

# PORTFOLIO MATTERS



## INSIDE THIS ISSUE:

<i>Recessions &amp; Yield</i>	1-4
<i>Individual Pensions</i>	5
<i>Efficient Markets</i>	5-8
<i>Financial Planning</i>	8
<i>Star Power</i>	9-11
<i>Portfolio Changes</i>	12

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## Recessions and the Inverted Yield Curve

### *Will It Be Different This Time?*

Investors seem to like the latest batch of economic reports. Recently, the Institute of Supply Management (ISM) released their so-called ISM index, which measures US manufacturing activity. It fell from 54.7 in July to 54.5 (the ISM index peaked in April at 57.3) in August. Traders saw that as evidence that the US economy was slowing enough to keep the Fed on the sidelines, but not enough to signal a recession.

Even more important was the employment report. The trend in non-farm payrolls have been up, with recent data showing the creation of 128,000 new jobs in the US. That number is in line with consensus estimates, and follows a trend line of moderate job growth. When you factor in hourly earnings up 0.1% in August, versus estimates of 0.3% (that translates into a year over year of +

3.9%), traders seem to like the numbers when viewed within the context of recent inflation data.

The question, of course, is whether this is the Goldilocks scenario that Wall Street is hoping for. A soft landing in the sweet spot of the economy, like the bowl of porridge that is just right. Perhaps! But those who remember the fairy tale will recall upon awakening, Goldilocks screamed and fled into the woods, never to return again.

Of course, in my efficient market discussion (on page 5) I make the point that the market is driven by millions of profit seeking investors, whose collective wisdom implies some fair value model. Leading into September, the majority of investors seemed to be betting that the market will remain on a bullish trend line. I was not sure at

the beginning of September, and am still not so sure.

I am not alone either. John Maudlin, writing in [www.investorsinsight.com](http://www.investorsinsight.com) offered some interesting perspective with two historical charts; 1) the S&P 500 from January 1<sup>st</sup> to December 31<sup>st</sup>, 2000 (figure 1 page 2), and 2) January 1<sup>st</sup>, 2006 to the present (figure 2, page 2).

Notice in figure 1, "that the market made its first highs in the spring and then made a real run at those highs in late August. The cycle high was September 1, 2000, where the market closed above 1520." It has not recovered that ground, and for Canadian investors with the rise in the loonie, US stocks are still 40% below where they were at the September 2000 peak.

