

Great-West Life Enhanced Bond Fund

Q3 2010

Investor profile: Suited to the investor who has low to medium tolerance for risk.

Objective: The fund's objective is to provide interest income with the potential for capital appreciation by investing primarily in Canadian fixed income securities, including government securities and corporate income producing securities.

Investment strategy: Laketon's active investment style is designed to continually capture incremental gains relative to the fund's benchmark. The manager adds value through yield curve and duration management, sector allocation and individual security selection.

Investment performance

	Annualized rates of return (%)			
	Quarter	1 Year	2 Years	3 Years
Great West Life Enhanced Bond	2.1	6.0	5.0	5.0

Portfolio management team

	Years of experience	Years with Laketon
Gary Morris, CFA	23	18
Thomas Gomes, CFA	14	10
Siek Djoe, CFA	15	5
Jenny Wan	7	6

Portfolio information

Assets:	\$16.9 million
Benchmark:	DEX Universe Bond Index
Total holdings:	33
Duration (years):	6.34 (portfolio) 6.29 (benchmark)
Yield:	3.25% (portfolio) 2.80% (benchmark)

Top 10 holdings

	Portfolio (%)
Canada 3.75% 01-Jun-19	15.5
Canada 5.00% 01-Jun-14	11.3
Canada 3.50% 01-Jun-13	9.8
Quebec 6.25% 01-Jun-32	8.7
Ontario 6.50% 08-Mar-29	7.5
HBOS PLC 5.11% 21-Jun-12	3.6
GE Capital Cda Fund 5.68% 10-Sep-19	2.9
C.I.B.C. 3.95% 14-Jul-17	2.9
Co-Operators Finance 5.78% 10-Mar-20	2.5
SunLife 5.12% 26-Jun-13	2.2
	66.9

Sector & quality diversification

	Portfolio (%)	Portfolio (%)
Federal	46.85	46.22
Provincial	17.83	25.80
Corporate	35.32	26.55
Municipal	0.00	1.43
Total	100.00	100.00
AAA	46.85	51.48
AA	17.36	22.60
A	26.67	19.88
BBB	9.12	6.04
Total	100.00	100.0

Fund performance attribution

Positive performance factors in the third quarter

- Investors extended duration but were only willing to do so through higher quality asset classes (i.e. Governments). This resulted in long provincials and municipals becoming the best performing asset class within the Universe. This was positive for the portfolio as it was approximately two thirds of a year overweight long provincial and municipal credit relative to the index on a duration weighted basis.
- In the corporate space, the same demand factors resulted in long Utility, Infrastructure and Energy issues outperforming. The portfolio is overweight these long sectors by one quarter of a year on a duration weighted basis relative to the index.
- Escalating competition, the ramifications of Bell's convergence play coupled with large new issuance (Rogers, Bell Aliant) and rumours of further supply (BCE, Shaw) pressured Telecom/Cable spreads across the curve. This was positive as the portfolio held no Telecommunication or Cable names.

Negative performance factors in the third quarter

- Dismal earnings from Manulife followed by a large – \$900M (upsized from \$500M) 5-year new issue pushed spreads on its bonds wider. It is worth noting that despite the deal coming at a hefty 185 basis points over the curve, representing a 30 basis point concession over secondary market levels, the 4.079% coupon was still well below the 4.896% paid when Manulife last came to market in May 2009 with a similar \$1.0 billion 5-year bond (+230 basis points).

Outlook & strategy

- There seems to be little doubt amongst market participants that the Bank of Canada will refrain from raising rates further this year, after having raised the overnight rate to 1% on September 8th. The weaker economic data in both Canada and the U.S. has created a backdrop for the Bank to put monetary policy on hold. We also note the certainty with which the Fed has indicated that overnight rates in the U.S. will not rise anytime soon.
- QE2 has become the TLA (three letter acronym) of choice, as members of the Fed have communicated their receptivity to further monetary stimulus through quantitative easing. We are sceptical of QE's ability to deliver more stimulus via both consumer or commercial channels and believe that the Fed will likely resort to QE only in the event that they feel capital markets need more propping up or there appears to be impasse on the fiscal front.
- As we are still in mid-term election season in the U.S., we don't expect much progress on any sort of fiscal stimulus; but we do expect the Obama administration to take up the gauntlet afterward.
- The concentration in 10-year bonds, has given the portfolio more running yield, reasonable positioning in the recent flattening, and good performance in the summer rally. We expect the 10-year part of the yield curve to stay out of trouble, and hence we will retain the portfolio's overweight in that part of the yield curve.
- The recent underperformance of corporate bonds had presented an opportunity to increase the portfolio's running yield at attractive yield spreads. We began increasing the corporate weight during the quarter and it is now largely completed; we would look at any further yield spread deterioration as an opportunity to increase our exposure further. Despite there being many areas of economic uncertainty, our expectation for policy support – both fiscally and monetarily, should keep yield spreads well supported.
- Although we are not immediately concerned about the North American sovereign debt situation, we have noted that the situation in the U.S. is something to be watched. However, we believe that the trouble with European sovereign debt will likely provide a longer window for the U.S. to address its issues.

Opinions expressed herein are the sole views of Laketon Investment Management and are subject to change without notice. Securities mentioned herein are not to be construed as recommendations to buy, hold or sell.

The indicated rates of return for one, two, three, five and 10 years columns, as well as the since inception column, are annual compounded returns for the period ending September 30, 2010 including changes in the unit values but does not take into account redemption fees or other applicable charges payable by the policyholder.

The stated returns are net of investment management fees and operating expenses but do not reflect redemption fees or other charges. Therefore actual returns will be less than illustrated. Please note that unit values and investment returns will fluctuate and past performance is not necessarily indicative of future performance.

A description of the key features of Great-West's Flexible Accumulation Annuity (FAA) and Flexible Income Fund (FIF) individual variable insurance contract is contained in the information folder, available from your financial security advisor. Any amount that is allocated to a segregated fund is invested at the risk of the policy holder and may increase or decrease in value.