

# Investment Outlook

An exclusive quarterly report from TD Waterhouse® Private Investment Counsel Inc.<sup>1</sup>

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## Investing successfully in China's growth

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When speaking to investors across Canada, we find that one of the most common questions posed is how to best invest in China. This is not surprising, since China's rapid economic growth has been one of the major stories of recent years and its stock market, despite a recent correction, has exhibited great strength over the past year.

### Economic ascent and choppy markets

As has been well publicized, China's economy has exhibited scorching growth of 9%–10% in recent years. This has reflected liberalization of its economy, massive foreign investment to take advantage of China's ample supply of low-cost labour, and a high savings rate among its people.

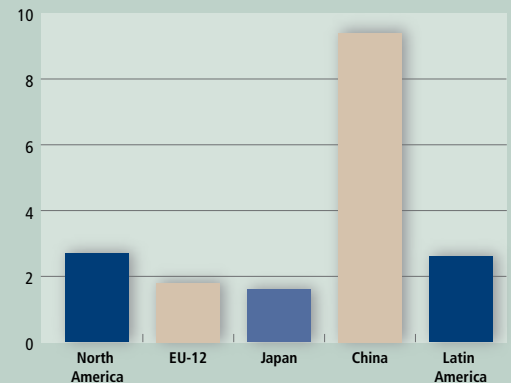
The chart to the right depicts China's rate of growth throughout this decade in comparison with that of other major economies. As illustrated, China's average growth rate of more than 9% has dwarfed the 3% figure exhibited by both North America and Latin America, which has, in turn, exceeded growth of less than 2% in both Europe and Japan.

At first blush, it would seem logical to assume that China's stellar economic record of late would translate into consistent stock market performance. Alas, this has not been the case, as depicted in the chart on Page 2, which contrasts Chinese economic and stock market performance. The graph's red line demonstrates the expansion of China's economy from 1996–2006, which more than tripled in nominal (before inflation) terms over that 11-year period.

### Global economic growth

#### China's economy leads the way

Average annual % change (2000–2005)



Source: International Monetary Fund

While the Shanghai stock market index has kept up with the Chinese economy over time, its path has been rocky and marked by extreme volatility. For example, the Shanghai Index peaked in 2001 and fell by about 44% over the following four years, even as the Chinese economy grew rapidly. The result was the Shanghai Index stood at the same level in November 2005 as it had eight years earlier, in November 1997. Subsequently, in 2006, the Shanghai Index reversed course and rose 130%, recouping the prior four years' losses and then some.

*Continued on Page 2*



## Investing successfully in China's growth

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### The Shanghai flu

That China's stock market exhibits exceptional volatility comes as no surprise. Like other emerging markets from the newly industrializing countries of Asia and Latin America, China's stock market is relatively small, its companies often demonstrate less than stellar accounting standards, and it is often subject to the vagaries of local politics.

This was amply displayed in the Shanghai market's recent sell-off. In short order, the Chinese government introduced a series of measures designed to dampen speculative fervour and reduce the liquidity, or cash, chasing Chinese stocks. Since the Shanghai Index was quite expensive, trading at more than 30 times current earnings, the market was susceptible to a sharp correction, which reverberated around the world.

### Participating in China's growth via Canada

If China's stock market is very volatile, often expensive, displays poor governance and is subject to political interference from the largest shareholder (the Government of China), how do

you invest to benefit from the rapid growth of its economy?

The answer, generally, is to invest indirectly in companies trading elsewhere, which will be beneficiaries of China's growth but trade in markets with higher accounting standards, clear rules and generally better valuations.

Perhaps the simplest illustration of such indirect investments is right here, in Canada. Many of our resource companies are major beneficiaries of the rapid industrialization in China and India, which has pushed commodity prices sharply higher and, in turn, earnings and share prices. Most notable are the energy stocks, which have benefited from the higher prices of oil and natural gas caused, in part, by incremental demand in the emerging markets. High-calibre, Canadian energy companies trading at reasonable valuations, such as **Encana**, **Petro-Canada** and **Suncor**, represent an excellent play on China's growth and are well represented in your portfolios. Similarly, Canadian producers of base metals, such as zinc, copper and nickel, have been winners as metal prices have climbed, as have their shares. Once again, such shares are

typically part of your portfolio holdings. One step removed from the commodity producers are Canadian railroad stocks, **CP Rail** and **CN Rail**, both of which have benefited from the higher volume of resource products cargo and the pricing power that has accompanied higher capacity utilization. Either one of these two stocks is typically held in the Canadian portion of your portfolio.

