Portfolio, Action & Research Team

BMO Nesbitt Burns®

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Portfolio Strategy March 2009

Since the last edition of *Portfolio Strategy* in early December 2008, global equity markets rallied and then gave back most or all of their gains into the end of February. This market action is consistent with our belief that, although equities at the late November lows represented excellent value, the epic nature of this bear market would require a considerable period of price consolidation before a solid foundation for the next cyclical bull market would be in place.

In fact, as this is written, the S&P 500 Index has slightly breached its November 2008 closing low of 752.44, to close February at a new bear market low of 735.09 — its lowest close since 1997. February 2009 was the worst February since 1933 for U.S. equity markets.

The S&P/TSX Composite Price Index fell 6.6 percent in price terms in February. Remarkably, the six months ended February 2009, with a combined price loss of 41.0 percent for the S&P/TSX, is the worst six-month period for Canadian equity markets in the history of our records, which begin in January 1919. However, unlike the broad U.S. equity markets, at the end of February the S&P/TSX was still 5.3 percent above its November 2008 closing low, at 8132.02.

Global equity markets, as represented by the Morgan Stanley Capital International World Index, fell 10.2 percent in U.S. dollar terms, and 6.8 percent in Canadian dollar terms due to ongoing weakness in the loonie *(Table 1)*.

Change in Recommended Asset Allocation

In this issue of *Portfolio Strategy*, we change our recommended asset allocation, further reducing exposure to EAFE (Europe, Australia, and Far East) equity markets in favour of the United States, and for the first time explicitly recommending portfolio exposure to the U.S. corporate bond market. As we will discuss below, we believe that there is a great return opportunity in the high yield sector of the U.S. corporate bond market, and a good return opportunity in the investment-grade corporate bond market.

As we wrote in *Investing Road Map* last month, we think of corporate debt as an equity substitute in investment portfolios. With this in mind, we recommend that, rather than deploy the monies raised by reducing the EAFE allocation into U.S. equities, investors allocate to the high yield sector of the U.S. corporate bond market. More risk-averse investors could instead invest in the investment-grade sector of the U.S. corporate bond market.

Table 1: World Indices as of February 27, 2009

		High	February 27, 2009	% Decline from High
S&P/TSX Composite	on	15,073.13 6/18/2008	8,123.02	-46.11
S&P 500 Index	on	1,565.15 10/9/2007	735.09	-53.03
DJ Euro Stoxx 50 Index	on	4,557.57 7/16/2007	1,914.51	-57.99
FTSE 100 (UK)	on	6,732.40 6/15/2007	3,695.18	-45.11
CAC 40 (France)	on	6,168.15 6/1/2007	2,623.31	-57.47
DAX (Germany)	on	8,105.69 7/16/2007	3,759.79	-53.62
Nikkei 225 Index (Japan)	on	18,261.98 7/9/2007	7,280.15	-60.13
KOSPI Index (South Korea)	on	2,064.85 10/31/2007	1,063.03	-48.52
Hang Seng Index (Hong Kong)	on	31,638.22 10/30/2007	12,811.60	-59.51
Shanghai SE Composite (China)	on	6,092.06 10/16/2007	2,093.45	-65.64

Source: Bloomberg

Whither Capitalism?

It would not surprise us if our readers were despairing for capitalism at this point. In the last week of February, the Obama administration introduced its first budget, laced with tax increases for high income earners and a massive increase in the federal budget deficit. Topping it all off, on the last day of February General Electric cut its dividend (its first dividend cut since **1938**), and Citigroup suspended dividends on its preferred shares to induce its investors to join the federal government and convert their preferred shares into common shares, with the government's stake in Citigroup rising to 36 percent.

Economic Data Relentlessly Downbeat

We won't recapitulate the grim economic data released in the three months since our last edition of *Portfolio Strategy*. Our readers have no shortage of sources for this information. What we would like to do, though, is discuss two important segments of the economy where we believe activity has slowed to an unsustainably low level.

Stein's Law famously says that if something cannot go on forever, it will stop. We take a great deal of heart from this law — it leads us to believe that the contraction in U.S. economic activity has reached an unsustainably low level in two of the most important sectors of the economy: residential homebuilding and automobile sales.

Housing Starts Unsustainably Low

For example, in the U.S. housing market, new housing starts have fallen steadily for more than three years now, and the January reading showed housing starts at a 446,000 annual rate. This is the lowest rate since the Commerce Department began keeping records in 1959. At this rate it would take nearly 280 years to replace the U.S. housing stock. More typically, housing is replaced at an average age of about 70 years.

We expect that the months' supply of new homes in the U.S. should fall at a fairly high clip, because housing starts should be at an annualized rate of more than 1.5 million just to keep up with replacement demand as a result of floods, fire, tornados, and population growth.

Vehicle Sales Unsustainably Low

And, the most recent reading on U.S. vehicle sales shows a seasonally adjusted annualized rate of 9.12 million vehicles — the lowest rate since 1981. If U.S. vehicle sales were to persist at this level, it would take more than 27 years to replace the rolling stock.

Now, some families that previously had three vehicles might in the future have only two, and those that previously had two might in the future live with one instead, but given that the average age of vehicles on the road in the U.S. is at a new record high of 9.4 years according to R.L. Polk & Co., it seems to us only a matter of time before vehicle sales have to pick up sharply.

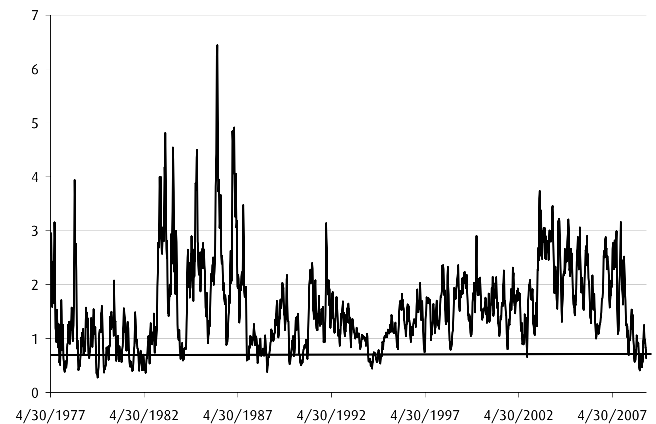
The above examples do not mean that recovery is imminent, but do suggest that with economic activity at such a low ebb, it would be difficult for the U.S. economy to slow much further.

