

PORTFOLIO MATTERS



INSIDE THIS ISSUE:

| | |
|----------------------------|-----|
| <i>The Global View</i> | 1-3 |
| <i>Prudent Speculation</i> | 4-5 |
| <i>Ticket Charges</i> | 5 |
| <i>Asset Allocation</i> | 6-8 |
| <i>Pool Calculator</i> | 8 |

Contacts

ICPM

Richard N Croft
(416) 752-7991 ext 330

Associate ICPM

Mark Taucar
(416) 752-7991 ext 328

Relationship Manager

Robyn Thompson
(416) 752-7991 ext 327

Administration

Kathy Quinn
(416) 752-7991 ext 326

Angie Mondino
(416) 752-7991 ext 332

Barbara Croft
(416) 752-7991 ext 329

Ron Quinn
(416) 752 7991 ext 331

The Global View

Bank earnings, economic commentary on Canada, US, Euro zone, Asia and Japan

For a brief moment, Canadian investors took their eyes off oil to focus on the earnings numbers for the big six Canadian banks. Despite some strong numbers, the results were met with mixed emotions. The Bank of Montreal was the first out of the gate, showed some strong numbers, raised their dividend and still the stock sold off. Why? Because analysts worried that the company was losing market share.

Royal Bank and CIBC, on the other hand, blew away expectations, as both gained market share, and in the case of CIBC began trimming costs. We own all the banks in our Core Income and Core Equity pools.

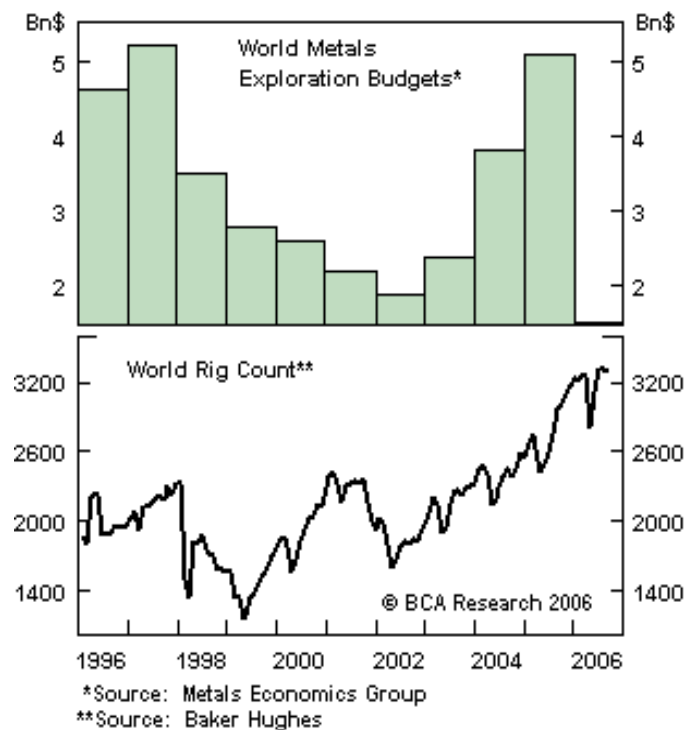
After the dust settled on the banks, investors turned their attention again to energy stocks. Oil moved back above

US \$60 per barrel for two reasons; 1) on news that OPEC would cut production at their meeting in Nigeria, and 2) because a cold snap in the US north west could increase demand for heating oil.

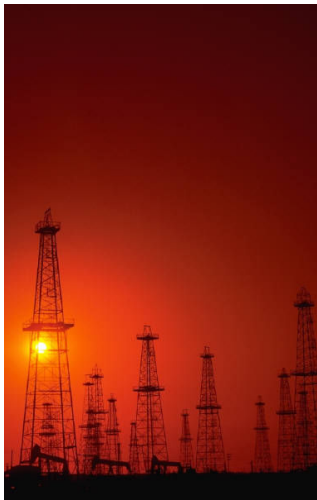
I am not convinced that oil will remain at these levels, but it was enough to drive Canadian stocks to new all time highs. That said, I continue to

believe that oil prices will eventually settle between US \$40 and US \$50 per barrel.

