Inside INNOVA

Solid. Stable. Considered.

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An Unfamiliar Role:

Bonds Take Centre Stage

Up until very recently bonds have been a largely boring asset class – and when it comes to investing, boring is not necessarily a bad thing.

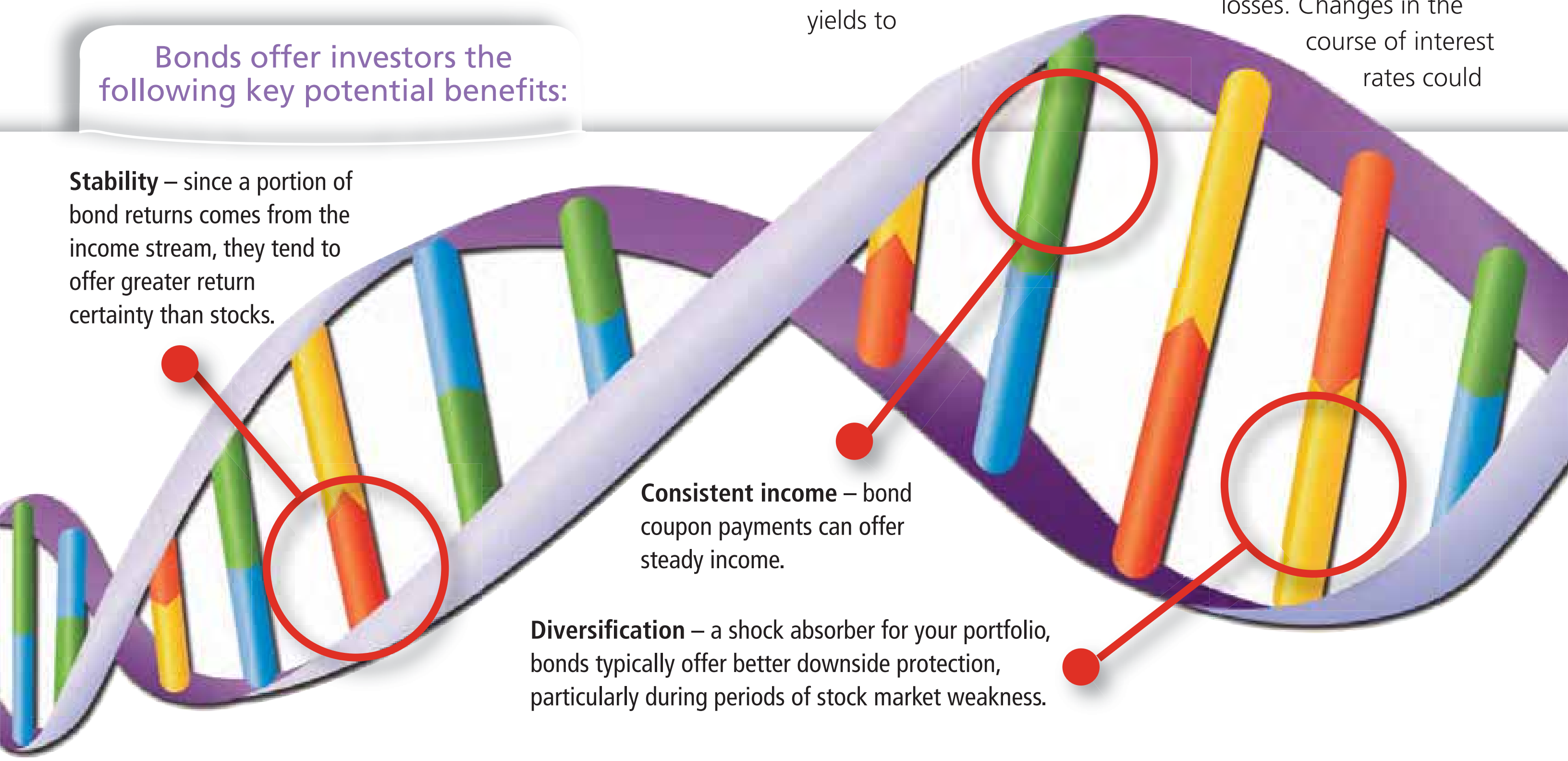
For the past three decades, bond investors have been well-rewarded as the bond market enjoyed the longest bull market in history. From 1982 to 2013 longer-dated bonds enjoyed an uncharacteristically high average annual return of 11.6% - thanks to a windfall decline in interest rates.[*] A look back at the prior 30-year period (1952-1982) provides a sense of what typical government bond returns looked like without the benefit of declining rates – a more subdued 3.7%.[†]

