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FIRST QUARTER REVIEW

Are we in the final stages of this bull market?

Are we approaching the final stages of a bull market rally? I guess it really depends on which market we are talking about and into what currency are we translating the returns.

If we are talking about US stocks in the hands of Canadian investors, then we have barely gotten out of the starting gate.

Because of the strong Canadian dollar, the S&P 500 composite index is up only 19.88% since the official end of the bear market in March 2003. Hardly what you would call a bull market rally.

Even when viewed in terms of US dollars, the picture does not imply an explosive three year growth pattern, with the S&P 500 up 51.13% over the same period, not including re-invested dividends (see figure 1).

Figure 1 Performance of US Stock Market

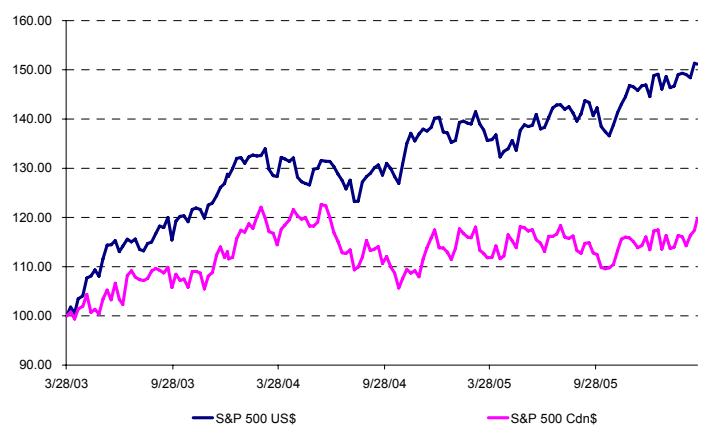


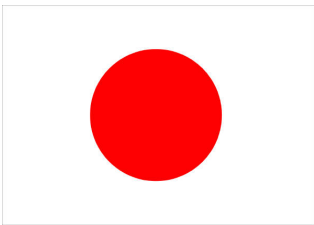
Figure 2 Performance of Canadian Market
As measured by the S&P TSX 60 index



But no matter how we frame the US numbers, they pale in comparison to the returns in the Canadian market, up 86.04%, since March

2003 (see figure2). And that could be considered a frothy environment, when looking for an end game in a bull market rally.

Surprising is the strength in the Japanese market, also being fueled by stronger than expected demand from Japanese consumers. Only in this case, we are looking at an economy where the consumer has been noticeably absent for 15 years.



Clearly, the Canadian market is being driven by a booming oil & gas sector (note the 3.5% unemployment rate in Alberta for evidence on just how powerful this sector has been in the Canadian economy). For the Canadian stock market to remain in high gear you have to believe that the oil and gas sector will remain buoyant.

That in and of itself creates an interesting dilemma for global investors, because historically, higher energy prices have kept a lid on future expansion. Particularly in economies that depend on imported oil to sustain growth (most notably, the US and Japan).

Having said that, we find it particularly interesting at just how robust the US economy

has been, lead by what seems to be an insatiable appetite of the US consumer, which given the low unemployment rate should continue to bloom. We are particularly mindful that US unemployment is below 5%, and that has long considered the demarcation line between real unemployment where people cannot find a job, to transitional unemployment, where people are simply moving from one job to another.

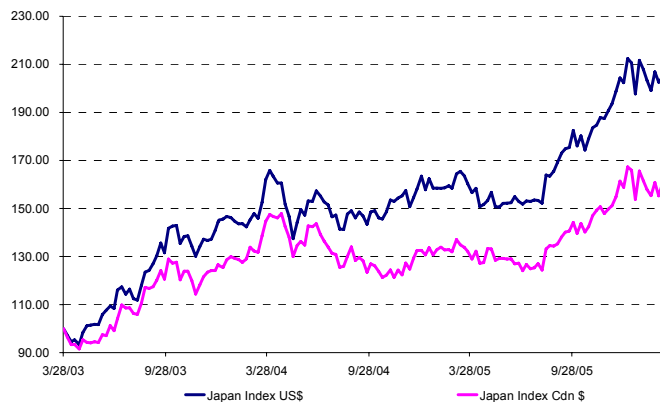
Even more surprising is the strength in the Japanese market, also being fueled by stronger than expected demand from Japanese consumers. Only in this case, we are looking at an economy where the consumer has been noticeably absent for 15 years. The apparent resurgence in Japanese

buying power may be attributable to a changing demographic with the new guard not wanting to follow in the footsteps of their parents. Whatever the cause, then effect is notable.

