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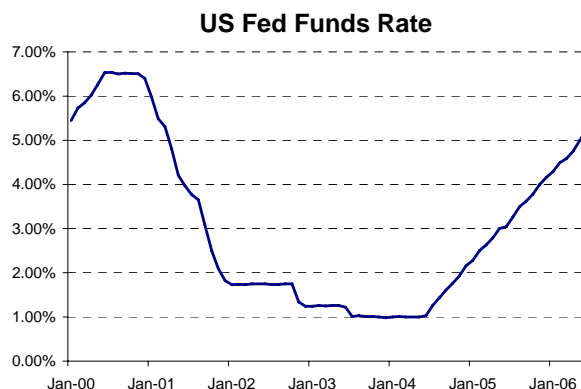
SECOND QUARTER REVIEW

Focus on the US Federal Reserve

The 25 basis point rate hike that took place on June 29th - the 17th hike in a row - will likely be the last hike of this cycle. At least the last hike until the end of the year.

Of course this forecast is not based on anything that Fed Chairman Ben Bernanke has said or, is likely to say, in the near future. If anything, I expect Uncle Bennie to keep his cards close to the vest and maintain his best poker face despite the markets attempts to dissect anything and everything that comes out of the Fed.

So where do I come up with this opinion and why is it important? To answer the last question first, the recent performance of the equity markets has re-enforced the perception that traders are firmly focused on the Fed.



The market danced the Latin two step leading up to the June 29th meeting and will continue to oscillate between euphoria and despair as new data comes to the market.

As for the Fed, they continue to sing the same mystifying lyrics played to a Latin two step... sing along everyone; *"inflationary pressures appear contained, but such pressures have increased."*

If and when the Fed raises rates again will depend, as the Fed says; on *"the evolution of the outlook for both inflation*

and economic growth, as implied by incoming information." Translation; we won't boost rates unless we have to.

That's just the kind of excitement one might expect from a good Latin dance, and the reaction was to move stock prices sharply higher on the last Thursday of June. Stocks did not follow through on Friday, but I think that had more to do with traders not wanting to hold major positions over the long week-end (July 1st in Canada and July 4th in the US).

Short term noise ignores the longer term trend. And trends are the only thing that really matter to the Fed. Which is why I believe the governors will pause and assess the impact of previous rate hikes before taking further steps after June.

So we know that the Fed will sit tight until it gets more data. And will likely only move in a worst case scenario. The market knows this, so as new data appears, markets will sway driven by the madness of crowds. But in the end, it is just noise. The danger is trying to profit from the madness of crowds, because you are playing in a market where volatility has increased, and that has a tendency to squeeze investors at exactly the wrong time.

More importantly, short term noise ignores the longer term trend. And trends are the only thing that really matter to the Fed. Which is why I believe the governors will hold steady and take the time to assess the impact of previous rate hikes before taking any further steps this year.

Fed rate hikes take time to work their way through the economy, and the impact of a Fed hike is not likely to be felt by consumers, or more importantly, translated into hard economic data for six to twelve months. I think the Fed statement at the end of June was really telling us that the Fed needs to analyze the

trends and impact from the previous 17 rate hikes, which probably requires at least three months and more likely, six months of new data before anything concrete emerges. At that point, the US is in the middle of Congressional elections, which historically, has been a period where the Fed sits on the sidelines.

Add to this discussion commentary from some of the more vocal Fed governors, and there is a little better clarity on the outlook for rates. I note for example, Kansas City Fed Governor Tom Hoenig's commentary from a speech prior to the May 10th meeting, where he let it be known his stance on interest rates. To quote his song and dance, "We're [Federal Reserve Board] very close to where we need to be." It seems to me that most of the Fed governors fall into this camp.

Having said that, we will be looking for more conflicting speeches from other regional Fed Governors in the weeks to come. And like the June FOMC statement, these speeches will provide some morsels for the market to chew on.

When you look at the longer term trends it appears that the Fed hikes are beginning to have a dampening affect on inflation . You can also see that, on a longer term basis, the June hike has taken rates almost back to where they were in 2000, when rate cuts and tax reductions began in earnest to stimulate economic activity.

You could argue that the Fed is merely correcting it's previous endeavors, which as it turned out, helped stimulate the US real estate market. To the point where the US housing market was looking a lot like a bubble about to burst.

As you know, I have long contended that the real reason the Fed was hiking rates at a "measured pace" was to prevent a collapse in the real estate bubble, which if it occurred, could take the US economy down with it. In a repeat of the deflationary scenario similar to the one that plagued Japan for the past 16 years.

The only way to slow down a bubble without bursting it, is to apply measured pressure to the homeowners'

pocketbook. The same homeowners who have been borrowing as much as they can using variable rate mortgages to buy the biggest house possible. The previous hikes have had an affect on variable rate mortgages, and to a lesser extent on longer term rates, which has effectively stressed homeowners.

