CANADIAN
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Emerging Market Bonds are Mainstream Investments

- BMO Global Asset Management Canadian ETF Outlook 2012
- Discover the Potential for Higher Yields and Risk Management
- Equity Factor Indexes for the Canadian Market

2012 marks the year of our 2nd annual Exchange Traded Forum

Looking back, 2012 was a year of tremendous growth for the Canadian Exchange Traded Funds industry with assets up 13% to $42.3B and the number of products in Canada increasing from 157 in 2010 to 227. This growth is significant and is expected to continue. The number of ETF providers doubled with the addition of First Asset Exchange Traded Funds, PowerShares, RBC and Vanguard joining the list.

What's in store for ETFs in 2013? We believe we will see continued growth in this rapidly expanding sector. However, in order to attract new assets the providers will need to launch new cost effective, innovative products. These products will be more sophisticated in both structure and sector allocation.

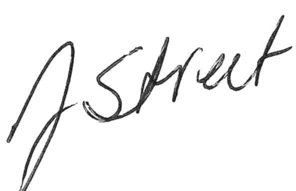
To this end there will be increased regulatory focus and plenty of media exposure, both good and bad. The need for education and understanding in all types of exchange traded products is now more necessary than ever.

In response to this need, **Exchange Traded Forum 2012** will divide our delegates into two tracks for part of the event. We want to assist those who are just beginning to incorporate ETFs into their practice by addressing ETF Fundamentals and core risks; we will also further the education of the more advanced ETF users.

We will also be adding many new sessions to address some of the key issues and shed additional light on the outlook for the future of ETFs in Canada.

We really hope you can join us as you continue to strive for excellence in your business.

Sincerely,



Judy Street, Vice President
Radius Financial Education

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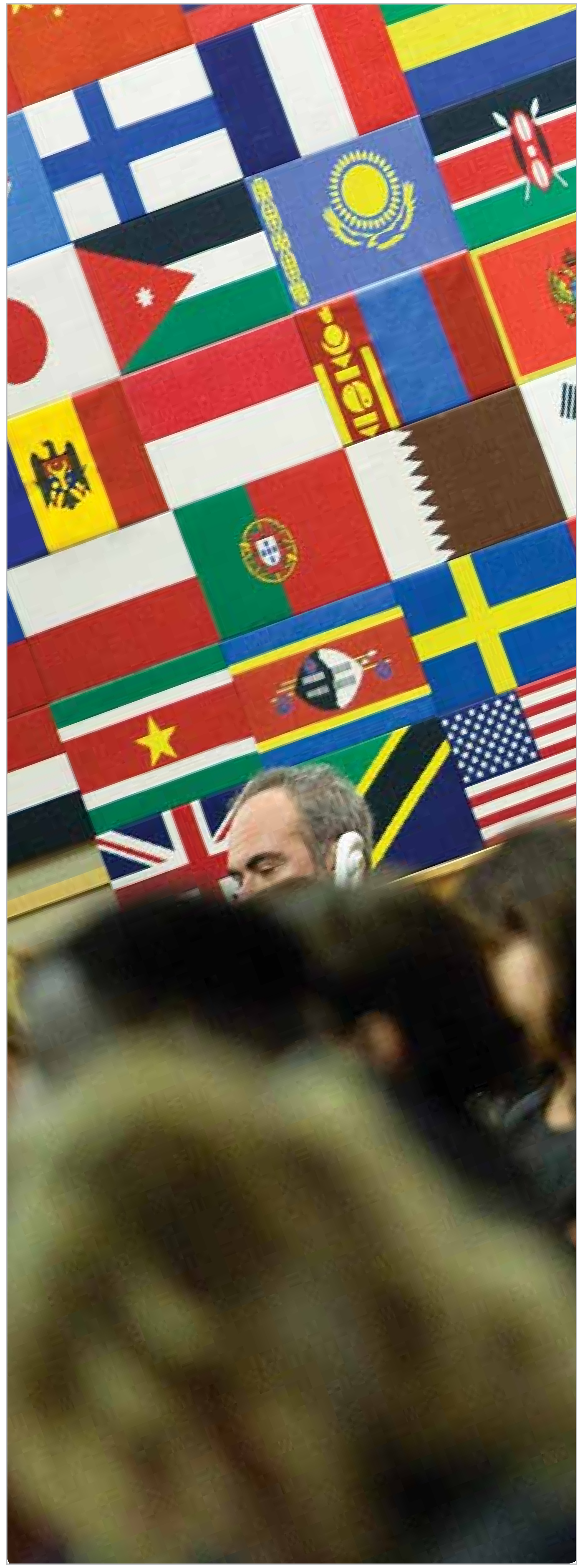

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Types of ETFs

*There are a variety of **Exchange Traded Funds (ETFs)** that provide investors an opportunity to develop a diversified investment portfolio. ETF sponsors are constantly adding to the types of ETFs available, providing investors with more choice. Many ETFs track the performance of an underlying index or benchmark. The underlying index or benchmark may be broad, or sector-specific, or be linked to commodities or currencies. ETFs have evolved, however, to include those that do not passively track an underlying index or benchmark.*

ETFs can be grouped into different categories, which may include:

Index ETFs

ETFs that use an index tracking approach generally follow a pre-selected index, called a benchmark, and the return on the ETF will closely correlate with that of the underlying index. Index ETFs follow a variety of indices, including the broad market (both Canadian and international), sectors such as infrastructure or health care, and commodities (including natural gas, oil and gold), as well as indices that offer exposure to dividends or fixed income. The weightings used in the underlying index could be based on market capitalization of the constituents or on fundamental factors such as financial criteria. Index ETFs may also follow indices that adhere to a certain investment style, such as value or growth.

Inverse and Leveraged ETFs

Inverse ETFs are designed to seek daily investment results that correspond to the inverse daily performance of their underlying index or benchmark. To meet their investment objectives, inverse ETFs use a variety of derivatives such as futures contracts and index swaps to reproduce a daily result that is the opposite of the underlying index or benchmark; so, when the index or benchmark goes down in value on a given day, the inverse ETF will correspondingly go up in value for that given day. Conversely, when the index or benchmark goes up in value, the inverse ETF will correspondingly go down in value. Investing in these ETFs is similar to holding short positions, or using a combination of advanced investment strategies to profit from declining prices.