Indications That the Market is Slowly Beginning to Turn

As the bear market has unfolded, we have been monitoring a number of indicators of investor sentiment, risk aversion and panic as we try to assess the evolution of the bear market. In *Investing Roadmap* published last month, we pointed out that we were beginning to see some glimmers of light in the indicators that we monitor. While no-one knows where and when the bottom will be, taken together our indicators suggest that the bear market is very advanced at this stage.

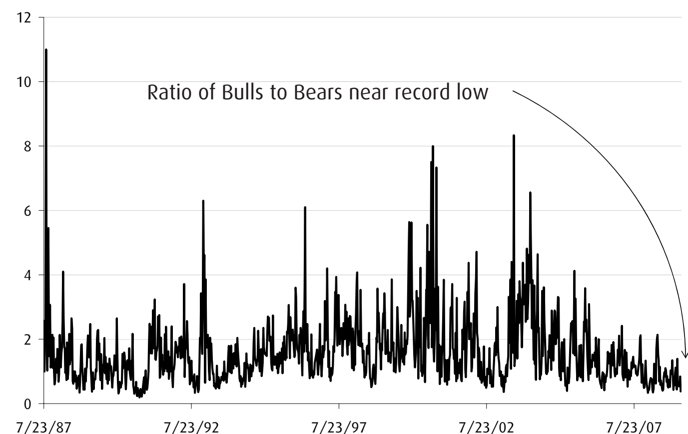
Our indicators include surveys of investor sentiment and consumer confidence, data on equity and bond mutual fund sales, yields on government securities, and yields on investment-grade and high-yield debt and their yield spreads relative to government debt.

Chart 1: Ratio, Investors Intelligence Bulls/Bears



Source: Investors Intelligence

Chart 2: Ratio, AAII Bulls/Bears



Source: Bloomberg, BMO Capital Markets Equity

Investor Sentiment Still Extremely Negative

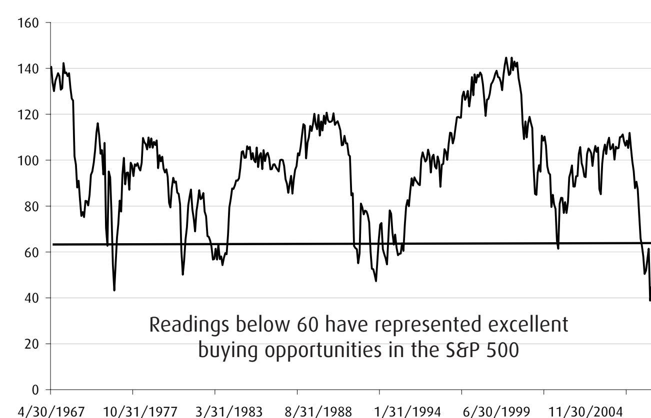
The sentiment surveys performed by the American Association of Individual Investors and Investors Intelligence both continue to indicate very high levels of investor bearishness. From a contrarian perspective, this is positive.

We believe that respondents to these surveys express an opinion about the market that they have already acted upon. With the very low ratio of bullish respondents to bearish respondents, we conclude that a majority of investors have satisfied their urge to sell equities *(Charts 1 & 2 on the previous page)*.

Uncharted Territory for the Consumer Confidence Index

Among the measures of investor sentiment, risk aversion and panic that we have been monitoring as the equity bear market progresses we have shown that the Conference Board's Consumer Confidence Index in the past has been reliable for identifying when sentiment was sufficiently washed-out as to signal a good entry point for the equity markets *(Chart 3 & Table 2)*.

Chart 3: Conference Board Consumer Confidence Index



Source: Bloomberg

In past editions of *Portfolio Strategy* and *Investing Roadmap*, we showed that — prior to this bear market — in 27 instances of a Consumer Confidence reading below 60, the S&P 500 had not shown a loss on a total return basis on a one-year or two-year horizon, and that the average rate of return on a raw percentage basis was quite high.

Following the failure of Lehman Brothers and the government takeover of AIG, not only did the bear market morph into the second-worst stock market crash in modern history, but consumer sentiment plummeted along with world equity

Table 2: Lower Price/Peak Earnings Lead to Higher Subsequent Returns

	Conference Board Consumer Confidence Index Readings Below 60	S&P 500 Price Index Level Then	S&P 500 Price Index Level 1 Year Later	S&P 500 Price Index Level 2 Years Later	Raw Price Return, % 1 Year Later	Raw Price Return, % 2 Years Later
October, 1974	54.5	73.9	102.9	87.04	39.24	17.78
December, 1974	43.2	68.56	107.46	89.21	56.74	30.12
February, 1975	54.5	81.59	99.82	96.83	22.34	18.68
May, 1980	50.1	111.24	132.59	111.88	19.19	0.58
June, 1980	56.1	114.24	131.21	109.61	14.85	-4.05
March, 1982	56.7	111.96	152.96	159.18	36.62	42.18
April, 1982	57	116.44	164.42	160.05	41.21	37.45
June, 1982	56.7	109.61	168.11	153.18	53.37	39.75
August, 1982	56.9	119.51	164.4	166.68	37.56	39.47
September, 1982	58.1	120.42	166.07	166.1	37.91	37.93
October, 1982	54.3	133.71	163.55	166.09	22.32	24.22
November, 1982	57.4	138.54	166.4	163.58	20.11	18.07
December, 1982	59.5	140.64	164.93	167.24	17.27	18.91
January, 1983	59	145.3	163.41	179.63	12.46	23.63
January, 1991	55.1	343.93	408.79	438.78	18.86	27.58
February, 1991	59.4	367.07	412.7	443.38	12.43	20.79
November, 1991	52.7	375.22	431.35	461.79	14.96	23.07
December, 1991	52.5	417.09	435.71	466.45	4.46	11.83
January, 1992	50.2	408.79	438.78	481.61	7.34	17.81
February, 1992	47.3	412.7	443.38	467.14	7.43	13.19
March, 1992	56.5	403.69	451.67	445.77	11.89	10.42
August, 1992	59	414.03	463.56	475.5	11.96	14.85
September, 1992	57.3	417.8	458.93	462.71	9.84	10.75
October, 1992	54.6	418.68	467.83	472.35	11.74	12.82
June, 1993	58.6	450.53	444.27	544.75	-1.39	20.91
July, 1993	59.2	448.13	458.26	562.06	2.26	25.42
August, 1993	59.3	463.56	475.5	561.88	2.58	21.21
May, 2008	58.1	1400.38	?	?	?	?
June, 2008	50.4	1280.00	?	?	?	?
July, 2008	51.9	1267.38	?	?	?	?
August, 2008	56.9	1282.83	?	?	?	?
October, 2008	38.8	968.75	?	?	?	?
November, 2008	44.7	896.24	?	?	?	?
December, 2008	38.6	903.25	?	?	?	?
January, 2009	37.4	825.88	?	?	?	?
February, 2009	25.0	735.09	?	?	?	?

