Private Investment Counsel

Investment Outlook

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In this issue

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Your portfolio: Investment Outlook 2007

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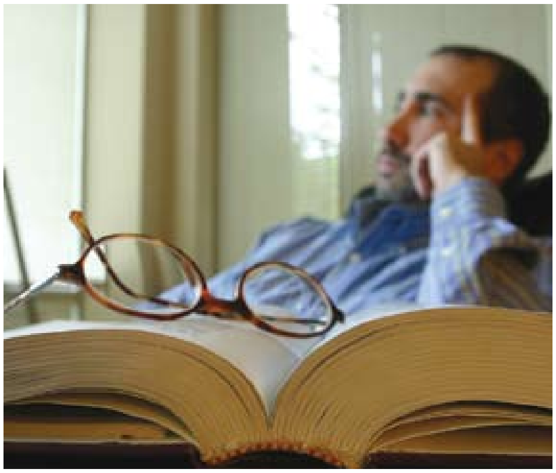
The New Year brings a valuable opportunity to examine what transpired in financial markets and in your portfolio in 2006. Equally important, it is time to outline what we believe will happen in 2007.



We believe 2007 will represent a year of very solid progress for your portfolio.

2006: The year in review

Last year at this time, we identified a number of themes that we felt would dominate in 2006. Let's review whether we were on target.

Theme 1: North American stock markets will continue their advance and rise for a fourth consecutive calendar year. Specifically, we stated that Canadian and U.S. markets would register mid-single-digit gains. Our prognostications have proven accurate with regard to the markets' direction, though the major indices, recording low double-digit returns at the time of writing, have performed somewhat better than forecast.

Key reasons for optimism one year ago were reasonable valuations (P/E multiples of 15 to 17 times) and solid corporate earnings growth. This worked out largely as planned. If anything, earnings growth was better than anticipated in 2006 and has helped ignite a strong rally in the fourth quarter.

The two major sources of concern cited last year were U.S. monetary policy and the anticipated slump in the U.S. housing market. In brief, we did witness the expected flattening and ultimate inversion of the yield curve and the resultant slowdown in the U.S. economy, characterized last year as a "mid-cycle correction." Meanwhile, the U.S. housing sector entered its first pronounced slump in over a decade. Neither factor was sufficient to offset the positive factors laid out above.

Theme 2: U.S. small-company shares (small caps) will underperform their large-cap counterparts. This was predicated on the fact that small caps were no longer cheap and that tightening credit conditions and a slowing economy would not augur well for smaller companies. In fact, while the shares of smaller companies did underperform large-caps for much of 2006, as we go to press, it looks as if

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small-caps may outperform in 2006 as a whole.

Theme 3: Market leadership will rotate into more defensive, large-cap stocks, characterized by stable sales, earnings, and dividends. South of the border, we cited **Colgate-Palmolive** and **PepsiCo** as beneficiaries of this trend. Both have done very well over the past 12 months. In Canada, we identified **Manulife**, **Sun Life**, and **Power Financial** as examples of this trend; all have made good progress.

Theme 4: Bond investors will earn a coupon approximating 4% and corporate issues will modestly outperform government bonds. This reflected our forecast of a flattening yield curve with longer-term interest rates remaining within a relatively narrow band. At present, bond returns seem poised to be close to the 4% forecast and corporates have indeed generated slightly higher returns than government issues.

Theme 5: Income trusts will bifurcate into high- and lower-calibre issues in a more pronounced fashion and trust returns will be lower than in past years. This has transpired, with the fate of lower-calibre trusts exemplified by the 30 or so issues that have had to cut or eliminate their distributions over the past year. In addition, trust returns were lower than in prior years even before the federal government's announcement of October 31 (see sidebar on Page 4 for a review of investment implications).

Theme 6: The Japanese stock market will continue to outperform its U.S. counterpart. This was the same call made in each of the previous two years, during which Japan's Nikkei Index had risen about 50% from around 10,700 to more than 16,000. The expected continuation of this advance was based on reasonable valuations, solid earnings growth, Japan's status as the largest exporter to China, and an improving banking sector.

