

Investment Outlook

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

Winter 2011

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The road ahead: An investment outlook for 2011

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With 2011 just under way, it's time to examine the prospects for financial markets in the year ahead. Which countries, asset classes and sectors will fare best, which will lag and what does this mean for your investments? Prior to addressing these questions, it is helpful to examine what was forecast a year ago, what actually transpired and why.

A glance back

The year 2010 was characterized by sharp swings in both investor sentiment and market averages. Let's review the forecasts made in this newsletter one year ago and see how they fared.

1. WE STATED THAT U.S. EQUITY MARKETS WOULD RISE FOR A SECOND SUCCESSIVE YEAR AND THAT THE S&P 500 INDEX WOULD RECORD A HIGH SINGLE-DIGIT ADVANCE. We cited six contributing factors at the time. First, valuations were reasonable, based on forecast S&P 500 Index earnings of \$75, a figure that proved conservative. Second, credit markets were improving, and third, monetary and fiscal policies remained accommodative. Fourth was moderate economic growth around 2%, in a low-inflation, low-interest rate environment. Strong productivity growth was the fifth factor, and very high liquidity the sixth.

What has happened? After a mid-year dip reflecting fears of deflation and a double-dip recession, the S&P 500 Index staged a vigorous advance and has recorded a high single-digit advance at the time of writing.

2. WITHIN THE U.S., WE HAD FORECAST A ROTATION FROM SMALL- TO LARGER-CAP STOCKS. Among expected winners were the tech sector, including software makers **Oracle**

and **Microsoft** along with hardware firms **IBM**, **Cisco** and **HP**. Consumer staple companies, such as **Procter & Gamble** and **PepsiCo**, which had lagged in the market recovery, along with consumer/healthcare giant **Johnson & Johnson** were expected to do well.

The expected rotation from small-cap to larger-caps stocks did not occur in 2010. The performance of tech stocks has generally not matched strong company earnings although **Oracle** and **IBM** shares have done very well while **Cisco** and **HP** have lagged. The consumer/healthcare names have generated market returns.

3. CANADIAN EQUITIES, LIKE THEIR U.S. PEERS, WERE EXPECTED TO RECORD A HIGH SINGLE-DIGIT RETURN IN 2010. A rotation into the more defensive dividend growth stocks was forecast, including many that had heretofore lagged, such as **Power Corp.**, **TransCanada Corp.**, **Shaw Communications** and **Bank of Nova Scotia**. To this point, the S&P/TSX Composite Index has advanced in line with expectations, as have the stocks cited.

4. CANADIAN BOND RETURNS WOULD BE 3% TO 4%, WITH INVESTMENT-GRADE CORPORATES OUTPERFORMING GOVERNMENT ISSUES, THOUGH BY A NARROWER MARGIN THAN IN 2009. To date, bond returns have exceeded forecast by one to two percentage points while corporates have generally outperformed, except at the long end of the curve.

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The road ahead

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5. AMONG MAJOR INTERNATIONAL MARKETS, WE ANTICIPATED HIGH SINGLE-DIGIT RETURNS AND FAVOURED NORTHERN EUROPE, citing Nestlé, Novartis, Standard Chartered PLC and Credit Suisse. Results have been mixed. Germany and Britain have advanced while Japan's Nikkei Index has slumped, though a rising yen has taken the edge off the losses. Meanwhile, the individual issues above have generally done very well, with the exception of Credit Suisse, which recorded a decline.

6. EMERGING MARKETS WERE ALSO EXPECTED TO POST HIGH SINGLE-DIGIT RETURNS, although we expressed reservations about excessive expansion of credit in China and inflationary pressure in India. Emerging markets overall have been in line with forecast, with India and Russia leading the group while China has lagged, recording a loss for the year.