Leveraged ETFs are designed to seek daily investment results to provide a multiple of the daily performance return of an underlying index or benchmark (for example, 200% the return). They are not intended to provide that same multiple of the return over the mid or long term. Investors should be aware that, while leveraged ETFs typically achieve their stated objective of a multiple of the daily performance of an underlying index on a daily basis, their returns can vary considerably from that stated objective if held for a period longer than one day. Note that some leveraged ETFs are also inverse, in that they track the opposite of the return of an underlying benchmark.

To meet their investment objectives, leveraged ETFs use a variety of derivatives such as futures contracts and index swaps to provide a multiple of the market exposure of the stocks in the fund. Leveraging increases the risk of the investment in such an ETF, in that losses will be magnified by that same multiple.

Inverse and leveraged ETFs are generally intended for use in daily or short-term trading strategies, and are not intended for investors who are looking to hold positions in a security beyond the short-term. Over time, a leveraged fund can drift from its benchmark due to the effects of compounding, especially during periods of market volatility. Therefore, the return on these ETFs for periods longer than a single day will not correlate with the return of the underlying benchmark. Accordingly, significantly more risk is involved in these types of ETFs than in index ETFs.

It is important that investors clearly understand the nature and risks of any ETF prior to investing.

Commodity ETFs

Commodity ETFs provide exposure to commodities such as energy (e.g., natural gas or oil), precious metals (e.g., gold, silver or platinum), or livestock and grains, either by (i) holding the physical commodity directly, (ii) tracking the performance of the spot market price through physical forward contracts, or (iii) investing in or tracking the performance of commodity futures contracts. ETFs that hold the physical commodity provide exposure to the spot price of the commodity without the trouble of storing the commodity. ETFs that hold futures provide exposure to futures without the trouble of rolling them over. Most commodity indices are futures price indices, reflecting a change in the price of commodity futures, not in the commodity price.

Currency ETFs

Currency ETFs provide exposure to currencies and can also hold either the actual currency or futures contracts. Some are designed to be long or short on one currency against others; some are designed to hold a mix of long and short futures positions among several currencies.

Actively Managed ETFs

Index ETFs are generally designed around a passive strategy and therefore typically have lower management fees. Some ETF providers offer actively managed ETFs that operate more closely to the concept of a mutual fund. These ETFs have an active manager making investment decisions, often with the objective of outperforming rather than tracking a particular benchmark index, but usually with lower management fees than a traditional mutual fund.

Exchange Traded Notes (ETNs)

Exchange traded notes are debt obligations of the issuer and trade like ETFs. They do not guarantee any return of principal at maturity and do not pay any interest during their term. While they exhibit no tracking error in that their return at maturity is linked to the return of the underlying index (minus expenses), they do exhibit credit risk linked to the issuer. ETNs offer long and short or inverse exposure to commodities and currencies as well as leveraged exposure.

Source: tmxmoney.com

Emerging Market Bonds are Mainstream Investments

There is a great deal of discussion these days about "emerging markets", and the dynamic growth opportunities for equities presented by those markets.

Barry Gordon
President & Chief Executive Officer

Accompanying this generally bullish perspective is a prevailing view that bonds issued both by emerging market sovereign states and corporations that operate within those markets are equally attractive and should be part of every portfolio. The overall performance of emerging market bonds bear this out, having been an extremely strong outperformer over the past decade. While I tend to agree, it is important for the average investor to be extremely well diversified and keep a close eye on liquidity when investing in emerging market debt. Somewhat obviously, ETFs offer an ideal investment vehicle in which to access the asset class.

Emerging market bonds are still subject to broader risk on/risk off trends that tend to increase volatility in the asset class, but there is no doubt that emerging market bonds have evolved beyond their former niche existence in darker corners of global capital markets, and that a well-constructed index of emerging market credits mitigates a good portion of this risk.

FirstAsset Exchange Traded Funds

A few key things need to be considered when assessing whether to allocate capital to emerging market bonds. First and foremost, what are "emerging markets"? Most people consider an emerging market to be a country whose economy is either in the earlier stages of development or recovering from underdevelopment, and to paint with a wide brush, typically includes most or all of South and Central American countries, Eastern Europe, Africa, the Middle East and even Russia, and Asia ex Japan. As you might expect, bonds issued by countries from these regions and corporations operating in them are typically considered to be more risky than their developed market counterparts. Investors need to bear that in mind – although it is increasingly true that many emerging economies have stronger fundamentals than their more highly rated and regarded western neighbours.

Second, as an investor, are you seeking to get exposure to sovereign credits, corporate credits or both? Corporate credit in the emerging market context can be more difficult to assess, as corporations operating and domiciled in emerging markets are subject to both sovereign risk as well as operational credit risk. The yields of bonds issued by sovereign credits in emerging markets have reflected the incremental risk, and typically yield many hundreds of basis points above developed market sovereign credits. The same is true of emerging markets corporate credits.