I believe this because oil prices are being driven by demand not supply problems. As growth slows in the industrialized countries that will translate into lower demand for energy, at a time when more energy is coming onto the market.



The trick for suppliers like OPEC, is to find the sweet spot that is the equilibrium between supply and demand. OPEC production cuts are always a dangerous game.



Think about this for a moment. The driver for higher oil prices has been the surge in demand brought on by explosive GDP growth, with particular emphasis on China and India. Commodity companies are not equipped to handle an unexpected surge in demand, and must adapt over time. Eventually commodity companies adapt, exploration budgets expand, and in case of oil, additional drilling rigs are deployed (chart page 1). In time, that increases the supply side at a time when demand is beginning to slow. And with that, we have sown the seeds of lower oil prices.

The trick for suppliers like OPEC, is to find the sweet spot that is the equilibrium between supply and demand. OPEC production cuts are always a dangerous game. The mere suggestion that production cuts were eminent was enough to send oil prices above US \$60 per barrel. But longer term, there is a wide gap between talk about production cuts and actual production cuts. On this note, the band plays on.

When it comes to production cuts and the impact that may have on

oil prices, there is one thing that economists seem to agree on. There appears to be a concerted belief that inflation in the major industrialized countries will be less sensitive to oil prices in the future. That seems reasonable given the upward shift in oil prices that has already occurred. Future price advance like the ones we've seen in the past three years, seems well... unlikely.

If I am right, then inflation will moderate, interest rates will start to fall or at worst, remain stable. We will not likely see any real surprises in the G7 economies. Not too much growth, no major slowdown, and no unexpected surge in demand for oil. For the record, this is the Goldilocks scenario that everyone was hoping for.

The wildcard in this debate is the impact a weaker housing market may have on consumer confidence. This is a major worry, as lower real estate values could have a major impact on the wealth effect. If US consumers get spooked, US growth could slow dramatically.

Most analysts do not believe this has been priced into the financial markets.

Perhaps I am being caught up in the Christmas spirit, but I do not believe the cracks we are seeing in US real estate will have any meaningful affect on the US consumer. There are differences in this downturn compared with real estate downturns of the past. For one thing this downturn has not spread beyond the real estate sector, as we continue to see stability in the US financial system, and no sign of banking sector stress.

Furthermore, when it comes to predicting consumer behavior, disposable income, job security and employment growth are more important than the wealth effect of real estate values. On that front, incomes are rising, unemployment is at record lows and job creation is strong.

The Canadian housing sector is feeling similar pain, although no one expects our market to soften as dramatically as the US. Mainly because our house prices never experienced the euphoria that the hottest US markets did.

The bigger problem for Canada is the impact that even a mild US slow-down will have on our

exports. The Bank of Canada believes that even a soft landing scenario in the US will have a major impact on Canadian exports. Most notably auto sales. Canadian GDP growth forecast for 2006 has been lowered from 2.9% to 2.8%. Canadian CPI to average 2.2% in 2006, down significantly from last month's 2.4% estimate. Assuming those conditions remain, I would expect the Bank of Canada to cut rates before the US Fed.

China and India

A poll of economists suggested that China and India will again lead the world in growth through 2007. The same poll also found that emerging economies generally, are expected to grow faster than developed countries through 2007.

We are playing that scenario in our Managed Global Mandate Fund with increased exposure to the emerging markets.

We have also moved out of broad based Canadian equity, raised our exposure to fixed income assets (both global and domestic) and maintained our US equity weighting.

When we talk specifically about China, what

concerns economists is its dependence on exports. A slowdown in the industrialized world will have a negative impact on China, in much the same way that a slowdown in the US has grave consequences for Canada.

The challenge for China is to develop a vibrant domestic economy. That will come in time, as that country develops a large, thriving middle class.

This is part of a maturing process, that takes time. Our approach to China is through an ETF like the iShares FTSE/Xinhua China 25 Index Fund (symbol FXI, Listed AMEX).

