



McLean Budden Perspective

Time to be Active About Being Passive

September 2011



McLEAN BUDDEN
LOOK FORWARD®

Six Benefits to Having Active Management for Fixed Income

1. Avoids placing a blind trust in rating agencies: Corporate credit exposure in the Dex Universe Index has tripled in the past 15 years.

2. Increases diversification: Active managers have the ability to own bonds not included in the index such as Maple bonds and U.S. pay bonds which increase diversification and potential returns.

3. Benefits from the manager's experience to add alpha: Active managers can choose to either underweight specific bonds to reduce event risk or overweight bonds to benefit from undervalued issues.

4. Increased volatility benefits active management.

5. Custom solutions: Active managers can customize solutions to client needs.

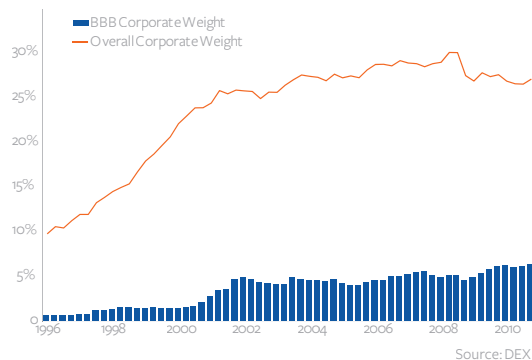
6. Efficient trading: Active managers can avoid inefficient trading situations.

1. Active managers provide professional oversight versus blind trust

Credit analysis is much more important today than it was 15 years ago because of the increased weight in corporate bonds in the DEX Universe Index. Active management requires internal credit analysis to determine the likelihood of default and the appropriate price for each bond. When looking for an active manager, a proven track record in avoiding defaults is critical. Indexed fixed income portfolios are blindly based on meeting a minimum rating of BBB – determined by rating agencies. The Index undertakes no further assessment of credit quality or value.

Since 1996 the overall allocation to corporate credit in the DEX Universe Index has increased from 10% to a high of almost 30%. During that same period, the weight in BBB credits has increased from less than 1% to over 6%.

Graph 1: BBB vs. Overall Corporate Weight



> Corporate exposure almost tripled in the past 15 years while BBB weight also surged.

McLean Budden has a long history of fixed income investment. For over 60 years we have managed our clients' bond portfolios. We are proud to state that no bond or money market instrument we purchased on behalf of our clients has ever gone into default or suffered significant losses. Below is a timeline highlighting notable periods of credit weakness and a brief description of how McLean Budden managed our clients' assets.

1995 Quebec Referendum – We underweighted Quebec bonds from the start of the debate until credit spreads hit record levels. At that point we calculated that the worst case scenario was priced in and we moved to a market weight position. Following the outcome of a “No” vote, Quebec bonds strongly outperformed.

2007 Third Party Asset Backed Commercial Paper “ABCP” – While this product was popular with many of our competitors, it failed to pass our thorough credit assessment. As a result we never purchased this asset class for our clients, sparing them from significant capital losses.

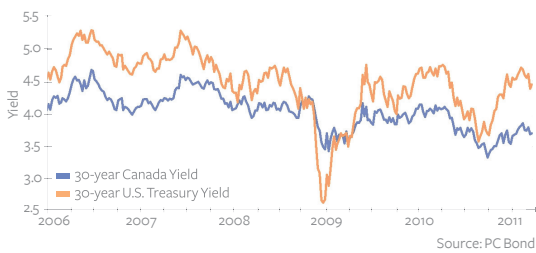
2008 Credit Crisis – McLean Budden's in house credit analysis led us to not purchase Lehman Brother's bonds, amongst others. This decision benefited our clients.

Six Benefits to Having Active Management for Fixed Income

2. Active management provides increased diversification

Active managers can provide exposure to bonds that are not in the index – to attain both higher yields and broader diversification. For example, an active manager can take advantage of the fact that U.S. Treasuries often pay higher yields than similar Government of Canada bonds.

