

Debt disagreements

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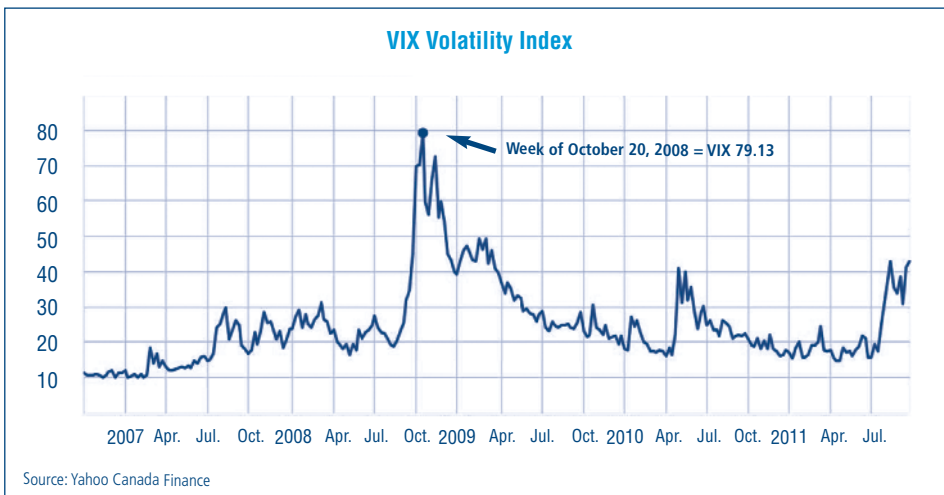
The third quarter started off with squabbling among U.S. politicians over whether or not to raise the debt ceiling, resulting in a downgrade of the U.S. debt. It was the start of a quarter that people quickly wanted to forget, given that a bear market (defined as a loss of more than 20% following a peak) was only just avoided. Dissension among politicians, combined with threats by the Troika (Russian/Bulgarian word meaning a ruling group of three)—the delegation of the European Commission, the International Monetary Fund, and the European Central Bank—to withhold bailout funds from Greece (a result of a perceived failure to implement the austerity plan necessary to extricate itself from its dire fiscal situation), created a bleak economic environment and volatile financial markets.

Weak economic indicators were enough to rekindle fears that the economic recovery, which to date has been slow but steady, could end in a double-dip recession. Second quarter growth was disappointing, proving to be weaker than expected in most developed countries, and revealing that these economies are losing steam. The effects of last spring's events (Arab spring and tsunami in Japan) were finally felt on commodity prices, including the price of oil which ended the quarter around \$79 USD per barrel.

What really captured our attention this quarter, and especially in September, was the future of Greece and the euro zone. It all began with the Troika's threat to delay until October, and now until November, the 8 billion euros needed by Greece to save its government from defaulting on its loans. The members of this alliance are not satisfied with the progress made by the Greek government in meeting its budget objectives.

Various plans have been circulating and the very idea that a plan is being put forward is enough to give hope that politics are being put aside to tackle the sovereign debt problem that has been plaguing Europe and that threatens to explode head on at any moment. But the problem is that the threat remains, because while these plans may be "circulating," none are being applied, because there is still no agreement on the best way to resolve this predicament, at least not for the moment.

The climate of uncertainty created by political disagreements within the U.S. Congress and by the political irresolution in Europe over a solution to its sovereign debt crisis con-



Source: Yahoo Canada Finance

tributed to a definite risk aversion among investors in the year's third quarter.

Stock markets have been in the grips of investors vacillating between taking risks ("risk on") and avoiding risks ("risk off") since the start of the year. Despite a few short-lived cycles in the last quarter, we can generally conclude that we are in a period where active risk seeking is not on the agenda.

The climate of uncertainty contributed to a definite risk aversion among investors in the year's third quarter.

Market volatility in the third quarter was high. For example, it took just one slightly negative comment by the chairman of the Federal Reserve to send stock markets into a spiralling descent that lasted several days. Then, news of a potential rescue plan for Europe gave hope, and markets were back up. Once the surprise effect was over, investors became less certain that this plan would really be implemented, and markets fell again. And so on, and so on. These ups and downs have become almost the norm

as investors remain on high alert and react violently to each piece of news.