Summer Swoon

Despite their dependable reputation, bonds aren't immune to volatility, as recent performance attests. Years of unconventional monetary stimulus aimed at kick-starting the global economy has driven bond yields to unprecedented lows. Earlier this year, the U.S. Federal Reserve (the Fed) spooked financial markets when it signalled it was considering tapering its bond purchase program, a possible prelude to higher interest rates (and falling bond prices) – more about this later.

Bond markets fell on this news, but have since recovered most of these losses. Changes in the course of interest rates could

Bonds offer investors the following key potential benefits:



Stability – since a portion of bond returns comes from the income stream, they tend to offer greater return certainty than stocks.

Consistent income – bond coupon payments can offer steady income.

Diversification – a shock absorber for your portfolio, bonds typically offer better downside protection, particularly during periods of stock market weakness.

Investors have traditionally sought bonds or the fixed income asset class more broadly, for income, stability and diversification.

* DEX Long-term Bond Index, 1-Year Rolling Returns. Source: Morningstar, October 31, 2013

† DEX Long-term Bond Index, 1-Year Rolling Returns. Source: Morningstar, 1952-1982

Figure 1

A bond is not a bond is not a bond…

Like the stock market, no single asset class consistently leads the pack, and the best and worst performers can change from one year to the next. The remedy: a diversified portfolio of different fixed income investments that lets you participate in potential gains while dulling the impact of those that have underperformed.

Year

Investment Return	2005	2006	2007	2008	2009	2010	2011	2012	YTD 2013
Highest	Emerging Market Debt 9.6%	High Yield Bond 13.3%	Emerging Market Debt 5.1%	Global Bonds 9.6%	High Yield Bond 35.3%	Emerging Market Debt 12.3%	Government Bonds 10.2%	Emerging Market Debt 17.8%	High Yield Bond 11.0%
	Government Bonds 6.6%	Emerging Market Debt 8.7%	Government Bonds 4.5%	Mortgages 10.6%	Emerging Market Debt 28.5%	High Yield Bond 8.8%	Global Bonds 9.6%	High Yield Bond 16.9%	Global Bonds 3.5%
	Corporate Bonds 6.0%	Global Bonds 9.6%	Mortgages 4.1%	Government Bonds 9.0%	Corporate Bonds 16.2%	Corporate Bonds 7.3%	Corporate Bonds 8.2%	Corporate Bonds 6.2%	Mortgage 2.4%
	Mortgage 4.5%	Mortgages 5.4%	Corporate Bonds 1.8%	Corporate Bonds 0.2%	Mortgages 10.3%	Government Bonds 6.5%	Emerging Market Debt 7.7%	Mortgages 4.9%	Corporate Bonds 6.2%
	High Yield Bond 7.7%	Corporate Bonds 4.4%	Global Bonds 9.6%	High Yield Bond -8.6%	Government Bonds 1.6%	Mortgages 4.6%	High Yield Bond 5.7%	Government Bonds 2.7%	Government Bonds -1.2%
Lowest	Global Bonds 9.6%	Government Bonds 3.9%	High Yield Bond -12.5%	Emerging Market Debt -13.8%	Global Bonds 9.6%	Global Bonds 9.6%	Mortgages 5.0%	Global Bonds 9.6%	Emerging Market Debt -3.7%