The EuroZone and Japan

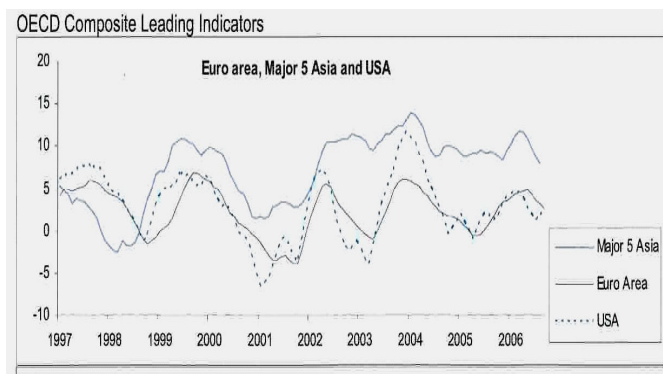
In the third quarter we began to see improvement in Europe's pace of economic activity, which has led to renewed confidence levels.

The challenge for Europe is to find a way

to navigate through a global slowdown. Economists forecasting GDP growth in 2006 raised estimates to 2.6% from 2.5%. Q-2 actual GDP growth was 2.7% or 3.8% quarter over quarter. The *Economist* estimates Eurozone CPI will be stable at 2.2% in 2007. Actual CPI was running at 1.6% in October or 2.5% year over year. On October 11th, the European Central Bank raised rates 0.25% to 2.25%.

Revised forecasts for Japanese GDP in 2006 is 2.7% down from 2.8%. Actual GDP was 2.5% in Q-2 or 1% quarter over quarter. Japanese inflation is forecasted at 0.3% although there was a 0.6% increase in September. Sentiment towards Japan among investors seems to be improving. A weaker Japanese yen and a pro-growth monetary policy are working in favor of the equity market. The risk; a sharp spike in the Japanese yen could hurt the Nikkei.

China and India will again lead the world in growth through 2007. Emerging economies generally, are expected to grow faster than developed countries in 2007.



Graham's Views on Prudent Speculation

David Horton, a Croft Financial Group Advisor in the Niagara Region, penned an interesting commentary that drew from the works of Benjamin Graham. It is worth repeating.

Benjamin Graham, for those who do not know, authored and/or co-authored the best books ever written on investing. Having been in the investment business in one capacity or another for over thirty years, reading Benjamin Graham is always a good use of time.

Occasionally we get asked by clients to buy speculative companies within their portfolio. We rarely do, and if we do, it is only within the smallest percent weight.

What we find interesting is how often we hear this request now that we have had a few years of decent growth. Somehow, investors perception of risk diminishes as the light from the treacherous bear market of 2000 to 2003 diminishes.

In light of these requests, and assuming that some of our other clients are thinking along the same

lines, we thought it timely to pass along some of Graham's thoughts about investing and speculating. The following excerpts are taken from the 1972 edition of *The Intelligent Investor* by Benjamin Graham.

"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook. More than that, some speculation is necessary and unavoidable, for in many common-stock situations there are substantial possibilities of both profit and loss, and the risks therein must be assumed by someone. There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: 1) speculating when you think you are investing; 2) speculating seriously instead of as a pastime, when you lack proper knowledge and skill for it; and 3) risking more money in speculation than you can afford to lose.

Graham went on to say; "Speculation is always fascinating, and it can be



a lot of fun while you are ahead of the game. If you want to try your luck at it, put aside a portion - the smaller the better - of your capital in a separate fund for this purpose. Never add more money to this account just because the market has gone up and profits are rolling in (That's the time to think of taking money out of your speculative fund). Never mingle your speculative and investment operations in the same account, nor in any part of your thinking."

We find it interesting that in one of the best books ever written on investing, the first four pages of chapter one are devoted to distinguishing between investing and speculating. In the money management business, speculating with client's money is almost always a losing proposition. Even when the clients are supposedly prepared for the potential losses. Because in reality, no client is prepared to lose money. Clients are willing to assume risk only when it

"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook"

Benjamin Graham

comes to upside performance.

Experienced money managers are always trying to reduce risk by applying rigid criteria – if you follow Graham’s philosophy that would include things like credit ratings, earnings history, and dividend history – to all types of investment assets.

And while it is not infallible, it is amazing how often these investment criteria provide fundamentally sound reasons for owning or avoiding a

particular stock, bond or any other asset class.

Mr. Horton has his own views on the subject; “when it comes to speculating, I find it time-consuming, stress-producing & ultimately unprofitable for clients & myself.” It is not something good money managers aspire to.

