

Investment Outlook

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

Summer 2006

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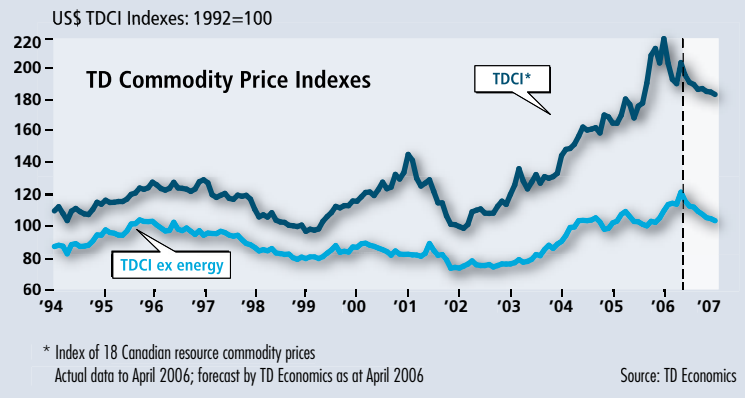
BY R.J. GORMAN, CFA, VICE PRESIDENT, PRIVATE CLIENT GROUP, TD BANK FINANCIAL GROUP¹

After a strong start to 2006 that saw Canadian and U.S. equity markets register high single-digit returns by April 30, stocks have shown increasing volatility, sending investors on an emotional roller coaster.

In May and early June, for example, North American stocks fell sharply and erased most of the year's gains. Why has this been happening? What is the outlook and what does it mean for your portfolio?

Canadian commodities pull back

As we anticipated, commodities have entered a more volatile phase, reflecting the prospect of slower U.S. economic growth.



Commodity prices drive market volatility

The principal reason for recent volatility in the Canadian market has been commodity price movement.

As depicted in the chart above, the TD Commodity Price Index has risen dramatically in recent years. Why? Well, throughout the 1990s and up until late 2001, as the chart illustrates, commodity prices remained low.

In fact, hard as it is to believe now, the price of crude oil was about US\$10 as recently as 1999. As a consequence of these low prices and resultant low profitability, commodity producers had developed few new mines or oil fields by the time the U.S. recession ended in late 2001.

Throughout 2001 and until mid-2004, in the wake of a mild U.S. recession and the events of September 11, 2001, the U.S. Federal Reserve reduced short-term interest rates

to extraordinarily low levels. Other countries followed suit and the result was strong global economic growth, which, when coupled with new-found strength in China and India, caused a resurgence in demand for commodities. Since little new production had come on stream in recent years, this increased demand came up against limited supply. The result was the recent commodities boom.

While commodity prices have risen for sound reasons, we have been expecting a pullback for some time. Prospects of slower U.S. economic growth and signs of specula-

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Making sense of market volatility

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tive commodity purchases by hedge funds meant that the 12% decline in the TD Energy Sub-Index by mid-May came as no surprise.

In anticipation of commodity-induced weakness, a more defensive position was adopted. Your portfolio holds very high-calibre energy issues to take advantage of the secular strength of this sector. At the same time, our energy holdings display strong defensive characteristics, making them less susceptible to commodity price weakness.

U.S. interest rates and housing

Two concerns cited in our January forecast — U.S. monetary policy and housing — have been major factors causing recent stock market volatility south of the border. In brief, U.S. interest rates have continued to rise, the yield curve has flattened further (see chart below), and short-term interest rates could go higher still. All portend a probable slowdown in U.S. economic growth, which is weighing on the market.

Meanwhile, the expected cracks in U.S. residential real estate are now on

full display, with housing sales down, unsold housing inventory up, and prices falling in overheated coastal markets such as Florida.

Your U.S. holdings have reflected our concerns. Your portfolios have virtually no direct exposure to the U.S. housing industry and we have avoided the U.S. regional banks and other lenders that could be vulnerable to a pronounced real estate slowdown.

Your mid-year portfolio update

In our January edition, we cited six key themes for 2006. It is now time for a brief, mid-term review.