Alas, investor concerns over a lower rate of corporate profit growth, slightly tighter monetary policy, and implications of reduced exports to a slowing U.S. economy left the Nikkei up less than expected in 2006 and our forecast off the mark.

So much for history. Let's now look ahead.

Dominant investment themes for 2007

We believe the central issue for global financial markets in 2007 will be the direction of the U.S. stock market. In our fall 2006 issue, we laid out the countervailing positive and negative forces affecting the outlook for the U.S. market. Let's quickly recap. We cited three major negative factors to be concerned about:

1. The U.S. economy is slowing, as confirmed by the 2.2% rate of growth in the third quarter of 2006, well below the average growth rate recorded in recent years. This is largely a result of tightening monetary policy, which has given rise to a mildly inverted yield curve (see chart below) which, in turn, could mean further slowing ahead.

2. The downturn in U.S. housing is upon us, with house sales and prices down while inventories of unsold houses and foreclosures are sharply higher.

3. As a result of the above, corporate profit growth should slow in 2007.

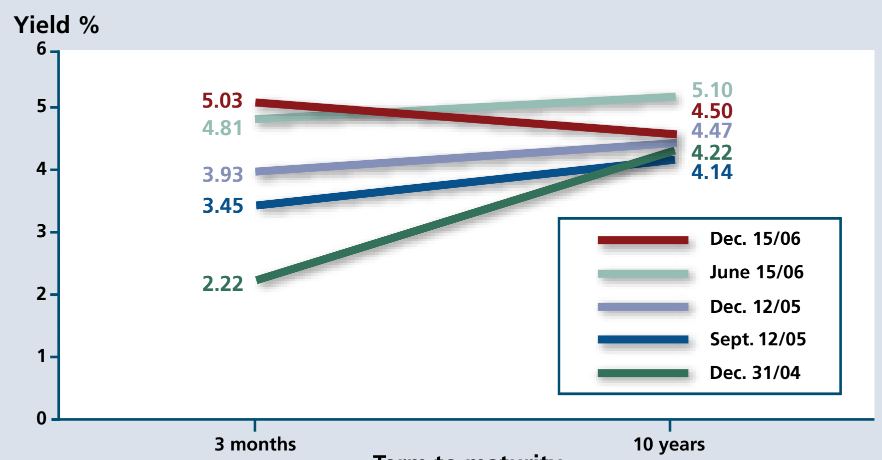
We identified the following key positive factors:

➤ Valuations are reasonable, approximating 16 times estimated '07 earnings.

➤ There is a supportive bond market. The U.S. stock earnings yield (earnings divided by the share price) is 6.25% (based on the P/E multiple of 16 cited above), or about 38% higher than the 4.50% yield of the 10-year U.S. Treasury Bond (see chart on next page). Normally, these two

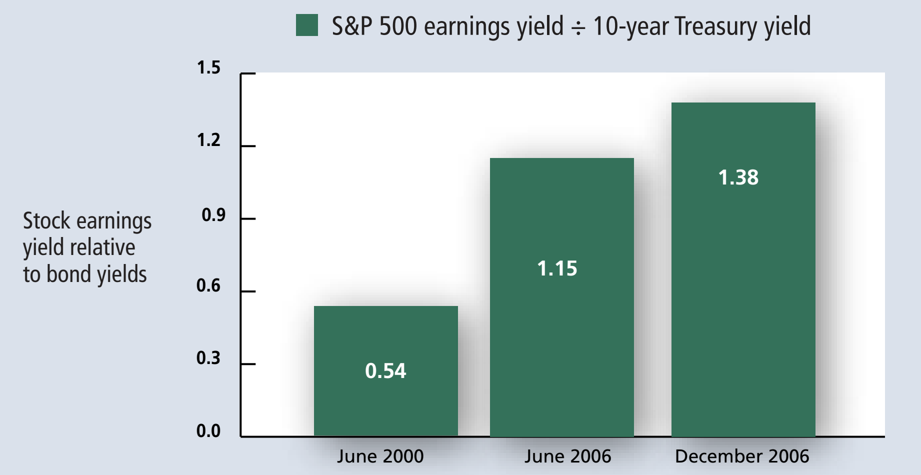
U.S. yield curve inverts

The U.S. yield curve has now inverted, a portent of a slowdown in the economy.