Coming full circle, our shorter term forecast is based on the events at the end of June. What played out in June was a rate hike followed by softer commentary. We think that may cause a rally in US stocks - albeit for the short term if the market concludes that rates hikes are over. After that, we get down to the real issues that

will impact US markets longer term. And these are the issues that I continue to believe is why serious long term investors should remain very cautious, keeping some cash on the sidelines, and where we invest in equities to focus on large cap high dividend paying blue chip stocks.

Economic growth has a rhythm that typically follows a path of least resistance. In a period where growth has been above a sustainable target, there is a natural tendency towards mean reversion, which simply means that economic growth will continue but over time, will converge towards an equilibrium, which we define as a sustainable growth rate.

A GLOBAL PERSPECTIVE

We see confusion, the market sees fear

The global correction in May and June was also driven by short term noise. We believe the noise reflects confusion, whereas the market equates noise to fear. Fear of inflation, fear of too much growth, fear of not enough growth, fear of the US Federal Reserve and fear of some kind of financial accident. Name your concern, and the market has at least two potential answers.

The confusion is to be expected, because it reflects a global business cycle that has advanced to a stage where inflation randomly appears, at the time when growth has started to soften. And for the record,

policymakers are just as confused based on what we see in their statements and actions.

The problem for investors, is that this fear / confusion is unlikely to dissipate quickly. The first step towards increasing confidence will be some clarity on the direction of interest rates.

We took some comfort from a recent special report in the Bank Credit Analyst (BCA) entitled "Are Inflation Fears Justified." They concluded that "inflationary pressures around the world are either still low, or well contained, and should diminish in the months

ahead as global growth slows."

Having said that, economic growth has a rhythm that typically follows a path of least resistance. In a period where growth has been above a sustainable target, there is a natural tendency towards mean reversion, which simply means that economic growth will continue but over time, will converge towards an equilibrium, which we define as a sustainable growth rate.

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A GLOBAL PERSPECTIVE

Continued from page 3

Following that line, we agree with the BCA, that the slowdown in global economic activity will likely be shallow, because the general condition for the world economy remains healthy.

remains healthy. Just how significant the slowdown will be, remains to be seen. We are, after all, in the early stages of this corrective phase.

However, according to the BCA, fundamentals behind the world economy remain largely positive and, assuming inflation remains sanguine, the

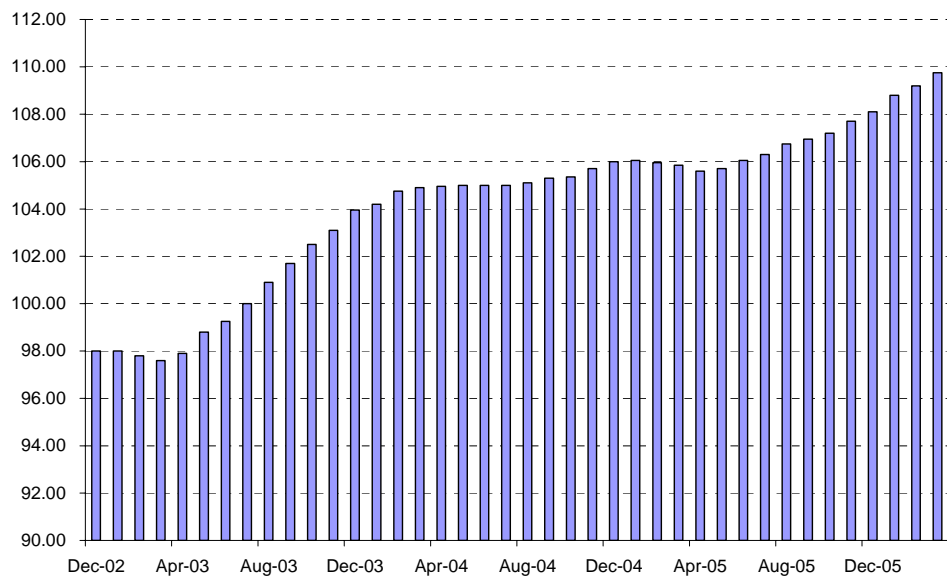
industrialized economies will continue to be productive, adaptive, and flexible.

The BCA points to the OECD Leading Indicator which continues to suggest an acceleration in growth over the coming months.

We see growth momentum across the

G7, Eurozone, and NAFTA. Add to that, upbeat forecasts for both China and India, and the outlook for world growth looks as if it will expand between 3.5% and 4% in 2006. Assuming this to be true, then we are most likely witnessing a healthy bull-market correction, that some would say, is long overdue.

OECD Leading Index



Be sure to read the material on our new corporate pool structures. We will be transitioning clients into these pools on or about August 15th. This transition will not result in a taxable disposition. The pools enhance your tax efficiency, allow us to manage your portfolio more effectively, and will have either no, or minimal, impact on your fees.