## Recessions and the Inverted Yield Curve

*continued from page 1*

Figure 1: S&P 500 Composite Index January 1<sup>st</sup>, 2000 to December

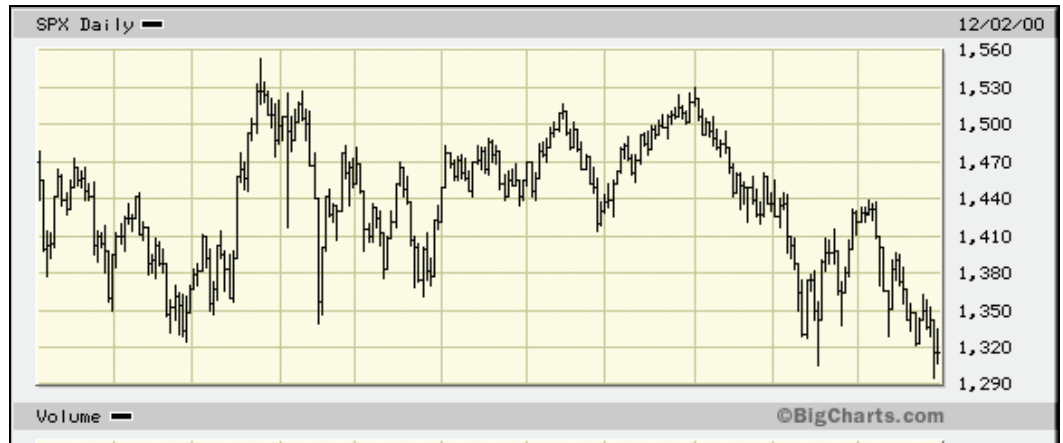
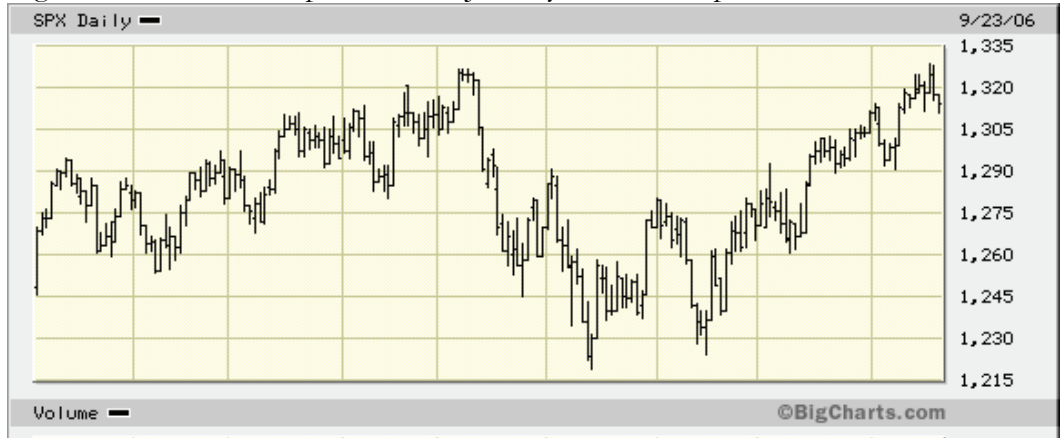


Figure 2: S&P 500 Composite Index January 1<sup>st</sup>, 2006 to present



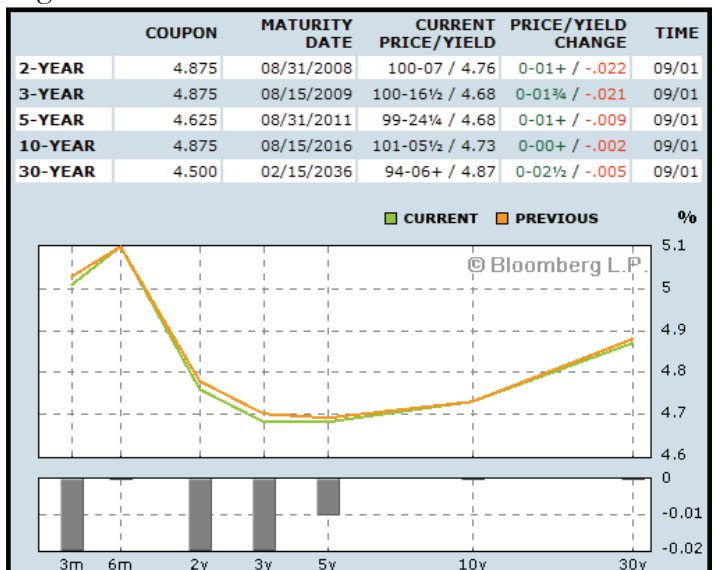
*It is important to frame performance data with other fundamentals.*

### Putting Some Context Into The Charts

What we have then, is two periods with similar trends, but still only one piece of the puzzle. It is important to frame performance data with other fundamentals. For example, in 2000, there was like today, an inverted US yield curve (i.e. short rates higher than longer rates).

In 2000, 90 day US treasury bills were yielding 6.27%, while 10-year US

Figure 3: US Yield Curve



Source: bloomberg.com

treasury Notes were at 5.68%, a difference of -0.59%. In 2000, writes Maudlin, “the inversion of the yield curve would top out four months later at a -0.95%. At that level, the yield curve was telling us the probability of a recession was better than 50%.”