Note figure 3 (chart of the Japan iShares that trade on the American Stock Exchange under the symbol EWJ), and you can see that the performance of the Japanese stock market has been, well, remarkable. Up 111.98% in US dollars and 68.14% in Canadian dollars (note we have calculated the returns on the Japan Index by starting with a base value of \$100, to keep the charts between the figures 1 through 3 consistent).

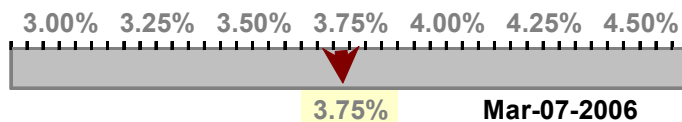
Equally notable; at a time when oil prices have been firmly entrenched above US \$50 a barrel, the Japanese economy has gained momentum. Both the US and Japanese examples are flying in the face of conventional wisdom. Which means to get a handle on exactly where we are in the bull market cycle, will require some unconventional thinking.

Figure 3 Performance of Japanese Stock Market
As measured by Japan Index iShare (symbol EWJ)



ON THE QUESTION OF INTEREST RATES

Target Overnight Lending Rate



In recent years, we have seen shifts in the way consumers manage their credit. Rather than carrying large debit balances on credit cards, consumers have opted to employ more efficient cash management strategies. Of particular interest has been the surge in demand for home equity loans.

You might have noticed that ScotiaBank purchased Maple Leaf mortgages in February, which is a played in this market, and that we think that purchase is a direct result of this change in mindset among consumers.

The surge in demand for home equity lines of credit may start to crimp consumer spending. We believe the US Federal Reserve has been raising interest rates specifically to slow down this segment of the market. So far the Fed interest rate hikes have had little impact on the longer end of the yield curve,

long thought to be the Fed's target. However, one could now argue that these rate hikes have been clearly targeted at dampening enthusiasm for home equity lines of credit, because these are floating rate loans whose interest rate is tied to short term interest rates.

Think about it this way. The Fed is trying to raise rates so as to slow down consumption without actually pushing the US economy into a recession, or worse, a Japanese style deflation scenario.

If the consumer is re-packing their debt by borrowing against an asset (i.e. the family home) that is rising in value, then from the standpoint of a personal net worth statement, the consumer has more disposable income. Add to that the low US unemployment rate, which boosts confidence among consumers, and you

have a recipe for an overheated spending spree that, according to the mainstream financial press, could lead to an inflationary spiral.

We are not so sure inflation is the real fear. The bigger problem might be the impact a downward spiral in housing prices would have on those personal net worth statements we have been talking about.

If the value of the family home falls below its loan value, we could see some of those home equity lines of credit being called by the lending institution. That leads us to a classic domino effect where falling house prices leads to a credit crunch among consumers, leading to a slow down in spending patterns, pushing companies into cost cutting mode, which translated means job losses, further eroding consumer confidence, which leads to price reductions by manufacturers, leading to a deflationary spiral and so on and so on...

We are beginning to see some slowing in the US

US rate hikes have more to do with slowing down an overheated real estate market than with dampening inflation expectations.

ON THE QUESTION OF INTEREST RATES

Continued from page 3

housing sector. Notably, single-family home sales in January came in 8.2% below their June 2005 peak.

Adding more potential fuel to the slowdown we note a report out of Scotia Economics that talks about the “rapid home price appreciation and the rise in mortgage rates [that have] pushed home affordability to its lowest level in fourteen years by late 2005, contributing to a significant increase in the supply of unsold properties in the past 12 months.”

While there is no clear evidence we are seeing a marked slowdown in the US housing sector, the potential domino effect from a slowdown is very real. Given that, the Fed must walk a fine line, which is exactly what they did with the last interest rate hike.

We think the March 28th hike may be the last one. At worst, one more hike should do it. At least it will give the Fed an opportunity to pause and study the impact of 15 rate hikes. That impact study may

take the Fed through to the end of 2006.

As for Canada, we can be less sanguine about the process, because we are less dependent on the consumer.

Our economy is being driven by a robust energy sector, which has led to solid growth in exports.

Canadian consumers do not spend nearly as enthusiastically as US consumers, and although home equity loans have been on an upswing in Canada, we do not enjoy the same tax benefits as US consumers. Note; US consumers can write off the interest on their home equity loan. In Canada, we can only write off the interest if we are using the loan to make investments.

More importantly, while the Canadian housing market has been strong, it has not been anything like the overheated market in the US.

We think that is one reason why last September, the Bank of Canada shelved its

policy geared to facilitating the economy’s adjustment to shocks originating from outside the country.

