



# Inside INNOVA

02 2010

COMMITTED TO HELPING YOU MEET YOUR INVESTMENT NEEDS WITH CONFIDENCE

## INSIDE THIS ISSUE

- > Sizing Up the Recovery
- > Lessons From the Beautiful Game
- > Quarterly Program Review

## Sizing Up the Recovery

While there is little debate on where we've come from, the future of the global economy remains uncertain. The unfolding debt crisis in Europe has rattled financial markets at home and abroad, leaving many investors on edge and the possibility of a double-dip recession back in play. Inside INNOVA spoke with John Varao, Chief Investment Officer at Scotia Asset Management (and the portfolio advisor to *Scotia INNOVA Portfolios™*), about his thoughts on the economy and the markets.

Few would argue that the global economy is on the mend. The question on the minds of economists and investors alike is whether it will stay that way. The sovereign debt crisis in Greece and potential contagion in Europe and beyond is a sobering reminder that the global recovery rests on relatively thin ice. John Varao notes that, "Sovereign defaults are uncommon but this is definitely not the first scare that we've been faced with. What makes this situation concerning is that this is the first real test of the European Monetary Union and the solidarity of its members."

The announcement on May 9 of a €750 billion support program for members of the European Union should assist certain countries such as Greece with their current debt obligations. "This is by no means a long-term solution, but it does provide countries like Greece, Spain, Portugal, Ireland and Italy the time they need to rectify their current fiscal problems," adds Varao.

### Root Causes

Many would argue that the root of current unsustainable spending by a number of developed countries was caused by three factors:

1. Pro-cyclical behaviour of fiscal authorities during the 2000-2007 boom (spending rises as taxes decline)
2. Direct costs of the recent financial crisis including the bail out of large financial institutions
3. The global recession that began in 2008



A number of the richest industrial nations are currently spending at a rate that simply cannot be maintained over the long term. Let's look at two high profile offenders:

#### United States



- 2010 deficit is expected to reach 9.2% of GDP, almost three times the size of the 2008 deficit. In a recent House Budget Committee meeting, Federal Reserve Chairman Ben Bernake warned that “the federal budget appears to be on an unsustainable path”.
- In 2010, gross interest payments on U.S. debt will total \$383 billion. (Source: Congressional Budget Office)

#### United Kingdom



- In May 2009, S&P gave the U.K.'s credit rating a negative outlook, on fears that net government debt could approach 100% of GDP by 2013. (Source: Standard & Poor's)
- The recent deterioration in U.K. fiscal fundamentals could lower the attractiveness of its bonds (known as gilts) with purchases by overseas investors weakening as a result.

### Technically Speaking!

Debt to GDP is a measure of a country's total national (i.e. federal) debt in relation to its total gross domestic product (GDP). The ratio provides an indication of whether a country can afford and ultimately pay back its debt by comparing what it owes to what it produces. The higher the debt-to-GDP ratio, the less likely a country can service its debt.

During periods of heightened volatility, macro events are often more influential on stock prices than corporate fundamentals. “With 2008 and the flash crash on May 6 still fresh in investors' minds, recent selling pressure in the equity markets is likely an overreaction to lock in gains,” notes Varao.

The potential knock-on effects of the debt crisis in Europe and rising interest rates in China in a slower growth environment have raised the spectre of a double-dip recession. Recent U.S. economic growth is largely attributable to provisional fiscal stimulus measures and inventory restocking. As these wind down in 2010, the stakes are raised for consumer spending and business investment to pick up the slack. Job growth will ultimately be the linchpin to improved confidence and improvements in retail, housing and auto sales.

#### Canada and Contagion



While the odds of a double-dip recession are arguably greater now than they were at the beginning of the year, they still remain low in absolute terms. Scotia Economics has forecast a global growth rate of 3.4% for 2010, with activity expected to be driven in large part by developing countries like China and India, both of which could see growth of 10% over the coming year. The current estimate for Canada is 3.6%, which should rank among the strongest for all developed countries. (Source: Scotia Economics).

Reiterating his confidence in European authorities' ability to manage their sovereign debt issues, Bank of Canada Governor Mark Carney recently noted that the situation in Europe will have only a modest spillover effect in Canada. It's a sentiment that's echoed by Mr. Varao, who remains constructive on equity markets, including Canada. Informing this view on the latter is a relatively favourable outlook for resource and financial stocks.

The entire management team at Scotia Asset Management continues to monitor the macro situation and reassess their portfolios as new information becomes available – focusing on fundamentals over fear and their disciplined process of uncovering compelling investment opportunities.

## Lessons From the Beautiful Game

Fresh from the fanfare of the 2010 FIFA World Cup, *Inside INNOVA* looked to see if the beautiful game offers any lessons for investors. It turns out there are quite a few.

