

Investment Outlook

An exclusive quarterly report from TD Waterhouse® Private Investment Counsel Inc.

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In this issue

Current Private Investment Counsel strategy

2

Preparing for retirement? Don't forget critical illness insurance

3

The role of TD's Wealth Asset Allocation Committee

4

The sovereign debt issue and your portfolio

BY ROBERT J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST, TD WATERHOUSE

Just when government policy makers and investors alike were breathing a collective sigh of relief that the recovery of both the global economy and financial markets was seemingly on track, the sovereign debt issue emanating from Europe has sidelined both. What happened? What are the implications for your portfolio?

Anatomy of a credit crisis

It is no secret that governments around the world ran up large deficits in the wake of the 2008 credit crisis to ward off a deep recession. In doing so, governments added to their existing debt, with the result that many countries' debt loads have risen sharply and are likely to continue doing so in the next few years.

The table, "The effects of the credit crisis," on Page 2 illustrates the fact that government debt, expressed as a percentage of countries' annual economic output or Gross Domestic Product (GDP), is rising sharply. This, in turn, has sparked concern that some countries, including several in southern Europe, may not be able to repay their debts as scheduled and could default on their obligations.

Greek tragedy

Greece has been the focal point of the concerns cited above. The Greek government adopted the euro as its currency in 2002, which has proven to be a mixed blessing. In using the same currency as economic powerhouses such as Germany, Greece has found it difficult to compete and, partly as a consequence, has incurred large budgetary deficits. By January 2007, before



the credit crisis, Greece's national debt was an imposing 95% of GDP.

As 2010 dawned, Greece's position had deteriorated further. As of January 2010, debt was 113% of GDP and the projected budget deficit for 2010 was 13% of GDP. Making matters worse was the fact that about 75% of Greece's debt was held by foreign investors. Worse still, over 50% of Greece's debt was maturing in the next several years, meaning that Greece would have to find new buyers for its bonds in an increasingly nervous market.

Continued on Page 2



The sovereign debt issue and your portfolio

Continued from Page 1

Investor nervousness led to a sell-off in Greek bonds as 2010 unfolded, amid fears that Greece would default on its debt. These concerns spread to other southern European countries such as Portugal with similar, if less severe, financial difficulties.

A rescue package?

At the same time, the euro's recent decline accelerated as questions were now being asked about the future of that currency should any of the European Economic Union (EU) members default on their sovereign debt. After much dithering, the EU acted in concert with the International Monetary Fund (IMF) and put forth a rescue package to support the Greek bond market that, it was hoped, would alleviate the anxiety surrounding European financial markets.

The EU's bailout package has been met with healthy skepticism by financial markets. Concern has mounted that the belt tightening necessary to reduce European government deficits could sharply reduce economic growth and perhaps cause another downturn — the much-feared double-dip recession. As a result, global stock markets have given up the gains made earlier in the year.

Impact on client portfolios

The direct impact of the European difficulties on your portfolio has been

limited. Bond holdings are largely Canadian and have been beneficiaries of the recent flight to safety. European stocks are generally a small part of client portfolios, and we have largely avoided southern Europe stocks, especially in the financial sector. Nonetheless, the slide in European equity markets and the decline of the euro have been a modest drag on portfolios over the past quarter.

The indirect effects of Europe's slide have been greater as Canadian and U.S. stock markets have given up gains posted earlier in the year. Fortunately, this has been dampened by our selection of high-quality, more defensive stocks in your portfolios. In addition, the decision of the Wealth Asset Allocation Committee to reduce equity exposure and add to bonds earlier this year has been quite beneficial (see the article, "The role of TD's Wealth Asset Allocation Committee," on Page 4).

Mid-year update

Our thesis heading into 2010 was that equity markets would rise for a second successive year and generate high single-digit returns, consistent with corporate earnings growth.