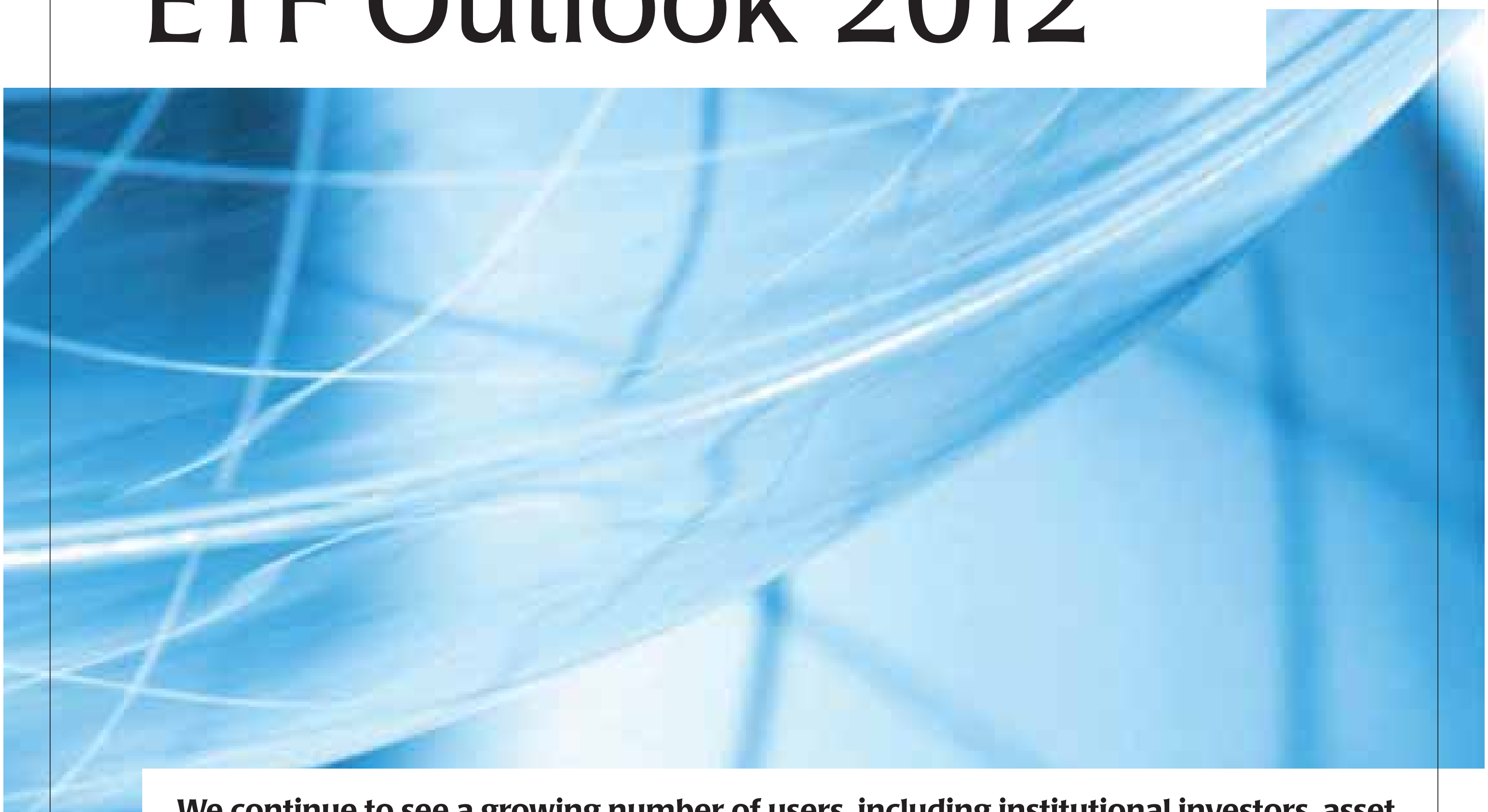
The third major consideration is what type of currency exposure you want/don't want. Emerging market bonds can be issued in the currency of the jurisdiction of the issuer, often referred to as "local currency emerging market debt", or in a major currency such as the U.S. dollar or Great Britain pound. A portfolio of emerging market bonds issued and payable in U.S. dollars is a very different proposition to one holding local currency debt. The risk/return profiles can be very different.

Regardless of your views regarding the considerations discussed above, there are several good investment options, including in particular ETFs which track emerging market bond indexes. One such index, which offers a holistic approach to emerging market debt, is the Morningstar® Emerging Markets Composite Bond Index℠, which combines exposure to sovereign credits and corporate credits in one index. It only includes bonds denominated in U.S. dollars, so there is no local currency exposure. To qualify for inclusion in the Composite Index, a bond must be a constituent of one of the two underlying indexes, the Morningstar® Emerging Markets Sovereign Bond Index℠, or the Morningstar® Emerging Markets Corporate Bond Index℠. The sovereign component is designed to provide diversified exposure to credit-sensitive, U.S. dollar denominated sovereign debt through the most liquid issues in the market. Similarly, the corporate component provides a benchmark for emerging market corporate debt that represents the characteristics, pricing and total return performance of the U.S. dollar-denominated emerging market corporate universe.

The detailed construction rules relating to ratings, liquidity and concentration can be found either on our website – **www.firstasset.com**, or the Morningstar Indexes website in the U.S. (indexes.morningstar.com). We believe that ETFs are a great, cost effective way for investors to get diversified exposure to the broad market. If your view is that attractive yields will continue to attract large capital flows, emerging market bonds will continue to be strong relative performers, and ultimately add diversity and value to fixed income portfolios.

Barry Gordon, President and Chief Executive Officer, First Asset
bgordon@firstasset.com

BMO Global Asset Management Canadian ETF Outlook 2012



We continue to see a growing number of users, including institutional investors, asset managers, investment advisors, and individuals, implementing ETFs as part of their portfolio construction process.

Alfred Lee
Vice President & Investment Strategist, BMO Asset Management

This year, the exchange-traded fund (ETF) industry has continued its strong pace of growth. As of August 2012, the Canadian ETF industry stood at approximately $50 billion in assets under management (AUM), up an estimated 15.9% year to date. In only eight months, the growth rate in 2012 far is already close to the Canadian ETF industry's compound annual growth rate (CAGR) of 18.5% over the last five years. We continue to see a growing number of users, including institutional investors, asset managers, investment advisors, and individuals, implementing ETFs as part of their portfolio construction process.

While ETF assets have shown significant growth so far in 2012, there have been a number of notable trends that have been driving this growth. The macro-economic backdrop and continued low interest rates in the developed world has certainly steered investors towards more defensive oriented ETFs. The Canadian ETF landscape also continues to evolve, both in terms of providers and also their respective product sets. Outside of a growing user base, we believe the key themes below have been instrumental to the growth in ETF assets in Canada so far in 2012.

Key themes in 2012

1) Bond ETFs continue to dominate fund flows

Despite the 10-year Government of Canada bond yield remaining near record lows, fixed income ETFs have continued to attract significant assets. Year to date, bond ETFs have grown from $12.9 billion to $17.8 billion in AUM. There has been a trend of investors becoming more tactical in their fixed income investing, targeting various parts of the yield curve and/or credit spectrum in order to generate higher total returns from bonds or reduce interest rate sensitivity. In addition, we continue to see a significant growth in higher yielding, non-Canadian bond ETFs such as U.S. high yield corporate bonds and emerging market debt.

2) A preference for dividend based ETFs over growth oriented areas

A combination of low interest rates and aging demographics continue to make dividend based ETFs a popular theme with investors. Although the year has seen some brief rallies in Canadian equities, it is clear that the appetite for risk amongst Canadian investors continues to remain low. The year to date growth of AUM in dividend based ETFs, which tend to be more defensively oriented, has already grown 45.2% more than it did in the entire year of 2011.

3) Continued innovation from Canadian ETF manufacturers

While the Canadian ETF industry represents roughly only 3.0% of global ETF assets, it continues to be one of the leaders in innovation. Several ETF providers in Canada have gone beyond plain vanilla ETFs, developing innovative solutions that help investors reduce volatility, source yield and in some cases both.