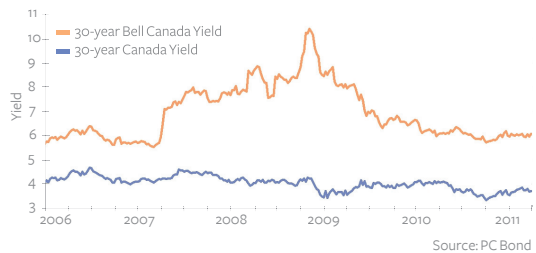
Graph 2: 30-Year Canada and U.S. Treasury Yields



3. Active managers use their experience to add alpha

Active managers can choose to either underweight bonds to reduce event risk such as leveraged buyouts or political risks, or overweight bonds to benefit from undervalued issues. Examples of event risk range from provincial issues during a politically sensitive period such as the Quebec Referendum in 1995, to owning corporate bonds such as Bell Canada’s during the 2007/2008 mooted leveraged buyout. Passive managers do not have the flexibility of not owning these bonds and, as a result, are more susceptible to event risk. Furthermore, active managers can add additional investment returns by overweighting undervalued bonds.

Graph 3: 30-Year Bell Canada and Government of Canada Yield



4. Increase volatility benefits active management

Active managers have the latitude to protect investors from rising interest rates more so than index managers.

Also, in today’s low interest rate environment bond prices are more volatile to given changes to interest rates. This gives active managers a better opportunity to take advantage of interest rate movements where Index managers cannot. The benefits of volatility also apply to foreign exchange and credit markets.

5. Active managers can create custom solutions

Active managers have the ability to create customized solutions to meet individual client needs such as:

- > “Socially Responsible Investment”
- > Targeted duration
- > Cash flow matching

6. Active managers can avoid inefficient trading situations

Index managers are subject to inefficient trading situations in order to adjust to a variety of index changes. They must match regular index duration extensions caused by coupon or “roll out” effects by buying long bonds, or sell when a bond falls out of the index due to a “roll down” (maturing in less than one-year) or a downgrade. They are also obliged to purchase many new corporate issues even if they are heavily oversubscribed. When the market is very illiquid, as it was in 2008, clients needing to redeem funds may have suffered significant “exit fees” by having to sell at distressed prices. Since active managers are not required to replicate index characteristics they are not subjected to these inefficient situations, and in fact can use them to their advantage.

Time to Be Active About Being Passive

Now is NOT the time to be passive about active management

Increased exposure to corporate credit and the ability to increase returns and diversification are a few of the reasons why active management is prudent for fixed income portfolios. To gain the benefits of an active manager, choose one with a reputation for assessing all forms of investment risks including credit risk. Also, seek managers that have avoided major credit downfalls over the years.

History of the Active/Index Debate

Market pundits have debated for decades about which investment style is best suited for fixed income investors – active or index. The recent increase in the popularity of indexed investment has been driven by two very different arguments. The first is a more academic one supported by the theory that the market is just a “zero sum game”. The other is founded on the notion that if you shop based purely on low fees and are willing to accept the average you won’t be disappointed.

Our position on this debate is based neither on theoretical arguments nor on frugal strategies focused on cost minimization. Our assessment strives to tackle the issue from an investor’s point of view and is derived from sixty years of bond management experience.

Knowing your options - the basics of both strategies

Index managers have the sole task of building a portfolio that replicates the characteristics of a fixed income index or benchmark. To be included in a DEX Index the bond must be rated BBB-low (or better), be denominated in Canadian dollars and be backed by a Canadian entity. It must also be publicly traded, have at least 10 institutional owners and have a minimum size of just \$50 million. Having met these criteria, DEX does not perform any further analysis, assessment of value or judgement of any kind. As long as the bond maintains the minimum credit standard, it remains in the Index until one year from maturity.

Active managers are not required to replicate the characteristics of a particular index. The active manager seeks to outperform the relevant index by using a variety of strategies including term management, yield enhancement and inclusion of bonds that are not in the index. Any deviation from the index can either add to or detract from the manager’s return relative to the index. Therefore, the active manager must have a very well thought out rationale for every security in the portfolio based on its credit worthiness, relative value and overall contribution to returns and relative risk. Because many factors need to be considered, the tasks are usually coordinated amongst a team consisting of market strategists, traders and credit analysts. While free to deviate from the index, good bond managers use strict investment guidelines to reduce unnecessary risk.

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