MUTUAL FUNDS update

SPRING 2004

Heavy Hitter®* Model Portfolios

by Ranga Chand

Whether you are an investor whose focus in one of asset accumulation or asset withdrawal, there are some fundamental investment goals that should be adhered to in order to build a successful mutual fund portfolio. These goals can be broken down into three steps that include selecting an appropriate asset allocation, effective diversification, and the choosing of suitable funds.

Selecting an Appropriate Asset Allocation

While most investors are able to clearly identify their investment goals, they often fail to establish a well thought out and detailed asset allocation strategy. To help you with this first crucial step, do take the time to complete the Risk Profiler questionnaire at bmoinvestorline.com. You will find this an excellent tool for determining your category of investor and which asset allocation strategy is right for your particular circumstances. Once this first step is completed, the results will direct you to one of the seven Heavy Hitter model portfolios that match BMO InvestorLine's seven Investor Profiles.

Effective Diversification

Each of the Heavy Hitter model portfolios provides investors with effective diversification through the spreading of one's investment assets among different fund categories to achieve both a variety of distinct risk/reward goals and a reduction in overall risk. Effective diversification eliminates unfavourable characteristics such as over-weighting or under-weighting a particular fund category. Over-weighting, particularly in higher-risk fund categories such as emerging markets, sector funds, and certain high-yield bond funds, can result in excessive volatility in the overall performance of a portfolio and disappointing returns which do not justify the high level of risk.

In constructing the seven Heavy Hitter model portfolios, we carried out a comprehensive analysis of parameters including returns, volatility, and correlation for key domestic and foreign markets. Then quantitative modeling techniques were used to determine the optimal mix between the major asset categories that maximize returns at different risk levels. Moreover, for maximum diversification, only one fund per fund company is included in each portfolio.

Fund Selection

The ten underlying funds for the model portfolios were chosen from the Heavy Hitter Select Fund List and include the following fund categories: Canadian Equity, Global Equity, Canadian Small-cap, Income Trust, Canadian Bond, Canadian Short-term bond, and Canadian Mortgage. These 10 funds, like their counterparts in the Heavy Hitters Select Funds' List, all have a strong performance history, superior risk/reward ratios, a minimum 5-year track record and below-average management fees within their respective categories.

THE HEAVY HITTER MODEL PORTFOLIOS

Capital Preservation

The investment objective of this all fixed-income portfolio is to provide current income with minimal risk and is best suited for investors with a low risk tolerance whose primary focus is income and capital preservation. It is also suitable for those investors with a short investment time horizon of less than three years. This portfolio has a very low risk profile and has delivered positive returns over any 12-month period during the 5-year period from March 1999 to March 2004. Looking at all 12-month rolling periods returns have averaged 6.2%, ranging from a high of 10.3% to a low of 2.1%. (see Table 1)

TABLE 1 – HEAVY HITTER MODEL PORTFOLIO RISK PROFILES
12-Month Rolling Returns (%) (March 1999 to March 2004)

	Average	Best 12 Months	Worst 12 Months	No. of Periods
Capital Preservation	6.2	10.3	2.1	49
Income	9.1	17.1	2.8	49
Balanced Income, Limited Growth	10.0	20.7	-1.0	49
Balanced Income & Growth	10.9	25.0	-4.7	49
Growth & Income	11.0	29.5	-8.6	49
Growth	11.6	33.8	-10.4	49
Aggressive Growth	11.6	39.1	-13.8	49

Income

The investment objective of this portfolio is to provide investors with current income with a modest opportunity for some growth while preserving capital and maintaining a low expected volatility.

This portfolio has a low risk profile and has delivered positive returns over any 12-month period during the 5-year period from March 1999 to March 2004. Looking at all 12-month rolling periods returns have averaged 9.1%, ranging from a high of 17.1% to a low of 2.8%.

Balanced Income, Limited Growth

This portfolio is designed for those investors seeking reasonable current

(continued on page 4)

China: The Awakening Giant

Contributed by: TALVEST™ Mutual Funds

The giant is awakening. In a relatively short period of time, China has had a dramatic impact on the world economy, and now its GDP is 6th highest in the world. Through continued economic growth and policy liberalization, foreign participation in China's development is escalating. Indeed, China itself has made a choice to develop and grow within the global community. Review the facts and you will see why you may want to make the choice to invest in China.