4) A growing number of ETF based products

As stated in our Canadian ETF Outlook Report at the start of the year, we have seen an increasing number of mutual funds or fund-of-fund products holding ETFs. These products are particularly appealing to those investors that are looking for a well diversified portfolio, but also looking for the flexibility of a mutual fund structure that would allow users to dollar cost average through a single trade. It is also possible that we will see an increasing number of fund-of-fund programs combining active and passive mandates together, to bring the best-of-class investment solutions.

We believe the strong asset growth in ETFs that we have seen in the first eight months of the year will continue to close out the year, despite a number of uncertainties that remain on the macro-economic landscape. Furthermore, even though the Canadian ETF industry has seen a significant growth rate over the last decade, we believe a continued evolution within the industry will bring further asset growth in the coming years. Although we do not see them as substitutes, ETF assets still represent only 6-7% of mutual fund assets in Canada. While the ETF industry may never surpass the mutual fund industry in terms of size, we do see room for further asset growth as both mutual fund and single security investors continue to recognize that ETFs are very complementary in their investment strategies and portfolios. From our perspective, we believe the following factors to be the key drivers in asset growth in the ETF industry.

1) Growing number of distribution channels

In comparison to actively managed mandates such as pooled funds and mutual funds, ETFs still lack the same penetration in certain distribution channels. For example, the use of ETFs in defined contributions (DC) plans is currently very limited, but with a growing number of asset managers now offering both active and passive solutions, this may allow them greater access to DC platforms.

On the brokerage side of the business, it is also possible we will see a greater use of ETFs on managed programs such as separately managed accounts (SMAs) and unified managed accounts (UMAs).

2) Potentially more entrants to the ETF space

Only a few years ago, the Canadian ETF landscape was made up of two providers. A few entrants and an acquisition later, the industry is now made of seven providers which benefits investors as they now have more choices. Over the next several years, we may potentially see more entrants and existing manufacturers ramp up their product offerings, which will continue to drive further innovation in the industry. The end result will be a greater number of solutions that appeal to a wider range of investors and thus more tools for their portfolio construction process.

3) Growing number of implementation strategies

With a growing number of ETFs based on varying styles, exposure types and niches, ETFs are being used in an increasing variety of ways by investors. From transition management to hedging to long/short strategies, there already are countless ETF based strategies, but it is likely new applications will continue to be uncovered. Furthermore, with increased segmentation and ETFs based on specific areas, even basic uses of ETFs such as cash equitization have become more efficient for investors.

4) Cost savings crucial in current market

As the investment landscape has become progressively more challenging and alpha generation less consistent, investors have become increasingly cost sensitive. As such, ETFs have become a popular solution for investors looking to reduce costs while also attaining market exposure. This is especially true given similar plain vanilla products are becoming less expensive due to pricing competition from various providers.

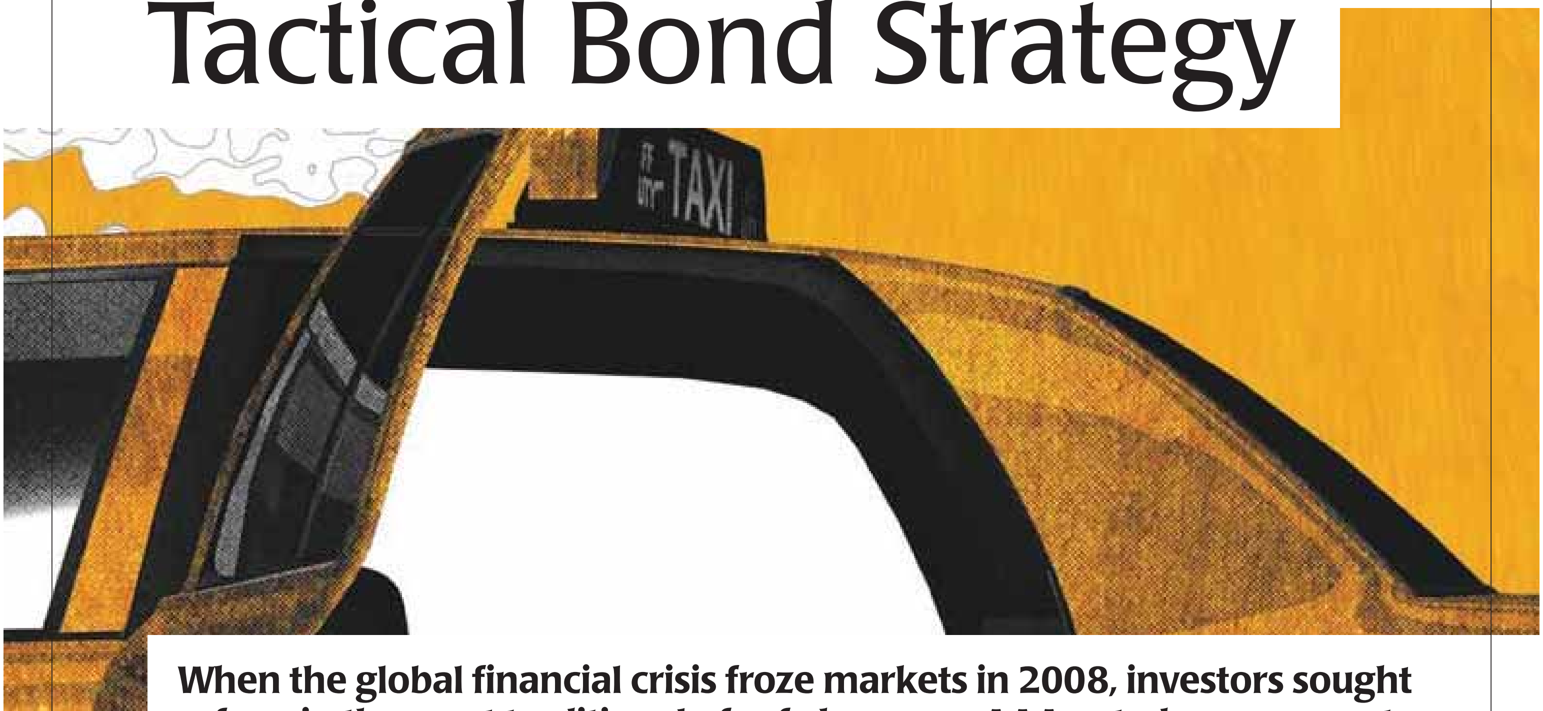
5) Potential entrance of active ETFs

Although the ETF structure may limit the effectiveness of actively managed mandates, a notable asset management firm has successfully launched actively managed ETFs in the U.S. this year. In addition, there have been rumours that other well known mutual fund providers are planning to make an entrance in the ETF space by providing actively managed products. Continued success of mutual fund providers in offering actively managed mandates in the ETF space may eventually lead some Canadian mutual fund companies to consider ETFs to complement their existing mutual fund offerings. Should this occur, it could potentially accelerate the growth rate of the ETF industry.