Even though market volatility (measured by the VIX volatility index, see graph) is well below the level reached during the 2008 crisis, it is still very high, and it is likely to remain so for a while.

It therefore comes as no great surprise that it was a very difficult quarter for stock markets. The Canadian stock market, represented by the S&P/TSX Composite Index, was down 12% (-11.9% for the year to date). Almost all sectors were down, with the exception of utilities, up 3.6%. The information technology sector (-18.8% for the quarter) continues to be an important source of the index's loss in value, but materials (ex gold) were also a major contributor to the loss.

The U.S. market, represented by the S&P 500, also had a difficult quarter, with a 13.9% drop, in local currency, but the depreciation of the Canadian dollar (more than 7%) was to the advantage of Canadian investors, translating the return into -7.2% in Canadian dollars. The financial sector was hit the hardest (-23% in \$US) as U.S. banks felt the effects of lawsuits instigated against a number of U.S. banks accused of being responsible for the 2008 crisis, and the risk of Greece's default. Even though, for the most part, U.S. banks do not have significant exposure to the debt of the countries in difficulty, a disorderly default would no doubt have significant repercussions for the global financial sector.

Outside of North America, the European market obviously suffered heavily, with the MSCI - Europe index down 16.6% for the quarter, in Canadian dollars. The MSCI - World index ended the quarter down 10.2% in Canadian dollars.

In this tumultuous third quarter, the winner was once again the bond market, which continues to profit from the sombre news coming from Europe. The DEX Universe Bond Index ended the quarter up 5.1% (+7.4% since the start of the year). Provincial bonds did best (6.6%), while corporate bonds, subject to investors' concerns, offered a three-month return of just 3.7%. Long-term rates (10 years or more) are at record levels (Canada 2.22%, U.S. 1.89%).

This performance can be attributed to investors' fears over the European situation, combined with the U.S. Federal Reserve's "Operation Twist." During the 2008 crisis, the Fed acquired large amounts of bonds. Some of these bonds will be maturing very soon. Operation Twist consists in buying longer-maturity bonds with the funds from the maturing, shorter-term bonds. Essentially, the shorter maturities will be replaced with longer maturities. Generally speaking, major bond purchasing activity translates into downward pressure on rates, keeping them "artificially" low.

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Table of net returns as at September 30, 2011