As such, we believe that increases in Canadian interest rates were the result of an assessment by the Bank of Canada that the Canadian economy is running at full tilt, and with that, the Bank has pushed the overnight lending rate to 3.75%.

As for the future, our best forecast (read guesstimate) comes from a research note provided by National Bank Financial, “Under these circumstances [Canadian growth and inflation issues] and given the downside tilt to the risks to the economic outlook expected in 2007 [read slowdown in the energy sector], the Bank of Canada will have to wield its monetary policy instrument with caution.”

This is why we believe that the Bank will raise the target rate by no more than another 25 basis points this year

While the Canadian housing market has been strong, it has not been anything like the overheated market in the US.

Consequently, if our expectations concerning inflation come true, the real target rate should hover around the middle of the neutral

zone, which we estimate to be in the range of 150 to 250 basis points. Once this mark is attained, the target rate should stay put for the rest of 2006.”

ON THE OUTLOOK FOR ENERGY

A simple very important question; Are energy prices likely to rise or fall? Unfortunately there is no simple answer.

On the side of the coin that suggests lower prices we can turn to the latest inventory reports. Crude oil inventories are 10% higher than they were a year ago and 12% higher than the average level at this time of year. Same story with Natural Gas, as reserves are 25% higher than for the same period in 2005 and 40% higher than the five year average. Lots of supply, and with more conservation on the horizon, perhaps a leveling of demand.

In fact the demand side of this equation has been the most interesting story, because the demand is being driven by the strong growth in major industrialized world. Demand then, is being

driven by strong economic growth, which even with prices at US \$60 barrel does not seem to be slowing.

We think the major industrialized economies have been able to absorb the oil price shock. Mainly because dramatic improvements in productivity brought on by improved technologies has offset higher energy costs.

Because workers have become more efficient, companies have been able to produce more at lower unit costs, even with the absorption of higher energy prices.

That would explain why oil prices have not had as dramatic an impact on inflation this time around. At least when viewed in terms of the inflationary spiral that took place in the 1970s, the last time oil spikes caused a ripple affect in the industrialized world.

At US \$60 per barrel, the market does not seem to be worried. As such, energy prices could stay at this level, without necessarily having an adverse affect on economic growth.

The other more pressing issue is the so-called doomsday scenario. A scenario which we do not give much weight to, but given its prominence after a CNN report entitled “We Were Warned!,” needs to be discussed as a remote possibility.

The doomsday scenario examines the possibility of a terrorist attack that threatens world oil supplies. The simple case suggests that oil prices would spike dramatically, and that thesis is supported by the “Fear” premium (i.e. unrest in Nigeria, the Iranian nuclear threat) that is responsible for prices above US\$60 per barrel.

Major world economies have been able to absorb the oil price shock because there has been some dramatic improvements in productivity brought on by improved technologies.

The worst case scenario says that we are not able to get oil at any price.

That scenario would bring chaos theory to life. Such an event would shut down economic activity and that would have a

devastating impact on all financial markets.

Obviously we do not believe in a doomsday scenario, mainly because we cannot see a scenario in which terrorists are able to infiltrate all world supplies at the same time.

It would have to be all or nothing for a doomsday scenario to actually play out. And while talking about it makes for good television, we think it plays out more like science fiction than as a real world impact event.

ON THE CANADIAN DOLLAR

“Slower global economic growth brought about by the U.S. economy’s sluggishness could have repercussions on the price of raw materials (read lower commodity prices including oil and natural gas), which would exert downward pressure on the loonie..”

We expect the Canadian dollar to average US 88 cents to US 90 cents, which we could see as early as the end of this year. For Canadian investors who want to diversify outside Canada, the strong Canadian dollar remains a major obstacle.

On the positive side, if the Canadian dollar continues to appreciate, it will help keep a lid on imported goods that should help keep inflation in check.

A report from National Bank Financial indicates that U.S. economic growth may fall short of expectations in the first half of the year. If that occurs, it will not be favorable to the Canadian economy. However, the report goes on to say, “the

Canadian economy is operating at near production capacity and, what’s more, could benefit from fiscal stimuli.

In this context, the respective monetary policy measures taken on both sides of the border will entail a closing of the short-term interest rate gap between the two countries.

This gap, which is presently in the greenback’s favor, could even disappear entirely towards year-end. However, slower global economic growth brought about by the U.S. economy’s sluggishness could have repercussions on the price of raw materials (read lower commodity prices including oil and

natural gas), which would exert downward pressure on the loonie”. We saw evidence of that recently, when fresh data from Stats Canada showed that Canadian GDP came in less than expected..

On the positive side, Canada is running an account surplus. If the Harper Tories actually follow through on their plan to reduce the federal domestic debt to 20% of GDP by 2020, public finances will be less vulnerable to downturns in the market or slowing international growth.