• China represents the convergence of several simultaneous economic themes leading to significant investment opportunities.

Almost 70% of China's 1.3 billion population still lives in rural agricultural regions. However, almost 10 million citizens are moving from the rural areas to the urban centres annually. This trend in urbanization is creating a large emerging middle class at a scale not yet witnessed in any other emerging market countries. The convergence of urbanization with an unprecedented privatization of former state owned enterprises has created a significant demand for basic infrastructures, building materials, energy resources and consumer goods.

• China's economy is emerging as the "21st Century's factory of the world".

Growth in real GDP has averaged 9.7% over the past 20 years[1], translating into a higher standard of living for the overall population, and GDP per capita is 3.7 times more than what it was just 18 years ago[2]. China's manufacturing growth rate is the fastest in the world and its output now ranks fourth in the world[3]. Contributing factors are the massive modernization of its factories, a large manufacturing labour force (largest in the world at approximately 80 million) and its manufacturing hourly wage, amongst the lowest and most competitive in the world (U.S.$0.62/hour)[4]. More evidence – the largest and fastest growing component of the U.S. trade deficit is with China[5].

• Foreign investors are investing in China's potential.

China is a leading recipient of Foreign Direct Investment (FDI), indicating a global conviction in China's potential. In 2003, China's FDI was estimated to be approximately US$57 billion, second only to the U.S.[6]

• The door is opening to this new investment frontier.

The full inclusion of China into the Word Trade Organization (WTO) in 2005 is yet another important step in improving the flow of capital and trade between China and the rest of the world. Better laws, greater transparency, corporate governance of corporations and deregulation will be achieved with the transition from authoritative/traditional governance to an open-market policy focus.

• With reward there's risk.

Like every other investment opportunity, with potential for reward, there are associated risks. The facts presented support a strong case for China's long-term economic and financial market growth. Still, this is an emerging economy in transition, which suggests that there will be short-term factors that temporarily interfere with its long-term growth trajectory. SARS put a sharp brake on investor sentiment earlier in 2003. Political transparency, social issues related to massive urban-rural migration, an undervalued currency and a complex investment share structure are all items that present short-term uncertainty and could impact the performance of China over the short- to mid-term.

• Think Talvest China Plus Fund

Talvest China Plus Fund was recently recognized as "Regional Equity Fund of the Year" at Morningstar's 2003 Canadian Investment Award. Created in February 1998, the fund has consistently performed among the top-rated funds in its mutual fund category – plus it has consistently outperformed its benchmark, the MSCI Golden Dragon Index. The Fund is managed by top-ranked Asian equity manager, Peter Chau of TAL Global Asset Management Limited. Based in Hong Kong, Mr. Chau employs a bottom-up growth approach to selecting stocks. He is supported by a team of five regional specialists who focus on generating returns by diversifying across sectors within China's primary markets: Hong Kong, Taiwan and Mainland China.

• The Bottom Line

China is being recognized as the new investment frontier. And there are significant potential rewards to be gained by those who understand the dynamics of this market and are able to invest for the long-term. For many Canadian investors with a low exposure to this opportunity in their portfolios, Talvest China Plus Fund offers a way to participate in China's prosperous future. In fact, Ranga Chand, one of Canada's leading economists and mutual fund analysts, has selected the Talvest China Plus Fund as one of BMO Investorline's Heavy Hitter Select Funds.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns, including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The Talvest logo is a registered trademark of CIBC Asset Management Inc.

[1] Source: Morgan Stanley Research 2003
[2] Source: Goldman Sachs 2003
[3] Source: PNP Paribas Peregrine
[4] Source: PNP Paribas Peregrine
[5] Source: BMO Nesbitt Burns, 2003
[6] Source: CSFB (1990-2002); UN World Economic Situation and Prospect 2004, 2003

Contributed by:
MORNINGSTAR®

A Better Way to Check Tax Impact on Fund Returns

by Rudy Luuko

Morningstar now has new analytical tools to assess the impact of taxes on mutual fund returns. They include Tax-Adjusted Rankings, which are the after-tax equivalent of Morningstar's Star Ratings.

