

# Investment Outlook

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

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## In this issue

The key role of CFA charterholders ..... 3

Current Private Investment Counsel Strategy ..... 3

Mid-year portfolio update ..... 4

## Takeover fever and your portfolio

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

One of the hallmarks of both Canadian and U.S. stock markets, throughout 2006 and to date in 2007, has been feverish takeover activity. Many large companies have been acquired by publicly traded competitors or, increasingly, by private equity firms.

**Inco, Falconbridge and ATI Technologies** are examples of firms taken over by other public companies, while the current battle for **BCE** is being waged between groups led by private equity. Since such takeovers are invariably completed at prices well above prevailing market values, these transactions are highly profitable for investors and well worth understanding.

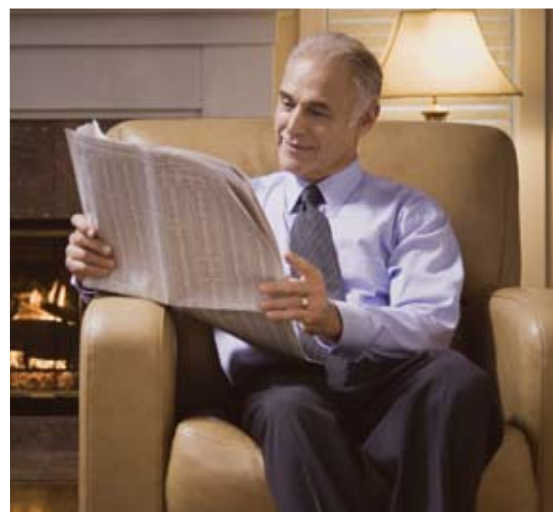
### Consolidation inspires takeovers

Nowhere has the urge to merge been more prevalent than in the mining sector. Iconic names such as Falconbridge and Inco have disappeared, taken over by foreign firms.

Both of these miners endured a long period of depressed nickel prices in the nineties and early stages of the current decade. In recent years, however, synchronized global economic growth and rising demand for stainless steel, of which nickel is a key element, gave rise to record nickel prices.

Flush with cash, mining conglomerates determined that it was cheaper to buy ore reserves on the stock market rather than drill for them; hence the acquisitions of Inco and Falconbridge with their profitable, long-life reserves.

This consolidation theme has been prevalent in many industries. **Dofasco** and **Domtar**, from the steel and paper sectors, respectively, represent excellent examples.



Recent purchases of publicly traded companies are very profitable for investors.

### Private equity becomes a force

Also worth noting is the increasingly high profile of private equity. Private equity represents investment capital, shares of which are not traded in public markets, such as a stock exchange. Ownership is private and not in the public domain.

Recently, private equity has been behind ever-larger purchases of publicly traded companies, some measured in tens of billions of dollars. Last year about US\$600 billion in publicly traded U.S. stock was taken off the market, much of it a result of private-equity

*Continued on Page 2*

## Takeover fever and your portfolio

Continued from Page 1

buyouts. This represented almost 5% of the total U.S. stock market.

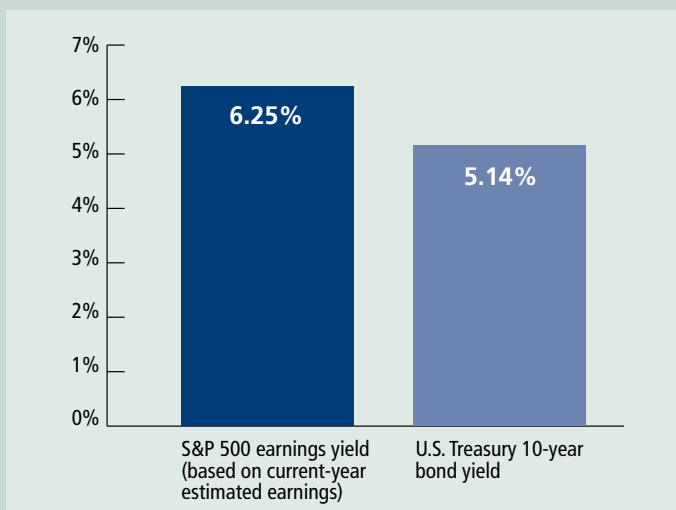
The ascendance of private equity reflects the availability of cheap, abundant credit for financing acquisitions. Readers of the June 2006 issue of our sister publication *TD Perspectives* or the winter 2007 edition of *Investment Outlook* may recall our discussions of the importance of comparing low, long-term interest rates against equity prices.