EMERGING MARKETS PERSPECTIVE:

India and China... No Landing In Sight

When you hear analysts talk about the potential for metals, be it precious metals like gold and silver or base metals like copper, the underlying thesis is that demand from China, India and the other emerging markets, was driving prices higher.

If you bought into that thesis, it is not surprising that the May / June sell-off in the emerging markets would negatively impact the price of gold and commodities. You could also take from that connection that the emerging markets are now facing a protracted slowdown in economic growth.

The problem with that thinking is that the initial assumption. The numbers never supported the thesis that demand from the emerging markets was driving commodity prices. In point of fact, demand from China for copper, steel and various other metals - it was never clear that demand for gold was that great in China - had been contracting for some time, and at last

review, continues to slow.

Further, we should not assume that China or the other emerging markets, have hit a brick wall in terms of long term growth. More likely we are seeing a shift in economic drivers, where future growth will be driven by the homegrown consumer, than from the export sector.

Thinking along this line implies that emerging market growth and demand for raw materials will simply slowdown to a more sustainable pace.

According to Cougar Global Investments, the portfolio advisor for the Croft Managed Global Mandate fund, the current sell off in the emerging markets is a "correction" rather than a sign of impending economic doom. And by extension, the parabolic rise in the price of gold, and copper for that matter, was driven more by speculation than with increased demand.

Sentiment also played a role in the emerging market sell-off. During the first quarter of 2006, for example, there was a stampede into the high-beta markets (i.e. China, India and the Pacific Rim). Driven by short term traders looking for opportunity.

Lazard's Emerging Markets Analyst cautioned back in April, that during the first quarter of 2006, inflows into emerging markets were as much as they were for all of 2005. The spillover effect from this excess capital flow into the emerging markets probably caused the buying frenzy in precious metals and base metals. Bottom line, we think the sell-off was a correction from overheated buying enthusiasm, rather than any serious change in economic growth patterns.

That brings us back to the economic drivers. We find it interesting that Chinese policy makers are going out of their way to encourage consumer spending. Something new on the horizon that we think

We should not assume that China or the other emerging markets, have hit a brick wall in terms of long term growth. More likely we are seeing a shift in economic drivers, where future growth will be driven by the homegrown consumer, than from the export sector.

has as much to do with politics as it does with a new found flair for economic planning.

If the Chinese consumer becomes a powerful force, it reduces political friction, because China can reduce their dependence on the US economy. It is much more difficult for the US to push human rights in China, if they cannot wield an economic stick.

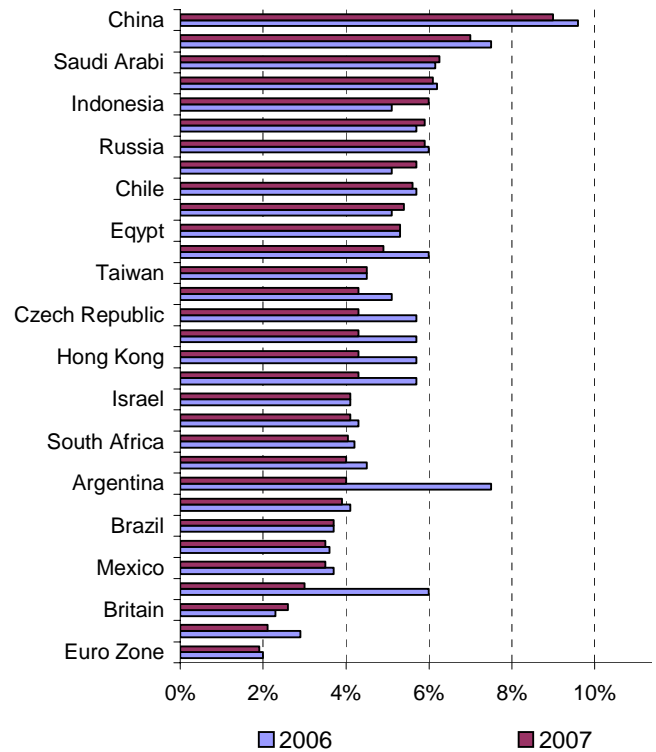
This experiment in China may well succeed, as we are seeing signs of rising prosperity among the Chinese middle class. In the end, that will drive spending on big ticket items, and drive growth in the Chinese economy. And a rising Chinese middle class will go a long way towards ushering in a new political spectrum.

In terms of numbers, China and India continue to lead the developing world. Look for GDP growth in China to come in at 8.7%, up from the previous forecast of 8%. India is expected to grow GDP by 7.2%, up from 6.8%, benefiting from robust domestic demand and strong external sectors.

