

Investment Outlook

An exclusive quarterly report from TD Waterhouse® Private Client Services

Winter 2010

In this issue

Why business owners need to plan for succession today

4

Have your insurance needs changed?

5

What's in store for 2010?

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How will global markets fare in 2010? Which asset classes, market sectors and geographic regions will lead the way? What will this mean for your investments? Before we look at these questions, it's instructive to look back at 2009 to see how market events unfolded and why.

A look in the rearview mirror

The year 2009 saw some of the most dramatic swings in financial market history. Let's review the six forecasts made in this column a year ago and see how close or far they were from the mark.

1. U.S. EQUITY MARKET WOULD BEGIN TO RECOVER, AFTER A VERY DIFFICULT 2008, AND REGISTER A HIGH SINGLE OR LOW DOUBLE-DIGIT ADVANCE IN 2009. We cited five key factors at the time. First, valuations were very depressed in the wake of a sell-off brought about by the credit crisis. As a result, stocks were inexpensive relative to bonds. Second, credit markets were improving.

Third, fiscal and monetary policies were accommodative. Fourth, cash on the sidelines was at very high levels, providing lots of latent buying power for equities. Finally, corporate officers and board members were strong buyers of their own shares, which is generally a positive portent.

What happened? After a difficult start to 2009, which saw the S&P 500 Index (S&P 500) fall about 25% from January 1 to its March 9 low, U.S. equities staged a brisk recovery, recording a double-digit return for the year. (See chart, "North American stocks recover," on Page 2.)

2. U.S. LARGE-CAP STOCKS WOULD GENERATE GOOD RETURNS FOR THEIR RELATIVELY MODEST RISK, THOUGH SMALL CAPS WOULD LIKELY PERFORM BEST COMING OUT OF THE RECESSION. This view reflected the fact that small companies are more economically sensitive, so their share prices tend to lead coming out of a bear market. At the same time, larger companies with more stable sales and earnings — our principal focus — would provide solid returns with much less risk.

Of the companies cited in this space a year ago, **Oracle** has performed best in the year to date with a strong double-digit return, **Johnson & Johnson** has also advanced and **Exxon Mobil** is down slightly over the same period.

3. THE CANADIAN STOCK MARKET WOULD START RECOVERING AND RECORD A HIGH SINGLE OR LOW DOUBLE-DIGIT RETURN. The S&P/TSX Composite Index (S&P/TSX) initially fell 16% from January 1 through March 6, but recovered to post a strong double-digit return, which exceeded our expectations. (See chart, "North American stocks recover," on Page 2.)

Commodities, which did come under pressure in the early months of 2009, recovered in anticipation of an improving global economy, and resource shares were among the strongest performers on the S&P/TSX. Producers of base metals, such as copper, benefitted greatly from

Continued on Page 2



What's in store for 2010?

Continued from Page 1

Chinese restocking of their inventories, which pushed prices up sharply from their lows.

Among stocks cited in this space a year ago, **Power Corporation** and **Encana** recorded solid returns in 2009 while **Rogers Communications** and **Shoppers Drug Mart** have lagged, as have similar companies in the more defensive sectors.

— was extremely wide. We felt this corporate spread would narrow as credit markets normalized, corporate bond prices would rise and corporates would therefore provide higher returns than government bonds. (See chart, “Corporate bond spread narrowed in 2009,” on Page 3.)

These events did take place, which boosted overall bond market returns to over 5% in 2009, slightly exceeding our forecast.

Europe's economic recovery has begun sooner and been slightly stronger than anticipated, in large part due to a sharp rebound in exports, directed in large part to the emerging economies of Asia and Latin America. As a result, the European stock markets have fared well and, as at the end of November, were only slightly behind U.S. equities. Japan's Nikkei Index advanced in 2009 but did lag the other major markets.

6. WE REMAINED CAUTIOUS ON EMERGING MARKETS SUCH AS CHINA AND INDIA IN THE NEAR TERM BUT ULTIMATELY EXPECTED A STRONG RECOVERY. Entering 2009, it was likely that investors' flight to safety would exact a heavy toll on the stock markets of China, India and other emerging nations. It was just as likely that those countries' markets, with their underpinnings of strong economic growth, would recover rapidly when investor confidence returned.