	Raw Price Return, % 1 Year Later	Raw Price Return, % 2 Years Later
AVERAGE	20.21	21.31

Source: Bloomberg

markets. The Consumer Confidence Index has fallen from one record low to another in the last five months, and has been below 60 for nine of the last 10 months. At its most recent reading, the index registered at 25, a new all-time low since the inception of the series in 1967.

With the unprecedented lows in Consumer Confidence we are now observing, the very long run of readings below 60, and the fact that at the time of the first sub-60 reading in this bear market the S&P 500 was at 1400, it seems highly likely that for the first time in the history of the data, a negative total return on a 12-month horizon will be experienced in the S&P 500. It is in our opinion a too-heroic assumption that the S&P 500 could recover all the way to 1400 by May of this year, which it would have to do in order to keep the track record of this indicator intact.

However, we continue to believe in the essential utility of this indicator as a gauge of public awareness of economic difficulties. When taken in the context of the very bearish investor sentiment, we believe it indicates universal awareness of the ongoing financial crisis. This increases the likelihood that the market has mostly 'priced in' the difficulties.

Equity Mutual Fund Sales Data Encouraging

In late 2008, equity mutual funds in the U.S. and Canada saw record monthly net redemptions. At its worst, in the U.S. the 12-month rolling sum of net sales of equity mutual funds set a new record: US$238.7 billion in net redemptions. In the history of the data, there have only been two prior instances when the 12-month rolling sum of equity mutual fund sales turned negative: after the stock market crash in 1987 and towards the end of the stock market meltdown after the popping of the tech/media/telecom bubble. In hindsight, both of those were better times to be buying equities, not selling.

From a contrarian perspective, we take encouragement from this data. Looking at the very high levels of redemptions in 2008, particularly the monthly records set in September and October and then the marked decrease in net redemptions since then, we believe that the urge to sell on the part of small investors has been satisfied. This implies to us that the capitulation for small investors has already taken place.

Measures of Panic Continue Well-Behaved

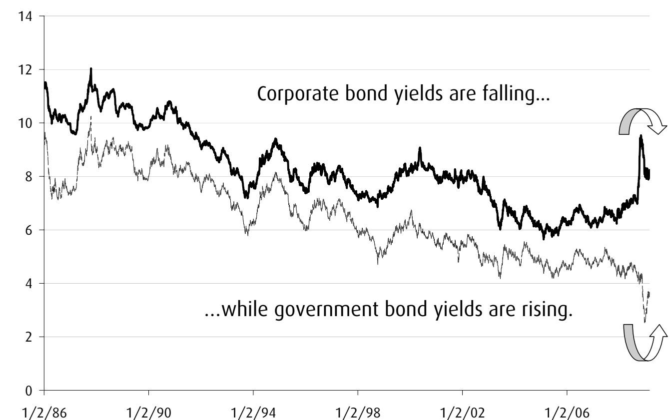
Two of the measures of investor panic we monitor, the S&P 500 Volatility Index, or VIX, and the Merrill Option Volatility Estimate or MOVE, have contracted sharply since late 2008 and remained relatively well-behaved as the U.S. equity markets moved to new lows. We see this as encouraging — it suggests that lower equity prices are not inducing panic. Rather, it suggests to us that investors are resigned to the bear market in equities, more evidence that the market has mostly 'priced in' the bad news.

Measures of Risk Aversion Continue to Improve

Regular readers know that we have been monitoring the yield differentials between corporate bonds, both investment-grade and high yield, and government securities. In addition, we have been following the absolute level of corporate bond yields in our effort to gauge the progress of the bear market. In particular, our focus has been on the U.S. corporate bond market. We have seen meaningful improvement in these measures of investor risk aversion since late November 2008.

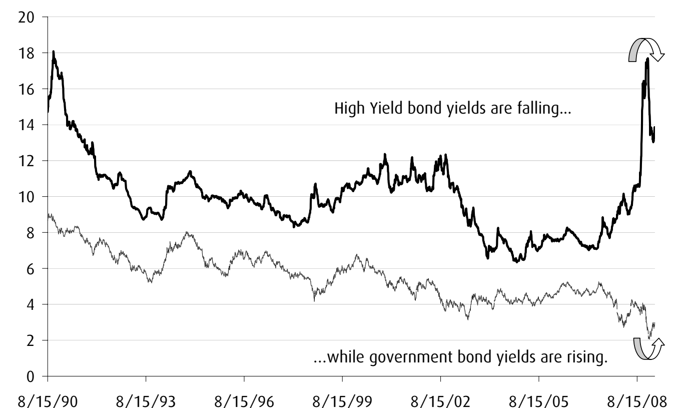
The yield differentials between corporate bonds and government securities in late 2008 reached levels last seen during the Great Depression, if at all. We believe that the rise in corporate bond yields and yield spreads over government bonds largely was the result of forced selling by leveraged market participants, such as hedge funds.

Chart 4: Yield Spreads are Narrowing — The Right Way
Moody's Seasoned Baa Corporate Bond Yield vs 30-Year Treasury Bond Yield



Source: Bloomberg, FRB St. Louis

Chart 5: Yield Spreads are Narrowing — The Right Way
KDP High Yield Daily Yield Index vs 10-Year Treasury Note Yield



Source: Bloomberg, FRB St. Louis

If one were to take the spreads between corporate debt and government securities at face value, one would conclude that we would soon see higher default rates than were experienced in the Great Depression. Clearly, we do not believe this is in prospect.

