

Investment Outlook

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In this issue

Is now the right time to invest in U.S. property?

2

Plan today to save tax

3

Where to invest cash now

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Even as the credit crisis begins to recede, credit remains relatively tight and is often expensive. At the same time, cash levels are extraordinarily high throughout North America. For example, south of the border, money market mutual funds currently hold about US\$3.6 trillion. While that is an astounding sum in itself, the figure is best put in perspective when you realize that those money market funds are equivalent to about 40% of the total value of the U.S. stock market — the highest such percentage in a generation. In short, there is a ton of cash on the sidelines. What’s happening here?

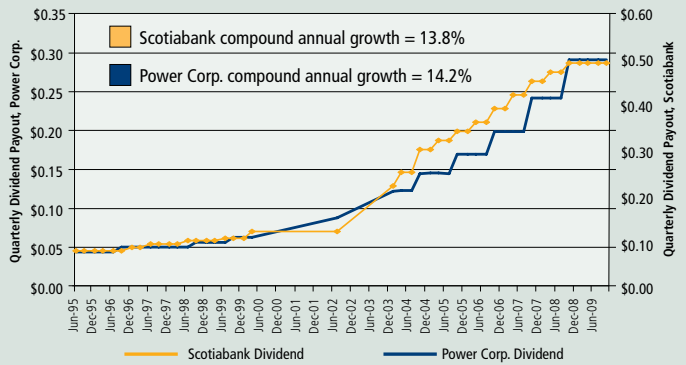
The cash conundrum

The human mind tends to attach outsized importance to recent events and very often makes assumptions based on that recent history — for example, that the future will look a lot like the recent past. It’s no wonder that investors, who were extremely fearful in 2008 and the early stages of 2009, are keeping lots of cash on hand to guard against future calamities.

The problem for investors is that holding cash may not be rewarding at this point. Money market instruments such as Treasury Bills and money market funds currently have yields of perhaps 0.5%. Adding insult to injury, the interest income is fully taxable — and we haven’t even discussed the corrosive effects of inflation. After taxes and

A history of rising dividends

Over the past 14 years, Power Corp. and Scotiabank have regularly increased their dividends.



Source: TD Economics

inflation, overall returns for cash are meager. At the same time, investors are understandably leery of taking on much incremental risk. How then, do you generate worthwhile incremental returns without a lot of risk?

Fixed income alternatives

Heading into 2009, our principal forecast for fixed income markets was that corporate bonds would significantly outperform government bonds in 2009. So far, this has proven to be the case, and our heavy weighting in corporate

Continued on Page 4



Is now the right time to invest in U.S. property?

Many Canadians periodically give thought to buying southern U.S. real estate for use in the winter months. With U.S. home prices having fallen in recent years and the Canadian dollar relatively high versus the greenback, more Canadians are now examining this option.

Recent history

As illustrated in the accompanying chart, U.S. housing prices doubled from 2000 through mid-2006. Why? In the wake of the economic downturn early this decade, U.S. interest rates were kept very low for an extended period and credit for prospective home buyers was easy — in some cases too easy — to come by. The result was very strong demand for housing, which caused a spike in prices.

This led to a boom in home construction, just as the ability of the typical American to buy a house was deteriorating due to rising prices. That decline in affordability, coupled with the credit crisis, caused prices to fall markedly from mid-2006 to the present.

U.S. housing today

The good news for prospective buyers is that prices today are well below their 2006 peak, with U.S. homes at their most affordable level in many years. At the same time, the rate of decline in house prices is slowing and we expect prices to bottom later this year or early next year.

In addition, our loonie is much

stronger than was the case only a few years ago, making purchases less expensive in Canadian dollars. Finally, recreational real estate is a discretionary purchase, which makes it very volatile in price, with the result that the Florida and Arizona markets — favourite spots for Canadians — have seen their prices fall more dramatically than the national average.

However, potential buyers of U.S. property should maintain proper perspective. Home prices have only retreated to 2003 levels, eliminating only the most egregious excesses from the market. Second, the supply overhang should persist for some time as should tighter credit, so we will not likely see a very buoyant U.S. real estate market in the near term. In addition, there are important tax implications arising from owning U.S. property.