Emerging markets were, in fact, pummeled in the first two months of 2009 but rebounded very strongly over the balance of the year.

The road ahead in 2010

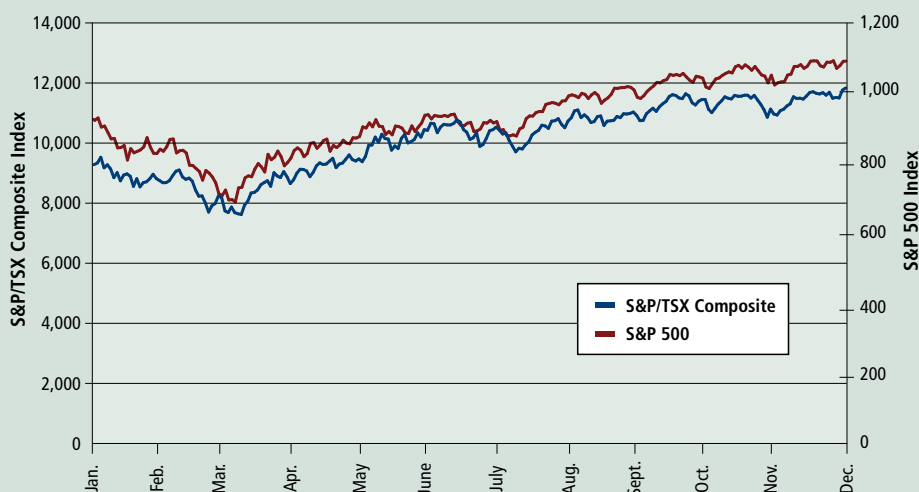
Here are the dominant investment themes for the major asset classes in 2010.

THEME 1. The U.S. stock market should advance for the second successive year, recording a high single-digit advance, for the following reasons:

- **Reasonable valuations.** U.S. stocks are reasonably valued. At the end of November, the S&P 500 was trading at about 14.5 times forecast 2010 operating earnings of \$75 — a multiple in line with the historical average. This means the stock market is not likely to be driven by a further expansion of P/E multiples, which should moderate the advance. Instead, share price appreciation will likely reflect improvement in corporate profits, which is a reasonable expectation.

North American stocks recover

Both the S&P/TSX Composite Index and the S&P 500 posted double-digit gains in 2009, which exceeded expectations.



Source: Bloomberg, Jan. 1–Dec. 2, 2009

Asset Allocation Note: Reflecting our positive view, we shifted some funds, where client mandates permitted, from government bonds to Canadian equities in the late spring and early summer of 2009. This has proven quite beneficial.

4. CORPORATE BONDS WOULD OUTPERFORM THEIR GOVERNMENT COUNTERPARTS, WITH OVERALL BOND RETURNS IN THE 4% TO 4.5% RANGE. During the worst of the credit crisis, investors were unsure that even the best companies could meet their obligations. As a result, the incremental yield paid by corporate bond issuers when compared with the Government of Canada — the corporate spread

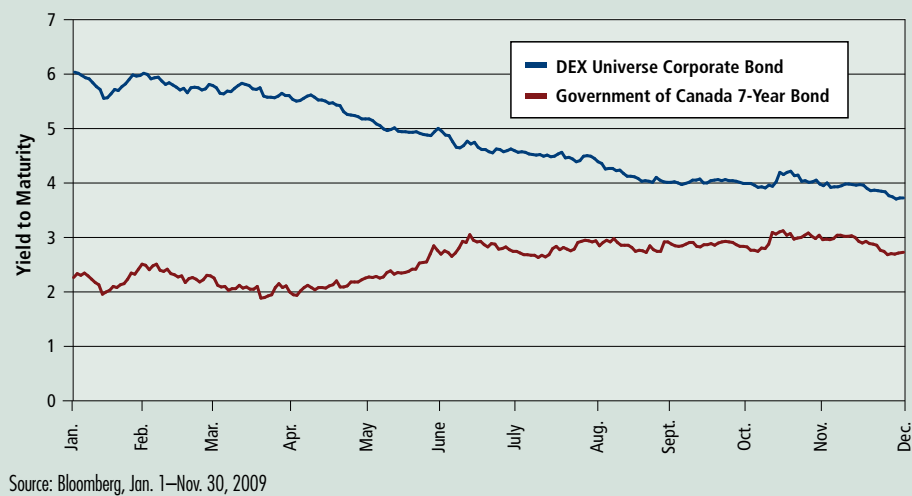
Asset Allocation Note: Due to our favourable outlook for corporate bonds, we sold government issues and added corporate bonds in late 2008, where client mandates permitted. This has worked out very well.