### Exposure in foreign markets

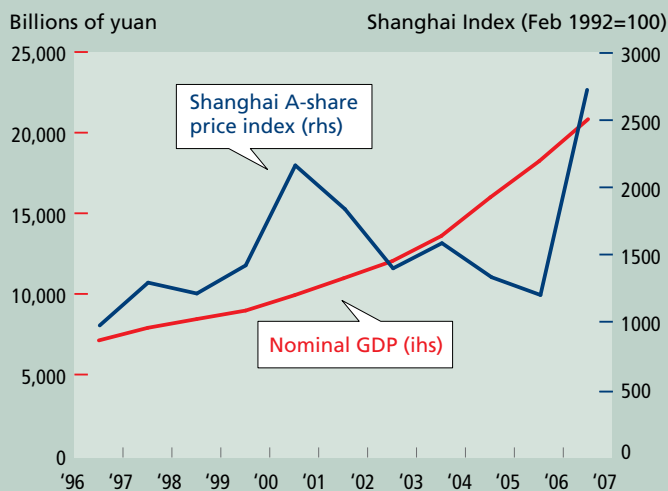
Among the best indirect means of participating in China's growth is the Japanese equity market. Japan, many are surprised to learn, is the world's largest exporter to China, typically of value-added products such as technology, electronics and robotics. While casual observers often think of the China-Japan relationship as a zero-sum game, with China's gain being Japan's loss, this is incorrect.

China's strength in recent years has been a significant factor in the recovery of the Japanese economy and stock market, represented in the international component of client portfolios. In a similar fashion, a number of European exporters held within our international portfolios have benefited from their rising shipments to China.

Finally, there are select Chinese companies that display the quality, size and reporting standards which meet our criteria and which we hold directly. The number of such companies will doubtless increase as the Chinese equity market matures, and you can expect to see more such direct exposure to China in the coming years.

China's emergence as an industrial power is and will be a key investment theme. Central to investment success will be the ability to capture that theme's investment returns without the current, excessive volatility of the Chinese market itself — precisely the approach taken within your portfolios.

### Chinese GDP and the stock market



While the Shanghai stock market index has kept up with the Chinese economy over time, its path has been rocky and marked by extreme volatility.

Source: China National Bureau of Statistics, Shanghai Stock Exchange, and Haver Analytics.

# Take steps now to preserve your estate

One of the responsibilities associated with significant wealth is taking appropriate steps to ensure that your chosen beneficiaries will receive it upon your death. A valid, up-to-date Will is essential, but you also need an estate preservation strategy. Otherwise, almost half of your estate assets' value could be eradicated by taxes.

## Taxation at death

Capital assets such as stocks, mutual funds and business interests are deemed for tax purposes to be sold at fair market value when you die. At present, capital assets are subject to the capital gains inclusion rate of 50%, which is then taxed at the deceased's marginal tax rate.

As you can imagine, the potential capital gains tax associated with items such as a family cottage purchased decades ago could be substantial. While capital assets can pass to your spouse with no immediate tax implications, they will still be taxable upon the death of your spouse.

The contents of your Retirement Savings Plan (RSP) or Retirement Income Fund (RIF) could also be subject to tax. Unless you leave registered assets to your spouse or a dependent child or grandchild, their full value will be entered as taxable income in the year of death.

There are other costs to consider as well — such as probate taxes that apply in many provinces, and legal fees.

Without an offsetting strategy or sufficient liquid assets, estate assets might have to be sold in order to meet the tax liabilities and expenses that arise at death. If the assets are of sentimental value, selling them may result in emotional as well as financial hardship.

## Estate preservation

Often life insurance provides an efficient, cost-effective way to preserve the value of an estate. Under current Canadian tax law, life insurance proceeds are received tax-free, providing immediate liquidity to pay taxes and other expenses that arise at death. Life insurance can also be used to generate a charitable donation upon death, thus resulting in a charitable donation tax credit.

There are various permanent insurance solutions available to fund an estate preservation strategy, including Universal and Whole Life insurance. This type of insurance may allow you to accumulate investments within the policy without paying tax on the growth, up to certain limits. Ultimately, permanent life insurance products allow you to customize the life insurance coverage to fit your risk tolerance, while helping to preserve and enhance the value of your legacy.