Markets to continue steady increase. First, we anticipated that North American stock markets would rise for the fourth consecutive calendar year and register single-digit returns in 2006. At this point, that seems a probable outcome, notwithstanding the recent market decline.

U.S. small caps to underperform. Second, we indicated that U.S. small caps would underperform in 2006. While shares of smaller U.S. companies started strong, they have weak-

ened of late in anticipation of a U.S. slowdown and tightening credit. This remains a close call.

Movement into large-cap stocks. Third, the anticipated rotation into defensive, large-cap stocks is unfolding as investors shift into companies that exhibit consistent sales, earnings, and dividend growth. These defensive stocks figure prominently in your portfolio and have proven beneficial during recent market turbulence.

Bond yields to decline. Fourth, we stated that bond investors would earn their coupon in 2006, or roughly 4%. Canadian bonds have had difficulty in the year to date as bond yields have risen. As evidence mounts of slower economic growth, we expect bond yields to decline and this should result in returns at or close to coupon levels.

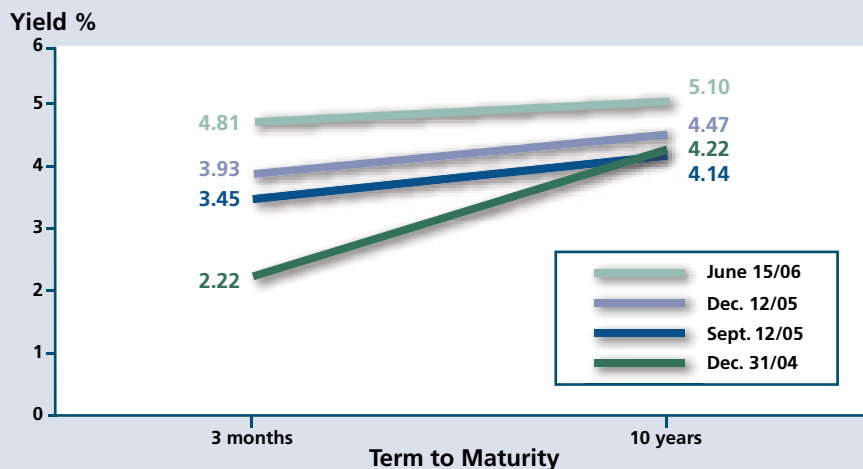
Income trust shakeout. Fifth, was the continuing bifurcation of income trusts into two categories: higher-calibre trusts that perform well and lower-quality issues that struggle with unmet distribution targets, reduced payouts, and falling share prices. This trend remains in effect. More important, the higher-calibre income trust holdings we manage on your behalf continue to perform well.

Japan to outperform. Finally, we had expected that the Japanese stock market would outperform the U.S. for the third consecutive year. Japan's Nikkei Index, like all Asian indexes, has lost ground of late, and now trails the U.S. We expect this to change in the second half of the year.

The recent market decline comes after a long period of uninterrupted gains and represents an overdue correction during the May–September period of seasonal weakness. Portfolios have been constructed to weather the current market storm and we expect a return to more positive markets later this year. ■

U.S. yield curve flattens

The yield curve has flattened significantly since the end of 2004. Long-term rates are now only 29 basis points higher than short-term rates.



How to minimize probate costs

BY ALAN WALKER, ASSOCIATE VICE PRESIDENT, PRIVATE TRUST², TD BANK FINANCIAL GROUP

The core of any estate plan is a valid and up-to-date Will that reflects both your financial and family situation, as well as the goals for your estate.

Your objective may be to keep the value of your estate intact while passing on your wealth in the way you see fit. Minimizing the cost of probate is an important part of maintaining the value of your estate.

Why is probate required?

The main purpose of probating a Will is to validate the appointment of the executor:

- Probate may be required before a legal change in ownership of real property can be made.
- Probate can protect the executor and third parties from legal liability.
- Third parties often require probated Wills before they will accept instructions from the executor named in the Will.