The road ahead in 2011

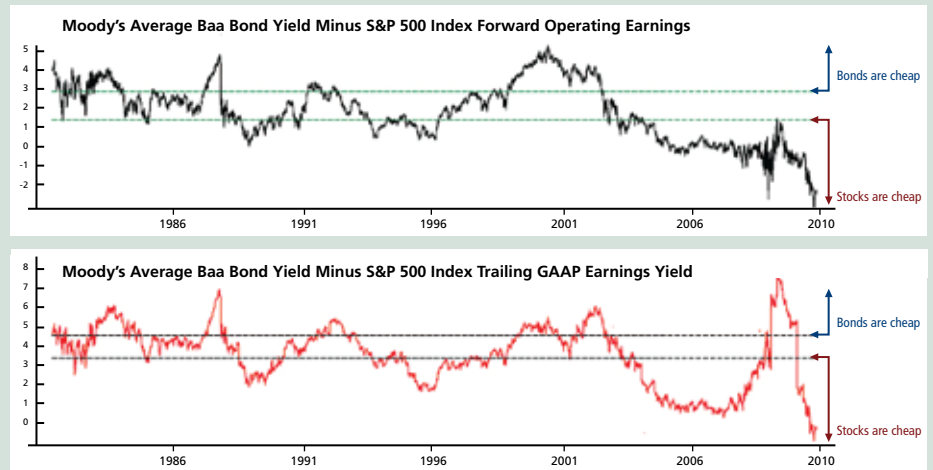
Looking ahead to 2011, we'll examine markets' dominant investment themes. From an asset allocation perspective, we believe the global macro environment favours equities over bonds.

1. U.S. EQUITIES GAIN ONCE MORE. U.S. markets and economy. Several macroeconomic concerns overhang the U.S. equity market. First is the much-discussed prospect of a double-dip recession. We continue to feel this is a low-probability event and instead, we expect we shall continue to see growth of 2% to 3%, a below-average range reflecting an overextended American consumer intent on paying down debt and increasing savings. Second is the possibility of deflation, which we also regard as improbable. Our view of current inflation data, commodity markets and TIPS¹-implied inflation rate suggests deflation is not on the horizon.

The sovereign debt crisis remains a major concern as with each sovereign debt tremor, currency, debt and equity markets are shaken. Both the U.S. economy and debt markets are susceptible to these

An attractive entry point for stocks

With an earnings yield far higher than bonds, U.S. stocks represent good value today.



Source: Ned Davis Research, as at September 27, 2010

aftershocks due to both the fragility of the economic recovery and high Federal debt levels, which come under increasing scrutiny of global investors.

Another major issue is U.S. monetary policy. The U.S. Federal Reserve has embarked on a second round of quantitative easing, which amounts to printing money. While this may be positive for global growth and equity markets, we are concerned it may produce headwinds for bonds.

Beginnings of a recovery in U.S. housing. U.S. housing remains a problem, with high inventory levels and foreclosures the major issues.

Overall, we expect U.S. equities to advance for the third successive year and the S&P 500 Index to record a low double-digit return.

Partly offsetting these issues is the best affordability in generations, a result of both the 30% decline in home prices from their peak in mid-2006 and record-low 30-year mortgage rates. Second, fewer than half the 1.4 million new homes constructed in an average year are now being built, with a resultant drawdown on the high inventories cited above. Third, employment and

consumer confidence are slowly improving, which will ultimately be reflected in home sales. As a result, another sharp downturn in home prices is improbable and a slow, multi-year recovery should take place in the sector.

U.S. commercial real estate, where prices are off 40% from their 2007 peak, is another concern. Commercial vacancy rates seem to be trending down from their recessionary peak and prices have stabilized. Refinancings in 2011 may prove difficult for property owners and lenders alike, which will limit recovery of the sector in the near term. Nonetheless, fears of a further meltdown in commercial property prices are not likely to be realized.

Support for U.S. Markets. On the positive side of the ledger are the following:

- **Valuations are reasonable.** Based on a below-consensus \$88 estimate of 2011 S&P 500 Index operating earnings, U.S. stocks are, at the time of writing, trading at a modest 13.6X forecast earnings. At the same time, stocks have an earnings yield far higher than bond yields (see Chart "An attractive entry point for stocks," above), an indication of stocks' good value relative to bonds.
- **Moderate growth.** The above-mentioned modest growth in the 2% to 3% range, in a low-interest rate,

low-inflation environment should be supportive for stocks.