Today, 90 day US treasury bills are at 5.01% versus 10-year Treasury Notes at 4.73%. An inversion of -0.28%, which has been rising. Some analysts think that 10 years rates could fall to 4.5% over the next couple of months. If treasury bills remained constant, that would put the inversion at -0.50%.

**Inversion = Recession**

The US Federal Reserve has done a number of studies looking at whether yield curves can forecast economic trends. In 1996 for example, Estrella and Mishkin, authored a Fed research paper on inverted yield curves. Specifically they set out to develop a probability table as to how likely a recession would be four quarters after a yield curve become inverted (see table 1).

Based on the numbers from table 1, with our -28 basis point inversion,

Table 1: Inversions and Recessions

<b>Estimated Recession Probabilities For Profit Model Using the Yield Curve Value of Spread Four Quarters Ahead</b>	
<b>Probability of Recession</b>	<b>Yield Spread Percentage</b>
5%	1.21%
10%	0.76%
15%	0.46%
20%	0.22%
25%	0.02%
30%	-0.17%
40%	-0.50%
50%	-0.82%
60%	-1.13%
70%	-1.46%
80%	-1.85%
90%	-2.40%

Yield curve spread is the spread between 10 year treasury notes and 90 day treasury bills

there is a 35% probability of a recession four quarters out. And that may be understating the real risk, because as the authors of that 1996 Fed study pointed out, in the future it was quite likely that the probability of a recession would increase with less of an inversion in the yield curve.

Adding other pieces to the puzzle, we need to look at sentiment. The views were eerily similar. In September 2000, many analysts were touting the “this-time-it-

is- different” argument. Making the case for new highs on the basis that the economy was heading for a soft landing. It turns out that the US was in a full fledged recession by March 2001.

**The Bubble Mentality**

Some would argue that today is very different than 2000. We are not correcting a decade of excesses from a technology bubble. True, but maybe we are seeing the end of a real estate bubble in the US, and

*Inverted yield curves have a long track record of correctly predicting recessions four quarters out*

*“to be bullish today, you have to believe that the inverted yield curve, which has yet to be wrong about a future recession, is giving us a false positive.”*

*John Maudlin*

## Recessions and the Inverted Yield Curve

*continued from page 3*

perhaps, a commodity bubble in Canada.

Maudlin concludes, that “to be bullish today, you have to believe that the inverted yield curve, which has yet to be wrong about a future recession, is giving us a false positive.”

I would add that you also have to believe that the US real estate market will slow in a measured pace, and that commodity prices (read gasoline and heating oil) will not have

a negative impact on the US consumer. That’s a lot to swallow.

Having said that, the market never telegraphs anything with certainty. We are always cautioned against being a lone wolf threatening to blow down your house (pardon my predilection for fairy tales).

So... maybe this time will be different. Maybe, the yield curve is giving a false signal. Maybe US consumers will continue to ignore higher energy

costs, and maintain their spending pattern. Maybe the trend in the stock market will remain intact and maybe the collective will of investors will turn out to be correct.

Maybe... but I am more comfortable playing with the conservative side of our portfolios. Keeping a little more cash, a little more fixed income and some dividend paying blue chip stocks.

## Individual Pension Plans

*Super Size Your Retirement Nest Egg*

An Individual Pension Plan (IPP) also referred to as a Defined Benefit Plan is a registered tax retirement savings vehicle designed for one person and sanctioned by the Canada Customs Revenue Agency (CCRA).

The plan is designed to aid tax disadvantaged high end income earners/business owners in retirement. Think of an IPP as a super sized RRSP that offers the plan member the same benefit of an RRSP by accruing tax sheltered growth until he/she retires at age 65.

The purpose of an IPP is to provide a lifetime pension starting at a certain age that will last to death do us part.

One of the main differences between the two plans lies in the available contribution room. In some cases, plan members may contribute up to 60% more to an IPP than a traditional RRSP.