If probate is required, then probate tax* ranging from 0% up to 1.5% of the value of the estate is generally payable.

Some commonly used strategies to reduce probate taxes include:

- Holding property in joint name with right of survivorship.

- Designating beneficiaries on RSP, RIF, and life insurance plans.
- Creating *inter vivos* trusts.
- Making gifts during your lifetime.

A slightly more unusual strategy is the use of multiple Wills.

How can multiple Wills help?

This strategy involves preparing two Wills — one dealing with assets administered by third parties, such as real estate or financial institutions, and the other designed for personally held assets, like personal effects or shares of a private company.

It is possible to segregate assets of an individual into multiple Wills:

- A primary Will holding assets that require the probate process.
- A secondary Will holding assets that do not require probate.
- A secondary Will can also be used to deal with foreign-held assets, particularly real estate — where foreign probate/estate laws may be more complex.

The purpose of having two Wills is to probate only the first Will and pay probate taxes on the assets governed by that Will. The two Wills coexist and do not revoke each other. Accord-



Effective estate planning will minimize the costs that can reduce the value of your estate.

ingly, a multiple Wills strategy could be an effective probate cost minimization tool.

It is important to weigh the costs of preparing multiple Wills (and estate administration) against the benefits. If you reside in a province that has very low probate taxes, such as Alberta, or in Quebec, where most Wills are notarial Wills, there may not be a need for this strategy. You'll want to review this with your legal advisor to ensure that you have considered all potential ramifications.

To speak with a Private Trust specialist in your region about your estate planning needs, please contact your portfolio manager. ■

*It is critical that you discuss this with your legal advisor, as probate taxes are based on provincial statutes, which vary across the provinces.

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 Asian holdings within international equities

Percentage return for indices

(For period March 15, 2005 – June 15, 2006)

Scotia Capital Universe Bond Index	-0.4%
S&P/TSX Composite Index	-6.4%
S&P 500 Index	-6.3%
MSCI EAFE Index*	-7.5%

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

Keeping the family cottage in the family

BY ALAN WALKER, ASSOCIATE VICE PRESIDENT, PRIVATE TRUST, TD BANK FINANCIAL GROUP

In many families, a cottage is treated as a common property used by several generations. It is often treasured as a source of recreation, centre of family gatherings, and store of family history.

Difficulties can arise when the actual ownership of a cottage property passes from one generation to the next. For example, when the ownership passes to anyone other than a spouse, the transfer is subject to capital gains tax.

At a time when the value of cottage properties in Canada is increasing, in many cases the value of the property (and the tax bill) may be disproportionately higher than other assets of an estate. Your heirs could be forced to sell the cottage simply to pay the taxes.

Establishing a plan

You should first determine whether family members want to keep the cottage, and more importantly, whether they are willing to share the cottage, and the costs of upkeep and repairs.

The lifestyles and financial resources of your children will likely vary, and this can potentially lead to future conflict over decisions to be made.

One option could be to create a testamentary trust in your Will, to hold the cottage in trust for your children. Advise your children of your plan, and begin to involve them now in the decisions regarding the cottage — for

example, who uses the cottage and when, and what repairs or upgrades are to be made.

This could provide an opportunity to confirm with your children that they want to share the cottage and that they can make joint decisions regarding the property.

People are generally willing to accept a plan they are involved in developing, so don't wait until you are no longer there to guide them.

Other considerations

Think carefully about the selection of an experienced trustee to administer the trust, given the potential complexity of the issues that may arise.

Your Will needs to provide for the flexibility to deal with changes in individual circumstances of current and future family members.

Down the road, it may no longer



Passing the family cottage from one generation to the next is an important part of estate planning. Talking about it now can help avoid family conflict and disappointment in the future.

make sense to keep the cottage within the family, or individual family situations may require that a family member be able to sell his or her interest.

To speak to a Private Trust specialist in your region about keeping the family cottage in the family, please contact your portfolio manager. ■

Leveraged risk disclosure statement

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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