

Investment Outlook

An exclusive quarterly report from TD Waterhouse® Private Investment Counsel Inc.¹

Fall 2007

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U.S. housing, sub-prime lending, and your portfolio

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

The biggest single issue facing the U.S. economy over the past year has been the troubled state of the American housing market. Meanwhile, the issue most affecting financial markets has been the related topic of sub-prime lending. In this issue of *Investment Outlook*, we will explore both phenomena, show how we have grappled with them on your behalf, and explain the impact on your portfolio.

The creation of the housing bubble

The current problems in U.S. housing had their origin earlier this decade. Readers may recall that prior to 9/11, the American economy had been weak and short-term interest rates were being cut (see Chart 1).

The events of 9/11 exacerbated that weakness and made U.S. authorities concerned about the potential for a deep recession or depression. In response, the U.S. Federal Reserve (the “Fed”) cut the benchmark federal funds rate. By mid-2004, the benchmark rate had reached 1%, the lowest level in half a century.

Cheap, abundant credit is a potent elixir for the housing market. The exceptionally low mortgage rates available at the time stimulated demand for housing, with U.S. home prices rising sharply in response. The blue line in Chart 2 reveals just how quickly U.S. home prices rose until late 2005.

The bubble bursts

Two factors burst this bubble of accelerating appreciation. First, U.S. short-term interest rates increased significantly from mid-2004 until June 2006 (depicted in Chart 1). Second,

CHART 1: U.S. federal funds rate

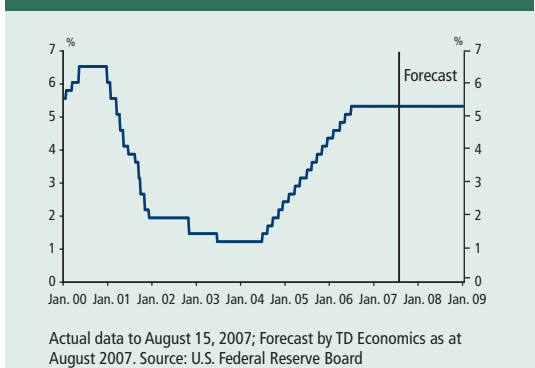
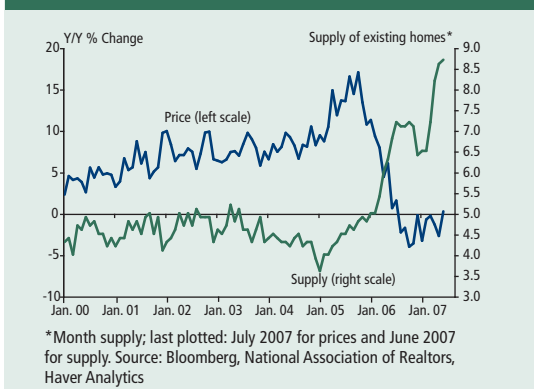


CHART 2: U.S. existing home prices & home supply



in 2005 the supply of U.S. homes began to increase dramatically (shown by the green line in Chart 2).

The combined effect of increasing supply and slowing demand is shown

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U.S. housing, sub-prime lending, and your portfolio

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by the blue line of Chart 2. Price appreciation began to decelerate sharply in late 2005; more recently, home prices have been falling.

The sub-prime lending fiasco

When credit was cheap and house prices were soaring, overly zealous U.S. lenders were tripping over each other, eager to provide mortgage financing to potential home buyers. The result was a lowering of credit standards, with mortgages granted to less-than-creditworthy buyers with no money down and interest-only payments.

These mortgages became known as “sub-prime,” distinct from “prime” loans extended to more reliable borrowers. During the overheated real estate market of 2005–2006, sub-prime mortgages accounted for 20% to 25% of new mortgages. Today, they represent about 10% of outstanding mortgages in the U.S.

Since many of the sub-prime borrowers had taken out adjustable-rate mortgages, their monthly payments increased with rising interest rates, causing the delinquency rate on sub-prime mortgages to double to their current level of 3%. Naturally, this has adversely affected U.S.

mortgage lenders that focused on the sub-prime market.

More important, many American lenders sold their sub-prime mortgage portfolios to securities dealers who packaged the loans as bonds. These were subsequently sold to yield-hungry investors. As the value of underlying sub-prime mortgages came into question, confidence deteriorated in both these securities and any fixed income investment of questionable quality. This crisis of confidence is at the heart of recent stock market weakness.

