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Why it still makes sense to have exposure to government bonds

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Ten years ago, for investors seeking capital preservation and some income, the case for holding government bonds was more compelling than it appears today. In 2001, five-year Government of Canada bonds paid an interest rate of more than 5%. But in today's lower-rate world, the yield on new five-year bonds has been cut in half, to approximately 2.34%. And with interest income taxed at full marginal rates, an individual in a 46% tax bracket would be left with an annual return of about 1.26%.

For those who find a 1.26% return acceptable, keep in mind we also live in a world with inflation. The price of food, gasoline, shelter and transportation has historically grown at a rate of over 2% per year. As a result, the money you lend to the government today will be returned to you in five years with less purchasing power, because of the combined effects of income taxes and inflation. It's not likely that income taxes will be reduced in the near term, given the size of Canada's national debt. And inflation will probably be above historical norms due to growing consumption from middle-class consumers in the emerging markets.

Yet we believe government bonds continue to be an important part of a diversified investment program. Why? They are a stabilizer for your portfolio. It makes sense to own some government bonds in a balanced income and stock portfolio because government bonds are negatively correlated to stocks. This means they tend to perform well when stock markets decline. We don't think they are attractive at their current value from an income-generation perspective. But we will continue to hold some government bonds in our portfolios, and will likely increase the allocation if the interest rates they offer climbs back to more normal levels.

We believe a well-crafted portfolio should provide a balance of capital preservation, income and growth. The optimal mix for each individual investor would depend on his or her risk tolerance and investment time horizon. We actively manage the asset mixes of the portfolios to ensure they meet our clients' objectives in different investment environments. Today, in the income portion of our portfolios, we generally have underweight allocations to Canadian government bonds compared to the index and overweight positions in corporate bonds and global government bonds. This strategy provides better yield and enhanced diversification.

In the stock portion of our portfolios, we favour foreign stocks to take advantage of the strong Canadian dollar relative to other currencies and also for the more attractive valuations we are finding outside of Canada. Our portfolios also tend to have a more diversified sector allocation that is less sensitive to the





fluctuations of volatile commodity prices, which have a significant impact on the Canadian equity market. We are more comfortable relying on value and good businesses to generate returns, rather than counting on commodity prices going higher.

Combined top 15 equity holdings as of May 31, 2011 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. AltaGas	6. TransCanada Corp.	11. Microsoft
2. Bell Aliant	7. CCL Industries	12. Pason Systems
3. Power Financial	8. Laurentian Bank of Canada	13. Research In Motion
4. E-L Financial	9. Empire Company	14. BCE
5. Canadian Utilities	10. Astral Media	15. Telus

Combined top 15 equity holdings as of May 31, 2011 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Toronto-Dominion Bank	6. Potash Corp. of Sask.	11. Encana
2. Barrick Gold	7. Boeing	12. Mullen Group
3. Microsoft	8. Ventas	13. Praxair
4. ExxonMobil	9. Royal Bank of Canada	14. Simon Property Group
5. Suncor Energy	10. Oracle Systems	15. Comcast

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting “open web link in browser”: <http://www.assante.com/wp/optima/financials.jsp#united15>.

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