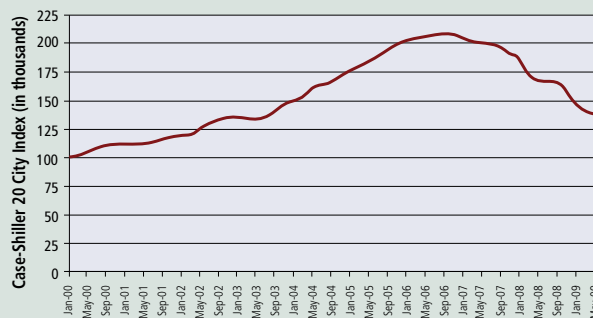
Tax implications

There are three main types of U.S. tax that may be of concern for Canadians who own U.S. real estate: income tax, estate tax and gift tax.

TAX ON RENTAL INCOME. If the U.S. property is rented to a third party, the rental income may be subject to U.S. income tax. Rental income is generally taxed in

U.S. home prices: A volatile ride

After doubling from 2000 to 2006, home prices have retreated to 2003 levels, eliminating some of the excess in the markets.



Source: S&P/Case-Shiller U.S. National Home Price Index, Jan. 2000-May 2009

one of two ways: A 30% withholding tax may apply on the gross rent received or, alternatively, a U.S. income tax return may be filed to have the rental income taxed on a net rental income basis.

CAPITAL GAINS TAX. The gains arising from the sale of a U.S. property may also be subject to U.S. tax. A flat rate of 15% may apply if the property was held for longer than 12 months. If the property was held for less than 12 months, then the gains will be taxed at the regular U.S. graduated tax rates.

ESTATE TAXES. Canadians who pass away while owning U.S. real estate may be subject to U.S. estate tax. Canadians who gift their U.S. real estate prior to death may also be subject to U.S. gift tax in lieu of the estate tax. The gift tax is based on the market

Continued on Page 4

Current Private Investment Counsel² strategy

Portfolio weighting

- Overweight in equities
- Underweight in bonds, with a somewhat shorter term than benchmarks
- Overweight corporate bonds, where mandates permit
- Overweight European industrial stocks and underweight financials within international equities

Percentage return for indices

(For the period June 15, 2009 – September 15, 2009)

DEX Universe Bond Index	2.8%
S&P/TSX Composite Index	11.4%
S&P 500 Index	8.6%
MSCI EAFE Index*	11.8%

* Morgan Stanley Capital International Europe, Australasia and Far East Index

Plan today to save tax — for this year and for next

No matter your age or income level, there are steps you can take to reduce the taxes you pay. It may be a matter of claiming all of the credits and deductions you are entitled to, or splitting income with your spouse to reduce your family's total tax burden. Here are some helpful tax-planning reminders.

Make the most of the medical expense tax credit

The medical expense tax credit can help families offset some of the cost incurred for treatments, devices and other medical expenses not covered under provincial health plans.

ELIGIBLE EXPENSES. These include payments to certain medical professionals; premiums paid for a private health services plan (including supplemental coverage while outside Canada); and costs of prescribed treatments not covered by existing plans. For a full list, search "eligible medical expenses" on the Canada Revenue Agency (CRA) website www.cra-arc.gc.ca.

CLAIMING THE EXPENSES. Medical expenses can be claimed for any 12-month period ending in the year (or 24-month period that includes the date of the individual's death) in excess of the lesser of 3% of the individual's net income or \$2,011 (for 2009).

Since the medical expense tax credit is based on the date the expense is incurred, not when service is delivered, consider paying this fall for elective procedures — such as braces or cosmetic surgery — that may be performed next year. That way, the credit can be claimed on your 2009 tax return.

Also, it may be beneficial for the lower-income spouse or common-law partner to claim the medical expenses

for the family given that 3% of his or her net income may be less than the \$2,011 (for 2009) amount.

OLDER CHILDREN.

Medical expenses paid on behalf of children 18 years and over, and other dependants, can also be claimed provided the expenses paid on behalf of each dependant exceeds that dependant's medical expense threshold (the lesser

of 3% of the dependant's net income and \$2,011) up to a maximum of \$10,000 for each such dependant.

By taking a strategic approach with your donations, it's possible to increase your tax savings and support the causes you believe in.