- **Solid corporate balance sheets.** Companies have record cash on hand of close to \$2 trillion. In combination with reasonable P/E multiples cited above plus low interest rates, merger and acquisition activity should increase and support equity markets.
- **Accommodative monetary policy.** Short-term U.S. interest rates are hovering close to zero and should stay there until at least the middle of 2011.
- **More supportive political environment.** The recent mid-term election has ushered in a new balance of power as we enter the third year of the U.S. presidential term, which is very often the strongest year for the U.S. stock market. History suggests this will be a net benefit for equity markets though there are legitimate concerns about possible political gridlock preventing authorities from responding to the next crisis.

Overall, we expect U.S. equities to advance for the third successive year and the S&P 500 Index to record a low double-digit return.

2. U.S. LARGE-CAPS SHOULD OUTPERFORM. Within the U.S., there is a significant valuation gap between small-cap and large-cap stocks and the anticipated rotation from the former to the latter should take place in 2011. For conservative investors, the strong dividend growers cited a year ago — **P&G, PepsiCo** and **Johnson & Johnson** — are expected to continue to provide good total returns.

The economically sensitive tech basket highlighted previously — **Oracle,**

Microsoft, IBM plus laggards **Cisco** and **HP** — could do well as fears of a double-dip diminish. Large-cap financials may see improved performance as credit conditions slowly improve, with **Goldman Sachs** benefiting from a pickup in merger-and-acquisition activity and **JP Morgan** benefiting from greater productivity in the former Washington Mutual network.

3. CANADIAN STOCKS SET TO ADVANCE.

Here at home, we expect the S&P/TSX Composite Index to record its third successive advance, with a high single-digit return. The relative performance of the dividend growers cited a year ago — **Power Corp., TransCanada Corp., Shaw Communications** and **Bank of Nova Scotia** — will not be as pronounced in 2011, though all should continue to be solid performers.

It is worth reiterating that these stocks currently have dividend yields higher than the yield of the 10-year Government of Canada bond. Moreover, these dividends often increase 4% to 8% per year, providing both a hedge against inflation and a rising floor under the issuers' share prices. Stocks of this sort continue to represent an attractive option for the years ahead.

The energy sector, which lagged severely in 2010, should do much better in 2011 as average commodity prices improve, with **Suncor** and **EnCana** being beneficiaries. Meanwhile, the major banks feature reasonable P/E multiples, attractive dividends that will be increased after a two-year hiatus and decent growth prospects. While the whole group should have a good year, **Royal Bank** and **Bank of Nova Scotia**

are our top two selections.

The U.S. Federal Reserve regards the future as “unusually uncertain”² and gold represents a hedge against extreme outcomes. Where warranted, positions have been incorporated in portfolios and will likely be maintained in the coming year.

4. MEAGRE RETURNS FROM BONDS.

As fears of deflation and a double-dip likely dissipate, bond yields may creep up modestly and bond returns are expected to be meagre, in the 1% to 3% range. High-quality corporate issues should outperform government bonds, reflecting the higher coupons and shorter durations of corporates.

5. NORTHERN EUROPE TO LEAD MAJOR INTERNATIONAL MARKETS.

Overseas, northern Europe should again fare best among the major markets and we would maintain positions in large-cap stalwarts such as **Nestlé, Novartis, Credit Suisse** and **Standard Chartered PLC**, adding **Diageo** and **BP**. Japan should benefit from less upward pressure on the yen and overall returns from international markets should be in the high single digits.

6. CHINA TO LEAD EMERGING MARKETS.

Within emerging markets, we expect that China, which has trailed its peers in 2010, will probably outperform the group in 2011 and register a low double-digit return. India's monetary tightening, required to tame inflation, means its market is not likely to fare as well but could post upper single-digit returns along with its peers.