5. EUROPEAN AND JAPANESE STOCK MARKETS WOULD ADVANCE, BUT WOULD UNDERPERFORM U.S. EQUITIES. The European economy tends to lag the American economy in the economic cycle, which we felt could moderate the anticipated gains in European bourses. And Japan was facing severe structural and currency issues that would likely temper the Nikkei's recovery.

- **Credit markets are much improved.** To cite one example, referred to in this column a year ago, the London Interbank Offered Rate (LIBOR), a measure of fear in the credit markets, reached 4.8% in the credit crisis of 2008, was 2.2% at this time a year ago, and is less than 0.3% today. In addition, the yield curve is very steep, which means long-term U.S. interest rates are much higher than short-term rates, which is beneficial for the economy in general and the American banking system in particular.
- **Monetary and fiscal policies remain accommodative.** Short-term U.S. interest rates are hovering close to zero and should stay there until at least the second quarter of 2010. Meanwhile, the U.S. federal government is running a deficit of over a trillion dollars to stimulate the economy.
- **Moderate growth.** Economic growth in 2010 should be moderate, perhaps 2% or so, reflecting subdued American consumers, who are right-sizing their balance sheets, saving more and paying down debt. Such middling growth is enough to boost corporate profitability without igniting inflation, which is very often a good environment for equity markets.
- **Rising productivity.** Gains in productivity have been strong in recent quarters as corporations have slashed staff and labour costs. This, in turn, means that any incremental sales volume that accompanies economic recovery could have a very salutary effect on profitability. In addition, corporate inventories have been sharply cut in recent quarters and the re-stocking that could take place at some point should have a similar beneficial impact on the bottom line.
- **Liquidity remains very high.** With about \$3.5 trillion in U.S. money market fund assets — high relative

Corporate bond spread narrowed in 2009

As economic recovery took hold, the spread between corporate and government bond yields decreased.



to stock market capitalization — there is a great deal of potential buying power for stocks. This lack of strong bullish sentiment on the part of the public is positive.

THEME 2. Expect a rotation of market leadership, from small companies' shares and more volatile sectors to larger-cap stocks and more stable groups. This transition will reflect investors' search for value after the initial bounce off the market bottom. Among the large-cap winners in 2010 should be the following:

- **Technology stocks** will likely continue to lead. Capital expenditures have fallen about 20% from pre-recession levels to 6.2% of GDP in the latter half of 2009 and should rebound along with business confidence and corporate profits. Business is motivated to increase productivity via technology in an environment in which top-line growth should be modest, corporations generally have strong balance sheets to fund the purchases and Windows 7 will bring an upgrade cycle. Software makers **Microsoft** and **Oracle** should continue to do well along with hardware firms **Cisco**, **IBM** and **Hewlett-Packard**.

- **The consumer staple sector** has lagged in the recovery, but has recently shown signs of improvement. Shares of **Procter & Gamble** and **PepsiCo** are currently trading at very reasonable multiples, have worthwhile dividends that they have regularly increased and their high proportion of foreign income should provide a hedge against U.S. dollar weakness.
- **Health care stocks** should exhibit better returns in 2010. Concerns about drug patents' expiration, lack of new drugs in the pipeline, lawsuits and government regulation have combined to compress P/E multiples, a trend that should begin to reverse in 2010. **Johnson & Johnson**, which is currently trading at an abnormally low multiple of earnings, has a good dividend that it has increased regularly and should be a beneficiary of that trend.