Protecting your assets

We were not surprised by the weakness in U.S. housing or sub-prime lending. In the Winter 2006 forecast edition of *Investment Outlook*, we expressed our concern about the looming crisis in the American housing sector. Later, in the Fall 2006 edition, we informed you that we were avoiding U.S. housing stocks, regional banks, sub-prime lenders, and manufacturers of consumer durables that would be vulnerable to a slowdown in residential real estate. Our actions have shielded you from the sharp reverses suffered in these sectors.

At the same time, the high-quality bonds that make up part of most client balanced portfolios have benefited from the upheaval. Investors’ flight to quality has pushed bond yields down and bond prices up, increasing the value of bonds and helping cushion the impact of stock market volatility.

A silver lining

The likelihood that the U.S. housing market will not be as strong in the coming years as it was earlier this decade should prove beneficial for the U.S. stock market. The “Equity shares” line on Chart 3 reveals that stocks’ share of American household assets dropped precipitously from a peak of 20% in 2000 to about 8% at present. This reflects both declining stock prices until the fall of 2002 and, more important, the massive shift into residential real estate over the same period, which increased to 33% of household assets from 23%.

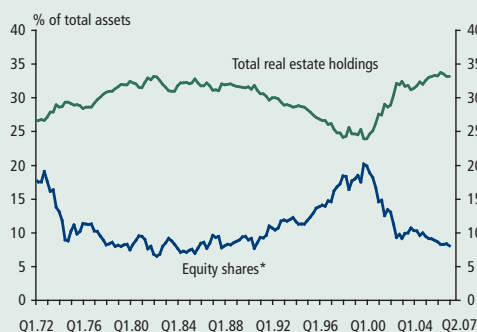
As Americans are now much less likely to count on sharply rising house prices in the coming years, we should see increased flows into the equity markets. The return of the individual investor to the markets should provide further support for stock prices.

The outlook

The recent pullback in global stock markets represents the first significant correction since the spring of 2006. As we stated then, there are legitimate concerns among investors but valuations are reasonable, earnings growth remains positive, and the bond market is supportive. As a result, we expect your portfolios to make renewed progress in the months ahead. ■



CHART 3: U.S. balance sheet – asset allocation



*Shares directly held at market value. Last plotted: Q1-2007.
Source: Federal Reserve Board/Haver Analytics

Effectively diversifying your portfolio

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

There are many great reasons to invest in Canada, as recent years have shown. We have a strong economy, which has been bolstered of late by high commodity prices. As a consequence, Canada has enjoyed significant trade and federal budget surpluses. The latter have allowed us to reduce our federal debt, and the country is in solid financial shape. Corporate profit growth has also been excellent.

Reflecting all of the above, Private Investment Counsel has had a very high proportion of client equity exposure in Canada for the past several years. In fact, Canada has represented 70% of our overall equity exposure.

This has been beneficial for clients. The Canadian stock market has done well, and our relatively modest foreign holdings have minimized the impact of the strong Canadian dollar.

Now, however, it is time to re-evaluate. While Canadian equities remain our biggest position, increasing selected foreign investments is a timely way to reduce risk and seek to enhance potential returns.

Time to rethink

The Canadian stock market typically out-performs other global markets during periods of strong commodity prices. As a result, periods of out-

performance have been cyclical.

While the high commodity prices that have helped propel our market since 2004 are very likely to stay above historical levels, they are not likely to provide the same impetus for our market in the next few years.

In addition, Canada represents only about 3.5% of global equity markets (see chart below); it stands to reason that there are some good investment ideas elsewhere. And with the Canadian dollar trading at its highest level in years, investors can use our now-valuable currency to buy foreign assets at relatively low cost.

Global focus

What to buy? In the U.S. and major international markets, especially Europe, some of the largest, highest-quality companies are trading at very

attractive prices.