Corporate Bond Yield Spreads Continue to Narrow — The Right Way

Markets for corporate debt, both investment grade and high yield have improved markedly since late 2008. To us, this suggests that investor risk aversion is falling, and is an early sign that the healing process for global markets is getting underway. Yield spreads between government bonds and corporate debt have narrowed sharply, and in the best way possible: government bond yields have been rising as corporate bond yields have been falling *(Charts 4 & 5 on the previous page).*

This means that returns from corporate debt have been very robust since late 2008. But even with the dramatic reduction in yields and concomitant rise in prices, corporate debt is still trading at wider spreads than prevailed at the depths of earlier bear markets for corporate debt. To us this means that there is still a tremendous return opportunity in the corporate debt markets *(Charts 6 & 7).*

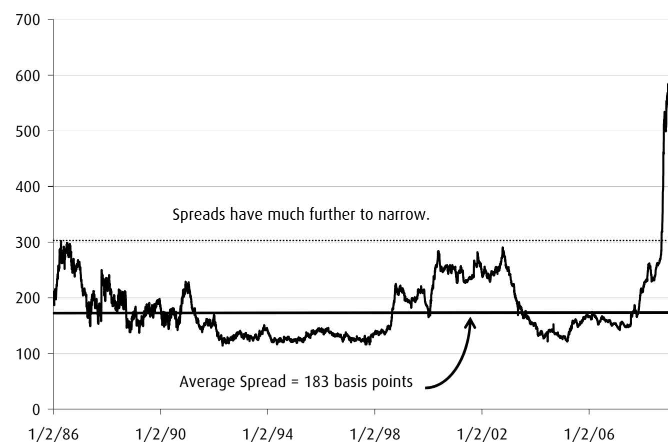
The Opportunity in High Yield Bonds

In the December 2008 *Portfolio Strategy* and in the February 2009 *Investing Roadmap*, we discussed the opportunity in the high yield, or junk bond, markets as well as the general opportunity in the investment-grade corporate bond markets.

We're going to flesh out the opportunity in the high yield markets. 'High yield' is the euphemism for junk bonds — corporate bonds rated below BBB-minus.

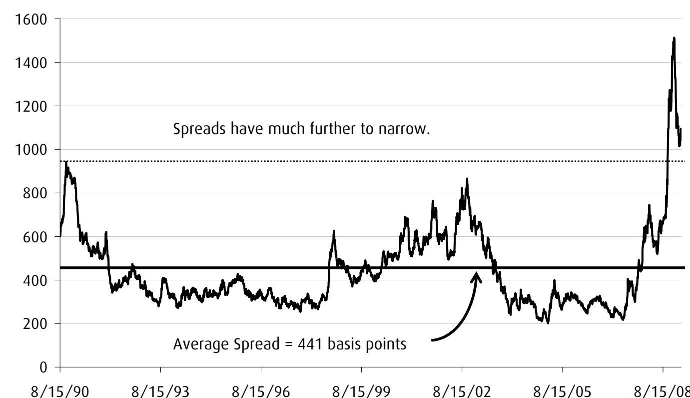
As we have pointed out, this financial crisis and bear market had its roots in the credit markets, and before significant upside progress can be made in the equity markets, we believe that the credit markets must improve. As this takes place we believe that investors will be paid good rent for their money, and that there is meaningful potential for capital gains in the U.S. corporate bond markets as well *(Chart 8).*

Chart 6: Yield Spread, Moody's Baa Corporate Bond Yield less 30-Year Treasury Bond Yield



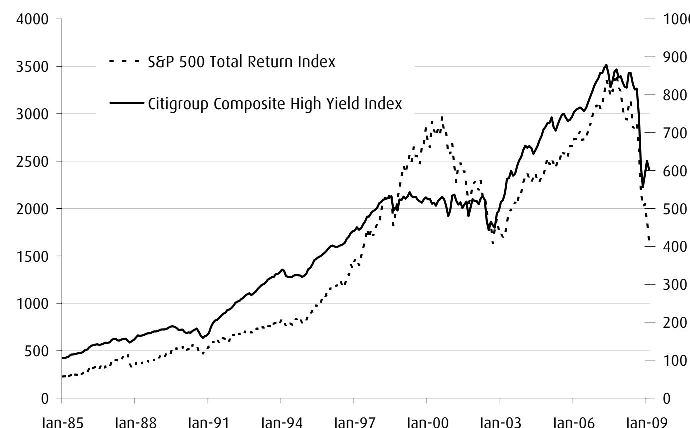
Source: FRB St. Louis, Moody's Investors Services

Chart 7: Yield Spread, KDP High Yield Index less 10-Year Treasury Note Yield



Source: Bloomberg, FRB St. Louis

Chart 8: High Yield Bond and Equity Returns Highly Correlated: High Yield Leads



Source: Ibbotson, Bloomberg

We fully expect a spike in the default rate for high yield bonds, but we believe that the yield available for a broad portfolio compensates sufficiently for this risk. In the nearby table, we do a 'back of the envelope' calculation showing the potential for good returns from the high yield sector, using a high-yield bond exchange-traded fund (ETF) for our example *(Table 3)*.

High Returns Possible in Spite of Default Rate Spike

In the last two credit crises in the high yield sector, the three-year cumulative default rate reached about 25 percent. For the purposes of our calculation, we assume that this time around the three-year cumulative default rate will reach 30 percent — worse than the two most recent spikes in the default rate, but not as bad as that experienced during the Great Depression *(Chart 9)*.

Our simplified calculation suggests a total return of more than 33 percent for a three-year holding period. To make the calculation more conservative, we are assuming zero recovery on defaulted bonds, and no re-investment of interest income received. In the period 1982–2007, investors in speculative-grade bonds recovered roughly 37 cents on the dollar. If similar recovery were experienced in this cycle, our rough-and-ready return estimate could rise by a further 11 percent.

In the last *Investing Roadmap* we showed a chart with a regression line suggesting that the expected return from high yield should be on the order of 60–70 percent on a three-year investing horizon. That type of return experience is entirely in the realm of possibility. In our example, we are making what we believe to be very conservative assumptions.

Equities in 'Deep Value' Zone

As we have written in the last *Portfolio Strategy* and *Investing Roadmap* we believe that equities represent great value on a price/peak earnings basis. At the end of February, the price/peak earnings ratio for both the S&P/TSX Composite and the S&P 500 were back below 10 — a level that in the past has foreshadowed robust five- and 10-year rates of return from equities.

In the United States in particular, when earnings for the S&P 500 peaked at US$89.75, financial earnings comprised US$24.81 of that figure. If we strip out financial earnings from the 2007 peak of US$89.75 for the S&P 500, the remaining peak earnings of US$65.24 against the February close of 735.09 results in a price/peak earnings ratio of 11.26 — a level still associated with quite robust rates of return on a five- and 10-year horizon. So, objectively the U.S. stock market is particularly cheap.