THEME 3. The Canadian stock market should rise again in 2010, exhibit high single-digit returns and witness a similar rotation into larger-cap stocks. Within the Canadian market, notable laggards in the past year's recovery have included the more defensive sectors, generally

Continued on Page 6

Why business owners need to plan for succession today

The goal of business succession planning is the orderly transfer of a business, usually from one generation to another, in a manner that meets the needs of the owner. One of the biggest questions for business owners considering a succession plan is what their company is worth. Yet, because of the complexities involved, some entrepreneurs do not take the time to find out.

“Establishing the value of their businesses will be a pressing issue for many Canadians in the next few years,” says William Fulton, President of TD Waterhouse Private Client Services. “A huge wave of business owners is set to retire, a trend that reflects the aging of the country’s workforce.”

Indeed, a survey conducted a few years ago by the Canadian Federation of Independent Business found that two-thirds of business owners plan to exit their business by 2015. However, only 10% of those had a written succession plan in place.

Succession plan components

The idea behind business succession planning is to set a framework for the future transfer of ownership and control of a business to a chosen successor, whether a family member, a related business or an outside party.

A sound succession plan will do more than establish and maximize the



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business’s value and facilitate its sale or transfer. It will also:

- ▶ Help to reduce taxes.
- ▶ Set a course for the owner’s future plans and family needs.
- ▶ Protect the business owner’s assets and estate in the event of death or disability.
- ▶ Integrate the business owner’s business and personal finances into an overall wealth-planning strategy.

Start the process today

Business owners commonly say that it’s too early for them to plan for succession. But in fact, it’s never too early to develop a business succession plan, and it puts a contingency plan in place should the owner become seriously ill or pass away. Without a

plan, the business itself may be at risk and its value substantially reduced, which could place considerable stress on the family of the business owner.

That’s why succession planning begins with a contingency plan, including a continuing Power of Attorney for property (or equivalent), an up-to-date Will and appropriate life and disability insurance coverage.

Family matters

Many entrepreneurs work hard to build up their business with the intention of passing it on to their children. Family businesses present their own set of challenges, including choosing and training the successor and utilizing insurance solutions to

Continued on Page 5

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.

NOTICE

Notice to unitholders of TD Funds

The 2009 annual report for investment funds managed by TD Asset Management Inc. (“TD Funds”) will be available at the end of March 2010. The 2009 simplified prospectuses are slated to be renewed in early 2010 for many TD Funds. Unitholders are entitled to receive an investment fund’s annual and interim financial statements and management reports of fund performance, available at the end of March 2010 and August 2010, respectively. These documents are available directly at www.tdassetmanagement.com or by contacting your Private Investment Counsel Portfolio Manager.

Plan for succession

Continued from Page 4

equalize assets upon inheritance for the benefit of the children who are not active in the business.

Communication and impartial advice are often key to solving any potential family disputes and taking the right path for the business.

Transferring ownership

For business owners seeking to transfer ownership of the business, there are many options in addition to family succession. Exit strategies may include taking the business public or transferring shares to a partner or a group of employees. Depending on how the business is being transferred, vendor and purchaser financing may need to be arranged. Putting a value on the business and taking steps to make the sale tax-efficient will also be important.

Training and mentoring of a new owner will also be crucial and this process can take a considerable length of time. In smaller businesses especially, when an owner declares an intention to retire, it can send shock waves throughout the employee base. A good succession plan will minimize uncertainty by making clear what everyone's role in the business will be.

Because of the complexities involved in succession planning — both the “harder” financial and tax issues and the “softer” family issues — it's very important to involve a team of professionals at all stages. These should include your accountant, estate planner and business banker, who can help with the valuation of your enterprise.

Private Client Services' Private Investment Counsel Portfolio Managers, Private Bankers and Estate and Trust Specialists are your points of contact for the professional expertise you need to produce a solid succession plan that meets the needs of you and your family. ■

REMINDER

Tax information for clients of TD Waterhouse Private Investment Counsel

A copy of the *Valuable Tax Information for 2009* guide is enclosed with your statement. Please refer to it for up-to-date information about:

- Recent changes to tax reporting.
- Timelines for receiving your tax slips from TD Waterhouse Private Investment Counsel.
- Answers to frequently asked questions.

Have your insurance needs changed?

A change in your financial situation can call for changes in your insurance strategy. If your net worth or the value of your investable assets has changed significantly, you may need to take a closer look at your insurance coverage, particularly life insurance.

