Letter from the President

Facing the Threat of Global Deflation: IIAC's Proposals to Bolster a Threatened Recovery

This year marked a major turning point in the industry's fortunes. Until the spring, markets were expected to move gradually higher, pushed by steadily improving recovery. But the sharp market sell-off led by commodity shares in April signaled a shift in economic conditions and investor sentiment. The recovery in the developed countries was perceived to be floundering. The negative market tone persisted and by late summer continuing into the fall investors faced the full brunt of market collapse as the acrimonious debate over the U.S. debt ceiling, and mounting debt problems in Europe, confirmed that pervasive indebtedness weighed down heavily on the recovery. The deleveraging of household balance sheets still has a long way to go, and this process is compounded by the serious indebtedness of the public sectors, particularly in Europe as well as the United States.

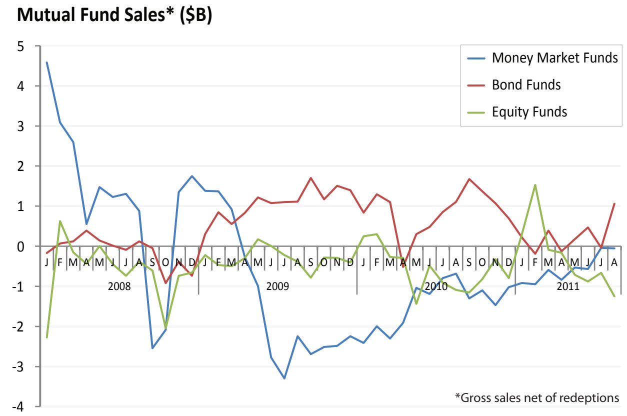
The Impact of Deflationary Conditions

Market participants find themselves in the midst of conditions that resemble a deflationary environment, characterized by low interest rates, falling equity prices, market turbulence punctuated by fears of financial default, and uncertainty about the economic outlook. Individual and institutional investors have pulled back from equity markets, opting for higher holdings of cash, liquid assets and bonds. The S&P/TSX Composite Index has fallen over 10% this year and the TSX Venture Index is down about 30%. Many companies, especially small and mid-sized firms, have scaled back investment spending because of a clouded economic outlook and limited access to competitively priced capital. One advantage Canada has, in contrast to its neighbor south of the border, is a sound policy framework – competitive corporate tax rates and contained deficit financing that gives confidence that taxes will stay competitive.

We have witnessed a decline in overall financing activity in recent months, and preliminary evidence suggests a fall-off in equity financings for small and mid-sized companies since the summer months. This collapse in small private placement financings reverses the stepped up pace of this financing activities last year and through the first half of this year. Non-brokered private placements have contributed to the financing upswing in 2010. The recent rally in markets has provided some limited financing opportunities.

Challenges for Investors – Especially Retirees

Investors, rattled by the sharp and sudden fall in equity prices and portfolio values, and the risk of institutional calamity (especially in Europe), have become much less active in markets than six months ago. With people looking for security, net sales of equity funds trended steadily lower throughout the year, with a corresponding increase in money market and bond funds (despite low returns). Until signs of stability and improved prospects return, activity will stay at depressed levels.



Probably the biggest challenge is faced by retirees and those near retirement. The baby boom generation, near or at retirement – with substantial financial portfolios – are stressed by portfolio losses, and deteriorating prospects of upside potential in the near term. For the most part, for these investors the share-price decline has been cushioned by conservative balanced portfolios with significant allocations of debt securities. Advisors are keeping their clients invested in investment grade debt securities, dividend-paying blue-chip companies, and higher than normal holdings of cash and liquid assets to weather the storm.

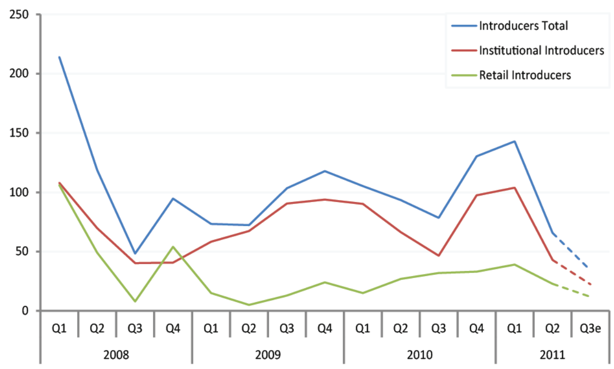
While it is important to balance portfolios to protect their value, investors closing on retirement (or already retired) shift away from accumulating assets and place more emphasis on income flow to meet cost of living expenses. In the past many retirees relied on bonds and GICs to meet needed income levels. However, that strategy is undermined with yields down dramatically. In 2006, for example, the one-year GIC paid on average just less than 3% and now pays around 1%, less than the rate of inflation. Investors are increasingly faced with taking on additional risk to earn higher returns.