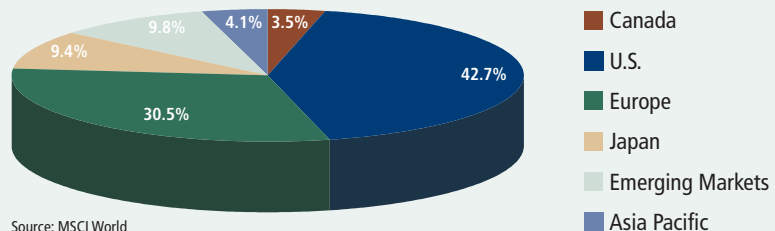
Global leaders in the pharmaceutical, industrial, and financial sectors have seen their price/earnings (p/e) multiples compressed in recent years, and may present some of the best values for investors. These companies typically display consistent sales and earnings growth, for which investors may well pay a premium if we enter a period of slower economic growth.

U.S.-based multinationals derive a high percentage of revenue and earnings from their overseas operations, providing a built-in currency hedge.

Individual client needs and objectives will dictate specific investment decisions and asset allocations. For further details, please speak with your Private Investment Counsel Portfolio Manager. ■

How global equity markets compare

This chart shows that Canada represents just 3.5% of world market capitalization. At 42.7%, the U.S. is still the biggest market.



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
- Where applicable, income trust holdings focus on higher-quality issues with stable, sustainable distributions
- Overweight European holdings and financial stocks within international equities

Percentage return for indices

(For the period June 15, 2007 – September 15, 2007)

Scotia Capital Universe Bond Index	2.0%
S&P/TSX Composite Index	-1.5%
S&P 500 Index	-6.2%
MSCI EAFE Index*	-6.7%

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

If illness strikes, protection is critical

Thanks to advances in medicine, the chances of surviving a critical illness have improved significantly over the past few decades.

When detected early and treated immediately, heart attack, stroke, and cancer patients now have a much higher rate of survival. In fact, according to the Heart and Stroke Foundation and the National Cancer Institute of Canada:

- More than 80% of heart attack patients admitted to hospital survive;
- 85% of stroke victims survive the initial event; and
- 75% of men and 77% of women who develop cancer survive.

Situation critical

Surviving a critical illness is extremely good news but it can be costly. Patients may be unable to return to work for some time.

Many are unable to return to their previous job, and need retraining in another field. They may need to travel to specialized facilities for treatment, or to hire someone to assist with household tasks while they're ill.

In many cases, survivors need to make modifications to their homes to accommodate disabilities. In severe cases, they may require long-term care.

Few people have sufficient cash on hand to meet costs of this magnitude. Even if they have disability insurance, it will replace only a portion of their income. And life insurance will pay beneficiaries only upon the policyholder's death.

Ease the burden

Critical illness insurance can fill the gap. It's designed to ease the burden for families facing unanticipated costs in addition to regular expenses.

Policies typically pay a lump-sum benefit if you survive 30 days after being diagnosed with a condition described in the policy definitions. Basic coverage can cover heart attacks, strokes, and cancer, while enhanced plans may provide protection against more than 20 illnesses.



How much is enough?

The critical illness benefit should be enough to enable you to take at least a year off work, plus enough to cover additional medical or other costs. Let's look at an example.

Bill is 45 and earns \$150,000 a year as a senior executive. His wife is a homemaker and cares for their two children, aged 10 and 12, who attend private school.

According to a 2003 Ipsos-Reid

poll, if Bill were to survive a stroke, he might face expenses such as the following:

- Acute-care costs (perhaps \$25,000 or more);
- Home renovations to accommodate a wheelchair (several thousand dollars);
- At-home nursing care (up to \$40 per hour); and
- Long-term care at a nursing home (\$30,000 to \$84,000 a year for a private nursing home, and \$12,000 to \$57,000 for a government-run facility).

An amount of \$250,000 would probably be sufficient to meet regular expenses and cover the extra costs arising from Bill's illness. He and his family would be able to use the \$250,000 for any purpose they choose.

Through insurance and estate planning specialists, your Portfolio Manager can help ensure that you and your family have the protection you need. ■

Each insurance policy or contract has different provisions in regard to coverages, benefits, exclusions and limitations. Any particular policy should be carefully reviewed to determine the rights and obligations of the owner and insured persons.

The people and situations identified in this brochure are fictional. These examples are intended to assist customers in identifying their needs. The circumstances emphasize the attributes of the products and strategies being described.

The insurance strategy described is not appropriate for all individuals. Particular insurance strategies should be evaluated relative to each individual's objectives and in consultation with a life licensed insurance advisor.

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The information in this newsletter is current as at September 18, 2007.

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