

London Life Fixed Income Fund (\$19)

Q2 2010

Investor profile: Suited to the investor whose objectives are income and growth over the medium term.

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

	Quarter	YTD	Annualized rates of return (%)			
			1 Year	2 Years	3 Years	5 Years
London Life Fixed Income	3.1	4.6	7.5	6.8	7.0	5.0
Benchmark	2.9	4.2	6.9	7.0	6.9	4.9
Value Added	0.2	0.4	0.6	-0.2	0.1	0.1

All returns are gross of fees. Prior to October 1, 2004, the Canada Life Fund equivalent was used.

Portfolio management team

	Years of experience	Years with Laketon
Gary Morris, CFA	23	17
Thomas Gomes, CFA	14	10
Siek Djoe, CFA	15	5
Paul Nazar	5	5

Portfolio information

Assets:	\$211.1 million
Benchmark:	DEX Universe Bond Index
Total holdings:	41
Duration (years):	6.03 (portfolio) 6.09 (benchmark)
Yield:	3.31% (portfolio) 3.08% (benchmark)

Top 10 holdings

	Portfolio (%)
Govt of Canada 3.75% 06-01-19	10.9
Prov of Ontario 6.5% 03-08-29	9.3
Government of Canada 3.50% 06-01-13	7.6
Canada Housing Trust 4.10% 12-15-18	5.7
Canada Housing Trust 3.55% 09-15-13	5.7
Prov of Quebec 6.25% 06-01-32	4.5
Government of Canada 3.50% 06-01-20	3.5
Prov of Manitoba 6.30% 03-05-31	2.9
Prov of Nova Scotia 4.15% 11-25-19	2.7
Sun Life Financial Inc 5.12% 06-26-18	2.6
Total	55.3

Sector & quality diversification

	Portfolio (%)	Benchmark (%)
Federal	34.97	47.28
Provincial	20.84	24.79
Corporate	41.06	26.52
Municipal	3.14	1.41
Total	100.00	100.00
AAA	39.05	52.44
AA	27.09	22.06
A	28.25	19.50
BBB	5.36	6.00
Total	100.00	100.0

Fund performance attribution

Positive performance factors in the second quarter

- The portfolio benefited from the duration extension in March and April of one-half of a year greater than that of the benchmark. Following May's rally the portfolio was brought back to neutral. Additionally, the portfolio's concentration in 10 year bonds proved to be reasonably good positioning in the recent curve flattening as 10 year yield rallied by 20 basis points and the 2-10 yield curve flattened by 32 basis points over this period.
- The running yield of the portfolio is much higher than that of the index (3.35% versus 3.08%) as a result of our concentration of higher-beta short corporates (35.1% versus 15.6%) and concentration in 10-year bonds.

Negative performance factors in the second quarter

- Coincident with corporate spread widening, provincial and municipal spreads also widened, but to a much lesser degree. For the quarter, mid and long-term provincial spreads widened by 7 and 17 basis points respectively. The portfolio is approximately one quarter of a year overweight provincial and municipal credit respectively, relative to the index on a duration weighted basis.

Outlook & strategy

- Following May's rally, the duration of the portfolio was brought back to neutral on May 31st. Although yields rose, it was only temporary, and now bond yields are back at their lowest for the year. We believe longer term yields are at the lower end of a trading range, but will continue to manage the portfolio's duration from a neutral to long position.
- Our take on the Bank of Canada, is that it has embarked on a tightening cycle that will be very much dependent upon current information. In the bank's spring Monetary Policy Report we thought the Bank was on a clear path to normalising rates, which we interpreted as a series of hikes to about 2%. In our view, recent events have caused the Bank to shorten its projection horizon, creating more policy uncertainty over the medium term. Consequently, we expect short term rates to be more volatile.
- The concentration in 10-year bonds, has given the portfolio more running yield, reasonable positioning in the recent flattening, and good performance in the second quarter 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 and provincial bonds has presented an opportunity to increase the portfolio's running yield at attractive yield spreads. We have begun this process and will continue to look for further opportunities. We expect credit spreads to remain at heightened levels, until there is further clarity on the PHIGS situation.
- 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.
- The first risk to our outlook is that sovereign debt problems, which have emerged in Europe, translate to the banking sector more significantly causing widespread credit concerns and a second credit crisis.
- The second risk is that governments' enthusiasm to reduce debt/GDP levels proves to be too aggressive and too early and ultimately too much for developed economies, resulting in a second recession. Although, we would question whether there would be resolve amongst governments to carry out austerity plans should there be signs of failing growth.