Some additional advantages of an IPP are; investment expense deductibility, bullet proof creditor protection, tax savings, and additional

funding on retirement.

An IPP is a sound business decision for entrepreneurs and business owners who have historically maximized their RRSP/ Pension Contributions and have the income to support a more aggressive tax deferral arrangement.

It’s your money, make the most of it with the lowest cost IPP model in Canada; the Croft Individual Pension Plan. To see if you qualify, contact:

Robyn Thompson at 416 828 7159 ext 327.

## The Randomness of Efficient Markets

*And The Impact That Has On Whether To Be A Passive Or Active Investor.*

I got to thinking about the randomness of stock prices as I watched activity during August and September. I noticed for example, that there was virtually no reaction to the Fed's decision not to raise rates, and there was initially, panic buying in reaction to the latest US inflation data.

It begs the question about whether the financial markets are so random as to make it impossible to earn excess returns on the basis of past performance?

But, if that were true, technical analysts would never be able to make buy and sell decisions.

One could also wonder if the market is so efficient that investors can never make money on mispricing opportunities, because as academics suggest, market prices are reasonable because they always reflect all publicly available information.

If that were true, how would value managers find an edge, because they would never hold cash, and would always be fully invested.

The view that the market is efficient and that stock

prices move in a random manner has been around for decades. And the argument in support of that position has merit. If the market consists of a large number of rational profit-seeking, risk-averse investors, then "any new information affecting a given stock is quickly known throughout the entire investment community, and it is therefore, rapidly reflected in the price of the stock to which the information relates." That from the book *Investment Analysis and Portfolio Management* authored by Jerome B. Cohen, Edward D. Zinbarg and Arthur Zeikel.

But that assumes that the information that is made public is accurate, has value, and was disseminated correctly, which is not always the case.

Gordon Pape, writing in his popular *Internet Wealth Builder* ([www.buildingwealth.ca](http://www.buildingwealth.ca)), doubts there is any value to efficient market theory. He cites as recent examples, the market's "knee-jerk" reaction to news that British authorities were able to foil "a mind-boggling terrorist

plot to destroy up to a dozen planes in flight with liquid explosives and camera flash bulbs."

Writes Mr. Pape, "That news, coupled with tough new restrictions on carry-on baggage, knocked down the price of crude oil by more than US \$2 a barrel on the theory that fewer people would want to travel, thus reducing demand for aviation fuel. Oil stocks sold off as a result, with Suncor (TSX, NYSE: SU) down as much as \$1.49 a share at one point [on the day] of the news." It rallied back later, but fell again the next trading session.

"In the meantime," Mr. Pape continues, "ACE Aviation shares, which would be much harder hit than Suncor by any fall-off in air traffic, gained more than \$1 on the [same] day and had another strong showing [on the following day]. Sure, the parent of Air Canada came out with good quarterly earnings but investors and analysts are supposed to look forward, not back."

Mr. Pape's use of specific examples make a valid argument against

*To believe the most stringent form of efficient market theory, one has to assume that information that is made public is accurate, has value, and was disseminated correctly.*

## The Randomness of Efficient Markets

*Continued from page 5.*

the concept of efficient markets. In these cases, the market clearly overreacted; negatively on Sun-cor, and positively for Ace Aviation. Certainly the price movements were random, but where is the efficiency in that?

Yet, with so many investors presumably making financially viable decisions with the same information placing bets with their own capital, how else can you define the resulting value except to say that it has been arrived at through an unbiased efficient process?

Interestingly, while these positions seem to be diametrically opposed, they may not be as far apart as they appear. And understanding this dichotomy is important, because it affects so many issues that investors constantly debate within the investment business.

For example, are you better off using a passive indexed base buy and hold strategy. Or, should you use professional money managers to ferret out opportunities if you believe they exist? And for the do-it-yourselfer who wants to pick stocks, assuming

that opportunities exist, should you follow a value or a growth approach when making those judgment calls.

