

Quadrus Laketon Fixed Income

Q3 2010

Investor profile: Investors should consider this fund if they are seeking a steady flow of current income over the long term and are comfortable with the risks associated with fixed income investments.

Objective: This fund seeks to maximize income consistent with prudent levels of risk by investing in a combination of Canadian government and corporate bonds of various terms, debentures, notes, mortgages, and other income producing securities.

Investment strategy: The portfolio is actively managed to achieve long term above average returns while assuming moderate risk. The primary strategy is top-down by managing the duration and sector allocation of the fund in response to yield and yield spread expectations. A secondary strategy is bottom-up management of individual securities in response to relative valuations.

Investment performance

| | Annualized rates of return (%) | | | | |
|---------------------------------------|--------------------------------|--------|---------|---------|----------------|
| | Quarter | 1 Year | 3 Years | 5 Years | From Inception |
| Quadrus Laketon Canadian Fixed Income | 2.7 | 5.8 | 5.6 | 3.7 | 8.0 |

*All returns are net of fees.

Portfolio management team

| | Years of experience | Years with Laketon |
|-------------------|---------------------|--------------------|
| Gary Morris, CFA | 23 | 18 |
| Thomas Gomes, CFA | 14 | 10 |
| Siek Djoe, CFA | 16 | 5 |
| Jenny Way | 7 | 6 |

Portfolio information

| | |
|-------------------|--|
| Assets: | \$102.0 million |
| Benchmark: | DEX Universe Bond Index |
| Total holdings: | 42 |
| Duration (years): | 6.28 (portfolio) 6.29 (benchmark) |
| Yield: | 3.05% (portfolio) 2.80% (benchmark) |

Top 10 holdings

| | Portfolio (%) |
|-------------------------------------|---------------|
| Canada 3.8% 01-Jun-19 | 12.4 |
| Ontario 6.5% 08-Mar-29 | 8.3 |
| Canada Housing Trust 4.1% 15-Dec-18 | 5.7 |
| Canada 3.5% 01-Jun-13 | 5.3 |
| Canada Housing Trust 3.6% 15-Sep-13 | 5.2 |
| Quebec 6.3% 01-Jun-32 | 4.5 |
| Canada 3.5% 01-Jun-20 | 4.2 |
| Manitoba 6.3% 05-Mar-31 | 2.8 |
| Nova Scotia 4.2% 25-Nov-19 | 2.6 |
| SunLife 5.1% 26-Jun-13 | 2.5 |
| Total | 53.5 |

Sector & quality diversification

| | Portfolio (%) | Portfolio (%) |
|--------------|---------------|---------------|
| Federal | 38.33 | 46.22 |
| Provincial | 19.55 | 25.80 |
| Corporate | 38.94 | 26.55 |
| Municipal | 3.18 | 1.43 |
| Total | 100.00 | 100.00 |
| AAA | 42.48 | 51.48 |
| AA | 26.29 | 22.60 |
| A | 27.42 | 19.88 |
| BBB | 3.81 | 6.04 |
| Total | 100.00 | 100.00 |

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, which resulted in long provincials and municipals becoming the best performing asset classes within the Universe. The portfolio benefitted from being approximately three quarters of a year overweight long provincial and municipal credits relative to the index, on a duration weighted basis.
- In the corporate space, the same demand factors impacting government credits, resulted in the outperformance of long Utility, Infrastructure and Energy issues. The portfolio is overweight the aforementioned sectors in the long end by two fifths of a year, on a duration weighted basis, relative to the index. Additionally, the portfolio's largest exposure in this space (and the portfolio as a whole) is Hydro One, whose spread compressed more than its peers. Hydro One had the added positive benefit of the Ontario government's decision in early July to rule out merging crown corporations and selling an equity stake to investors.
- New Basel guidelines led to significant spread widening on new or third generation high coupon "par call" innovative Tier 1 spreads. While negative for these specific issues, the news was positive for other existing subordinated and older generation hybrid issues as under the new reforms, these structures will be phased out and replaced by securities that have contingent capital provisions. The scarcity premium attached to these grandfathered issues was positive as the portfolio holds a number of them. We would note that we have always limited our exposure to Tier 1 hybrids from older generation series with holder exchange features.
- The financial yield spread curve steepened significantly over the quarter as short-term yield spreads tightened by 14 basis points whereas mid and long-term spreads widened by 3 and 16 basis points respectively. The portfolio is fairly overweight short financials.

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 any time 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.

The commentaries on the company specific information and purchases and sales were provided by the fund manager. Quadrus Investment Services Ltd. will not be liable for any loss, or damages whatsoever, whether directly or indirectly incurred, arising out of the use or misuse of or errors or omissions in any information contained in this newsletter. 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. Past performance is no guarantee of future results.

The data provided in this commentary is for information purposes only and, except where otherwise indicated, is current as of September 30, 2010.

Make your investment decisions wisely. Important information about the Quadrus Group of Funds is found in the funds' simplified prospectus. Please read this carefully before investing. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently. Mutual fund units are not covered by the Canada Deposit Insurance Corporation or by any other government deposit insurer. There can be no assurances that the fund will be able to maintain its net asset value per unit at a constant amount or that the full amount of your investment in the fund will be returned to you. Past performance of the funds may not be repeated.

Laketon Investment Management Ltd. became the portfolio sub-advisor to the fund on June 24, 2005. The performance record of the fund prior to that date was that of the fund's previous portfolio sub-advisor.