Source: TD Securities

Stocks represent good value versus bonds



Source: Bloomberg Financial Services

yield figures are close. The significantly higher earnings yield indicates that stocks are not expensive relative to fixed income alternatives.

➤ Monetary policy should become more accommodative, as U.S. short-term interest rates decline modestly in 2007.

➤ Housing, while a major contributor to the U.S. slowdown, should not precipitate a recession.

➤ Currency risk should not be a major factor for your portfolio as the Canadian dollar is not likely to appreciate significantly in relation to the greenback. In fact, with some commodity prices likely to soften in 2007, our currency may edge downward slightly against the U.S. dollar.

➤ The year 2007 represents the third year of the U.S. presidential term, which is generally a strong year for U.S. equities. Historically, years one and two of the presidency, which follow the presidential election, represent a period of tightening monetary policy and a rigourous legislative agenda. Conversely, years three and four — when monetary policy is often more accommodative and legislation less controversial (in anticipation of the next presidential election) — are far better for the U.S. stock market.

While it is naïve to slavishly follow any one historical indicator, all the factors listed above suggest that the presidential cycle should have a positive impact in 2007.

U.S. market forecast

Since our fall issue, the U.S. market has staged a brisk rally. While a pullback in the near term would not be surprising, we remain positive and **theme number one for 2007 is that we believe the U.S. stock market should rise for the fifth year in a row, record its best year since 2003, and could generate double-digit returns.**

Theme two is that, within the U.S. equity markets, we should witness the continuing rotation of leadership into large-cap stocks. This trend, which began in 2006, is driven by valuation.

Since 2000, P/E multiples of large caps have been compressed. Today, shares of the largest, highest-calibre businesses often trade at a discount to the market.

In 2007, leadership among the large-caps is expected to broaden beyond the household goods producers cited last year to include, for example, major U.S. banks such as **Citigroup** and **Bank of America**, which exhibit dividend yields of about 4% and low P/E multiples. We also expect home improvement retailers such as **Home Depot** to benefit later in 2007, as will the technology sector, beneficiaries of pent-up demand, strong corporate balance sheets, and a steepening yield curve. These positions, or similar issues, are represented within your U.S. holdings where appropriate.

The Canadian stock market outlook

The Canadian stock market has outperformed its U.S. counterpart since 2002, even before considering the impact of the rising Canadian dollar, which has had the effect of depressing the returns of U.S.-dollar-denominated investments.

Canada's outperformance in recent years has reflected two factors. First, U.S. short-term interest rates have risen more than our own. Second, and more important, has been the impact of rising commodity prices, which have been very beneficial for Canadian producers.

In 2007, we expect U.S. short-term interest rates to slip more than Canadian rates, providing greater impetus for U.S. equities. We expect commodity price movement to be uneven in 2007, with mixed results for Canadian stocks.

We expect to see leadership within the Canadian stock market shift from cyclical sectors to the less cyclical in 2007. Past favourites such as **Manulife**, **Sun Life**, and **Power Financial**, and major banks including the **Royal Bank** and **Bank of Nova Scotia**, should be solid performers in this environment.

Theme three is that without the same impetus from natural resources, the Canadian stock market will likely underperform its U.S. counterpart for the first time since 2001. Still, it should generate creditable single-digit returns.

Fourth, after several years of rising short-term interest rates in both Canada and the U.S., 2007 will witness a change in direction. Short-term interest rates peaked last summer and should begin to decline modestly in the coming months. Bond yields are likely to stay within a narrow band, and **bond investors should once again earn their coupon of about 4%**. Corporate issues should continue to generate slightly higher returns than government bonds and are well represented within your portfolio, where mandates permit.