Equity Market Outlook

From a technical perspective, the S&P/TSX Composite and the S&P 500 remain in bear markets, and quite frankly the worst bear markets in living memory. As we have written many times, we will only know in hindsight that a bottom has been made for the equity markets.

We believed that the late November lows were likely to be retested, and that the market would rebound from the vicinity of those lows. In the U.S., trading in the last week of February put paid to that notion. On the last day of February, the S&P 500 broke down through its November 20, 2008 closing low of 752.44 to close at 735.09 *(Charts 10 & 11 on the following page)*.

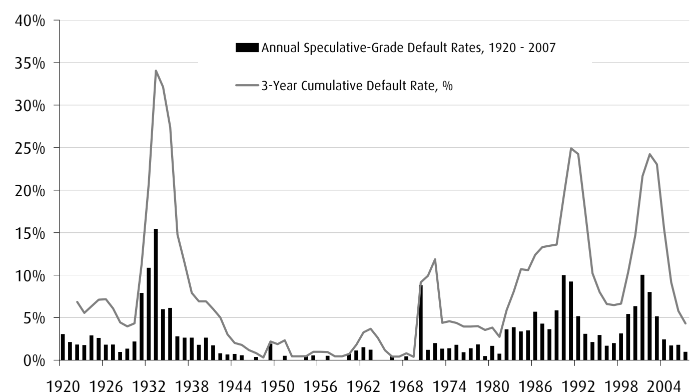
Table 3: High Yield — Back of the Envelope

SPDR Barclays Capital High Yield Bond Fund ETF-Ticker: JNK
Yield to Maturity: 17.49% as of February 26, 2009

Simplified Estimate of 3-Year Raw Return, %	
Yield returned in Year One:	17.49%
Less Defaults at 10%:	-10.00%
Yield returned in Year Two:	15.74%
Less Defaults at 10%:	-10.00%
Yield returned in Year Three:	14.17%
Less Defaults at 10%:	-10.00%
Assumed Recovery :	0.00%
Estimated Price Appreciation over 3 Years:*	15.75%
3-Year Return Estimate, %:	33.15%

**(based on an expected 350 basis point drop in yield)*

Chart 9: Annual Speculative-Grade (High-Yield) Default Rates, 1920-2007



Source: Moody's

BMO Capital Markets Quantitative Research indicates that on its quantitative screens the S&P/TSX Composite Index and all its sub-indices remain undervalued.

BMO Capital Markets Equity Research Strategist Ben Joyce believes that, based on his earnings forecast and valuation models, the equity bear market should bottom in the first quarter of 2009 at approximately 7700 for the S&P/TSX and 700 for the S&P 500.

BMO Capital Markets Equity Research has lowered its one-year target for the S&P/TSX Composite and S&P 500 indices to 9,500 and 925, respectively.

S&P/TSX Composite Index market sectors currently rated Outperform include Precious Metals & Minerals, Integrated Oils, Railways, Consumer Discretionary — Cable, Durables and Apparel, and Telecommunications Services.

Chart 10: S&P/TSX Composite Price Index

Source: Bloomberg

Chart 11: S&P 500 Composite Price Index

Source: Bloomberg

Table 4: Recommended Asset Allocation as of March 2009

	Income		Balanced		Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	10	5	5	5	5	5
Fixed Income	55	70	30	45	10	25
Equity	35	25	65	50	85	70
Canadian Equity	15	15	25	25	35	35
U.S. Equity	20	5	* 35↑	15	* 40↑	20
EAFE Equity	0	5	5 ↓	10	10↓	15

* Allocate 5% of portfolio to U.S. Corporate Debt.

U.S. Credit Investment Recommendations

DANIEL SOLOMON, CFA, SENIOR MANAGER, FUND RESEARCH
DENNIS FONG, MUTUAL FUND ANALYST, FUND RESEARCH

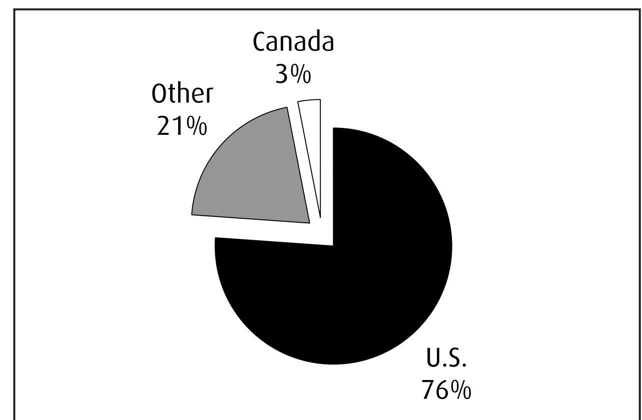
In the last *Portfolio Strategy* issue, corporate debt (investment grade and high yield) was highlighted as a potential investment opportunity. We revisit this "corporate debt" theme in this month's issue and further emphasize the points discussed in last month's report. We will provide context on the benefits of investing in the corporate debt asset class — risk/reward potential, correlation with other major asset classes and income/yield generation. Finally, we provide some investment options for you to consider for both mutual funds and ETF's.

We suggest that any weighting placed in High Yield Bonds should be taken from the Equity portion of your portfolio and not be considered as part of the fixed income allocation. High Yield Bonds displayed significant positive correlation with equity markets while being negatively correlated to Government Bonds, which makes them a potential equity substitute from a risk/reward point of view. Even though the yields are appealing, rising defaults are likely to continue to provide some headwind in the short term. We are suggesting that you gradually build a position in that space and consider keeping a higher quality focus at this time or keep a significant portion in Investment Grade U.S. Corporate Bonds.

Why Focus on the U.S. High Yield Market?

When it comes to High Yield Bonds, the approximately 35 Canadian issuers represent 3% of the Merrill Lynch Global High Yield Index, and are heavily concentrated in a few industries. Contrast this with south of the border and you will find a vast pool of 876 U.S. issuers covering a wide range of industries with 76% of the Index being available. It should not come as a surprise that most Portfolio Managers focus on U.S. High Yield in order to build a portfolio where the largest position often does not exceed 2-3% in order to minimize individual issuer risk *(Chart 1)*.