**Expect the Unexpected** – Like no other before it, the 2010 FIFA World Cup was one of the improbable and the unthinkable. Who would have predicted the early departure of heavyweights Italy and France in the first round, Germany's 4-1 defeat over England in the knock out round, and the number-one ranked Brazilian team's defeat to the lower ranked Dutchmen in the quarter-finals. More than ever before, it's anyone's game. Shocks of the economic, political or natural disaster variety also happen in the marketplace. The lesson for investors is that while exogenous events can't be predicated, they can be managed. Professionally managed portfolio solutions, like *Scotia INNOVA Portfolios*, aren't a silver bullet against losses, but they should provide you with comfort that the best and brightest are working on your behalf to navigate volatile markets while uncovering investment opportunities.

**Find Your Balance** – In soccer (football for the purists), good defenders will keep you in the game, but it's your strikers that will win it for you. Scoring a total of 16 goals and conceding 5, the tactical discipline of the young German team was demonstrated through their highly organized defence and the striking prowess of frontmen Miroslav Klose and Thomas Muller. It's an approach that can work equally well for your portfolio. Maintaining a balance of conservative investments, be they cash, GICs or bond funds, and more growth-oriented equity funds that's aligned with your risk tolerance can help your portfolio on the downside, while ensuring you capitalize on opportunities to score on the upside.

**Think Global** – Most long-term investors should maintain some exposure to foreign investments given their ability to broaden the growth potential and to reduce the overall risk of a portfolio. With Canada's share of the world's equity market registering at little over 2%, the case for global investing is particularly compelling for Canadians. And just like soccer, opportunities for growth aren't limited to the heavyweights. More than any other sport, soccer is truly a global game, with no shortage of developing talent from Africa and Asia. Investors can tap into the tremendous growth potential of emerging economies such as Brazil, Russia, India and China, albeit at more risk than comparable developed market exposure.

**Don't Chase Performance** – England's Wayne Rooney, Argentina's Lionel Messi and Portugal's Cristiano Ronaldo – some of soccer's most gifted players underwhelmed us on the world stage, scoring a single goal between them. There is also an investing lesson to be learned here: this year's top performers are rarely next year's. It's practically impossible to consistently forecast the asset class, country or sector that will lead the market from one year to the next, but diversified exposure across each will help ensure you aren't on the bench when one outperforms.

**Patience is a Virtue** – Investing for a long-term goal such as retirement isn't about instant gratification; it's a process that put simply, takes time and patience. A sound investment plan properly aligned to your needs and combined with regular monitoring has a good chance of realizing your goals, provided you're willing to stick with it through good times and bad. The temptation for some is to jump to conclusions about the success of their long-term plan based on a timeframe of a few years or even a few months. It's a bit like judging Spain's chances for the Coupe du Monde following their disastrous 0-1 opener against Switzerland. Answering their early critics, La Furia Roja (the Furious Reds) advanced all the way to the win the final. It would seem that patience pays off in soccer as well as investing!

### Portfolio Performance as at June 30, 2010

INNOVA Portfolio	3 Month	YTD	1 Year	Since Inception*
Scotia INNOVA Income Portfolio	-0.1%	1.5%	6.9%	9.1%
Scotia INNOVA Balanced Income Portfolio	-1.5%	0.1%	6.5%	10.9%
Scotia INNOVA Balanced Growth Portfolio	-3.3%	-1.8%	5.6%	11.2%
Scotia INNOVA Growth Portfolio	-4.7%	-3.3%	4.7%	12.8%
Scotia INNOVA Maximum Growth Portfolio	-7.1%	-5.8%	3.3%	12.3%

\* January 19, 2009.

ScotiaFunds are available from Scotia Securities Inc., a corporate entity separate from, although wholly-owned by, The Bank of Nova Scotia, and other dealers. ScotiaFunds are managed by Scotia Asset Management L.P., a limited partnership wholly-owned directly and indirectly by The Bank of Nova Scotia. Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments. Important information about ScotiaFunds is contained in the Funds' simplified prospectuses. Copies are available through all branches of The Bank of Nova Scotia, Montreal Trust, National Trust and Scotiabank and Trust. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns as at March 31, 2010 including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns.