One thing we know is that the market reacts to sentiment. Whether stocks are bid up because of “irrational exuberance” or sold off on the basis of irrational paranoia, sentiment plays a role. At least initially.

More importantly, the market’s (read also individual stocks) initial reaction to events has become more violent, because among other things, investors have instant access to information 24 hours a day.

The problem with instant access, is that serious analysts have very little time to draw conclusions about the longer term impact of new information. And since the initial reaction is driven by sentiment usually from average investors who do not have the tools to make reasonable judgments, we often see events like Mr. Pape examples. In the process whipsawing investors into reactions that are not always in their best interest.

Surprisingly, what seems to be a contradiction, is often used to support efficient market theory and random stock price movements. That stock prices react quickly to an event supports the efficiency argument, that whipsaws occur with great frequency, supports the position that prices are random.

The problem is magnified when we look at macro issues that affect a specific sector (i.e. the oil market, the tech bubble, real estate, etc.) or a particular asset class (i.e. bonds and the Fed). Because it goes to the heart of the debate between active and passive management.

If you believe in the most rigid form of the efficient market hypothesis, then a passive buy and hold strategy is always the right choice. When there are pricing anomalies within a sector or an asset class, efficient market theorists would maintain their buy and hold model because they would surmise that the sector is not trading at an extreme valuation, but rather, is trading at its fair value based on information that was

*If we use time as our constant, then no one price reflects the markets view about a stock, but rather, the market would view value in terms of a range of prices.*

available at the time.

Those types of situations do the most harm, and unfortunately, are only obvious in hindsight. Mr. Pape cites, as an example, the 1990s tech bubble which was clearly an excess. It eventually corrected, but only after a painful three year bear market. And for the companies that survived, many may never again see the prices that existed at the height of the euphoria (i.e. Nortel, Cisco Systems, Dell, and even Microsoft).

Theorists simply explain away the bubbles by arguing that efficient markets eventually correct excesses. But could active investors not take the same tact, and simply look at extremes as opportunities. Sell short at a top (irrational expectations), buy at a bottom (irrational paranoia). Like most things in life, there is a middle ground. And also like most things in life, a middle ground is the toughest to find.

To begin the search, we need to first define market efficiency and randomness. We know over short periods, hysteria can move markets. The day to day changes in the value of a stock would seem, at best, random. It could be argued that movement in the share price is being

driven by new information that has not been properly vetted by the market.

But longer term, perhaps the value placed on that stock is reasonable. After all, is that not what technicians do when they employ moving averages? Maybe the moving average is the efficient price, and the day to day movement is simply noise.

Having said



that, perhaps we can make the case that longer term views are probably the best way to judge a market's efficiency. Say a 200 day moving average, to pick a number. At least by using a longer time frame, we have a better chance at being able to assess a fair value, than trying to argue against the random nature of day to day noise.

If we use time as our constant, then no one price reflects the market's view about a stock, but rather, the market would

view value in terms of a range of prices. I am talking about a channel in which the stock tends to trade, with the upper and lower band being the market of efficiency, and the current price being just noise (i.e. randomness). That approach would work for the value manager, tying entry and exit points to the bottom and top of a trading channel.