Chart 1



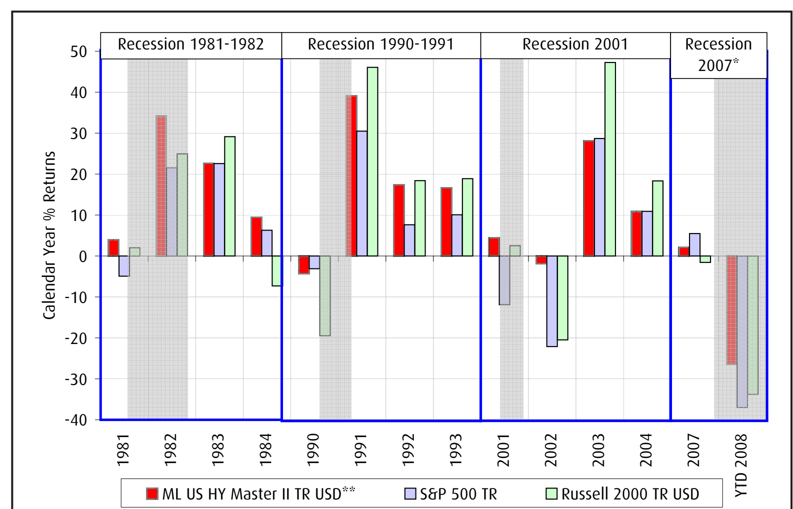
Source: Merrill Lynch Global High Yield Index, as at December 31, 2008

Why U.S. High Yield Bonds Now?

After briefly peaking at close to 2,200 bps Option-Adjusted Spread above Treasuries in December 2008, the High Yield Bond market has experienced its two best months since 1989 in December and January, before retreating somewhat in February to close at 1,738 bps. High Yield bonds have outperformed equities in down years while exhibiting an equal or superior return potential after an economic recession as displayed *(Chart 2)*.

In a more pessimistic scenario, High Yield bond holders are closer to the companies assets and are "paid to wait" for the recovery. The question that still remains is how high will defaults go and what will the recovery rates be? Defaults are expected to reach or exceed the previous peak of 10.5% reached in 1991 with JPMorgan and Merrill Lynch placing recovery rates as low as 20-25%.What does it means for the high yield investor? Considering a spread of approximately 1,600 bps and 12% default rate with a recovery value of only 25% would mean a net spread of 16% — (12% x {1 – 25%}) = 8% or 800 bps still well above the 18 year average spread of 508 bps *(Chart 3 on the following page)*.

Chart 2



Source: Bloomberg, NBER.

Shaded areas indicate U.S. recessions.
* "Recession 2007" started in Dec-07 and continues through to 2009 (as of Feb-09)
** Merrill Lynch U.S. High Yield Master II TR Index — data from 1981 to 1985 refers to the Citi HYMarket 10+ Yr TR Index

This scenario is also missing an important factor… as defaults materialized, spreads could well become tighter for the remaining high yield issuers and a significant potential capital gain could be realized.

Credit Quality: How deep should you go?

Both Investment Grade Corporate and High Yield Bonds offer spreads that historically have not been seen since the 1930s so an argument could be made for investing in both. Investment Grade bonds also offer quite attractive yields on the S&P 500 as illustrated in *Chart 4*, although they are still substantially lower than High Yields.

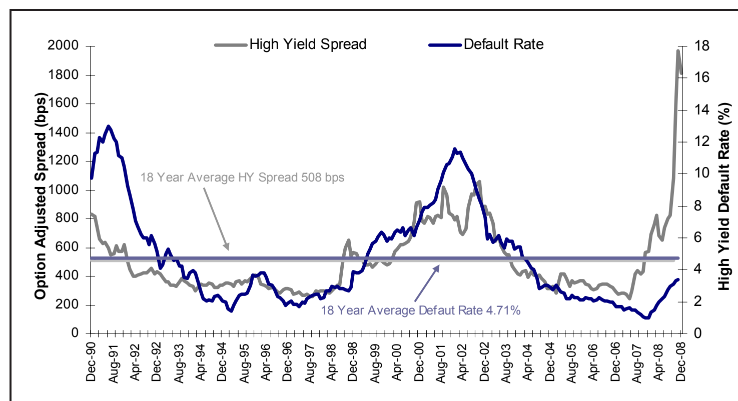
While Investment Grade Bonds can be expected to outperform in a continued recession scenario, they tend to be positively correlated to Treasuries whereas High Yield Bonds (BB and below) have tended to exhibit a negative correlation to Treasuries *(Chart 5)*. In a recovery scenario, where yields on Treasuries are increasing because of either less demand or higher inflation rate, High Yield Bonds may well outperform as they tend to be more correlated to equities than to Investment Grade bonds or Treasuries.

What Are My Options?

Building a diversified portfolio of U.S. Investment Grade or High Yield Bonds is more easily accomplished by using either Mutual Funds or Exchange-Traded Funds (ETFs). You will find below various suggestions that will enable you to implement this investment theme in various degrees of credit quality. As a replacement for a portion of your equity exposure, High Yield Bond is the primary choice and we provide two levels of "credit depth" based on the percentage of CCC and below credit allowed in the portfolios. We are also providing an Investment Grade option that allows you to capitalize on the abnormally high spreads in this space without taking much exposure to below Investment Grade Bonds.

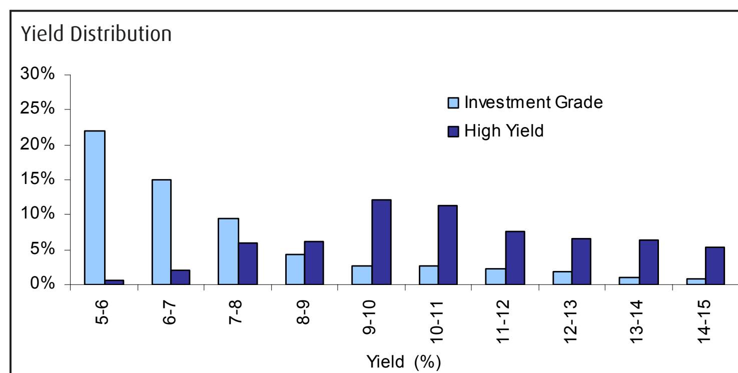
While ETFs do not offer currency hedging, we have chosen Mutual Funds that either offer or have a currency hedging strategy already built into their mandates. Given the relatively high exposure to U.S. Dollar denominated investments in the recommended asset mixes we suggest that a hedging strategy should be considered for a portion of the U.S. investments.