	Unit value \$	Net assets ¹ in millions \$	Simple returns ²			Compound annual returns				MER ³ %	Investment Advisor
			1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %		
FOCUS FUNDS											
											ECOFLEX MY EDUCATION
Focus Prudent	13.87	148.3	(0.8)	(0.5)	(0.1)	0.5	4.0	2.1	3.5*	2.88	Various Managers
Focus Moderate	13.91	222.1	(2.2)	(3.3)	(3.3)	(1.5)	3.2	1.3	3.3*	2.92	Various Managers
Focus Balanced	13.87	375.0	(3.7)	(6.1)	(6.5)	(3.5)	2.3	0.5	3.0*	2.97	Various Managers
Focus Growth	13.77	125.4	(5.2)	(8.9)	(9.6)	(5.5)	1.3	(0.4)	2.7*	3.01	Various Managers
Focus Aggressive	13.63	60.7	(6.6)	(11.6)	(12.6)	(7.6)	0.2	(1.3)	2.4*	3.04	Various Managers
INCOME FUNDS											
											ECOFLEX MY EDUCATION
Money Market	16.92	265.2	0.0	0.0	0.1	0.2	0.2	1.2	1.3	1.47	Industrial Alliance
Short Term Bonds	15.30	205.1	0.5	1.9	2.7	1.9	3.4	2.7	2.7	2.14	Industrial Alliance
Bonds	26.24	1,651.4	1.5	4.6	6.0	4.5	5.8	4.0	4.5	2.14	Industrial Alliance
Bonds - series 2	17.39	599.6	1.6	4.3	5.5	4.4	5.8	3.8	4.3	2.15	Industrial Alliance
DIVERSIFIED FUNDS											
											ECOFLEX MY EDUCATION
Diversified Security	16.95	296.1	(1.9)	(1.7)	(1.2)	0.2	4.2	2.2	4.0	2.76	Industrial Alliance
Diversified	29.59	1,611.9	(4.1)	(6.0)	(5.8)	(2.1)	2.7	1.0	4.0	2.77	Industrial Alliance
Diversified Opportunity	18.02	201.1	(6.0)	(9.2)	(9.4)	(4.3)	1.9	0.3	4.2	2.84	Industrial Alliance
Fidelity Canadian Asset Allocation	14.82	473.1	(4.9)	(6.1)	(8.0)	(2.4)	2.6	2.0	4.8	3.39	Fidelity
Diversified Income	17.59	170.4	(6.8)	(10.3)	(10.5)	(3.9)	4.3	2.3	-	2.77	Industrial Alliance
Global Diversified (Aston Hill)	9.21	30.7	(5.3)	(9.1)	(8.0)	(2.5)	1.1	-	-	3.12	Aston Hill
CANADIAN EQUITY FUNDS											
											ECOFLEX MY EDUCATION
Dividend Income	9.81	133.1	(5.8)	(11.8)	(11.3)	(8.7)	(1.8)	(2.9)	4.6*	2.42	IA Clarington
Dividend Growth	12.51	673.6	(4.8)	(9.1)	(7.1)	(1.9)	2.4	2.0	7.8*	2.66	Industrial Alliance
Canadian Equity (Leon Frazer)	14.82	171.3	(4.5)	(6.9)	(2.8)	1.6	4.9	2.4	6.9*	2.98	Leon Frazer
Canadian Equity Index	15.91	137.4	(8.6)	(12.9)	(13.7)	(7.4)	(2.3)	(0.3)	4.4	2.78	Industrial Alliance
Select Canadian	22.20	45.2	(10.2)	(14.0)	(15.2)	(7.0)	0.4	0.0	5.8	2.72	Industrial Alliance
Canadian Equity Value	33.17	360.9	(9.1)	(13.7)	(15.1)	(7.9)	(1.8)	(2.2)	4.2	2.78	Industrial Alliance
Canadian Equity (Dynamic)	14.88	506.8	(14.1)	(19.7)	(24.9)	(19.0)	(1.1)	(0.9)	8.1	3.14	Dynamic
Fidelity True North®	21.44	330.5	(6.6)	(10.1)	(11.3)	(3.6)	(0.5)	0.4	5.6	3.40	Fidelity
Canadian Equity Growth	19.34	215.0	(8.9)	(14.0)	(15.9)	(7.7)	2.4	2.8	-	2.75	Industrial Alliance
Fidelity Canadian Opportunities	25.03	188.5	(7.9)	(9.8)	(12.6)	(2.0)	11.8	6.1	8.0	3.40	Fidelity

Returns after deduction of MER (Management expense ratio). Past performance is not a guarantee of future returns.

The EcoStrategist in Brief / Ecoflex | My Education economic and financial bulletin, produced monthly, and its more exhaustive quarterly version, are available on the Company's website under *Investment Vehicles and Publications*.

¹ Total net assets of the fund including individual and group contracts.

² The rates for the period are non-annualized.

³ Management expense ratio (GST and HST included).

⁴ Industrial Alliance has managed this fund since March 2010. Prior to that date, it was managed by Legg Mason.

⁵ Indexes presented in this document are total return index.

* Simulation of past returns as if the fund had been in effect for these periods.

Index funds: Simulation of past returns from the return of the index that the fund aims to reproduce.