So far this year, volatility has been somewhat greater than anticipated due to the above-mentioned sovereign debt concerns. These concerns have added a new dimension to our outlook and

led us to be slightly more cautious. On one hand, valuations are reasonable, corporate earnings growth is solid and monetary policy is accommodative. All of these are positive for stocks.

At the same time, the response to global government debt concerns should likely moderate growth; hence our reduction to equity positions earlier this year. On balance, we remain cautiously optimistic, though mindful of the volatility that lies ahead. Meanwhile, Canadian bonds were expected to produce returns in the 3%-4% range, and this forecast continues to look reasonable. ■

The effects of the credit crisis

Governments will be paying rising debt loads for years.

Country	Debt/GDP Ratio (%)	
	2007 (Pre-crisis)	2014 (Estimate)
U.K.	44	98
U.S.A.	62	108
Germany	63	89
Canada	64	69
France	64	96
Portugal	65	99
Greece	95	134
Italy	104	129
Japan	188	246

Source: International Monetary Fund, November 2009.

Current Private Investment Counsel strategy

Portfolio weighting

- Modest overweight in equities
- Slight underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Major underweight in European banks within International holdings

Percentage return for indices

(For the period March 15, 2010–June 15, 2010)

DEX Universe Bond Index	0.6%
S&P/TSX Composite Index	-0.1%
S&P 500 Index	-1.8%
MSCI EAFE Index*	-7.9%

*Morgan Stanley Capital International Europe, Australasia and Far East Index

Preparing for retirement? Don't forget critical illness insurance

Facing a critical illness can be a difficult and stressful time for you and your family. While advances in medical technologies mean that your chances of surviving a critical illness are greater than ever, the cost of getting the right care can be prohibitive. Private or alternative medical treatment, home care and replacing lost income are just a few costs that could set you back a substantial sum.

Of course, if you need special care, you will do everything you can to pay for it, which could include using your retirement savings. However, withdrawing from your portfolio to cover out-of-pocket medical costs and other expenses could have a negative long-term effect on portfolio growth and hence affect your retirement plan.

An illustrative scenario

Consider the following scenario. Michael*, a married and successful 57-year-old accountant, is less than 10 years away from retirement. About two years ago, Michael was diagnosed with colon cancer. At the time, his doctor

expected a full recovery, as the cancer was diagnosed in its early stages. Although Michael has just now returned to work, he was able to focus on getting better and didn't need to worry about his living expenses or his retirement plan during his recovery.

Preparation is key

Michael, of course, did not plan on getting sick, but in preparing for his retirement several years ago, his TD Waterhouse Private Investment Counsel Portfolio Manager showed him how a critical illness could derail his personal and retirement savings.

At that time, Michael and his wife, Nancy, each purchased a critical illness insurance policy (see table, "Preserve your portfolio") that would provide them with a lump-sum benefit of \$250,000 should either of them be diagnosed with any one of 24 typical critical illnesses such as cancer, stroke or a heart attack.

The policy also included an additional benefit that would provide them with a return of their premiums upon cancellation or expiry of the policy,



Critical illness insurance allows you to focus on your recovery, not your finances.

provided that no critical illness benefit was paid.

The cost of illness

If Michael's only option had been to withdraw funds from his portfolio in order to pay for his medical expenses and to maintain his family's standard of living, the impact would have been devastating. Based on his existing portfolio and annual contributions, withdrawing \$250,000 from Michael's portfolio at the time of his critical illness would have reduced the accumulated value of his portfolio by almost \$381,000 (see scenario B in table) by the time he turned 65.

Had Michael retired at age 65 without making a critical illness claim on his policy, he would have been eligible to have all his premiums returned to him. Plus, the cost of that valuable critical illness protection for all those years would have been only \$31,000, or just 1.2% of the portfolio's total value at age 65.