Given much of the success of the ETF industry has been its appeal to investors, such as low fees, transparency and product support, it is essential that ETF providers maintain these characteristics. Continued growth in the industry will not only be dependent on ongoing product innovation and creating viable solutions for investors, but also on a strong emphasis on client education. Although existing ETF users are becoming increasingly sophisticated, it is also important that newer users receive the same level of support as in the past to ensure newer investors have a good client experience. Local expertise and on the ground specialists will be key in ensuring both new and existing clients get the needed education and support.

Alfred Lee, Vice President & Investment Strategist, BMO Asset Management ***alfred.lee@bmo.com***

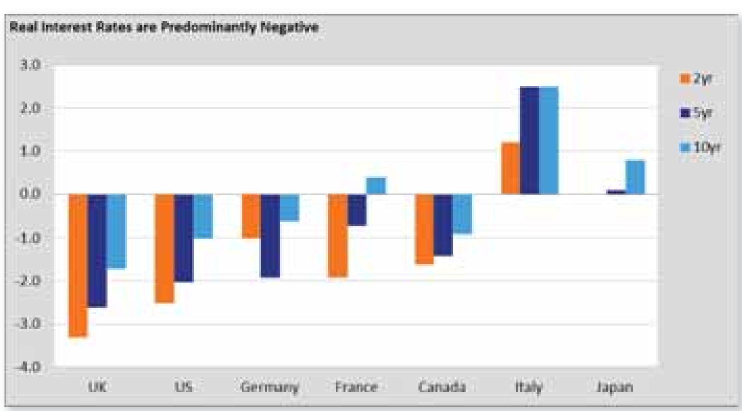
Discover the Potential for Higher Yields and Risk Management with Tactical Bond Strategy



When the global financial crisis froze markets in 2008, investors sought refuge in the most traditional of safe havens – AAA-rated government bonds, particularly those of the U.S. and Canada.

Michael Cooke
Head of Distribution
PowerShares
Canada

While this was just the latest surge in a 32-year bull market for government debt, it drove yields to their lowest levels in a generation. Many government bonds across the G7 now offer negative real returns yielding less than the rate of inflation and eroding the purchasing power of investor savings.



Source: Research Affiliates, based on data from Bloomberg LP, as at June 30, 2012

With a fragile global economic recovery, the prospect of rising interest rates would seem remote in the near term. For example, U.S. Federal Reserve Chairman Ben Bernanke has stated the central bank must serve "a greater good" than protecting savers. That greater good is the recovery of the U.S. economy, which is still reliant on ultra-low rates. The outlook for Canadian interest rates is closely tied to predictions of where the global economy is headed. Recently, the Bank of Canada indicated some concern that external headwinds could knock the country's economy off course.

Investors who have chosen the relative safety of government bonds face the dilemma of low yields and capital erosion should interest rates rise.

Other investors have gravitated to ETFs that track aggregate corporate bond indices as a one-ticket solution to managing their fixed-income exposure without fully understanding the inherent risks associated. Many of these indices weight securities by market capitalization, effectively lending more money to borrowers with the most amount of debt outstanding. Traditional market-cap-weighted bond indices can overweight companies with large amounts of debt on their books. At the same time, these indices may underweight companies with strong fundamentals but little debt.

The low rate challenge

Low interest rates have made income generation much more challenging. As a result, investors have become far more conscious about the fees they pay on their fixed-income investments. It's a lot easier to stomach a 1.25% MER when a bond portfolio is yielding 5% than when the yield is only 1.5%.

The alternative of buying individual bonds presents its own challenges including difficulty of access, liquidity, investment risk and cost. As a result, more investors are turning to exchange-traded funds for their fixed-income exposure as lower cost, diversified alternatives. A wide spectrum of solutions is now available with more than 550 fixed-income ETFs globally. But for many investors, this choice is not enough to help them build diversified portfolios that provide the potential for higher yields and risk management.

Structuring a portfolio of fixed-income ETFs would require the ability to make prudent asset-allocation decisions and periodic portfolio rebalancing. With costs a major factor in the decision to employ ETFs, the transaction costs of rebalancing four or five ETFs, even semi-annually, start to eat into returns.

In search of a solution

The uncertainty facing the global economy and the outlook for interest rates require a different approach by investors. Taking a long-term strategic view is no longer enough. Investors need the agility of tactical asset allocation to take advantage of emerging opportunities while seeking to protect capital in changing market conditions.

In the current low-interest rate environment, it is prudent for fixed income investors to seek lower management fees and trading costs where possible in relation to managing their own bond portfolio.

Based on investor demand, PowerShares Tactical Bond ETF (PTB) was launched August 24 on the TSX. PTB provides investors with the opportunity to gain exposure to a tactically managed, diversified fixed-income portfolio, with the potential for monthly distributions.

Tailored to the Canadian investor, the strategically diversified portfolio primarily consists of Canadian government bonds, investment-grade corporate bonds, real return bonds and U.S. high-yield corporate bonds.

PTB's holdings are managed by Invesco's Global Asset Allocation (GAA) team, led by Chief Investment Officer Scott Wolle, recently named a Rising Star of Mutual Funds by Institutional Investor Intelligence.

The portfolio can be repositioned monthly within the predetermined tactical ranges depending on the different prevailing indicators to seek to improve the risk-return profile of the portfolios. Tactical asset allocation attempts to capitalize on near-term market opportunities by increasing or reducing exposure to different market sectors.

The GAA team uses an overall diversification strategy that employs asset classes that it believes have historically performed well in different economic cycles.

For example, based on the GAA team's research, it is of the view that during recessionary periods, Canadian long-term government bonds have been the most favourable fixed-income asset class. The GAA team believes that periods of non-inflationary growth have favoured investment-grade and high-yield corporate bonds and emerging market bonds, while periods of inflationary growth have favoured Canadian real return bonds, as well as commodities such as gold and silver.