In 2007, the focal point within the income trust group will be energy trusts. **Our fifth theme is that 2007 will represent a flashpoint, as some energy trusts become viewed as diminishing assets, their cash flow is impaired, and mergers in the sector result, with stronger trusts taking out the weak.** In this environment, it will be important to invest in energy trusts displaying strong management, finances, and a history of successfully replenishing reserves and production. Your core holdings of **Bonavista, Arc,** and **Vermillion**, among others, display these traits.

Finally, **theme six is that we feel that Europe will represent the best major international market in 2007**. Trading at 12 times estimated ’07 earnings, in line with its earnings growth rate, and sporting a dividend yield exceeding 3%, Europe represents very good value at current levels. Japan remains on solid footing and we are maintaining our positions, but it may not repeat its very strong performance cited earlier. In summary, we believe 2007 will represent a year of very solid progress for your portfolio. ■

Proposed income trust tax changes and your portfolio

On October 31, 2006, the Federal Minister of Finance proposed a new tax on distributions by income trusts to their investors. This was done to stem the conversion of Canadian corporations to income trusts. Should the proposed taxes become law:

- Commencing in 2011, income trusts in existence prior to the October 31 announcement, excluding most real estate investment trusts (REITs), will pay tax at a 31.5% combined federal/provincial rate on most income distributed to investors. Taxable Canadian dividends, business income earned outside Canada, and return of capital payments will be exempt from this new tax.
- Investors who receive distributions subject to the new tax will pay tax on these distributions as dividend income and not ordinary income. This is important, as it sharply reduces the impact of the new tax on investments held outside RSP/RIF accounts.

Investment implications

In the wake of the October 31 announcement, income trusts sold off sharply, although Private Investment Counsel (PIC) clients were generally not much affected for several reasons.

First, income trusts are but a part of clients’ portfolios, so even as income trust share prices declined, prices of your dividend-paying stocks rose and often fully offset the trusts’ impact.

Second, we have been underweight in oil and gas trusts, which were often the most adversely affected by the Federal announcement.

Third, we have been somewhat overweight in REITs, which have been largely unaffected by the proposed new tax.

Finally, our emphasis on large, higher-calibre trusts left your portfolio less susceptible to the sell-off that befell many smaller, lower-quality issues.

The high-calibre trusts held within PIC client portfolios should continue to represent a solid investment. We will be monitoring the income trust market closely in the months ahead and taking any necessary action on your behalf.

Leverage 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.

Choosing your executor — a trust company can bring value

BY ALAN WALKER, ASSOCIATE VICE PRESIDENT, TD WATERHOUSE PRIVATE TRUST

One of the most important estate planning decisions you will make is deciding who your executor (or executors) will be. The person you select is responsible for protecting your property, fulfilling the wishes you express in your Will, making decisions in a timely fashion, and being responsive to the needs of your heirs. An executor's duties are extensive, and the involvement of a professional may be appropriate for you.

Estate planning assistance

Trust companies, including The Canada Trust Company, have offices across the country staffed by professionally trained Trust Officers who will provide personal attention to your heirs — listening to their needs and goals, explaining the decisions that need to be made, and completing tasks quickly and efficiently.

The trust company will assist you at the planning stage. When appointed as corporate executor (or co-executor), the professionals at The Canada Trust Company will help you develop a Will or estate plan that clearly sets out your wishes and ensures the executor has the authority and flexibility to deal with all property expeditiously and to the advantage of your beneficiaries. They will partner with your professional advisors and share their extensive experience in estate and trust administration.

Management of tasks

One of the most daunting tasks for many executors is to complete the necessary tax returns. As many as four returns may need to be filed for the year of death. If prior years' returns have not been filed, they need to be completed. The executor must not only have an understanding of the tax provisions that apply in Canada, but must also be familiar with those of any foreign jurisdictions where you may own property.

The trust company will take on the burden of protecting all property (business, investments, real estate, and personal collections), paying all debts and taxes, and coordinating all work with other professionals. It will ensure the assets are appropriately managed during the administration of the estate before property is transferred to the heirs or to a trust.