Table of net returns as at September 30, 2011 (continued)

	Unit value \$	Net assets ¹ in millions \$	Simple returns ²			Compound annual returns				MER ³ %	Investment Advisor
			1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %		
U.S. & INTERNATIONAL EQUITY FUNDS											ECOFLEX MY EDUCATION
Global Dividend (Dynamic)	9.65	56.8	1.3	(6.5)	(3.3)	4.1	2.5	(0.2)*	-	3.25	Dynamic
Global Equity (Templeton)	8.45	185.9	(4.4)	(14.8)	(12.4)	(10.2)	(4.8)	(7.2)	(2.2)	3.38	Templeton
Global Equity	8.51	6.3	(3.9)	(13.8)	(11.4)	(7.3)	(0.7)	(4.8)	-	3.24	Industrial Alliance
Fidelity NorthStar®	9.03	34.3	(4.3)	(10.8)	(11.5)	(5.4)	0.5	(3.1)	-	3.43	Fidelity
Global Equity Small Cap. (DB Advisors)	8.23	81.9	(4.6)	(12.5)	(12.2)	(6.0)	1.4	-	-	3.35	DB Advisors
International Equity Index	5.87	11.8	(3.6)	(13.0)	(12.3)	(10.1)	(3.9)	(7.0)	(1.9)	2.76	BlackRock
International Equity (Templeton)	10.48	57.8	(4.4)	(15.3)	(14.1)	(13.0)	(6.0)	(7.7)	(2.2)	3.33	Templeton
International Equity (McLean Budden)	8.18	6.2	(3.9)	(12.7)	(12.3)	(10.8)	(3.2)	(6.4)	(2.1)	3.24	McLean Budden
Fidelity European Equity	7.30	53.9	(5.4)	(17.4)	(16.6)	(14.0)	(6.2)	(3.8)	0.3	3.44	Fidelity
U.S. Equity Index	6.86	27.3	(1.2)	(7.6)	(6.3)	(0.3)	(2.7)	(5.6)	(4.4)	2.75	SSgA (State Street)
U.S. Equity (McLean Budden)	7.90	28.9	(3.8)	(11.4)	(12.4)	(7.3)	(5.0)	(6.1)	(2.9)*	3.20	McLean Budden
U.S. Equity ⁴	4.81	8.8	(3.6)	(11.1)	(12.1)	(4.0)	(4.3)	(12.1)	(7.3)	3.09	Industrial Alliance
SPECIALTY FUNDS											ECOFLEX MY EDUCATION
Asian Pacific (Dynamic)	5.00	43.2	(13.7)	(20.5)	(24.5)	(23.3)	17.3	6.2	6.2	3.06	Dynamic
Emerging Markets (Mackenzie Cundill)	12.05	41.6	(11.5)	(20.0)	(27.9)	(18.4)	2.8	(0.7)	6.5	4.32	Mackenzie Cundill
Global Health Care (Renaissance)	11.60	10.9	0.8	(6.0)	3.6	5.3	1.5	(1.5)	0.9	3.56	CIBC
Real Estate Income	20.82	25.0	(1.5)	(2.2)	7.4	6.5	10.5	4.1	-	2.78	Industrial Alliance
U.S. DAQ Index	4.22	14.3	1.2	(1.4)	(0.9)	5.7	7.3	1.6	(0.5)	2.79	Industrial Alliance
EDUCATION SAVINGS PLAN											ECOFLEX MY EDUCATION
Diploma Elementary	11.74	234.2	(2.6)	(5.2)	(5.0)	(2.2)	0.5	(0.7)	1.6*	3.39	Industrial Alliance
Diploma Secondary	11.27	31.9	(0.1)	0.2	0.1	0.0	1.2	0.6	1.5*	3.40	Industrial Alliance
FUNDS NOT OFFERED TO NEW CONTRACT SUBSCRIBERS											ECOFLEX MY EDUCATION
Diploma	9.65	169.0	(2.2)	(4.9)	(4.6)	(1.9)	0.4	(1.0)	1.1	3.40	Industrial Alliance
Dividends	30.76	539.2	(4.8)	(9.0)	(6.8)	(1.3)	2.7	2.3	8.5	2.16	Industrial Alliance
Multi-Strategy	7.53	2.1	(1.3)	(3.6)	(4.8)	(3.1)	(7.8)	(6.7)	(1.9)*	4.11	Lyxor Asset Manag.

Returns after deduction of MER (Management expense ratio). Past performance is not a guarantee of future returns.