Opportunity and protection with Universal Life

Universal Life (UL) is a common type of permanent life insurance protection, especially if you are looking for flexibility, investment control and tax-sheltering opportunities.

A UL policy has two components: life insurance protection and a tax-deferred investment account for growth and accumulation of savings. It lets you adjust your insurance protection — and build wealth on a tax-deferred basis — as your life circumstances change. For instance, protection is usually more important earlier in life, while at later stages, when your earnings are typically higher and you are looking to shelter income, the investment component becomes more important.

A UL policy has two components: life insurance and an investment account for protection and growth.

Most UL policies give you a range of investment options, including all the major asset classes, to allow you the benefits of investment diversification. A UL policy gives you the flexibility to vary the amounts of your deposits that are in excess of the cost of the pure insurance protection, in order to suit your cash flow and savings goals. Strong investment performance may allow you to take a break from making deposits, provided you have sufficient policy cash value to cover the ongoing cost of insurance charges.

Enhancing your estate

Universal Life can play an important role in your estate planning, as beneficiaries of your UL policy can receive the value of your insurance policy, as well as the value of your investment component, on a tax-free basis.

Your Private Investment Counsel Portfolio Manager can help you assess your estate planning needs based on your specific circumstances and, if necessary, draw on the expertise of insurance and estate planning specialists.



What's in store for 2010?

Continued from Page 3

characterized by fairly consistent sales, earnings and dividend growth. Many of these stocks currently have dividend yields higher than that of the 10-year federal government bond, even before accounting for the dividend tax credit that makes each dollar of Canadian dividends like receiving \$1.30 or so in interest income. Herein lies an opportunity for more conservative investors.

Canadian equities that regularly increase their dividends offer investors some key advantages, such as improved cash flow and a hedge against inflation (which fixed bond yields do not provide). Rising dividends also tend to put a rising floor under share prices. A few examples poised to do well in the coming year are: **Power Corporation**, a repeat from 2009, **TransCanada Corporation**, **Shaw Communications** and **Bank of Nova Scotia**.

THEME 4. Bond returns should

be a modest 3% to 4%, with high-quality corporate issues once again outperforming government issues. However, the outperformance should be narrower than that witnessed in 2009. These developments will likely reflect a continued reduction in corporate spreads and some modest increases in short- and longer-term interest rates.

THEME 5. Europe and Japan should record high single or low double-digit returns in 2010. Like North America, look for a rotation of leadership from the smaller companies to the larger-cap stocks. The European economic recovery seems to be on track and their stocks are now especially inexpensive based on low P/E multiples and high dividend yields.

Among the large-cap stocks that should generate solid returns with modest risk are the following: **Nestlé**, the food giant with substantial exposure in the developing markets that display rapid growth; **Novartis**, a well-managed pharmaceutical firm that has managed its patent expiration and product development better than most global

peers; **Credit Suisse**, an exceptionally well-capitalized financial services group with a strong global private banking franchise; and **Standard Chartered PLC**, a London-based bank that has a strong presence in emerging Asia.

THEME 6. Emerging equity markets should record high single-digit returns in 2010, well below 2009's double-digit advance. Cautionary notes include excessive lending via China's banking system, which could bring about excesses in real estate, and signs of developing inflationary pressures in India. We continue to generally favour indirect exposure to emerging markets via Canadian and other major market companies that could benefit from events in China, India and Brazil.

A year ago, we stated that 2009 would mark the first year of what could prove to be a four-year healing process in equity markets. At this point, we see no reason to alter our thesis and, for the reasons outlined, feel 2010 will represent the second year in that process. ■

Current Private Investment Counsel strategy

Portfolio weighting

- Overweight in equities
- Underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Overweight European materials and technology stocks and underweight financials and industrials

Percentage return for indices

(For the period September 15, 2009–December 15, 2009)

DEX Universe Bond Index	1.2%
S&P/TSX Composite Index	1.1%
S&P 500 Index	4.5%
MSCI EAFE Index*	1.1%

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

The information in this newsletter is current as at December 16, 2009, and does not necessarily reflect subsequent market events and conditions.

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Waterhouse

Wealth of Experience