The GAA team makes monthly tactical asset allocation decisions for PTB to take advantage of near-term market opportunities. The team also seeks to protect investors from market downturns by selectively managing exposures to different sectors.

PTB's strategic diversification and tactical management make this ETF a compelling single-trade solution, reducing implementation costs while eliminating the need for rebalancing within a fixed-income portfolio.

Weighted index information	PTB1	DEX Universe Bond Index*
Yield to Maturity	2.94%	2.30%
Interest Yield	4.75%	3.18%
Duration	5.72 yrs.	6.88 yrs.

*Source: PC-Bond, as at August 31, 2012

Underlying holding	Index
PowerShares Ultra DLUX Long Term Government Bond Index ETF	DEX Ultra DLUX Long Government Bond Index
PowerShares 1-5 Year Laddered Investment Grade Corporate Bond Index ETF	DEX Investment Grade 1-5 Year Laddered Corporate Bond Index
PowerShares Fundamental High Yield Corporate Bond (CAD Hedged) Index ETF	RAFI High Yield Bond CAD Hedged Index
Canadian real return bonds2	DEX Real Return Bond Index

Commissions, management fees and expenses may all be associated with investments in exchange-traded funds (ETFs). ETFs are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus before investing. Copies are available from Invesco Canada Ltd. at **www.powershares.ca.**

There are risks involved with investing in ETFs. Please read the prospectus for a complete description of risks relevant to the ETF. Ordinary brokerage commissions apply to purchases and sales of ETF units.

Continued on page 12

Most PowerShares ETFs seek to replicate, before fees and expenses, the performance of the applicable Index, and are not actively managed. This means that the Sub-advisor will not attempt to take defensive positions in declining markets but rather continue to hold each of the securities in the Index regardless of whether the financial condition of one or more issuers of securities in the Index deteriorates. In contrast, if a PowerShares ETF is actively managed, then the Sub-advisor has discretion to adjust that PowerShares ETF's holdings in accordance with the ETF's investment objectives and strategies.

DEX Investment Grade 1-5 Year Laddered Corporate Bond Index and DEX Ultra DLUX Long Government Bond Index are trademarks of PC-BOND. These marks have been sublicensed for use for certain purposes to Invesco Canada Ltd. by PC-Bond, a business unit of TSX Inc. PowerShares 1-5 Year Laddered Investment Grade Corporate Bond Index ETF and PowerShares Ultra DLUX Long Term Government Bond Index ETF (the "Products") are not sponsored, endorsed, sold or promoted by PC-BOND, its affiliates (including TSX Group Inc.) and third party data suppliers (collectively, "PC-Bond Group"). PC-Bond Group makes no representation, warranty, or condition regarding the advisability of investing in the Products.

Investors should be aware of the risks associated with data sources and quantitative processes used in our investment management process. Errors may exist in data acquired from third party vendors, the construction of model portfolios, and in coding related to the index and portfolio construction process. While Research Affiliates takes steps to identify data and process errors so as to minimize the potential impact of such errors on index and portfolio performance, we cannot guarantee that such errors will not occur.

Michael Cooke,
Head of Distribution, PowerShares Canada
michael.cooke@invesco.com

[1] The weighted index information for PTB is shown as at August 31, 2012 and is derived by Invesco Canada using data provided by the relevant index providers for the indices described below (which are used as proxies for the specified holdings held within PTB), and the allocations of those holdings at August 31, 2012. The shown interest yield and yield to maturity are not indicative of the yields an investor could expect to earn on PTB and will vary over time. As market prices change, the allocations within PTB may vary from the allocations at August 31, 2012 and weighted index information shown above may not reflect the current duration or yields of PTB itself.

[2] PTB may gain this exposure through fixed income securities or other ETFs.

TMX – an ETP leader since DAY 1

TMX | Toronto Stock Exchange

Exchange Traded Products ETPs

TMX

ETP Style
Broad-based
Narrow-based
Equal-weight
Balanced
Buy Write
Preferred Share
Dividend Income
Small-cap
Large-cap
Growth
Value
Spreads
Volatility
Managed Futures

Management Style
Passive
Active
Leveraged
Inverse
Bullish
Bearish

Sectors
Agriculture
Base Metals and Materials
Energy
Financial
Healthcare
Infrastructure
Information Technology
Mining
Oil Sands
Real Estate
Socially Responsible
Utilities
Water

Fixed Income
Corporate Bonds
Convertible Bonds
Government Bonds
Long-term
Short-term
Money Market
Laddered
High Yield
Target Maturity
Floating Rate Bonds

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Pound
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EAFE (Europe, Australia, Asia and the Far East)

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Equity Factor Indexes for the Canadian Market

In the 1960s, several academics independently formulated what came to be known as the Capital Asset Pricing Model, or the CAPM for short.[1] According to the CAPM, the expected excess return of every security is proportional to its systematic risk (beta) with respect to the market portfolio.

Paul Kaplan, Ph.D., CFA
Director of Research,
Morningstar Canada

MORNINGSTAR®

Furthermore, every investor should hold nothing other than a combination of the market portfolio and cash (long or short), the blend between the two reflecting individual risk tolerance. This later predication of the CAPM is the intellectual origin of broad market index investing.

However, research in the late 1970s and early 1980s showed that over the long run beta is not the only factor relevant for predicting performance. Over long periods of time, small-cap stocks and those with relatively favorable valuation ratios tend to outperform market beta portfolios. (These two phenomena are often called the size effect and value effect, respectively.) As academics began to accept these empirical rejections of the CAPM, two schools of thought emerged to explain them.[2]

1. The efficient market school, which views the size and value effects as systematic risk factors (or proxies thereof) in addition to the market portfolio which the markets rationally awards risk premiums for taking.