Determining the amount of coverage needed to preserve your estate involves

calculating expenses that will arise several years into the future. Your Portfolio Manager has access to financial planning tools specifically designed to determine the estate liabilities associated with your assets today and project their future cost.

This helps determine the amount of life insurance needed to cover all the potential liabilities that arise upon death, including final expenses, capital gains tax, income tax on registered assets, probate fees and other estate costs (based on current tax laws), as well as to fund bequests. The cost of the insurance can be quite effective when compared with other methods of funding the liability (such as paying it from the estate or setting aside funds in advance), especially when you take into account the time value of money.

*Contact your Portfolio Manager for information on an estate preservation strategy for your assets. With access to many of the top insurance carriers in Canada, we can help you select appropriate coverage for your needs.*

## Why you need life insurance

Imagine, Wayne, 60 and a widower, is successful in his career and is looking to maximize what he has saved to pass onto his children. As this table shows, the assets he has accumulated would currently trigger a tax bill of \$514,800 for his estate. And as these assets increase in value, so will the associated taxes. Permanent life insurance is one of the most effective solutions to fund Wayne's estate liabilities and final expenses.

	Original cost	Fair market value	Potential current liability	Estimated potential liability (age 90) <sup>1</sup>
Cash assets	—	\$200,000	—	—
Non-registered equity funds	\$650,000	\$900,000	\$56,250	\$1,044,788
Registered funds	—	\$750,000	\$337,500	\$172,261
Property (principal residence)	—	\$750,000	—	—
Cottage	\$150,000	\$600,000	\$101,250	\$303,760
Probate and legal	—	—	\$19,800	\$370,056
<b>Total</b>	—	—	<b>\$514,800</b>	<b>\$1,890,865</b>

<sup>1</sup> Liability calculation assumes further contributions of \$50,000 to non-registered assets per year to age 65, \$20,000 to registered assets per year to age 65, withdrawals of 10% per year from registered assets beginning at age 69, and legal and probate fees at death of 2% each.

## Canadians 55+ are working more, playing less

A recent Statistics Canada survey\* of Canadians over the age of 55 uncovered an interesting shift in time use and activity. Those between the ages of 55 and 64, for example, are spending on average one hour a day more on paid work than when the last survey was conducted in 1998. In fact, two-thirds (68%) of men aged 55 to 64 are working for pay, compared with 59% in 1998. For women, the results are similar: 51% working, compared with 41% in 1998.

Once they hit 65, however, Canadians begin to spend more time enjoying themselves. Men aged 65 to 74 devote an average 4 hours of every day to active leisure pursuits, such as golfing. Women in the same age group spend less than half an hour a day on paid work.

The study underlines what seems to be a growing trend among older Canadians. With an increasing awareness of healthy living and improved medical procedures, many Canadians are able to stay more

active longer. Fewer people seem to be striving for retirement at 55. Instead, they are continuing to generate earned income. Managed properly, this extra income can mean a richer retirement lifestyle, or a larger estate.

*For advice on how to make the most of your pre-retirement — or even post-retirement — income, speak with your Portfolio Manager.*

\*Statistics Canada General Social Survey: Time Use Patterns of Older Canadians

## Notice to all holders of the Private Dividend Fund

In your March Portfolio Report you will notice a change in the classification of the Private Dividend Fund. This fund had previously been classified as other Canadian bonds. Going forward, the Private Dividend Fund will be reflected as Canadian equities to more accurately reflect the composition of the fund. This fund will also distribute income monthly as of January 2007, to provide unitholders with more frequent income. In addition to these changes, the benchmark used to evaluate the performance of this fund has changed to: 25% Scotia Capital Universe Bond Index-C\$, 30% Nesbitt Burns 50 Preferred TR-C\$, 45% S&P/TSX 60 TR Index-C\$. Please contact your Portfolio Manager for further information on these changes.

## 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 non-Japan Asian holdings and financial stocks within international equities

### Percentage return for indices

(For the period December 15, 2006 – March 15, 2007)

Scotia Capital Universe Bond Index	1.1%
S&P/TSX Composite Index	0.7%
S&P 500 Index	-0.3%
MSCI EAFE Index*	2.7%

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

The information in this newsletter is current as at March 16, 2007.

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