- DEX Government Bond
- DEX Residential Mortgage Market Index
- DEX All Corporate Bond TR
- Barclays Global Aggregate TR CAD
- Barclays Global High Yield TR CAD
- JPM EMBI Global Diversified Hedge TR CAD

Source: Morningstar. Annual total returns in Canadian dollars.

mean increased volatility for bond markets in the short term, but shouldn't mean that long-term investors should abandon this asset class. "While timing remains uncertain, a rising interest rate environment can be effectively navigated through active management," says Judith Chan, Portfolio Manager of Scotia INNOVA Portfolios. "Exposure to bonds and fixed income investments that are more credit sensitive than interest rate sensitive is just one way you can improve the risk-return profile of a portfolio in a rising rate environment." Moreover, some stocks perform well during periods of rising rates, offering balanced investors additional return potental.

Scotia INNOVA Portfolios® offer investors measured exposure to different fixed income and equity investments through a powerful combination of leading money managers. Continuous fine tuning is designed to help ensure the portfolios remain on track day after day and year after year.

The result is a portfolio designed to provide you with enhanced return potential, and the ability to weather a variety of market and economic conditions and improve performance potential.

Technically Speaking

While bonds and bond mutual funds are among the most commonly held investments, they can also be difficult to understand.

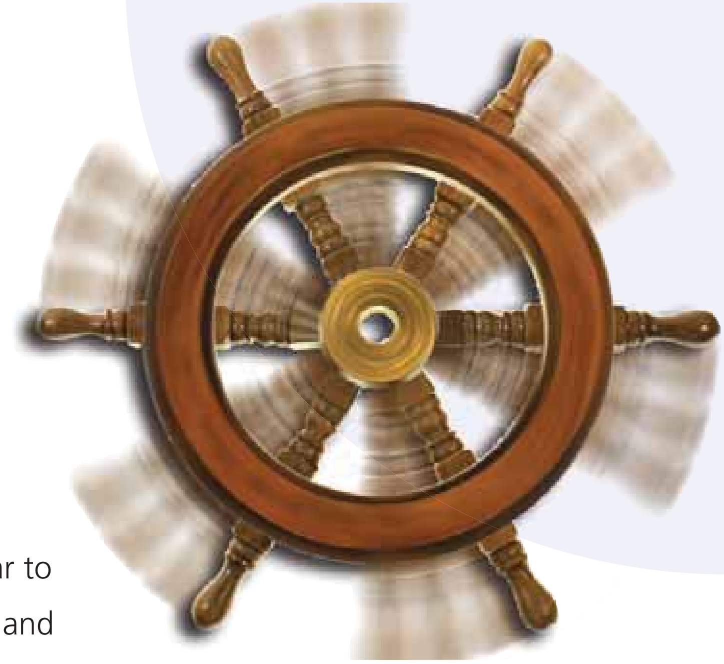
A bond's total return is made up of two components:

- Interest income from periodic coupon payments.
- Capital gains (or losses) from changes in a bond's value when the bond is sold or matures.

Interest rates and bond prices have an inverse relationship. When interest rates rise, bond prices usually fall and vice-versa. This is because as market interest rates rise/fall a bond's coupon becomes less/more attractive relative to the going rate.

Harnessing **diverse strategies** to

Navigate the bond market



Over the past few months, global bond markets have responded more than is typical to the influx of news headlines surrounding the global economy, in particular to the U.S. government's uncertainty over its debt ceiling and whether to taper its $85 billion a month bond-buying program.

The resulting volatility seen recently has reminded investors that bonds still carry risks - primarily interest rate risk and credit risk. We turned to some of the key fixed income Portfolio Managers - Romas Budd, *Scotia Canadian Income Fund*, Jude Driscoll, *Scotia Private American Core-Plus Bond Pool* and Stephen Kearns, *Scotia Private High Yield Income Pool* - to find out how they are managing these risks.