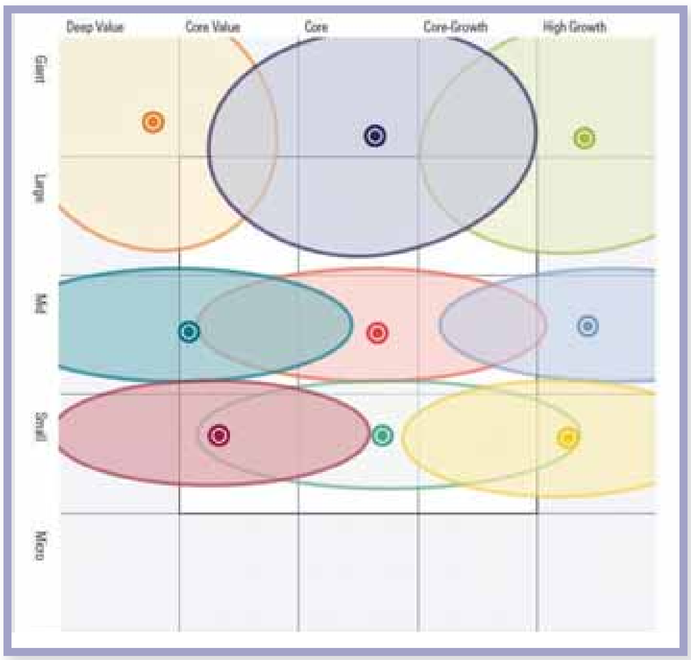
2. The inefficient market school which believes that market prices differ from fair values but that as the differences tend toward zero over time, value and size premiums will occur without any connection to risk factors.

Factor Indexes

In the U.S., the existence of the size and value effects led to the practice of dividing the market into groups of stocks on the basis of market capitalization and valuation ratios. Morningstar began to popularize the concept in the 1990s with its Equity Style Box.SM The Equity Style Box is a 3×3 grid that on the vertical axis shows whether Morningstar classifies a stock or equity fund as being Large-cap, Mid-cap, or Small-cap with respect to size as measured by market capitalization, and whether it falls in the Value, Core (or Blend), or Growth area as measured by Morningstar's proprietary multi-factor style model.

In the early 2000s, Morningstar expanded on the Style Box for equity funds with the Equity Ownership Zone.SM In Ownership Zone analysis, the Style Box is treated as a piece of graph paper and each stock in a portfolio is plotted on it. The assetweighted average position is called the Centroid and is plotted as well. The Ownership Zone itself is an ellipse that contains the stocks that make up 75% of the portfolio closest to the Centroid as measured by asset value.

Figure 1: Morningstar US Style Indexes Ownership Zones – April 30, 2012



Source: Morningstar Direct

Factor Tilt Indexes for Canada Morningstar took a different approach to introducing equity factor indexes for the Canadian market than it did in the U.S. First all of all, rather than starting with the Style Box, we took a broader view of equity factors based on academic findings that suggest that there are equity factors beyond size and value/growth orientation. Recent research has identified Momentum[3] and Liquidity[4] as distinct factors in addition to Value and Size. Furthermore, dividend yield is often treated as a factor, which we regard as a special type of value orientation. The practical manifestation of this has been the creation of several dividend indexes and ETFs in the U.S.

Secondly, we leveraged the expertise of Toronto-based Computerized Portfolio Management Services (CPMS), a leading expert on factor-based equity investing in the Canadian and U.S. markets, which Morningstar acquired in 2009. CPMS provides a broad range of portfolio analysis and equity return enhancement products to the Canadian investment community and has a reputation of delivering high quality data on over 4,000 companies in North America. Clients include institutional money managers, pension plans, institutional brokerage departments, financial planners, and investment advisors.

Morningstar created three equity indexes for the Canadian market based on the following CPMS factor-based strategies:

1. The Canadian Value Strategy. This strategy is suited for investors seeking value for money through stocks with low price to reported earnings, price to book and cash flow ratios. The strategy emphasizes stocks with low P/E multiples based on reported and expected earnings, low price to cash flow multiples based on reported cash flow and low price to book ratios. Importance is also placed on stocks with high earnings estimate revisions. The Morningstar® Canada Value IndexSM is based on this strategy.

2. The Canadian Earnings Momentum Strategy. This strategy is suited for aggressive, short-term, active investors. The strategy emphasizes stocks with high earnings estimate revisions and quarterly earnings momentum. Importance is also placed on stocks with positive earnings surprise and positive price change. The Morningstar® Canada Momentum IndexSM is based on this strategy.

3. The Canadian Dividend Growth Strategy. This strategy is suited for income-oriented investors seeking to buy profitable companies that are growing their dividends. The strategy emphasizes stocks with high expected dividend yields and dividend growth. Importance is also placed on stocks with high cash flow momentum and return on equity. The Morningstar® Canada Dividend Target 30 IndexSM is based on this strategy.

In each strategy, stocks are screened to ensure they have minimum liquidity and analyst coverage as well as earnings in the upcoming year. Stocks are also screened to be included in the top 250 stocks within the CPMS Universe. Each of the three Morningstar indexes is an equally weight portfolio of the top 30 stocks based on the weighted average of the selection factors.

Morningstar indexes offer some style diversification with respect to the TSX 60. The Dividend index, while still large cap, has stocks with less marker-cap than the TSX 60. Not surprisingly, it has more of a value orientation. The Value and Momentum indexes each have a mid-cap focus which can provide diversification across the size spectrum within a portfolio. Additionally, the Value index has a clear value bias and the Momentum strategy has a clear growth bias.

In addition to opportunities for style diversification, the Morningstar indexes also provide opportunities for diversification across economic sectors. The Canadian equity market is heavily weighted in Financial Services, Energy, and Basic Materials and Morningstar Value and Momentum indexes are exposed to these sectors. Hence, Canadian investors can use the Morningstar indexes to tilt away from Financial Services, Energy, and Basic Materials to form a more diversified portfolio within Canadian stock market.

Continued on page 16

Not surprisingly, investors are mostly concerned with performance and risk. As Figures 2 and 3 demonstrate, all of the Morningstar factor indexes have significantly outperformed the TSX 60 over the period January 2002 – April 2012. This is consistent with the idea that each factor index will ultimately deliver the premium that each is designed to capture. Furthermore, as Figure 3 shows, by combing these indexes among themselves and with the TSX 60 (or TSX Composite), these premiums could have been realized with reducing the risk of an overall portfolio. Due to the high realized factor premiums over this period, most of the portfolios along curve consistent only of the factor indexes. Only those points extreme left end of the efficient frontier contain the TSX 60, the largest exposure being 8.76 percent for the minimum variance portfolio.

Conclusion

Extensive academic research has shown that there clearly exist distinct factors that explain returns on U.S. stocks. Because exposure to these factors, especially size and value, have been shown to generate premiums for investors that tilt their portfolios towards them over the long run, equity factor indexes and ETFs that embody them have been become quite popular among U.S. investors.