Chart 3



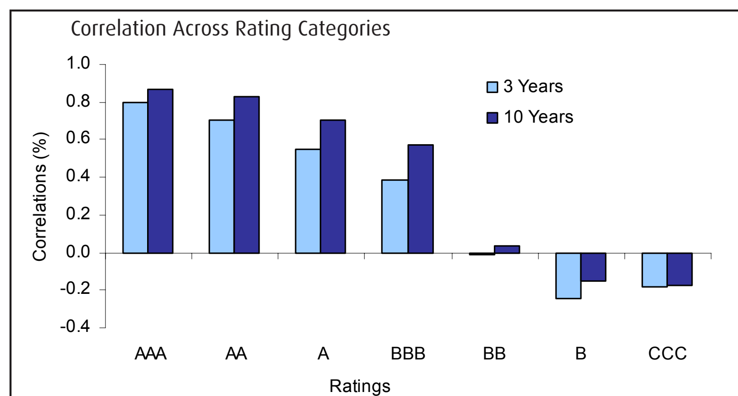
Source: Merrill Lynch and Moody's. Note: Default Rate is Moody's Trailing 12-month U.S. Issuer Based Speculative Grade Default Rate. As of December 31, 2008.

Chart 4



Source: Merrill Lynch, HIM Monegy, Inc.
Notes: As at December 31, 2008.
Correlation of monthly returns with 10 year Treasuries

Chart 5



Source: Merrill Lynch, HIM Monegy, Inc.
Notes: As at December 31, 2008.
Correlation of monthly returns with 10 year Treasuries

U.S. Investment Grade (Mainly BBB and above):

iShares iBoxx $ Investment Grade Corporate Bond Fund (LQD): LQD has an expense ratio of 0.15% and tracks the performance of the iBoxx $ Liquid Investment Grade Index, which is a rules based (equal weighted) index comprised of up to 100 highly liquid, investment grade, U.S.-dollar denominated corporate bonds designed to maximize liquidity while maintaining an adequate representation of the U.S. corporate bond market. All bonds included in the index must have a minimum amount outstanding of $500 million with at least 42 months remaining until maturity. We believe LQD is appropriate for investors who believe Investment Grade credit will outperform the High Yield Debt market given that many companies that make up the High Yield market are typically smaller and more economically sensitive.

RBC Global Corporate Bond Advisor Series (FE-RBF753, LL-RBF118, DSC-RBF853, F-RBF638): While not a "pure" play on the U.S. Investment Grade Corporate Bond market, this fund offers a well-managed alternative way to implement a similar strategy. The RBC Asset Management conservative bottom-up, value approach used by this Fund is complemented by momentum strategies. The use of intensive fundamental and technical credit analysis result in a widely diversified portfolio with 413 holdings as of January 31, 2009. With AUM of 442 Million on a well-below average MER of 1.64%, the Fund has been ranked in the first quartile of its category over the last one and three years. The mandate neutral stance is 80% Investment Grade Corporate Bonds, 10% High Yield Corporate and 10% Emerging Markets Debts. Geographically, between 50-70% of the exposure must be in the U.S. The policy of the Fund is to hedge back to the Canadian Dollar the vast majority of the currency exposure although strategically limited; currency positions may be taken on a tactical basis as opportunities arise.

High Yield — Above Market Credit Quality (Mainly BB/B)

BMO U.S. High Yield Bond Fund (No load BMO737, F-95737): HIM Monegy is a specialist manager of credit risk assets which has extensive experience constructing, analyzing and managing portfolios of High Yield Bonds and loans. Sadhana Valia is the lead Portfolio Manager with 24 years of experience and employs an investment philosophy that uses a bottom-up process to select the most attractive issues on a risk/return basis. The High Yield team focuses on building high Sharpe ratio portfolios with low volatility, employing a multi-faceted process which couples proven quantitative credit analysis risk measurement technology with sound fundamental analysis. To minimize risk, the fund maintains a fully diversified portfolio and places a 1% issuer limit restriction and also uses a top-down industry overlay to ensure no undue concentrations. This Fund, although in a high risk / high return asset class, is managed conservatively and their process of risk control and capital preservation is exemplified by the 98% weighting in securities ranked B or higher (as of December 31, 2008). The Fund's policy is to fully hedge currency risk and the historical default rate of 0.2% for the composite (2000-2008) is comparing advantageously to the 4.8% default rate of U.S. High Yield issuers. Although the Fund appears small, it is part of a Fund of fund structure that totaled 93.8 million, as of January 31, 2009. Our recommendation is based on HIM Monegy institutional track record dated back to Oct 1999, and their more recent performance in managing the U.S. High Yield portion of the BMO Bond Fund for the last 3 years rather than the shorter timeframe of this specific offering.

Northwest Specialty Global High Yield Bond (FE-NWT10142, LL-NWT842, DSC-NWT10243, F-NWT543): This Fund is sub-advised by Aviva Investors North America ("Aviva") who specializes in institutional, income-driven asset management. The High Yield investment process is designed to seek high current income, and secondarily, capital appreciation by investing in below Investment Grade debt instruments. The High Yield investment management team utilizes a disciplined portfolio management research approach simultaneously considering fundamentals, valuations and technical factors. Aviva focuses on bottom-up security selection with top-down sector overlays and purchases securities that they believe have the highest likelihood of positive credit momentum with the potential for upgrade. This approach is designed to outperform during down markets by focusing on keeping default rates well below the industry norm (historical default rate of 0.5% for the composite from 1996 to 2006). This strategy aims to minimize principal loss by analyzing each potential candidate company's fundamentals, capital structure, and bond relative valuations. Based on Aviva's High Yield Composite, over the past 13 years of High Yield management, the Composite has had only one negative calendar year of performance. As of January 31, 2009, the Fund had over 90% of its portfolio invested in the U.S. market with an overall credit quality between BB-B. The Fund is more conservative in the High Yield space with less than 15% of its portfolio ranked CCC or lower. The Fund's foreign content is fully hedged back to the Canadian Dollar and thus removes currency risk.

High Yield — Market Average Credit Quality (Average credit quality B)

iShares iBoxx $ High Yield Corporate Bond Fund (HYG): HYG carries an expense ratio of 0.50% and seeks to replicate the performance of the iBoxx $ Liquid High Yield Index, a rules based (equal weighted) corporate bond market index designed to provide a balanced representation of the U.S. dollar-denominated High Yield Corporate Bond market through some of the most liquid High Yield Corporate Bonds available.

SPDR Barclays Capital High Yield Bond ETF (JNK): JNK charges a 0.40% fee and tracks the performance of the Barclays Capital High Yield Very Liquid Index. The index is comprised of publicly issued U.S. dollar-denominated, Non-Investment Grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, regardless of optionality. In addition, the constituents are High Yield using the middle rating of Moody's, S&P, and Fitch and have at least $600 million outstanding face value.