Overall, we expect 2011 will represent the third year of a four-year recovery in global markets and a year in which equities will notably outperform bonds. ■

Current Private Investment Counsel strategy

Portfolio weighting

- Moderate overweight in equities
- Position in gold where appropriate within client portfolios
- Moderate 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 September 15, 2010 – December 15, 2010)

DEX Universe Bond Index	0.6%
S&P/TSX Composite Index	9.7%
S&P 500 Index	7.4%
MSCI EAFE Index*	4.7%

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

How to talk to your family about your estate plans

It's not always easy to talk about finances with loved ones, particularly if it's about how you want to distribute family assets when you're gone. But making your wishes for the future known to beneficiaries, including the details of what's in your Will, can help secure your plans, avoid ambiguity and put everyone's mind at ease.

Engage family in the process

It's a good idea to revisit your estate plans and Will from time to time, and this process can present a great opportunity to talk to adult children and family members about your wishes.

The legal documents you may have put in place when your children were younger may no longer reflect today's realities or your current financial situation. Families grow and evolve, and your own wishes may also have changed.

There's no right or wrong way to



Involve your family in discussions about your estate.

involve family in discussions about your estate planning decisions. You could opt to spend time one-on-one with each individual to talk about your plans and gauge any concerns. For others, a family meeting could be the right occasion.

Introduce trusted advisors

Bringing in an objective professional to lead your family discussions about estate plans can keep the conversation grounded. You might also consider an informal meet-and-greet for your spouse and adult children with your legal, financial and estate advisors, who they may need to call on for help in the future.

Talking openly to your children and family members about your estate plans may also help them think about their future roles to carry on family traditions in your absence. It's a powerful way to encourage continuity and help each individual prepare

for any responsibilities you want to bestow, such as taking charge of your charitable causes.

Your Portfolio Manager can put you in touch with appropriate expertise and support to help safeguard and manage a family legacy. ■

Align your values with your financial life

When was the last time you stepped back and thought about what is truly important to you — and whether those values are reflected in your financial and investment plans?

Meaningful connections

Life planning is all about connecting the dots between the people, ideas and causes you care about today, and the kind of world you see for yourself and your loved ones in the future.

Since financial and investment matters often command a sense of urgency, it sometimes takes a conscious effort to step back from the day-to-day decisions and allow yourself to look for meaningful

connections between the different elements of your life. For instance:

- Does your retirement and estate planning anticipate and reflect your personal goals and beliefs?
- Does what you invest in support and represent your values, in terms of what's important to protect and preserve?
- Do the donations you make to charities each year contribute to your favourite causes in the most meaningful way possible?
- Have you taken the time to convey to your family what's important to you to live life to the fullest, while defining the mark you'd like to leave on the world?

A fully formed vision

Life planning encourages discussions with your spouse and adult children to create a fully formed vision of your retirement and your future together.

Ask your Portfolio Manager for guidance and resources that can help you take a more holistic approach to your investment and estate plans. For example, working through our Life Discovery Tool with your Portfolio Manager can help you map your financial priorities to fit your values and help your loved ones appreciate how you measure success. ■

The role of annuities in a portfolio

As you prepare to retire, your investment strategy will need to shift from the accumulation phase to the income phase. A well-balanced retirement plan that includes annuities may help to transform your savings into a lifetime of sustainable income.

In exchange for a single lump-sum deposit, an insurance company will make guaranteed regular income payments for a chosen period of time or for the lifetime of you and/or your surviving spouse.

The benefits

Annuities can guarantee a stable and predictable income for life, regardless of market conditions or interest-rate fluctuations.

INFLATION PROTECTION. Annuities can be indexed so the income increases by a set amount each year to help you keep up with inflation.

GUARANTEEING INCOME FOR A SPOUSE. A Joint and Survivor annuity can cover the lives of two individuals — a primary and a secondary annuitant. Income is paid to the primary annuitant and, upon his or her death, the secondary annuitant continues to receive the income for the rest of his or her lifetime.