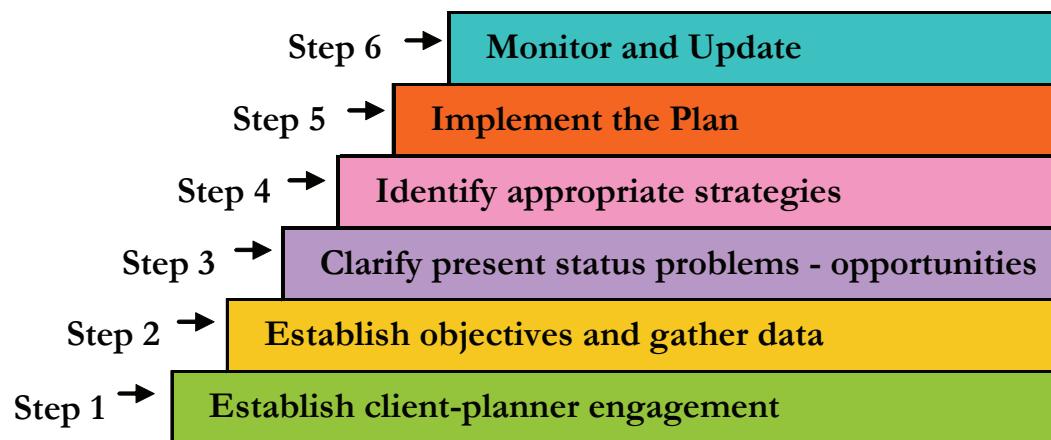
Further, I could then say that Suncor is an example of market inefficiency because its price oscillated through two days of random excesses driven by the madness of crowds. I could also say that Suncor was an example of market efficiency, because it traded within a "normal" range, that over a longer time period, seems to reflect both new and old information.

This view is still in its infancy, but what it does is change the way we define fair value. In the end, maybe fair value has more to do with a time line than with day to day noise. At least, if time is the one constant, it tells us that the two sides in this debate, are really not that far apart.

*If we use time as our constant, then no one price reflects the market's view about a stock, but rather, the market would view value in terms of a range of prices.*

## Introducing Full Service Financial Planning

*The first Step With Any Investment Program*



Source: I.F.S.E.

*Fifty years ago, Canadians were planning to retire at age 65 with a life expectancy of 75. Today, people retire earlier and are living longer. That means fewer working years in which to save for a longer retirement.*

It is often said that the only constant in this world is change. Not only have we seen a tremendous amount of change in the markets recently, but over the longer term we've seen changes in how people are choosing to spend their retirement. With our new financial planning service, we are able to work with you in achieving your retirement goals.

Fifty years ago, Canadians were planning to retire at age 65 with a life expectancy of 75. Today, people retire earlier and are living longer. That means fewer working years in which to save for a longer retirement.

If you are concerned about keeping your retirement plans on track in these changing times.

We can help by;

1) Creating a meaningful budget for the future. It is possible to factor in the effects of inflation and project the annual income you can expect to receive not only from your own savings and any pension plan you may have at work, but also from government programs like the Canada Pension Plan and Old Age Security.

2) Running “Monte Carlo” simulations, by using a computer program that generates thousands of hypothetical situations based on historical data. With this, it is possible to predict both “best-case” and “worst-case” scenarios for your retirement plan. What if the market crashed the month before you retire? What if your

asset mix underperformed for three years in a row? We can review what the future may hold and how best to plan for it.

3) Reviewing your current savings and asset mix. Are you in a position where you can be comfortable assuming additional risks in the hopes of earning a higher rate of return, or have you reached a point in your life when a more conservative approach would be more appropriate? Are you still putting enough aside to fund the lifestyle you have in mind?

If you are interested, I encourage you to set up an appointment to discuss this service further. Please contact Robyn Thompson at 416 752 7991 x 327.

## Star Power and the Hedge Fund Game

*Hedge Fund Fallout from Natural Gas... Is There More to Come?*



Natural gas prices dropped sharply in September. A couple of reasons; 1) there is every indication that we are in for one of the mildest winters on record which would reduce demand for natural gas, and 2) prices have been weaker of late because we are nearing the end of this commodity cycle. The latter point being something we have talked about in recent weeks.

As with any event in which a major move results, there are casualties. And this time was no different. During the second week of September, Amaranth Advisors Hedge Fund lost US \$5 billion – or more than half of the assets – over five tumultuous days. All resulting from a wrong way bet on natural gas; i.e. betting that prices would rise not fall. In fact it was even worse as Bloomberg reported the following

week, that Amaranth lost another US \$1.4 billion last week, “as the firm unloaded assets at a discount to avoid a shutdown.”