Instead of using one to five stars, as Morningstar's Star Ratings do, tax-adjusted rankings are expressed as a number between one and five. The rankings are based on a composite of the tax-adjusted returns (pre-liquidation) for the three-, five- and 10-year periods.

Tax-adjusted rankings are calculated only for categories with at least 20 funds that have a minimum of three years' tax-adjusted performance history, whose returns are reported net of fees, and whose distributions are disclosed. In addition to excluding segregated funds from the calculations, rankings will not be calculated for funds in the Alternative Strategies, Labour-Sponsored Venture Capital, and Specialty or Miscellaneous categories.

The enhancements to Morningstar's fund performance reports better enable investors to determine how effectively fund managers are able to minimize taxable distributions, says Mark Warywoda, Morningstar Canada's director of analysis. They'll also help investors make better informed decisions about which of their funds to hold in RRSPs and other registered accounts, and which to hold in taxable accounts.

Among the other new measures are the tax-adjusted return (pre-liquidation) and the tax efficiency measure (pre-liquidation). They cover the one-, three-, five- and 10-year periods ended Dec. 31.

The tax-adjusted return (pre-liquidation) is what the fund returns after taxes on interest, dividends and capital gains distributed by the fund. This measure covers periods during which investors continue to hold the fund.

Tax efficiency (pre-liquidation) is also based on the period before the investor decides to sell. It is calculated by dividing the fund's tax-adjusted return (pre-liquidation) by its total return before tax. A perfect score is 100%.

These and other new tax-impact measures are calculated only for mutual funds. Segregated funds are excluded because of reporting differences; they make allocations to their policyholders, not distributions. These allocations are generally not reported to Morningstar.

In real life situations, while the pre-tax return is the same for every investor, the after-tax return won't be. That's also certainly true of the Morningstar measures. They represent a worst-case scenario for a hypothetical investor. In each instance, the tax rate used will be the highest marginal tax rate in any Canadian province or territory that year.

For example, for 2003 the Morningstar tax calculations assume tax rates of 48.6% for interest, 37.3% for dividends and 24.3% for capital gains. All three of these rates are the actual rates for Newfoundland. Similarly, for 1998, British Columbia was used as the benchmark tax rate for interest and capital gains, and Quebec for dividend income, which respectively had the highest rates during that year.

Needless to say, the actual tax impact on your fund returns isn't going to be as great as in the Morningstar ratings. The thinking behind Morningstar's methodology, says Warywoda, is that it enables all Canadian fund owners to know that their own after-tax returns will fall somewhere between the after-tax returns reported by Morningstar and the fund's pre-tax return.

This would not be possible if other rates – such as median tax rates – were used. Based on your own marginal tax rates and specifics of your personal tax situation, you and/or your advisor will need to make your own judgments as to where your own after-tax returns are likely to fall.

The tax impact for the period during which investors hold the fund tells only part of the after-tax story. Depending on the holding period and on how much the fund's unrealized capital gains have grown, the biggest tax impact may take place at the time that the fund is redeemed.

To measure this impact, Morningstar has developed several other analytical tools, including:

- **Tax-adjusted return (post-liquidation):** This expresses the rate of return to the investor after taxes payable on the distributions while the fund is held, and on capital gains that may be realized when the fund is redeemed.
- **Tax-cost ratio (on liquidation):** This enables investors to compare the fund's after-tax return while it is still being held to the after-tax return after the fund is redeemed. The ratio is expressed in a similar manner to a management-expense ratio, except in this instance it is the cost of taxes, not fees, that is being reported.
- **Total tax efficiency (post-liquidation):** Expressed as a percentage, with 100% being a perfect score, this measures the proportion of the pre-tax return that the investor retains after paying all taxes, including capital gains tax payable when the fund is sold.

Rudy Luuko is Investment Funds editor of Morningstar Canada.