Research conducted by Morningstar shows that similar factors operate in the Canadian market with similar potential benefits for Canadian equity investors. Based on this research, Morningstar has created a dividend, value, and momentum index to capture each of these three factors respectively. We have shown that these indexes can indeed provide several benefits to investors. In particular, investors can use them to gain diversification across the Style Box (i.e., across both the dimensions of size and value/growth orientation) and across economic sectors. Furthermore, when combined with the popular TSX 60, these indexes can simultaneously reduce the overall risk of a Canadian equity portfolio and enhance performance, thus bringing investors to an overall better place in risk/return space.

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[1] *For a history of the development of the CAPM, see Bernstein, Peter L., 1992. Capital Ideas: The Remarkable Origins of Modern Wall Street, New York: Free Press.*

[2] *For a more detailed discussion, see Kaplan, Paul D., 2011. "Investing at Full Tilt," Morningstar Indexes 2011/12 Yearbook, Morningstar, and Inc.*

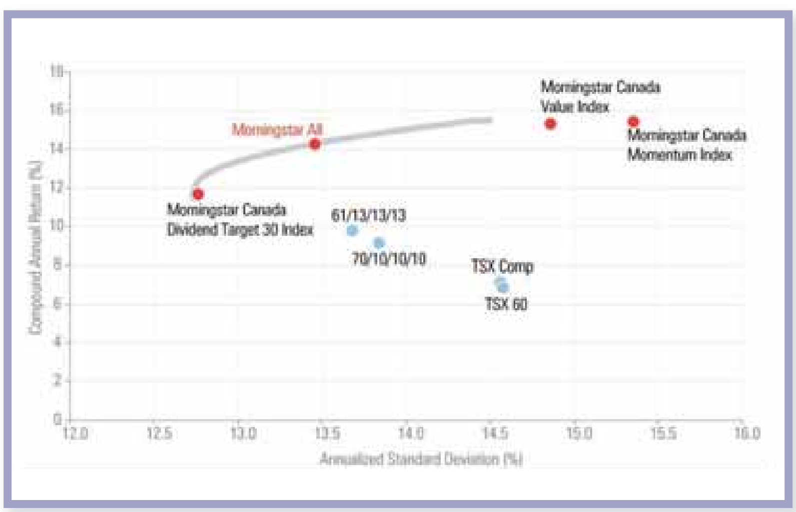
[3] *The academic literature on the momentum effect begins with Jegadesh, Narasimham and Sheridan Titman. 1993. "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency," Journal of Finance 48:65-91*

[4] *For a discussion of the liquidity effect, see Ibbotson, Roger G. and Zhiwu Chen. 2012. "Liquidity Investing," Ibbotson Stocks, Bonds, Bill, and Inflation (SBBI) Classic Yearbook, Morningstar, Inc.*

Figure 2: Risk and Retrurn Canadian Equity Index Portfolios

Data from January 2002 – April 2012 Source: Morningstar Direct, Morningstar Indexes

Figure 3: Canadian Equity Index Performance



Data from January 2002 – April 2012 Source: Morningstar Direct, Morningstar Indexes

New ETF Listings YTD

December 8, 2011	iShares DEX Floating Rate Note Index Fund To Trade On Toronto Stock Exchange
December 2, 2011	Vanguard Canadian Short-Term Bond Index ETF To Trade on Toronto Stock Exchange
December 2, 2011	Vanguard MSCI Emerging Markets Index ETF To Trade on Toronto Stock Exchange
December 2, 2011	Vanguard Canadian Aggregate Bond Index ETF To Trade on Toronto Stock Exchange
December 2, 2011	Vanguard MSCI U.S. Broad Market Index ETF (CAD-hedged) To Trade on Toronto Stock Exchange
January 23, 2012	PowerShares S&P 500 Low Volatility (CAD Hedged) Index ETF To Trade On Toronto Stock Exchange
January 24, 2012	PowerShares FTSE RAFI US Fundamental (CAD Hedged) Index ETF To Trade On Toronto Stock Exchange
January 24, 2012	PowerShares FTSE RAFI Canadian Fundamental Index ETF To Trade On Toronto Stock Exchange
February 2, 2012	XTF Morningstar Canada Dividend Target 30 Index ETF To Trade On Toronto Stock Exchange
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February 13, 2012	XTF Morningstar Canada Value Index ETF To Trade On Toronto Stock Exchange
February 13, 2012	XTF Morningstar Canada Momentum Index ETF To Trade On Toronto Stock Exchange
February 28, 2012	Horizons Silver Yield ETF To Trade On Toronto Stock Exchange
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May 28, 2012	Horizons Universa US Black Swan to Trade On Toronto Stock Exchange
July 6, 2012	First Asset DEX Canada Bond Barbell Index ETF To Trade On Toronto Stock Exchange
July 6, 2012	First Asset DEX Government Bond Barbell Index ETF To Trade On Toronto Stock Exchange
July 6, 2012	First Asset DEX Corporate Bond Barbell Index ETF To Trade On Toronto Stock Exchange
July 26, 2012	IShares MSCI Canada Minimum Volatility Index Fund To Trade On Toronto Stock Exchange
July 26, 2012	IShares MSCI EAFE Minimum Volatility Index Fund To Trade On Toronto Stock Exchange
July 26, 2012	IShares MSCI All Country World Minimum Volatility Index Fund To Trade On Toronto Stock Exchange
July 26, 2012	IShares MSCI Emerging Markets Minimum Volatility Index Fund To Trade On Toronto Stock Exchange
July 26, 2012	IShares MSCI USA Minimum Volatility Index Fund To Trade On Toronto Stock Exchange
August 16, 2012	iShares U.S High Dividend Equity Index Fund (CAD-Hedged) To Trade On Toronto Stock Exchange
August 22, 2012	PowerSharesTactical Bond ETF To Trade On Toronto Stock Exchange

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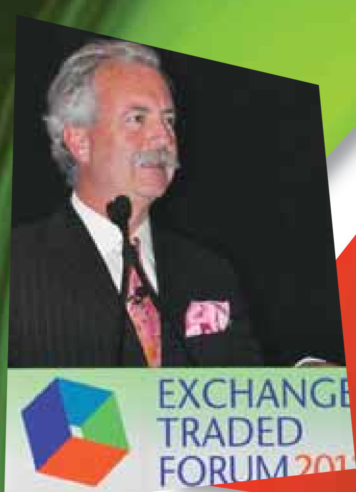

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Claymore launches ETFs

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