The question for the rest of us is whether there are disasters – perhaps larger than what we have already seen - waiting in the wings.

Last week, for example, we saw a sharp downward movement in the price of oil, and many hedge fund managers had been betting that the price would see US \$100 per barrel before it saw US \$60 per barrel. Could that play havoc on some of the larger hedge funds? And if so, what impact might that have on investor sentiment?

A large enough disaster, like say the Long Term Capital collapse in the late 1990s, could have an impact on liquidity, and send shockwaves through the capital markets. Short circuiting any of the good will investors are feeling because interest rates have stabilized and GDP growth seems to be in line with the Goldilocks scenario; not too fast to

spur inflation, not to slow to send the economy into a recession.

Timing is also an issue. It is not by chance that such disasters occur most often around this time of year. It has as much to do with leverage and compensation structures within the hedge fund industry as it does with volatility in the capital markets. And there is at least one train of thought – of which I subscribe to - that the volatility in the capital markets may be directly related to the trading patterns of highly leveraged hedge funds. The “tail-wagging-the-dog” scenario.

For investors and particularly, for portfolio managers like myself, it is important to be mindful of the risks, and to set in motion a disaster relief plan. Unlike a hedge fund that sets out to assume risk, our goal is to manage risk.

As a starting point it is important to be aware of what drives hedge fund managers. Only by recognizing their foibles,

*The question for the rest of us is whether there are disasters – perhaps larger than what we have already seen - waiting in the wings.*

## Star Power and the Hedge Fund Game

*Continued from page 9*

can we truly appreciate the risks associated with their trading patterns.

Hedge funds managers prey on volatility. The more... the better. When you look at the trading pattern of 32 year old Calgary based Brian Hunter - the energy trader at Amaranth who was blamed for losing the US \$5 billion - the loss should not have come as a surprise.

According to the Wall Street Journal, his account was up by US \$2 billion at the end of April. He lost US \$1 billion in May, made that back over the summer and by the end of August, the Amaranth trading desk was up 20% year to date.

Then of course, came the US \$5 billion bloodbath, wiping out all the year to date gains and then some. All from trading volatile natural gas futures, that over the last year, have been as high as US \$15 per BTU (December 2005), and as low as US \$5 BTU (the current price).

Add leverage into the equation and you can see why US \$1 billion can be

won or lost on any given day.

What this pattern does is go to the heart of the hedge fund manager's psyche. You had a fund that was up 20% year to date by the end of August. That's a class "A" return for any investor over the course of eight months, and quite frankly, over the course of a full year. If Mr. Hunter had simply moved into cash for the final quarter, his clients should have been quite pleased, and he and his company would have earned a decent performance bonus.

It would also have provided Mr. Hunter with back to back years of solid performance, with 2006 being even better than 2005. And that speaks volumes about this business, because by some accounts, Mr. Hunter generated US \$800 million in fund profits in 2005, and earned US \$75 million in performance bonuses.

So what drives a manager to assume great risk after having already put to bed solid returns by the end of August. And

the answer, I think, comes down to star power. Where attempts to excel with other peoples money, has as much to do with setting a place in history, as it does with financial compensation.

Think about this for a moment. In baseball, a 20 something pitcher with a 100 mph fast ball, is finishing a multi-year \$50 million contract.



The team promotes him as their star, and now at the end of his first contract, he wants to be paid as a star.

During negotiations for a new contract, he explains that it is all about respect. He pits one team against the other in search of a bigger contract. Not because he needs the money, but because he is no longer the highest paid pitcher in the league. When it comes to star power, financial compensation is simply

*Hedge funds managers prey on volatility. The more... the better. When you look at the trading pattern of 32 year old Calgary based Brian Hunter - the energy trader at Amaranth who was blamed for losing the US \$5 billion - the loss should not have come as a surprise.*

the scorecard.