Finally, financial imbalances in the U.S. economy are bad for the US dollar and good for gold. Canada holds 43% of the market cap of the world’s gold stocks.

WHAT IS A PORTFOLIO

A personalized portfolio is the result of an investment process.

Beginning with a get-to-know-yourself investment questionnaire driving down to an asset mix decision, which we view as the first layer of diversification within a portfolio.



Having established an asset mix, you can then look for securities using a process that brings additional layers of diversification to the portfolio including diversification by geographic region, fund objectives, and management style.

These additional layers of diversification add two major benefits to your portfolio: 1) they help reduce the risk within the portfolio; and 2) they help make the portfolio more efficient.

The litmus test for the process is really quite simple: Does the end portfolio produce better than average returns with lower than average risk?

The Investing World Is Changing

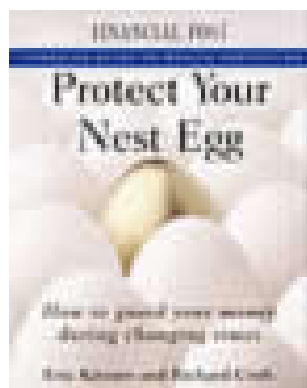
What we are talking about is a major change in mindset from thirty years ago. It was not that long ago, when the purchase of a mutual fund was itself, enough to provide diversification. Mutual funds finally allowed individual investors the opportunity to reduce the company specific risk associated with individual stocks.

We recall the 1970s when portfolio theory meant trying to find ways to reduce or ideally, eliminate company specific risks. You could offset say the risk of an airline company which is negatively affected by changes in the cost of jet fuel, with an oil company, that benefited from higher fuel prices.

In this example we have the same fundamental issue, but with a much different impact on in very different industries. Theoretically, if you had shares of an oil company and an airline company, you would eliminate much of the

risk associated with changes in the price of oil. Taking that to the next level, a portfolio of 15 to 20 well-thought-out stocks in a cross section of industries should reduce 95% of company-specific risks. But who can afford to buy 15 to 20 Canadian stocks? The cost for such a portfolio could be as high as \$100,000. And that's where mutual funds excel. A good-quality Canadian equity fund easily replaces a portfolio of 15 or 20 well-thought-out Canadian stocks. And, for added comfort, you get a professional portfolio manager to guide you along the path at the right time in the business cycle.

Mutual funds provide instant diversification within an asset class. A Canadian equity fund provides instant diversification within the Canadian stock market. A Canadian bond fund provides instant diversification within the Canadian fixed-income market. Balanced funds go even one step further, providing diversification in both the equity and



fixed-income markets. But mutual funds do not eliminate market risk. But in the 1970s and for most of the 1980s that did not matter. Market risk was not so important, and anyway, there was no effective way to eliminate it. So the thinking was quite straightforward: Buy a good-quality, well diversified mutual fund and relax.

October 1987 changed all that. Before the stock market crash, few investors believed that market risk would ever have much of an impact on their pocketbooks. But when the Canadian stock market fell more than 20% in one day, so did most Canadian equity mutual funds.

That one event redefined the role of diversification.

Asset allocation became a buzzword after the 1987 stock market crash. And why not, because it was the only strategy that actually defended investors during the crash. That led to the idea of building portfolios of mutual funds. Books were written on the subject (Between us, we wrote five such books).

The concept was straightforward. A mutual fund eliminated company-specific risk; a portfolio of funds representing different asset classes reduced market risk (It still couldn't eliminate risk itself, mind you. But a portfolio of funds representing different asset classes and geographic boundaries does reduce some of the volatility attached to market risk).

A portfolio of 6 to 10 mutual funds lets you sleep at night. The problem, of course, is making sure that each fund you choose is actually bringing some added value to the portfolio. It doesn't help much to have three funds doing exactly the same thing.

It also doesn't help if you hold a portfolio of funds without really knowing what each fund has to offer.

The funds may be the right choices, but without a frame of reference, you don't know.

The Better Way

There is a better way to build portfolios: Buy the best securities in each

category, without regard to specific fund families. Rather than getting into the debate around index funds versus actively managed funds, pay attention to a rigorous portfolio building process that brings together the best funds within a well-diversified format.

Will your portfolio be immune to the ebbs and flows of the business cycle? Not by a long shot. However, you will know that you did all you could to smooth out the fluctuations associated with economic cycles.

So what's new? It's the realization that selecting the right portfolio involves a bit of science and a lot of art. The science lays the foundation for making decisions; the art is mixing and matching within a portfolio to provide above-average risk-adjusted returns.



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