

ECONOMIC ENVIRONMENT

After an enormous deterioration in economic data over the past several quarters, the most recent information has been somewhat more constructive at the margin. The pace of decline of many indicators is slowing, and a number of data points have actually shown improvement. Furthermore, the breadth of government policy response to the financial crisis has been unprecedented. Interest rates have been set at rock bottom levels in the United States, Canada, and elsewhere, and the fiscal stimulus packages in countries such as the U.S. and China have been immense. To be sure, the North American economy remains in recession, and the housing market at the core of the crisis continues to decline. In addition, the banking sector is still on its heels. However, we are likely moving into the latter phases of the U.S. recession (already nearly 18 months old) and house price declines (into their fourth year). As well, the all important unemployment data, while still climbing, no longer seem to be doing so at an accelerating pace. Overall, gradual stabilization (albeit at a very depressed level) appears to be the order of the day.

EQUITIES

As indicated in our last Investment Posture, stocks appeared to be oversold by late winter following the near-record magnitude and speed of the declines. Equities had underperformed government bonds to a historically extreme degree; indeed, the S&P 500 Index's total returns over the past decade were negative, a very rare occurrence. With abysmal investor sentiment and significant amounts of cash on the sidelines, the markets were poised for a meaningful rebound.

The resulting rally has been exceptionally strong, although not inconsistent with those following recession-induced bear markets. The Acuity equity funds have generally delivered industry-leading returns due to their exposure to high growth sectors. In expectation of improving conditions, we deployed the funds' excess cash by late April. We anticipate that equities may deliver further gains, as many investors remain underinvested. In addition, observers have historically underestimated the economic rebound from areas such as inventory restocking following slow downs. Despite the strong results to date, we remain selective about the sectors which we perceive to hold the best long term opportunities. For instance, we believe that high system-wide debt levels and substantial amounts of impaired assets, particularly in real estate, are likely to weigh on the banking sector for years to come. Such an eventuality does not mean that financial stocks cannot rise; however, we anticipate that they are likely to underperform the overall market over the long term. Consequently, we remain underweight financials. In contrast, we anticipate that huge infrastructure investments in China and elsewhere may generate superior performance in certain industrial and commodity-based sectors. Accordingly, the Acuity funds are focusing on investments in these areas.

INCOME/BALANCED

Given our more constructive view on equities, we have gradually increased the Acuity High Income and Acuity Balanced Funds' exposure to stocks at the expense of bonds. While we anticipate further gains in equities going forward, more risk averse investors should continue to benefit from conservative products such as Acuity's balanced and income funds. These products deliver significant exposure to the stock market, while offering superior capital preservation characteristics and solid income generation capabilities compared to equity funds. Indeed, the Acuity balanced and income offerings have produced very strong gains since the market lows in March, while maintaining meaningfully lower volatility profiles than traditional equity funds.

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FIXED INCOME

Government bonds have delivered lackluster results over the past few months following last year's strong rally, as investors have gradually shifted toward more risky assets. However, corporate bonds have benefited from this shift, rallying significantly this year. Following our more constructive stance towards equities, we increased the Fund's exposure to corporate bonds to take advantage of very attractive yields due to historically wide spreads. Given the inevitable rise in defaults over the next year or two, we are very selective about the corporate bonds included in the portfolio, and are vigilant for any signs of deterioration in business fundamentals. As for government bond yields, we believe the significant back-up witnessed this year may be getting overdone. Inflation does not appear to be a concern for the time being, as a result of the huge slack in the economy from rising unemployment and record low capacity utilization. Furthermore, bonds have historically performed well following financial crises, even after the recession ends, and despite rising supply from the enormous deficits. We believe overall bond yields remain attractive in this environment.

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