Reference indexes⁵ - Returns as at September 30, 2011

	Simple returns ²			Compound annual returns			
	1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %
INDEXES RELATED TO INCOME FUNDS							
DEX 91 day Tbill Index	0.1	0.3	0.8	1.0	0.9	2.1	2.5
DEX Short Term Bond Index	0.6	2.3	4.1	3.9	5.5	5.1	5.0
DEX Universe Bond Index	1.8	5.1	7.4	6.7	8.1	6.1	6.5
S&P/TSX Capped Income Trusts (Total Return)	0.0	(0.3)	14.7	26.3	13.9	9.0	16.3
SB - World Government Bonds (Can. \$)	4.1	10.3	11.2	5.5	7.0	6.0	3.0
INDEXES RELATED TO CANADIAN EQUITY FUNDS							
S&P/TSX 60	(8.1)	(12.1)	(11.6)	(4.3)	0.9	2.4	7.7
S&P/TSX Completion Index	(10.3)	(11.9)	(12.9)	(1.5)	9.0	3.5	9.4
S&P/TSX Composite Index	(8.7)	(12.0)	(11.9)	(3.6)	2.7	2.6	8.0
S&P/TSX Capped Composite Index	(8.7)	(12.0)	(11.9)	(3.6)	2.7	2.6	8.0
INDEXES RELATED TO U.S. & INTERNATIONAL EQUITY FUNDS							
S&P 500 (Can. \$)	(1.3)	(7.2)	(4.6)	2.0	0.6	(2.6)	(1.4)
S&P 500 (Can. \$) (Reuters)	(0.9)	(7.0)	(4.2)	2.7	0.6	(2.5)	(1.4)
MSCI - World (Can. \$)	(3.0)	(10.2)	(8.3)	(3.5)	(0.7)	(3.6)	(0.5)
MSCI - World Small Cap. (Can. \$)	(5.7)	(14.2)	(12.0)	(2.8)	4.4	(1.4)	4.7
MSCI - EAFE (Can. \$)	(3.9)	(12.7)	(11.2)	(8.6)	(1.8)	(4.8)	0.7
MSCI - EAFE (Can. \$) (Reuters)	(3.6)	(12.5)	(10.8)	(7.9)	(1.8)	(4.8)	0.7
MSCI - Europe (Can. \$)	(5.4)	(16.6)	(11.3)	(10.5)	(2.8)	(4.9)	1.0
INDEXES RELATED TO SPECIALTY FUNDS							
MSCI - AC Asian Pacific Free (Can. \$)	(3.3)	(8.7)	(12.0)	(7.1)	3.9	(1.4)	3.3
MSCI - Emerging Markets (Can. \$)	(9.3)	(16.5)	(18.2)	(15.1)	5.9	3.7	11.6
MSCI - World Health Care (Can. \$)	0.8	(3.7)	4.0	3.6	0.4	(2.8)	(3.5)
NASDAQ 100 (Can. \$)	1.4	(0.9)	0.7	8.0	9.6	3.8	1.9
S&P/TSX Capped REIT Index	0.4	(0.1)	14.4	12.1	14.8	6.2	13.0

	Variation			Compound annual variation			
	1 month %	3 months %	YTD %	1 year %	3 years %	5 years %	10 years %
EXCHANGE RATE (Can. \$ / US \$)							
As at September 30, 2011: 1.0389	6.2	7.7	4.5	0.9	(0.7)	(1.4)	(4.1)
EXCHANGE RATE (US \$ / Can. \$)							
As at September 30, 2011: 0.9626	(5.8)	(7.2)	(4.3)	(0.9)	0.7	1.4	4.3

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However, with rates already at low levels, unemployment remaining high, consumers still in a savings and debt reduction pattern, and banks making it harder to obtain mortgages, there is reason to question whether Operation Twist will really make a difference in the equation.

Given current valuation levels of stocks and companies that continue to post good results, we are more optimistic about returns for the stock markets. Effectively, we would not be surprised to see stock markets post some very good results over the next twelve months.

We must not invest by focusing on the past but, by looking toward the future. And on this premise, even though the situation remains uncertain, it is clear that the outlook for stocks is brighter than the outlook for bonds. ■