Fidelity American High Yield Fund (FE-FID255, LL-FID055/855, DSC-FID555, F-FID655, Currency Neutral version FE-1255, LL-FID1055/1855, DSC-FID1555, F-1655): Harley Lank assumed responsibilities of the Fund on August 1, 2007 and even though he has had a short history of managing the Fund, the investment process has remained the same and the Fund has ranked above median over all time periods for the past three years versus its peers. This Fund is a high octane pure U.S. High Yield play which has the return potential for a high payoff, but also comes with a higher risk profile as the fund currently has a significant weighting in issues rated CCC or below. The Fund does control risk by having a well-diversified portfolio across industries and issuers and typically holds about 200 names with an average credit quality ranging from BB to B. To effectively monitor risk, the investment process employs a fundamental, bottom-up credit research, combining quantitative and qualitative analysis. Fidelity maintains a team of 25 High Yield research analysts and two lawyers who cover approximately 80% of the High Yield universe. The analysts conduct a complete capital structure analysis of the company and generate internal ratings based on their comprehensive research and meetings with the companies. Given the size and scope of the team and their research capabilities, the portfolio management team does not maintain or keep track of default rates as they believe this measure does not add value to their investment process. There may be instances where the portfolio manager may purposefully purchase securities that are in default as he may see value from a recovery or tradable gains perspective. Although the Fund is small at about $33 million CAD, the Fund is managed in the same way as all of Fidelity's High Yield Fixed Income mandates (over $300 million CAD) across all platforms which allow for economies of scale benefits. A currency neutral version of the fund is also available for those seeking to hedge currency risk.

Fixed Income Strategy March 2009

MICHAEL HERRING, CFA, CMT, INVESTMENT STRATEGIST

In the last three months, yields on government securities have risen sharply from multi-decade lows, as investor risk aversion has fallen. However, government bond yields are still near 50-year lows. Since the best predictor of the future rate of return from a government bond is the yield at which the bond is purchased, we can say with some confidence that prospective rates of return from government securities are quite low, indeed.

With the low yields on government securities in mind, for most passively inclined investors we recommend laddered portfolios of bonds with a maximum term to maturity of 10 years. While this strategy was clearly sub-optimal during the great bond bull market from the early 1980s into the 2000s, we strongly believe that it has a good chance of outperforming the broader market over the next 10–20 years.

Against the prior secular backdrop of falling long-term interest rates, the optimal bond investment strategy was to hold the longest term securities possible. Previously, we believed that the secular bull market for long government bonds ended in 2003 in the U.S. and in 2006 in Canada.

For much of the time since then, long-term government bond yields essentially have been range-bound. However, in the fall of 2008, long-term government bond yields plunged, most particularly in the U.S. where long-term yields were at their lowest level since the late 1950s. On this basis, our belief that the secular bull market had ended was premature at a minimum *(Charts 1 & 2)*.

Irrespective of whether we are in a sideways or rising trend for long-term bond yields in the future, the risk-adjusted rate of return for longer-term bonds likely will not compare well to that of shorter-term bonds.

Given the current credit crisis, there is a powerful deflationary impulse in the form of lower prices on real estate, and on financial assets. This deflationary impulse is being met by powerful interventions on the part of global central banks, and by governments themselves. Ultimately we expect these measures to work, and for inflationary forces to regain the upper hand. In the current secular environment, investors should favor

Chart 1: 30-year Government of Canada Bond Yield

Source: Bloomberg

Chart 2: 30-year U.S. Treasury Bond Yield

Source: Bloomberg

shorter-duration government bonds over longer-duration bonds.

We believe that as the credit crisis abates the monetary backdrop for the developed economies of the world will once again be characterized by inflationary pressures rather than deflationary pressures. As we transition into an environment of interest rates generally moving sideways or gradually rising over time, laddered bond portfolios should be expected to exhibit good risk-adjusted rates of return vis-à-vis the broader bond market.

As may be seen *Table 1,* which shows average annual total returns from holding long-term government of Canada and U.S. Treasury securities over a complete secular cycle, and during a secular bearish phase and a secular bullish phase, we can see that bonds exhibit different return profiles for the two phases.

Table 1: 30-year Government of Canada Bond Yield

Average Annual Returns — Canada Bonds

Term	Secular Cycle 1963 - 2003	Bear Market 1963 - 1981	Bull Market 1982 - 2003
2 Years	7.83%	6.43%	9.04%
4 Years	8.16%	5.82%	10.19%
7.5 Years	7.83%	5.05%	11.45%
15 Years	8.94%	3.96%	13.24%

Average Annual Returns — U.S. Treasuries

Term	Secular Cycle 1963 - 2003	Bear Market 1963 - 1981	Bull Market 1982 - 2003
5 Years	7.47%	4.70%	9.64%
10 Years	7.73%	3.52%	11.03%
20 Years	7.82%	2.02%	12.36%

Source: Bank of Canada,
BMO Nesbitt Burns

In a secular bullish phase such as that of the 1980s, 1990s and early 2000s, average annual total returns are positively correlated to term to maturity. In a secular bearish phase, average annual total returns are inversely related to term to maturity. In other words, in a secular bearish phase such as the one we believe to be the case now, shorter-term bonds exhibit higher average annual total returns than do longer-term bonds.

The reasons we expect five- to 10-year bond ladders to outperform the broad market are twofold.

First, a 10-year (or shorter) bond ladder would have no exposure to the long end of the bond market, while approximately 30 percent of the broad market is comprised of long bonds. With our expectation that the nominal returns from long bonds will be low simply as a result of the low nominal yields to maturity at which they trade, and the potential that the real, or inflation-adjusted rates of return will be flat or even negative, we wish to exclude long bonds from our portfolios.

Second, by definition the ladder would have a shorter average term than that of the broad market, and so would provide more frequent opportunities for reinvestment as bonds mature. If we are correct that the next 10–20 years will be characterized by flat to rising nominal interest rates, this more frequent reinvestment should be accretive to returns.

We recommend a minimum term to maturity of five years for bond ladders. In deciding on the optimal length of a bond ladder, we recommend taking into account the investor's need for predictable income. The higher that need, the longer the ladder should be, constrained to a maximum term of 10 years. Shorter ladders tend to be more responsive to changes in the level of medium-term bond yields and, as such, will typically exhibit higher variability of coupon income than would a longer-term ladder.

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