Inside INNOVA

Solid. Stable. Considered.

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Keep returns close & volatility closer

Whether you attribute the famous phrase "Keep your friends close, and your enemies closer" to ancient military tactician Sun Tzu, Renaissance philosopher Machiavelli or Michael Corleone from The Godfather, this strategy of understanding and even embracing challenges can extend to many facets of life.

In the investing arena, volatility is generally seen as the villain.

Used interchangeably with risk, volatility is sliced, diced, measured, and even bought and sold in the financial markets. However, it's important to understand that volatility is not the enemy many would have us believe. In fact, upon closer examination, it is a necessary participant in the quest for investment success.

VOLATILITY AND RISK

Volatility quantifies the price fluctuations of securities, which can excite emotions but falls short as the complete definition of risk. In thinking about risk, we need to understand what investors worry about. Most investors do not fear volatility. What they fear is the possibility of a loss of capital.

> The trick is trying to achieve a balance between the risk of loss and the risk of not taking enough risk, so that you can attain your financial goals while minimizing anxiety.

Two sides of risk

Imagine risk as a coin, with the risk of loss on one side and the risk of missed opportunity on the other. Investors can eliminate one of these risks, but not both. The trick is trying to achieve a balance between the risk of loss and the risk of not taking enough risk, so that you can attain your financial goals while minimizing anxiety.

The problem with defining risk using terms like "risk of loss" is that risk lacks what volatility measures offer – and that is being quantifiable. The probability of loss is no more measurable than the probability of rain. It can be forecasted and it can be estimated, but it cannot be known. So how can we invest effectively under these cloudy circumstances?

Know what is knowable and plan for the rest

Not being able to know the future doesn't mean we can't plan for it. It's one thing to know what's going to happen and something very different to have a sense of the range of possible outcomes and the likelihood of each one happening. Saying we can't do the former doesn't mean we can't do the latter.

In the long run, it is a business' ability to grow its earnings above the rate of inflation that determines the risk of investing in its shares. Investors can study the nature of a company's business – its competitive advantages and position, its earnings and cash flow situation, and its balance sheet – to come up with a reasonable assessment of its growth potential, risk profile and price. Even if the fundamental characteristics of the company are sound, great investments can still be subject to significant downside volatility for various reasons and can stay below their value for extended periods of time. This is what makes patience and focus invaluable attributes of successful investors. How we focus on investing in strong businesses, how much we pay for those companies, and how we remain invested through volatility and seek additional opportunities, are proven steps toward keeping investment returns close. ■

The POWER of DIVIDENDS

If you're familiar with the phrase "a bird in the hand is worth two in the bush," then you're already familiar with the concept behind owning dividend-paying stocks.

And if your portfolio includes a diversified equity fund, then odds are you're already investing in them (See page 3 for more on this).

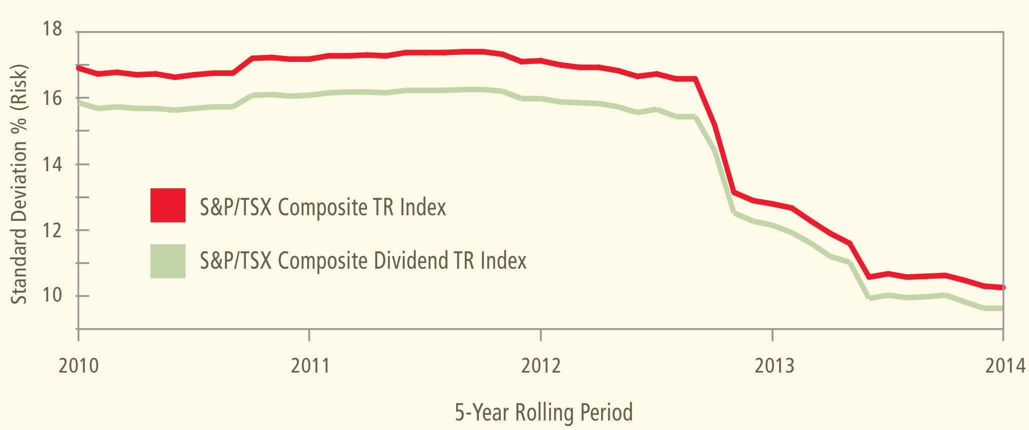
In technical terms, a dividend is a distribution of a portion of a company's earnings to its shareholders. Instead of reinvesting those earnings directly back into the company, they are paid to investors in cash. Yet why dividends matter is far more important than how they work. "It's like getting paid to wait while a company grows over time,"says Jason Gibbs, Portfolio Manager of Scotia Canadian Dividend Fund. "Receiving a regular stream of dividends is a sign that a company has a long history and is relatively stable, because they are able to pay out a steady stream of cash flow."

Getting paid to wait offers other dividends. As illustrated in the chart below, dividend-paying companies have proven to be less volatile versus the broader stock market. "In general, my strategy is to find companies that can grow their dividends in excess of the market, have great balance sheets, with management teams that I can trust, while still trading at reasonable valuations," says Cecilia Mo, Portfolio Manager of Scotia Dividend Balanced Fund.

Managing volatility while generating a sufficient return can be a tricky balancing act for even the most savvy investment professionals. "You have to do your homework," says Jason. "Not all dividend-paying stocks are necessarily good companies. That's why it's important to ensure we are buying the best-in-class businesses with quality management teams while paying a reasonable price for them."

With interest rates at historic lows, the search for regular income in an investment that holds the potential for long-term capital appreciation has become increasingly important. Dividends can be a powerful tool to help manage some of that volatility while looking to generate long-term returns. ■

Dividend-Paying Stocks vs. The Broader Market



Source: Morningstar. Based on 5-year rolling annualized standard deviation from January 1, 2006 to December 31, 2014. Standard deviation is a measure of volatility, which is an indication of risk. Canadian dividend-paying stocks are represented by the S&P/TSX Composite Dividend Total Return Index. The broader Canadian stock market is represented by the S&P/TSX Composite Total Return Index. The information is for illustrative purposes only. It is not possible to invest directly in an index.