Romas: Once rates do begin to increase, we will take positions in floating rate securities to dampen the effects. In terms of credit risk, we take a prudent, diversified approach to selecting provincial and corporate bonds to add meaningful value. That being said, we do not expect rates to move up as quickly as they did during the second quarter.

Stephen: We focus primarily on high-yield corporate bonds, which have traditionally shown little correlation to interest rates, but would be impacted by a substantial and sustained rise in rates. As a result, we've been buying higher coupon (which are more resistant to rising rates), and shorter maturity issues.

Jude: We believe that fixed income markets are efficient with respect to interest rate risk. However, they regularly misprice securities exposed to credit risk, so by focusing on security and sector selection we can exploit these inefficiencies. We structure our fund to invest in investment grade bonds for stability and supplement with high-yield bonds for added return potential. We're currently underweight bonds that are sensitive to rising interest rates, and favour corporate and emerging market credit, as investors' risk appetite gradually improves. ■

Portfolio Performance (as at October 31, 2013)

SCOTIA PORTFOLIOS	3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	Since Inception
Scotia INNOVA Portfolios Series A						
Scotia INNOVA Income	2.42%	0.46%	4.50%	4.94%	4.04%	6.37%*
Scotia INNOVA Balanced Income	3.37%	2.07%	7.15%	6.42%	4.69%	7.59%*
Scotia INNOVA Balanced Growth	4.48%	4.45%	11.19%	8.42%	5.52%	8.60%*
Scotia INNOVA Growth	5.51%	6.66%	14.65%	10.09%	6.19%	9.77%*
Scotia INNOVA Maximum Growth	7.16%	10.28%	20.57%	12.99%	7.36%	10.82%*
Scotia INNOVA Portfolios Series T						
Scotia INNOVA Income	2.42%	0.47%	4.51%	4.95%	4.05%	4.77%**
Scotia INNOVA Balanced Income	3.37%	2.07%	7.15%	6.42%	4.70%	5.27%**
Scotia INNOVA Balanced Growth	4.48%	4.45%	11.19%	8.42%	5.53%	5.75%**

* January, 2009 **January, 2010

A Look at the Markets

Outlook provided by 1832 Asset Management L.P., portfolio manager to Scotia INNOVA Portfolios.

Materials rebound while interest-rate-sensitive sectors decline.


Sunny

The Canadian equity market performed well over the past quarter, which was a welcome reversal from the performance experienced over the past year. Strong returns were fueled by takeover activity, a small recovery in the resource sector, and strong performance from Canadian banks.

U.S. equities maintain momentum through taper talk.


Sunny

The U.S. equity market maintained its upward trajectory in the third quarter, albeit with an increased dose of volatility. U.S. stocks were supported by stable economic growth and backed by the Fed's decision to maintain its bond-purchasing program. The U.S. equity market has been well ahead of most equity markets this year. Its strong performance has been fueled by continued recovery in U.S. housing and employment, sustained growth in corporate earnings, and improving consumer finances.

Eurozone turns the corner on improved business activity.


Cloudy

The eurozone pulled out of its one-and-a-half-year recession in August, thanks to faster-than-expected growth in Germany and France. European markets rallied through the period resulting in impressive gains. Meanwhile, the International Monetary Fund advised that urgent economic action was still needed to help turn some of the more embattled economies around. As such, the European Central Bank left its key interest rate at 0.5% in September, as widely expected. However, the Bank said it would cut rates or provide economic stimulus if needed, to help the eurozone's early recovery ■

Index Performance

3-Months (as of Oct. 31, 2013, C$)

▲ 5.9%	MSCI Emerging Markets Index
▲ 8.3%	Global equities (MSCI World Index) .
▲ 5.2%	U.S. market (S&P 500 Index)
▲ 6.3%	Canadian equities (S&P/TSX Composite Index)
▲ 1.0%	Canadian bonds (DEX Universe Bond Index)

Source: Bloomberg

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The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns.

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