As the chart to the right illustrates, the interest rate attached to a 10-year bond has been well below the earnings generated by a typical North American company (called the earnings yield). This means that well-financed private equity firms could borrow large sums at low cost and buy out a publicly traded company, secure in the knowledge that the earnings of the acquired company should cover the borrowing cost of the acquisition.

Once the newly privatized company is out of the public eye and away from the pressure to focus on short-term, quarterly earnings, the now-private business will generally restructure

### Low interest rates fuel takeovers

Low interest rates combined with relatively high corporate earnings have created the ideal environment for takeovers. Private equity firms are able to borrow the large amounts needed without taking on a high level of risk.



Source: TD Securities

operations. Often, the company will become more efficient in the process and be taken public once again some years hence.

A fine example of this process was

the acquisition of **Shoppers Drug Mart** from the Imasco conglomerate in the late nineties by private equity firm Kohlberg, Kravis. Shoppers was restructured and put back on the public market as a standalone Canadian company earlier this decade. More recent examples of Canadian privatizations include **Four Seasons Hotels** and **Fairmont Hotels and Resorts**.

### Who is buying whom?

This table lists some of our holdings that have been acquired, along with the name of the buyer.

Sector	Acquired company	Buyer
Energy	Shell Canada	Royal Dutch Shell
Materials	INCO	CVRD
Technology	ATI Technologies	AMD
Materials	Falconbridge	Xstrata
Industrials	Dofasco	Arcelor
Materials	Placer Dome	Barrick Gold
Utilities	Terasen	Kinder Morgan
Health Care	Aventis SA	Sanofi-Synthelabo
Materials	Franco-Nevada Mining	Newmont Mining

### Profitability in acquisition targets

While we do not purchase stocks strictly for their appeal as takeover candidates, our selection criteria are often the same as would-be acquirers. As a result, clients have been beneficiaries of many takeover bids, some of which are cited in the adjacent table.

Individual client holdings vary, of course, depending on client needs and objectives. For an assessment of how your holdings may have been affected by merger and acquisition activity, speak with your Portfolio Manager.

## The key role of CFA charterholders

Being an educated consumer is important, especially when it comes to your money. That is why you need to be familiar with CFA Institute and the CFA® (Chartered Financial Analyst®) designation.

Through its education, standard-setting and advocacy programs, CFA Institute sets the benchmark with respect to knowledge, integrity, and professionalism in the investment industry. As a result, when you work with a CFA Institute member, you can feel confident that he or she has the requisite investment knowledge and adheres to the Code of Ethics and Standards for Professional Conduct.

Your direct exposure to CFA Institute may seem limited; but in the end, virtually all of the CFA Institute programs and initiatives are designed to serve you, the investing public.

### What is the CFA Program?

The CFA Program is a graduate-level, self-study curriculum and examination program for investment specialists, particularly securities analysts, money managers, and investment advisors.

Established in 1962, the CFA Program sets the global standard for investment knowledge, standards, and ethics. Clients, employers, and colleagues know that a CFA charterholder has mastered a rigorous curriculum covering

a broad range of investment topics and is committed to the highest ethical standards in the profession.

Earning the designation also serves as a “passport” to entrance or advancement within the profession or to work in other countries.

### Who administers the CFA Program?

The CFA Program (its curriculum, exams, and grading) is administered by CFA Institute.

### What are the CFA Institute Code of Ethics and Standards of Professional Conduct? Why are they important to you?

Membership in CFA Institute and the CFA designation symbolize integrity. This is important because the trust that you place in your investment advisor must be unconditional.

To be worthy of such trust, your advisor’s integrity must never come into question. For this reason, CFA Institute members and CFA charterholders must comply with the CFA Institute Code of Ethics. This Code of Ethics requires them to always place the client’s interests first, to maintain independence and objectivity, and to serve with integrity and honesty. As a result, you can invest with confidence.