The *Art* Behind the Science

Scotia **INNOVA** Portfolios

While market volatility gets a lot of flak in the headlines, there are always two sides to every story. To get a better sense of how Scotia INNOVA Portfolios are positioned to manage volatility, we sat down with Judith Chan, CFA, Portfolio Manager, Scotia INNOVA Portfolios.

A Conversation with Judith Chan, CFA
Portfolio Manager,
Scotia INNOVA Portfolios

How do you view market volatility?

If we look at the markets with a longer lens, volatility has been relatively muted, at approximately half of its historic average over the past six years. With that said, now is not the time to become complacent. In fact, we have intensified our focus on risk management – not just on the day-to-day ebb and flow of the markets but also on mitigating the impact of more significant market corrections.

Can you briefly explain how you manage volatility in Scotia INNOVA Portfolios?

Much of what we do involves learning from the past, investing in the present and anticipating the future. Investment risk factors have changed over time, which means the past 20 years will probably look nothing like the next 20. Much of our time is allocated to understanding the historical factors that have driven market returns, but an increasing amount is spent anticipating new risks and secular changes in the economy and then positioning the portfolios accordingly. We are not only focused on generating risk-adjusted returns, but have also placed an increased emphasis on capital preservation. The need for and strategies used to lower downside risk, for instance, have evolved considerably since 2008 and that is where we have focused in Scotia INNOVA Portfolios.

Can you provide an example of how you are doing this differently?

Cash, for instance, is a basic tool used to manage risk – increasing the allocation as markets decline, and subsequently decreasing it as they recover. While helpful in the pursuit of reducing swings in the market value of a portfolio, it also dampens the potential to capture market upturns. We prefer to use more innovative strategies that focus on managing risk without significantly sacrificing returns. I liken these to shock-absorbers for a portfolio – they allow investors to participate in the growth potential of the markets, but, like the shock absorbers in a car, when the markets hit a speed bump, the downside protection is designed to kick in.

What role do dividend funds play in the construction of Scotia INNOVA Portfolios?

In order to achieve a desired result, we have to ensure that any investment we make serves a purpose. While still a critical diversifier in a balanced portfolio, traditional fixed income investments no longer provide the same level of income they once did. With interest rates at generational lows, increased exposure to dividend-paying equities is just one of the strategies we use to increase the yield potential of the portfolios. As a category, they're also less volatile than non-dividend-paying equities. ■

Portfolio Performance (%) as at March 31, 2015

SCOTIA INNOVA PORTFOLIOS	3 Mth	6 Mth	1 Yr	3 Yr	5 Yr	Since Inception
Scotia INNOVA® Portfolios Series A						
Scotia INNOVA Income	3.33%	5.13%	7.42%	5.97%	5.65%	6.64%*
Scotia INNOVA Balanced Income	3.97%	5.91%	8.46%	7.46%	6.44%	7.92%*
Scotia INNOVA Balanced Growth	5.14%	7.62%	10.61%	9.73%	7.60%	9.27%*
Scotia INNOVA Growth	6.28%	9.05%	12.23%	11.57%	8.46%	10.60%*
Scotia INNOVA Maximum Growth	7.55%	10.60%	13.93%	14.19%	9.68%	11.90%*

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 or insured by the Canada Deposit Insurance Corporation or any other government deposit insurer, their values change frequently and past performance may not be repeated. 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.

* January 2009

A LOOk at the Markets

Canadian equities post positive returns, despite plunging oil prices


Sunny with Clouds

A further decline in crude oil prices, along with a falling loonie were not enough to drag down the overall return of the S&P/TSX Composite Index which posted a gain of 2.6% for the first quarter. A surprise interest rate cut by the Bank of Canada in January as well as stronger economic data gave equities a boost, with only the financial and energy sectors posting negative returns at quarter end. Health care companies had an exceptionally strong quarter, with the sector surging over 45% on increased merger activity within the sector.

Interest rate hikes are on the horizon


Sunny with Clouds

The U.S. Federal Reserve took one step closer towards raising interest rates by removing from their written communication a reference to exercising "patience" when considering the appropriate time to raise rates, as economic data painted a picture of a strengthening economy. Data released near the end of the quarter showed that the U.S. economy had grown 2.2% in the fourth quarter of 2014. The markets responded positively overall, as the S&P 500 posted positive returns for the quarter. From a sector perspective, health care and consumer discretionary rose 6.5% and 4.8% respectively while the energy, industrials, financials and utilities sectors all closed in negative territory.

Europe turns on the money taps while China settles for 7% growth target


Sunny with Clouds

In a bid to spark a boost in the eurozone economy, the European Central Bank launched a European-style quantitative easing program, purchasing up to €60 billion per month of euro-area bonds, with the stimulus scheduled to last until September 2016. China also grappled with its own growth concerns, with Premier Li Keqiang acknowledging the slowing economy by setting a GDP growth target of 'around' 7%, compared to 7.4% in 2014, but still higher than developed nations. International markets were strong, with the MSCI World Index up by 11.8% during the first three months of 2015, outperforming North American equities and bonds, while emerging markets gained 11.6%. ■

Market Performance (YTD returns as at March 31, 2015)

S&P/TSX Composite Index	S&P 500 Index	MSCI World Index	MSCI Emerging Markets Index	FTSE TMX Canada Universe Bond
▲ 2.6%	▲ 10.2%	▲ 11.8%	▲ 11.6%	▲ 4.1%

Source: Bloomberg

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