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Figure 4

GDP Forecasts
Percent increase year over year



Although Brazil and Mexico are expected to grow “only” 3.6% and 3.5% respectively, this is still far higher than expected GDP growth in any developed country. As was reported in the Economist (April 22nd edition); all of the emerging economies could enjoy faster GDP growth than America, Japan, or the Euro area, according to the IMF’s latest forecasts.

In the end, Emerging markets are a leveraged play on global growth, and it will make sense to

tap into that market when the current correction abates. Already we are beginning to see some very interesting valuation parameters, with many big name companies trading at trailing price to earnings multiples of 14.6 and forward P/Es at 11.9.



THE SOUND OF MUSIC

And the madness of crowds



A look at any month end brokerage statement of the average investor and it is clear that few really understand how to build portfolios. In most cases, the brokerage statement will show a basket of securities often focused on specific sectors of the economy, and rarely with any thought as to what the individual securities bring to the whole.

Dig a little deeper into the investor's thought process and we find that individuals are usually holding some version of the pick of the day. Stocks are bought and sold based on the view of others, whether it be a broker's recommendation, a buy, sell or hold comment from analysts on television, or an interview in the financial press. In the end, your basket looks much like every other investor's basket, suggesting that stock prices have as much to do with peer pressure as they do with fundamentals.

Enter into this debate, the madness of crowds.

Get enough investors trying to buy a limited number of shares at the same time, and the fundamentals supporting the stock's price take a back seat to momentum. Irrational exuberance takes hold, the stock's price climbs for a short period beyond any level that can be justified by the company's financials, and then ultimately reverts to the mean.

Tim Horton's being a recent case in point, where prices soared more than 30% on the initial public offering. You could also make the same case for tech stocks in the 90s, real estate at the turn of the century and, now energy and commodity stocks. All with the same results.

Those in the investment business know this. If you want to launch a new product and generate lots of sales, you manufacture what people are buying. That's why we are seeing so many new commodity funds (note: the recent launch of the silver ETF as a case on

point), and natural resource funds coming to the market.

This is not just a behavioral trait associated with making decisions to buy and sell securities. This is a trait ingrained in the way we live. A point made in a recent we came across authored by Matthew J. Salganik and Peter Sheridan Dodds of Columbia University, and Duncan J. Watts of the Santa Fe Institute.

The authors set about to prove the impact of peer pressure, and rather than using investments, they did it with music. In this case, 14,000 participants were recruited and offered a random play list of 48 songs that they could download.

The authors sub-divided the participants into nine groups. The first group was provided the random play list and nothing else. The remaining eight, call them the peer groups, were provided the same random play list, but were also given

information as to the number of times a particular song had been downloaded by other members in their group.

What’s interesting with this approach, is that each peer group only saw the results of other members within their group. The end result was that the authors created nine independent worlds with the same play list, one world that did not know what others were doing, and eight worlds that provided knowledge of what others were doing.

The peer groups were influenced not only by the song itself, but also by the popularity of the song among other the other members of their group. The first result was interesting, and for us, as expected. The gap between the least popular songs and the most popular songs was much wider within the peer groups, than it was in the one group that could not see what the other members were doing.

Another result also came to light. It seems that the most popular and least popular songs within the eight peer

groups varied. In other words, one peer group’s top ten list was different from another groups top ten list. What the study tells us is that the gap between winners and losers remained consistent, but the actual winners and losers was random. Dependent we suspect, on how each group was influenced.

The results have interesting applications in the financial markets. We justify to ourselves why a stock or mutual fund was bought or sold, but in reality, much of what we do is influenced by other investors.

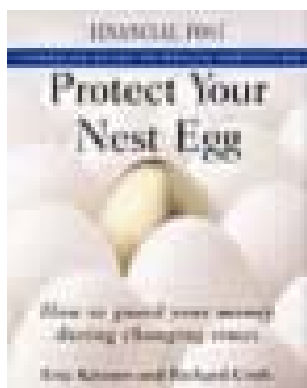
That also means that the price of a stock, or performance numbers of a fund, have as much to do with momentum as they do with real world fundamentals. Coming full circle, we find that individual

investors usually buy and sell at exactly the wrong time.

Buying a mutual fund because of the recent performance numbers, or a hot stock or sector is like riding the cars of a freight train, rather than driving the locomotive. The analogy to the locomotive is where the portfolio comes in.

The idea that the whole is worth more than the parts is what long term investment management should be. If we continue to invest based on the views of others, rather than on the view of how investments fit within a portfolio, we will end up following trends that more often than not end badly.

Unfortunately for most investors.... the band plays on.



US Economic Indicators	
Indicator	Value
Inflation	4.07%
GDP Growth	3.68%
Unemployment	4.60%
Gold \$/oz	\$ 613.50
Oil \$/bbl	\$ 73.93
Prime %	8.25%

June 30, 2006 (close of day)

Source: www.forecast.org