The Code works in tandem with the Standards of Professional Conduct,

which clarifies how to apply rules, regulations, and ethical guidelines within the investment industry so that investment professionals can safely avoid ethical quandaries and properly serve their clients and employers.

Should ethically based complaints be lodged against CFA charterholders, they are required to disclose these complaints in full detail to CFA Institute or risk losing the right to use the CFA designation.

Source: CFA Institute

### What does the CFA designation mean to TD Waterhouse Private Investment Counsel?

The majority of our portfolio managers are CFA charterholders. And all of our portfolio managers have completed the educational requirements for registration as portfolio managers, which in most provinces includes successful completion of Level I of the CFA curriculum, at a minimum.

At TD Waterhouse Private Investment Counsel, we adhere to the CFA Institute Code of Ethics and Standards of Professional Conduct.

We also support our employees in their pursuit of the CFA designation and their continued educational development. Our goal is to provide you with discretionary investment management, delivered with integrity and confidence.

## 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 March 15, 2007 – June 15, 2007)

Scotia Capital Universe Bond Index	-2.6%
S&P/TSX Composite Index	10.5%
S&P 500 Index	0.2%
MSCI EAFE Index*	0.5%

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

# Mid-year portfolio update

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

**W**ith the halfway point in 2007 upon us, this is an opportune time to revisit this year's forecast, compare our key themes to what has transpired and outline how your portfolio should fare over the balance of the year.

## 1 The U.S. stock market should rise for the fifth year in a row and generate double-digit returns.

Our first theme for 2007 was based on the existence of reasonable valuations, a supportive bond market, and our view that the travails of the housing sector would cause a slowdown but no recession and that the presidential cycle would assert itself in 2007.

At the time of writing, the S&P 500 has recorded a solid single-digit return for the year to date, so we appear to be on track to reach our objective.

Detracting from results to date has been the recent strength of the Canadian dollar, which has partially offset gains in U.S. stocks. Our currency's rebound has reflected a recovery in oil prices and some strong Canadian economic data.

Currencies often overshoot on both the upside and the downside, however, so just as our dollar descended to a too-low U.S. 62 cents several years ago, it may remain perched above its fair value for a while. Nonetheless,

U.S. stocks should fare well for clients over the year, in either currency.

**2 The rotation into large-cap U.S. stocks should continue.** After a slow start to the year, large caps have indeed outpaced their smaller counterparts of late and this appears to be unfolding as suggested.

**3 Canadian stocks should also rise for a fifth straight year, recording single-digit returns as leadership rotates into less-cyclical sectors.** So far, Canadian equities have registered single-digit advances, so our forecast looks solid. We expect the shift into more defensive industries to unfold in the year's second half.

**4 Bond returns of about 4% in 2007.** While bond yields have backed up in recent weeks, depressing returns in the second quarter, we expect the 4% figure to hold up for the year as a whole.

**5 Within the energy trust sector, weaker trusts should fall prey to forced mergers, making it imperative to be invested only in the higher-calibre energy trusts.** The recent merger of Shiningbank and PrimeWest, two struggling trusts, is an example of the activity that we

forecast. Meanwhile, the higher-quality energy trusts, in which we have invested on your behalf, continue to make solid progress.

**6 Europe should be the best major international market in 2007.** This appears to be working out, as Europe has staged a solid, upper single-digit return to date, with a firm euro currency unit aiding Canadian investors.

As usual, there is no shortage of issues to worry about. An overheated Chinese stock market, tightening monetary policy in Asia, turmoil in the Middle East and a disquieting bond market are but a few.

Nonetheless, we expect to navigate through this turbulence and record another year of solid returns for your portfolio in 2007.

## Investor 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.

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

The statements contained herein are based on material believed to be reliable, but are not guaranteed to be accurate or complete. Articles do not provide individual financial, legal, tax or investment advice and are for information purposes only. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any fund or portfolio. Investments should be evaluated relative to each individual's investment objectives. TD Waterhouse Private Investment Counsel Inc., The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

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