corp.	MSFT	Outperform	Medium	\$27.91	\$36.00	\$0.64	2.3%	31%
Oracle Corp	ORCL	Outperform	Low	\$31.30	\$38.00	\$0.20	0.6%	22%
Energy								
Canadian Natural Resources	CNQ	1-SO	High	\$44.35	\$44.00	\$0.30	0.7%	0%
Occidental Petroleum	OXY	Neutral	Medium	\$98.10	\$104.00	\$1.84	1.9%	8%
Suncor Energy	SU	2-SP	Medium	\$38.28	\$41.00	\$0.40	1.0%	8%
Talisman Energy	TLM	8-CS	Medium	\$22.12	\$25.00	\$0.25	1.1%	14%
TransCanada Corporation	TRP	1-SO	Low	\$37.99	\$48.00	\$1.68	4.4%	31%
Materials								
Barrick Gold	ABX	1-SO	High	\$53.12	\$28.00	\$0.11	0.2%	-47%
Teck Resources Ltd.*	TCK/B	Not Rated	n/a	\$61.79	\$70.00	\$0.60	1.0%	14%

*Currently Scotia Capital does not provide research coverage - target price based on consensus data.

Source: Scotia Capital Credit Suisse; Bloomberg; Value Line

The Guided Portfolios returns are not calculated according to CFA Institute "Performance Presentation Standards". Returns are calculated on a total return basis (including dividend income). The returns are used to gauge our performance by comparing the returns of the Portfolios to benchmark total return indices such as the S&P/TSX 60 and the S&P 500. Historical performance of the Guided Portfolios is not necessarily indicative of future performance. Each client's return will vary depending on the number of shares purchased, as well as the timing of purchases or sales. The Guided Portfolios themselves should not be used as benchmarks with which to compare our clients' portfolios.

Notes

Notes

The author(s) of the report own(s) securities of the following companies.

Barrick Gold Corporation, Bank of Montreal, Bank of Nova Scotia, Canadian National Railway Company, Crescent Point Energy Corp., Enbridge Inc., Fortis Inc., Great-West Lifeco Inc., Rogers Communications Inc., Royal Bank of Canada, Sun Life Financial Inc., Suncor Energy Inc., TELUS Corporation, Teck Resources Limited, Toronto-Dominion Bank, Talisman Energy Inc., Thomson Reuters Corporation, TransCanada Corporation, Intel Corp, Microsoft Corp, United Technologies Corp,

The supervisors of the Portfolio Advisory Group own securities of the following companies.

Bank of Nova Scotia, Canadian National Railway Company, Suncor Energy Inc., TELUS Corporation, TransCanada Corporation, Colgate-Palmolive Co,

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Comparative Canadian Bank Information				
Bank	Symbol	Scotia Capital Recommendation	Risk Rating	1 Yr Target
Bank of Montreal	BMO	2-Sector Perform	Low	\$68.00
Bank of Nova Scotia	BNS	2-Sector Perform	Low	\$72.00
CIBC	CM	1-Sector Outperform	Low	\$100.00
National Bank	NA	1-Sector Outperform	Low	\$90.00
Royal Bank	RY	2-Sector Perform	Low	\$65.00
Toronto-Dominion Bank	TD	1-Sector Outperform	Low	\$100.00

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