LAKETON

Canadian Fixed Income

Q3 2010

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

Objective: The portfolio'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 portfolio'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	YTD	1 Year	2 Years	3 Years	5 Years
Canadian Fixed Income	3.22	8.21	7.67	9.43	7.68	5.72
DEX Universe Bond Index	3.15	7.51	7.33	8.82	7.41	5.55
Value Added	*0.07*	*0.70*	*0.34*	*0.61*	*0.27*	*0.17*

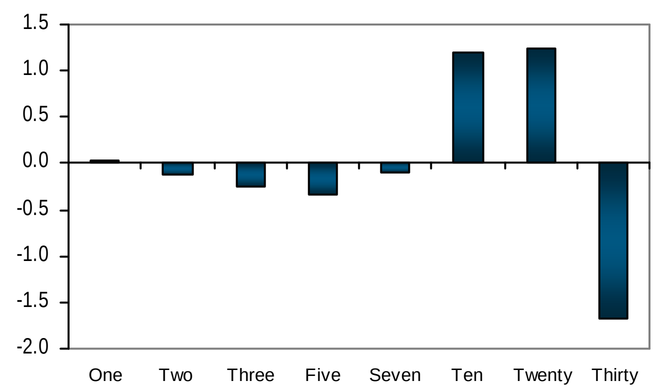
Returns shown (which are gross of fees) reflect the performance of the model portfolio. Actual returns experienced by an investor may differ from those shown.

Portfolio Characteristics

	Portfolio	DEX Universe Index
Running Yield	2.96%	2.80%
Modified Duration* (years)		
Canada	1.74	2.47
Provincial	2.91	2.23
Corporate	1.43	1.49
Municipal	0.21	0.10
Total	6.29	6.29

*duration contribution indicates the level of spread exposure

Duration Contribution vs DEX Universe Bond Index



Top 10 Holdings

Top 10 Holdings	Portfolio (%)
Canada 3.75% 01-Jun-19	20.73
Ontario 6.50% 08-Mar-29	13.95
Canada Housing Trust 3.55% 15-Sep-13	7.52
Quebec 6.25% 01-Jun-32	5.10
Nova Scotia 4.15% 25-Nov-19	5.10
407 International Inc. 4.65% 20-Jan-12	4.28
GE Capital Cda Fund 4.38% 28-Sep-12	3.98
GTAA 6.25% 30-Jan-12	3.75
Bank of Nova Scotia 5.04% 08-Apr-13	3.74
Thomson Corporation 5.20% 01-Dec-14	3.32
Total	71.46

Sector weights* & quality diversification

	Portfolio (%)	DEX Universe Index (%)
Federal	30.44	46.22
Provincial	27.27	25.80
Corporate	39.34	26.55
Municipal	2.95	1.43
AAA	33.56	51.48
AA	31.88	22.60
A	34.56	19.88
BBB	0.00	6.04

*weight indicates the level of credit exposure

Market Review

Take that Sandusky!

- Cedar Point Amusement Park in Sandusky Ohio is referred to as The Roller Coaster Capital of the World, but no matter how big its largest roller coaster drop is - 400ft on the Top Thrill Dragster, the sensation riders feel is likely only marginal when stacked up against the thrill bond investors have experienced from the ongoing descent in bond yields.
- Yes, bond *riders* have had a roaring time over the last couple of years, and for those who thought maybe the Fed had used up their last tokens, in comes Bernanke et al (save Hoenig and some others) with a bag full – ready to be opened soon – in the form of a second round of quantitative easing.
- The market, or more correctly, bond investors are expecting a Treasury buying program, likely to be gradual in the short to middle part of the yield curve, so much so that they have been happy to purchase treasuries and push yields lower.
- Indeed, during the third quarter, 10-year Treasury and Government of Canada yields fell by 42 and 32 basis points to 2.51% and 2.76% respectively, edging ever-closer to the recent lows of 2.06% in the U.S. (12/30/08) and 2.56% in Canada (01/14/09).
- The Canadian bond market returned a stellar 3.15% for the quarter (according to the DEX Universe Index), especially impressive given that the overall yield to maturity averaged only 3.04% during the quarter.
- Canadian corporate bond market returns were only average, returning 3.16% for the quarter (according to the DEX Universe Index) despite having an average yield close to 1% higher than that of the government sector.
- While the Fed has been helpful in making the bond market more amusing, the fun has been helped along by the generally poor macroeconomic data coming from pretty much everywhere. G7 economies have been slowing, and even dependable China has become lacklustre. (Although we would never rule out the capacity of China to *turn on a dime*.)
- The Bank of Canada raised rates one more time to 1%, but as we previously mentioned it might do, has used its self-declared retrospection to signal that it would likely not move again this year.
- With interest rates on hold at low levels in most of the developed world, equities and corporate bond markets have managed to remain steady, despite questionable economic prospects.
- Corporate bond issuers have taken advantage of this agreeable climate to issue in significant quantities amounting to $365 Bln in the U.S. and $16 Bln in Canada during the quarter.

Portfolio performance attribution

Positive performance factors in the third quarter

- Investors had a need to extend 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 is approximately three quarters of a year overweight provincial and municipal credit (concentrated in the long-end) 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 yield spreads on the portfolio’s sole long corporate holding, Hydro One, tightened by 9 basis points over the course of the quarter. Within the utility space, Hydro One’s spread compression also outperformed its peers as it had the additional positive benefit of the Ontario government’s decision in early July to rule out merging crown corporations and selling an equity stake.
- 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.

Portfolio performance attribution

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). Negative performance of the issue held was mitigated somewhat by its shorter-term and soft-retractable hybrid features.
- Earnings at HBOS came in well above expectations as margins rose, impairments dropped and funding concerns eased. Overcapitalized, profitable and with no dividends, buybacks or major acquisitions to occur prior to 2012, HBOS subordinated debt rallied. This rally however was not reflected in the Canadian bonds as a significant domestic liquidity discount attached to this bond and other similar Maple issuers remained.

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.