Considering the possibility of a critical illness can be unsettling. But as Michael and Nancy learned, when you're planning for the future, you need to plan for the unexpected. Critical illness insurance was able to provide them with the peace of mind they needed to focus on what really mattered — getting better. ■

*The people and situations identified in this article are fictional. This example is intended to assist customers in identifying their needs. While assumptions and values used for this example were reasonable at the time the example was prepared, using tax laws in effect at that time, they are for illustration purposes only. The circumstances emphasize the attributes of the products and strategies being described. Clients should seek qualified professional accounting, tax or legal advice before proceeding on any course of action. All insurance products and services are offered by life licensed agents of TD Waterhouse Insurance Services Inc. a member of TD Bank Financial Group.

Preserve your portfolio

Drawing on your retirement savings to pay for medical expenses and maintain your lifestyle while recovering from a critical illness can deplete your portfolio.

Scenario	Descriptions	Portfolio value at age 65	Impact on portfolio at age 65
A	<ul style="list-style-type: none"> • Annual deposits • No insurance • No critical illness 	\$2,635,185	
B	<ul style="list-style-type: none"> • Annual deposits • No insurance • Critical illness at age 55 • \$250,000 withdrawal from portfolio 	\$2,254,197	-\$380,988
C	<ul style="list-style-type: none"> • Annual deposits reduced by critical illness insurance premium • No illness occurs • Return of premium claimed at age 65 	\$2,604,424	-\$30,761

A \$250,000 Term 75 Critical Insurance policy with Return of Premium, purchased for a male non-smoker, age 50; an annual premium of \$8,172. As of age 50, assuming total combined registered and non-registered assets of \$1.2 million; \$30,000 annual contributions to the portfolio; and a 5% compound rate of return.

Source: Sun Life Assurance Company of Canada, May 6, 2010.

The role of TD's Wealth Asset Allocation Committee

BY ROBERT J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST, TD WATERHOUSE

One of the key elements of TD Waterhouse Private Investment Counsel's portfolio management process is TD's Wealth Asset Allocation Committee (the "Committee"). The Committee is comprised of eight members, all of whom have extensive experience in domestic and foreign financial markets.

Collectively, the Committee's members are charged with the responsibility of deciphering the crosscurrents of global financial markets and issuing advice and guidance across TD Wealth Management that could help reduce risk and potentially bolster returns for our investors.

Sound decisions

Meeting monthly, or more often if required, Committee members review in detail current market trends and valuations. Even more important, they study emerging risks and issues that may have a significant impact on the direction of stocks, bonds and currencies in the coming months and years.

The net result is a series of recommendations covering asset mix issues such as the split between stocks and bonds; allocation among Canadian, U.S. and international equities; the appropriate mix of

corporate and government bonds; and currency considerations. An implementation committee then weighs the recommendations and how they can best be employed.

Recent recommendations

Asset allocation recommendations are implemented to capture major market trends, not short-term movements. In the current market cycle, we have implemented three recommendations for clients of TD Waterhouse Private Investment Counsel, where their mandates permit:

- 1 In late 2008, during the heart of the credit crisis, we sold some of our government bond holdings and bought high-quality corporate bonds at attractive prices. This was beneficial for clients, as corporate bonds have sharply outperformed government issues from late 2008 through mid-2010.
- 2 In the spring of 2009, we sold more government bonds and used the proceeds to buy Canadian stocks. This was also beneficial for clients, as Canadian equities have outperformed government bonds from the spring of 2009 through mid-2010.

- 3 During this past spring, we trimmed stock holdings and added to bonds. While we currently believe that equities could continue to do better than bonds, the degree of outperformance is not likely to be what it has been over the past year. At this early stage, this move could prove to be of benefit.

The Committee's views are encapsulated in the quarterly publication *Market Outlook*. Clients interested in this material can obtain a copy from their TD Waterhouse Private Investment Counsel Portfolio Manager. ■

INVESTOR NOTICE

Leverage risk disclosure

Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by its terms remains the same, even if the value of the securities purchased declines.

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