Perhaps of most importance is the relationship a Trust Officer will establish with your heirs — listening to their concerns and questions, keeping them informed on estate issues, and advising them on the challenges of dealing responsibly and wisely with their inheritance. The trust company has the advantage of access to expertise in investment management, taxation, and banking to meet the needs of beneficiaries.

An effective solution

While many executors may try to manage estate administration on their own, it is often advisable to get professional help to assist in settling an estate. A trust company can play a role (as executor, co-executor, or acting as agent for an executor) to administer the estate quickly and efficiently.

Perhaps most importantly, a trust company can take on the responsibilities at a time when family members may be least able to cope with complex decisions. An impartial executor such as The Canada Trust Company will help avoid conflicts of interest or disputes within a family and recommend solutions to problems.

The costs will be based on a percentage of the value of assets in the estate. Trustee fees are partially tax deductible, which along with time savings, can help reduce the costs of estate administration.

You may think that a trust company will act only where there is great wealth. This is not the case, and for most of us, the value of our property — home, investments, retirement plans — is often greater than we may think. ■

To speak with a Private Trust specialist about your estate planning needs, contact your Portfolio Manager.

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 September 15, 2006 – December 15, 2006)

Scotia Capital Universe Bond Index	1.8%
S&P/TSX Composite Index	11.1%
S&P 500 Index	12.5%
MSCI EAFE Index*	15.3%

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

Resolving to stay on track in ’07

Looking for New Year’s resolutions that are worth keeping? Here are seven that will make your life a little less complicated, could help enhance portfolio returns, and might even save you some money.

1. Consolidate your investments

When you consolidate, keeping track of your financial life becomes simpler.

With fewer statements to review, you will be able to determine quickly whether your portfolio is diversified and structured to achieve your personal financial goals.

Consolidating your investments will save you time explaining pieces of your financial life to several advisors. Instead, invest your time wisely developing a relationship with one advisor who will be able to see your big picture more clearly. The results should be a financial strategy that is better positioned to meet your personal goals.

We often find that clients with multiple advisors have duplicated investments and too much exposure to a particular asset class or industry sector. This may result in unnecessary risk and volatility.

You could even save money. When you have larger amounts to invest, you may be eligible for reduced fees.

2. Where do you want to go in 2007

When was the last time you re-evaluated your financial goals? Sometimes life’s developments call for new objectives.

For example, your plans can be altered by the birth of a child, marriage, divorce, increased income, or even a change in the state of your health. If this is the case, it is time to meet with your Portfolio Manager to review your investment strategy with your new goals in mind.

3. Save and invest more

Find ways to funnel more earnings into savings and investments. Consider a pre-authorized plan to save automatically, or invest a portion of your income every month.

4. Maximize your RSP contribution

If you are not already doing so, contributing the maximum amount to your RSP should be one of your key priorities. The sooner you get money into an RSP, the longer it has to grow while sheltered from tax. And if you missed making contributions in the past, 2007 is a good time to take advantage of unused contribution room.

5. Consolidate your retirement plans

Whether you are contributing to an RSP or taking income from a RIF, consolidating your plans with us will make record keeping and tax reporting easier.

6. Be tax-smart

Plan now to save taxes and invest tax-effectively. And remember that the dividend tax credit increased in 2006.

Taxation can affect how your investments perform inside and outside your registered plans. Consolidating your registered and non-registered investments with your Portfolio Manager will allow him or her to assist you in allocating your investments in a tax-efficient manner.

7. Meet with your Portfolio Manager

With professional guidance, you can help to ensure that you keep your financial resolutions for 2007. Your Portfolio Manager can show you how to make the most of your investments and financial plan. ■

Notice to TD Asset Management Inc. unitholders

The 2006 annual report for investment funds managed by TD Asset Management Inc. (“TD Funds”) will be available at the end of March 2007. The 2006 simplified prospectuses are slated to be renewed in early 2007 for all 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 2007 and August 2007, respectively.

These documents are available directly at **www.tdassetmanagement.com**, or by contacting your Portfolio Manager.

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