Contribute to charity and save taxes

Canadians are very generous with their charitable donations. In 2007, more than 80% of Canadians donated money to charity. For instance, you can maximize tax credits by combining the donations of you and your spouse on one return, or by grouping your own donations from multiple years. Another tax-effective way to give is to donate qualified securities in-kind to eliminate capital gains taxes.



There are steps you can take to reduce your family's overall tax burden.

Please speak with your Private Investment Counsel Portfolio Manager for further information on how you can be more effective with your philanthropic efforts.

Give your spouse a loan to invest

One way to take advantage of income-splitting is to have the higher-income partner lend the lower-income partner monies to invest.

If the loan is set at an interest rate that is at least equal to the prescribed rate determined by the CRA at the time of the loan, the income may be taxed in the hands of the lower-income partner.

For loans established between October – December 2009, the prescribed interest rate is 1%. Assuming the loan earns a return that exceeds the prescribed rate, say 5%, the income on the difference (4%) is effectively shifted to the lower income partner's hands.

Please speak to your Private Investment Counsel Portfolio Manager to see if a prescribed rate loan to your spouse may be appropriate in your situation. ■

Where to invest cash now

Continued from Page 1

bonds, where client mandates permit, has benefited client portfolios.

In early September, a general portfolio of high-quality, well-diversified corporate bonds yielded just above 4% — far exceeding the 0.5% being offered in the money markets. What's more, we would characterize the risk of holding corporate bonds today as very modest.

However, investors today are concerned about the potential for much higher inflation in the coming years, reflecting massive government stimulus programs and their resulting large deficits.

While we do not yet know if inflation will surge, one means of guarding against the risk of inflation is real return bonds, which provide investors with a return that varies based on the rate of inflation as measured by the Consumer Price Index (CPI). These bonds are issued primarily by the federal government, are somewhat complex and are thinly traded, so you should speak with your Private Investment Counsel Portfolio Manager about the role they could play in your portfolio.

Conservative equity alternatives

Historically, bond yields have been higher than Canadian common share dividend yields. If investors wanted to participate in the upside potential of the stock markets, they had to sacrifice income when switching from bonds to stocks. Today, this is not the case, as dividend yields are often equal to or greater than bond yields.

Canadian dividends offer several advantages over bond interest. First, the Dividend Tax Credit makes a dollar of Canadian dividends roughly equivalent, on an after-tax basis, to receiving \$1.30 in interest. For instance, a Canadian bank's dividend yield of 3.6% is roughly equivalent to a bond's yield of about 4.6%. Second is the extremely important fact that many of the highest calibre companies have regularly increased their dividends. To cite a few specific examples, Power Corporation and Scotiabank have increased their dividends at compound annual rates of 14.2% and 13.8%, respectively, over the period from 1995 to 2009 (see "A history of rising dividends" on Page 1). These dividend increases boost investors' current income, provide a hedge against inflation, and tend to provide support for higher share prices over time.

Of course, dividends can sometimes be cut, as witnessed over the past year, although this is relatively uncommon among the highest calibre companies. In addition, even the best companies' shares are subject to sharp sell-offs in tumultuous periods, as we saw over the past year, although share price recoveries typically ensue.

What's right for you

While maintaining some cash for contingencies is prudent, many investors are sitting on inordinately high cash holdings. For those investors who

seek higher potential to increase yields without adding to equity exposure, high-quality corporate bonds may be right for you, and these can be complemented by real return government bonds, where appropriate. For those investors willing to add to stock market positions, Canadian companies with relatively high dividend yields and records of increasing their dividends over time could provide incremental income and the potential for higher share prices over time. ■

Right time to invest in U.S. property?

Continued from Page 2

value of the real estate at the time of the gift and is levied at graduated rates similar to the estate tax.

CANADIAN TAXES. Canadian taxes may also apply on the income from the U.S. property. To prevent the income from being taxed twice (both in the U.S. and Canada), a tax credit may be available in Canada with respect to related U.S. tax paid.

The tax implications for Canadians who own U.S. real estate are extremely complex. Consultation with a tax advisor who is familiar with tax laws both in Canada and the U.S. jurisdiction in which the real estate is located is strongly recommended. ■

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