The hedge fund business works much the same way. Hedge fund managers are promoted as stars, who rather than being able to throw a 100 mph fastball, have been able to hone a black box model that can produce above average profits from the ebbs and flows of a particular sector.

Like the pitcher who does not want to give away the secrets of his split finger fastball, neither does the hedge fund want to share its proprietary research into what drives a particular sector higher or lower. So what's left... star power. The spin may be about performance rather than championships, but the goal is the same... it is about getting fans into the seats, or investors into the fund.

The problem in the hedge fund business, as with the sports business, is that it is all spin. There are no stars (with perhaps the exception of Babe Ruth). In the end, one pitcher may end up with a better record or a lower earned run average

over the course of a year, but the difference in the performance of the top ten pitchers in the league, is usually nothing more than one bad pitch during the course a month.

In the end, a pitcher throws a baseball, a hedge fund manager picks stocks or sectors. The strategy of a hedge fund is not that different from the strategy of a traditional portfolio manager. The difference is that a hedge fund manager assumes risk through the use of leverage, the traditional manager avoids risk through un-levered diversification.

And since no one has yet put in place viable passive benchmarks to evaluate hedge fund managers, they are basically left to play up to their own delusions of grandeur. Which, unfortunately, spells problems for the rest of us.

We have already seen what can happen with a hedge fund manager who

wanted more than 20% returns. What about a hedge fund manager who has not had a very good year to date?

Their performance bonus is generally based on the results over a calendar year, and with only a quarter left, don't you think some of these less than stellar stars, are going to attempt to break the performance barrier over the last quarter.

Like star pitchers, a star hedge fund managers who believes his own press clippings will set out to excel at all cost. When you combine youth, leverage and volatility, you end up with a very potent mélange. Star pitchers who over extend themselves, often succumb to injury, which can mean a month or two out of the rotation. In the hedge fund business, it means multi-billion losses.

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Be sure to read the material on our new corporate pool structures. We have re-scheduled our transition into these pools to mid-October. The pools should enhance your long term tax efficiency, and will allow us to manage your portfolio more effectively.



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## Improving The Way We Manage Your Portfolio

The CFG Custom Portfolio Corporation has been set up and we will be moving some clients into the new corporate share classes during October. This is an exciting time for all of us, as the new share class structure will allow us to manage our client's portfolios more effectively; from a tax perspective, from a transaction cost perspective and most importantly,

did not want to unintentionally trigger large capital gains in a portfolio if the client was already holding a security that we would likely continue to hold inside the corporate class structure. We wanted to review these positions on a client by client basis. As such, not all client assets will necessarily be transitioned into the share class structure.

out of the Canadian market on September 5<sup>th</sup>, the day after labor day. We sold the S&P TSX 60 iShares at \$69.35 (8 cents below the top of the market), and because of that, our clients have not experienced the subsequent sell-off related to the end game in the commodity cycle that has plagued the Canadian stock market. That decision will trigger some capital gains, but we believe that trade was the right move.

Going forward this new structure will provide a tax efficient, low risk, low cost environment for our clients' portfolios. And we believe that is essential for delivering the kind of risk adjusted performance serious investors demand from serious portfolio managers.



from a risk management perspective. As we transition client assets into the new share class structure we will also be closing the Croft Enhanced Income Fund.

Originally we were going to transition assets into the share class structure in September. However, we needed to ascertain whether there would be any adverse tax consequences to investors before implementing the transition. Specifically, we

Having said that, if we deem a transition to be appropriate despite the tax consequences, we will make the move. Our first goal is to ensure that our clients have a low risk portfolio and in some cases, the transition of a particular security will clearly reduce risk. In such cases, risk reduction takes precedence over tax issues.

As an example, you will note that we sold clients