One option for retirees is to invest in dividend-paying companies. But there are currently only 75 companies (excluding REITs) listed on the TSX that pay a dividend yield of 4% or more. That leaves income-seeking investors with little choice, undermining diversification strategies and exposing them to the risk of possible dividend adjustments.

Impact on Issuers: Small and Mid-size Companies Hurt

While larger companies can continue to obtain capital, small and mid-sized companies are likely to find it more difficult in the current environment. Through the first half of the year, IPOs for 2011 in Canada come to $3.2 billion, compared to $7.8 for 2010 (entire year). Small and mid-sized business financings have fallen 20% in the second quarter this year – estimated at an even lower level in the latest quarter. In the venture markets, financing and trading activity typically collapse quickly in downward trending markets, and rebound rapidly when conditions suddenly reverse direction. This market elasticity was exhibited in the 2008-2009 financial crisis and its immediate aftermath. The trigger for sudden recovery would likely be a dramatic policy move in the United States or in Europe.

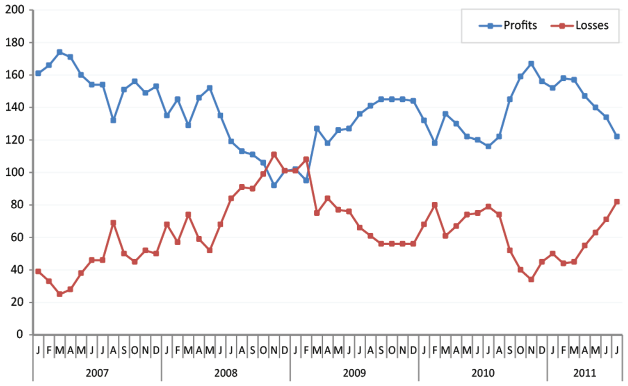
Operating Profit ($M)



Impact on Industry

Based on preliminary data we estimate that retail revenue (commission earnings, fee income and net interest income) in the industry will be down roughly 20% if weak conditions in the summer and fall continue to year-end. The introducer-firm segment will find even tougher sledding. Relatively low operating cost increases are unlikely to materialize this year, reflecting a more competitive market for carrier broker platforms. This will push operating profits for the introducer group to the meager levels in 2009. We have noticed the number of firms losing money has increased steadily in the April-July period, and has likely moved even higher in more recent months. As shown in the attached chart, we are moving closer to an even split among the 200 industry firms between those making money and those losing money. As compliance costs escalate in the next year or so as the Client Relationship Model is implemented, operating margins will be squeezed further. The upshot will be further consolidation among the small firms in the industry.

Number of Firms with Profits and Losses



Canada's Strengths Cannot Shelter Us From Global Economy

Canada stands out among the G20 countries, with its financial sector on a sound footing and fiscal and monetary policies well managed. But as a small open economy with domestic markets tightly yoked to international markets, Canada is nonetheless heavily influenced by offshore economic conditions, and the policy decisions of other governments -- notably stimulative monetary policy and European actions to address fiscal deficits and debt overhang. Our trading partners face systemic risks from government and institutional default.

IIAC Proposals: Keep Budget Deficits and Debt Burden on the G20 Downward Trajectory, Reduce Cost of Capital, Moderate Pension Adjustments

The recommendations to the House of Commons Standing Committee for the upcoming federal budget next February are well-timed and supportive given difficult conditions faced by small issuers and investors in capital markets. We focus on three themes:

- Holding to the G20 fiscal targets of cutting the 2008 deficit and public debt burden in one-half by 2013.
- Introducing a cost-effective incentive to reduce the after-tax cost of capital to promote external financing and capital formation by small and mid-sized businesses.
- Making modest adjustments to pension arrangements for individual Canadians.

Long-term targets for deficit and debt reduction give the greatest confidence for stable policy – particularly the final stage of corporate tax rate reductions to a competitive federal rate of 15%, and ensuring scope for fiscal maneuverability if economic conditions worsen.

Deteriorating business confidence and reduced availability of equity capital will truncate business spending, particularly by small and mid-sized business. But a targeted incentive to reduce financing costs, through lower capital gains taxes or applicability of flow-through shares to non-resource companies, or extending the preferred corporate tax rate to mid-sized companies, could reverse decisions to shelve investment plans.

We recommend several modest improvements to pension plan arrangements to encourage increased retirement savings. These include providing Group RRSPs with the same payroll tax treatment as defined contribution and defined benefit plans, and implementing industry suggestions to ensure the proposed PPRP plans are structured as effective retirement savings vehicles.

Yours sincerely,

Ian C.W. Russell, FCSI
President & CEO, IIAC
October 2011