Published with permission of Morningstar Research Inc. Originally published on January 28, 2004, on www.morningstar.ca

(continued from page 1)

income combined with some capital appreciation and who are comfortable with moderate fluctuations in the value of their portfolios. This portfolio has a low/moderate risk profile and looking at all 12-month rolling periods during the 5-year period from March 1999 to March 2004 returns have averaged 10.0%, ranging from a high of 20.7% to a low of –1.0%.

Balanced Income & Growth

The investment objective of this portfolio is to provide a combination of income and long-term growth of capital. It is intended for investors who can tolerate moderate fluctuations in the value of their portfolios in exchange for potentially higher long-term returns. It is not suitable for investors with a short investment time horizon. This portfolio has a moderate risk profile and looking at all 12-month rolling periods during the 5-year period from March 1999 to March 2004 returns have averaged 10.9%, ranging from a high of 25.0% to a low of –4.7%.

Growth & Income

This portfolio is designed to provide investors with moderate long-term growth of capital and reasonable current income. It is suitable for those investors who can withstand moderate to significant year-to-year fluctuations in the value of their portfolios in exchange for potentially higher long-term returns. It is not suitable for investors with a short investment time horizon. This portfolio has a moderate/high risk profile and looking at all 12-month rolling periods during the 5-year period from March 1999 to March 2004 returns have averaged 11.0%, ranging from a high of 29.5% to a low of –8.6%.

Growth

The investment objective of this portfolio is to provide long-term growth of capital for investors. It is suitable for aggressive investors with a long-term time horizon who can withstand significant year-to-year fluctuations in the value of their portfolios in exchange for potentially higher long-term returns. It is not suitable for those investors seeking income or those with a short investment time horizon. This portfolio has a high risk profile and looking at all 12-month rolling periods during the 5-year period from March 1999 to March 2004 returns have averaged 11.6%, ranging from a high of 33.8% to a low of –10.4%.

Aggressive Growth

This all equity portfolio is designed to provide maximum long-term growth of capital. It is suitable for very aggressive investors who have a long investment time horizon and who can withstand substantial year-to-year fluctuations in the value of their portfolios in exchange for potentially higher long-term returns. It is not suitable for those investors seeking income or those with a short investment time horizon. This portfolio has a high risk profile and looking at all 12-month rolling periods during the 5-year period from March 1999 to March 2004 returns have averaged 11.6%, ranging from a high of 39.1% to a low of –13.8%.

MODEL PORTFOLIO PERFORMANCE

The aim of each Heavy Hitter Model Portfolio is to deliver a potential return that is commensurate with the risk taken. As you will see from Table 2 which highlights the Heavy Hitter model portfolio performance over the five years ending March 31, 2004, the Aggressive Growth portfolio posted a compound return of 13.8% while the Capital Preservation portfolio delivered a return of 5.6%. As expected, the higher risk portfolio provided the higher return. The returns of the remaining five portfolios also fall in line with their respective risk/reward characteristics. However, over shorter time periods and depending on the performance of financial markets, investors should expect more variations in returns especially with the portfolios with heavier equity weightings. This is where a 'buy and hold' strategy plays to an investor's advantage. Moreover the power of effective diversification can be best illustrated by comparing the 5-year portfolio performance returns with those of the various benchmarks.

TABLE 2 – HEAVY HITTER MODEL PORTFOLIO PERFORMANCES

(Period ending March 31, 2004)

	Q1 04	1 Yr	3 Yr	5 Yr
PORTFOLIO				
Capital Preservation	2.5	7.1	6.2	5.6
Income	3.5	15.3	8.7	8.9
Balanced Income, Limited Growth	4.0	20.7	9.5	10.6
Balanced Income & Growth	4.5	25.0	10.2	11.9
Growth & Income	4.9	29.5	9.8	12.5
Growth	5.4	33.8	11.4	13.3
Aggressive Growth	5.8	39.1	11.7	13.8
BENCHMARKS				
91-Day Treasury Bill	0.7	3.0	3.1	3.9
SCM Universe Bond	3.1	10.8	8.3	6.9
S&P/TSX Total Return	4.9	37.7	6.0	7.1
MSCI World ($C)	4.2	28.9	-4.2	-3.3