TAX REDUCTION. For those age 65 and over, taxable income from an



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annuity generally qualifies for the annual \$2,000 Pension Income Tax Credit. For non-registered prescribed annuities, the income payments are considered to be a combination of interest and return of capital, only the interest income is taxable. A prescribed non-registered annuity spreads the taxable portion evenly over the life of the annuity, for additional tax efficiency.

An annuity at work

Let's say that a 65-year-old male purchases a \$250,000 Single Life annuity and receives approximately \$17,902³ annually for the rest of his life. As income payments are considered to be both interest and return of capital, his taxable portion will be only \$4,166. Assuming a 45% tax rate, his net annual income

from the annuity will be \$16,028.

If he took the same amount of money and deposited it into a fixed-income investment yielding a return of 4.5% and systematically withdrew the same amount annually, his capital would be exhausted before he reached age 85. Conversely, with the annuity, if he lives to and beyond age 85 he'll not have to worry about outliving his income.

How much you should invest when purchasing an annuity will depend on your situation. An annuity should never be the only solution when it comes to retirement planning, but it can play an integral part of your retirement income plan.

Speak to your Portfolio Manager about the role annuities can play in your plan, drawing on our new Retirement Income Planning Tool. ■

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.

Make documents easy to find

Settling an estate can be an emotional time for family members, and the last thing they'll need is to get lost in a disorganized paper trail. Tell your family how and where you've filed your records and provide them with the names and contact information of your lawyer, accountant and portfolio manager. Just knowing where to immediately find all your up-to-date financial, legal and insurance documents will reduce unnecessary stress for your family during difficult emotional times.

Message from Dave Kelly, Group Head, Private Investment Counsel

As we greet the New Year and look forward to fresh opportunities in 2011, I'd like to thank you for putting your trust in us. It is a privilege to work with you and your family to help you achieve all of your financial goals.

To help you meet your objectives, we are committed to providing you with a robust suite of investment options, access to leading money managers and expert guidance at each step of your financial path.

Active listening

In 2010, we completed a strategic review process that involved actively listening to what is important to you. A number of themes emerged from this process. You told us that capital preservation and risk management were assuming much greater importance. You also told us you wanted more tax-efficient income solutions and access to investments that perform well at all points in the market cycle.

We listened, and then we acted. TD Waterhouse Private Investment Counsel introduced a TD Private

Canadian Blue Chip Dividend Fund focused on providing tax-efficient income. We also introduced two new TD Private Target Return Funds that aim to produce positive returns in all market climates.

The TD Private Target Return Funds are also competitive when it comes to fees, as no additional management fees are involved to purchase these funds.

As always, the TD Wealth Asset Allocation Committee is a key element in our dedicated approach to your wealth. The eight members of the Committee meet monthly to decipher the crosscurrents of global financial markets and provide guidance to help reduce risk and bolster returns.

Your wealth and your life

We also understand that decisions about your investments and your wealth are part of the bigger picture for you and your family. Our new Life Discovery Tool is our way of helping you see how the many strands of your life — including your family, your work and your legacy — fit together. Speak to your Portfolio Manager for more information.

Thank you again for placing your trust and confidence in us. We are dedicated to helping you achieve your goals and will continue to look for ways to bring more value to you in 2011 and beyond. ■

NOTICE

Notice to TD Private Funds and TD Mutual Fund® unitholders

The 2010 annual report for investment funds managed by TD Asset Management Inc. ("TD Funds") will be available at the end of March 2011. The 2010 simplified prospectuses are slated to be renewed in early 2011 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 2011 and August 2011, respectively. These documents are available directly at www.tdassetmanagement.com or by contacting your Private Investment Counsel Portfolio Manager.

The information in this newsletter is current as at December 16, 2010, and does not necessarily reflect subsequent market events and conditions.

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¹ TIPS — Treasury Inflation-Protected Securities (Bonds with returns linked to inflation)

² The "unusually uncertain" phrase was employed by Fed Chairman Ben Bernanke on July 21, 2010 when speaking before the U.S. Senate Banking Committee during his semi-annual testimony.

³ Source: Cannex 11/29/2010 (Canada Life)

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Wealth of Experience