# Quarterly Program Review

What happened in the second quarter of 2010?	Outlook
<p><b>Fixed Income</b> Comments provided by Scotia Asset Management L.P., portfolio advisor to Scotia INNOVA Portfolios.</p> <ul style="list-style-type: none"> <li>Canadian fixed income markets outperformed their equity counterparts in the second quarter, with the DEX Universe Overall Total Return Index rising 2.9%.</li> <li>Sector performance reversed in the second quarter to favour Government of Canada issues over provincials and corporates, as credit concerns globally filtered into the Canadian credit market.</li> <li>In contrast to the U.S., the Canadian economy is thriving, led by strong improvement in the employment and housing markets. As expected, the Bank of Canada raised its target overnight rate 25 basis points (bps) to 0.50% in June.</li> </ul>	<ul style="list-style-type: none"> <li>The Canadian economy remains strong relative to its global peers and Canada is in the unique position of being able to set its own interest rate policy.</li> <li>Credit markets look for the Bank of Canada rate to continue to rise steadily toward a more neutral, less stimulative level throughout the rest of 2010 and into 2011. The Canadian dollar is expected to move through parity with its U.S. counterpart as a result.</li> <li>Ongoing weak housing and employment markets remain concerns in the U.S. Forecasts for the first increase in the Fed Funds rate have generally been pushed further out, from late 2010 to some point in the first half of 2011.</li> </ul>
<p><b>Canadian Equities</b> Comments provided by Scotia Asset Management L.P., portfolio advisor to Scotia INNOVA Portfolios.</p> <ul style="list-style-type: none"> <li>Canadian equity markets as represented by the S&amp;P/TSX Composite Index fell 5.5% as overseas events washed ashore.</li> <li>Telecommunications was the top performing sector as investors migrated to stable, dividend paying stocks with moderate growth prospects. The Consumer Discretionary and Materials sectors outperformed the broader benchmark. Gold stocks led the Materials sector in gains, while base metals stocks underperformed by a wide margin on fears of an imminent slowdown in China.</li> <li>Information Technology led the Index in losses, led by a selloff in Index heavy-weight Research In Motion (RIM). Financials were also in the red on mixed quarterly results by the banks and weak performance by a number of life insurance companies.</li> </ul>	<ul style="list-style-type: none"> <li>While some challenges to sustainable global growth over the next few years are in evidence, including the well-publicized European debt problems, we remain constructive on Canadian equities.</li> <li>Our well regulated financials sector has been able to withstand the debt crisis from last year and remains robust. Our market exposure to resources benefits from the growth in demand that continues to come from the Far East, especially China.</li> <li>However, any reduction in demand from these growth areas would affect commodity pricing and the current worldwide focus on financial reform may have some unforeseen consequences for Canadian financials.</li> </ul>
<p><b>Foreign Equities</b> Outlook provided by Metropolitan West Capital Management, LLC, portfolio manager to Pinnacle American Value Equity Fund, a holding in all 5 Scotia INNOVA Portfolios.</p> <ul style="list-style-type: none"> <li>Global equity markets were stressed by a string of unfavourable developments, including a fragile sovereign debt situation in much of Europe and subsequent negative impact on major European currencies, the oil spill in the Gulf of Mexico and policy initiatives in China.</li> <li>The modest economic improvement that appeared to be gaining traction was overshadowed by talks of global austerity programs and reduced stimulus measures and their resulting impact on economic growth. Against this backdrop the S&amp;P 500 Index declined 7.5% and the MSCI World Index lost 8.6% in Canadian dollar terms.</li> </ul>	<ul style="list-style-type: none"> <li>While there is always the "news of the day," we strive to determine whether current headlines are analyzable, truly differentiated and meaningful to long-term investors. Where broader issues are indeed relevant, we take a long-term view, attempting to minimize the distractions of today's front-page topics.</li> <li>Our opinion remains that the U.S. and global economies are in the process of returning to normal and will maintain their recent upward growth trajectories, but the recovery will be muted, uneven and may not be sufficient to result in rapid employment growth.</li> <li>The current environment should favour our company-centric investment approach as companies will need to focus on internal factors including innovation, new markets and margin improvement rather than depending on a strong economic recovery.</li> </ul>

© Copyright 2010 Scotia Asset Management L.P. All rights reserved.

This document has been prepared by Scotia Asset Management L.P. and is not for redistribution. This document is provided solely for information purposes and is not to be used or relied on by any other person. This document is based on information from third party sources that are believed to be accurate and reliable, but Scotia Asset Management L.P. does not guarantee their accuracy or reliability. The information provided is not intended to be investment advice. Investors should consult their own professional advisor for specific investment advice tailored to their needs when planning to implement an investment strategy to ensure that individual circumstances are considered properly and action is taken based on the latest available information. The

information contained in this document, including information relating to interest rates, market conditions, tax rules, and other investment factors are subject to change without notice. Nothing in this document is or should be relied upon as a promise or representation as to the future. Unless otherwise indicated, securities purchased through Scotia Asset Management L.P. are not insured by a government deposit insurer or guaranteed by The Bank of Nova Scotia, and they may fluctuate in value.

This report may contain forward-looking statements about the fund. Such statements are predictive in nature and depend upon or refer to future events or conditions. Any statement regarding future performance, strategies, prospects, action or plans is also a forward-looking statement. Forward-looking statements are subject to known and unknown risks and uncertainties and other factors that may cause actual results, performance, events, activity and achievements to differ materially from those expressed or implied by such statements.

Such factors include general economic, political and market conditions, interest and foreign exchange rates, regulatory or judicial proceedings, technological change and catastrophic events. You should consider these and other factors carefully before making any investment decisions and before relying on forward-looking statements. We have no specific intention of updating any forward-looking statements whether as a result of new information, future events or otherwise.

™ Trademark of Bank of Nova Scotia, used under License.

ScotiaFunds are available from Scotia Securities Inc., a corporate entity separate from, although wholly-owned by, The Bank of Nova Scotia, and are also available from other dealers. ScotiaFunds are managed by Scotia Asset Management L.P., a limited partnership wholly-owned directly and indirectly by The Bank of Nova Scotia. Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.