Having said that, clients do speculate with hard earned money. Presumably because, as the Canadian blood services advertises, “It is in you to give.” Only in this case it is in your

pocketbook.

If you find yourself pining to speculate, may we humbly suggest that you follow Ben Graham’s advice: take a small portion of your money and open a separate satellite account and trade. Or use the speculative component of your managed investment account agreement, and buy units of our Core Speculative Pool. If you want more information on The Speculative Pool ask your advisor. We expect it to begin trading in mid-January 2007.

Ticket Charges for 2007

Over the past year, NBCN has been downloading work onto our trading desk. Through this process we have tried to maintain a desk to manage the day to day trade flow, without passing on these costs to the client. What we did not want to do, nor do we ever want to do, is raise our core charges (i.e. \$500 CFG annual investment counsel fee + \$300 CCM admin / platform fee) that the client ultimately pays.

Having said that, we needed to deal with the downloads from NBCN

and the volume of transactions that have been occurring. In short, we had a problem, and we had to deal with it. After much deliberation, including discussions with clients, advisors, and NBCN, we concluded that the best approach would be for NBCN to raise their ticket charges to \$35 per trade from \$25 per trade. This change is slated to take place in February 2007. Ticket charges for client self managed satellite accounts remain at \$50 per trade.

With the increased ticket charge, NBCN will pay

CCM \$10 per trade to manage the order flow and deal with allocations to client accounts. After looking at all possible solutions, we felt this user pay model was the fairest way to deal with this. In our managed account program, the ticket charge is a flat fee per trade (regardless of the number of shares) and is still one of the cheapest no minimum ticket charges in Canada. In our managed program, fees will only be triggered when a re-balancing occurs. We believe the re-balancing has a value beyond the cost of the trade.

Experienced money managers are always trying to reduce risk by applying rigid criteria – if you follow Graham’s philosophy that would include things like credit ratings, earnings history, and dividend history – to all types of investment assets.



Could I have been blinded by eighty years of academic research? Was Harry Markowitz wrong? Has the Capital Asset Pricing Model now been debunked? Should pension fund managers move to the sidelines because asset mix no longer matters? Should we throw out university level finance courses, chastise the Chartered Financial Analysts program, ask the Canadian Securities Institute to stop promoting this “pile of bunk?”

Asset Allocation, Diversification, Efficient Frontier

None of this works according to Mr. M.V. – It is nothing but a “pile of bunk”

It was a little over ten years ago, that the Financial Post asked myself and Eric Kirzner (Value Chair at the University of Toronto, Rotman) to develop a series of indices to help investors measure their performance against a passive low cost portfolio benchmark.

What got me to thinking about this was an e-mail I received about a month ago. And as we ease out of Christmas and into the New Year, I thought what better time to revisit benchmarks, and more importantly, address some interesting issues raised by Mr. M.V. a financial advisor in British Columbia.

“Has it been ten years already?” asks Mr. M.V. “I think I became a financial advisor almost to the day you created the Financial Post Indexes (i.e. FPX Indices). I feel like they and I have grown up together.”

Having waded through the preamble, the spotlight dims, and Mr. M.V. strikes with both barrels; “unfortunately,” he writes, “the indexes are based on the faulty

theory of asset allocation. There’s some oft quoted line about 90% of returns coming from asset allocation. What a pile of bunk!”

Remember these comments are coming from the mind of a licensed financial advisor.

To support his position, he asks point blank; “Doesn’t your data prove it? You’ve now got ten year numbers and the two extreme portfolios - 70 / 30 equity / fixed income (FPX Growth Index) and the polar opposite (FPX Income Index) – have delivered to investors a difference of only 0.18% per year! Asset allocation, efficient market, wide diversification, ETFs... our industry has to get beyond this stuff, it doesn’t produce.”

Forgive me if I seem a little dazed. I need a moment to think about this. I ask myself, could I have been blinded by eighty years of academic research? Was Harry Markowitz wrong? Has the Capital Asset Pricing Model now been debunked? Should pension fund managers move to the sidelines because

asset mix no longer matters? Should we throw out university level finance courses, chastise the Chartered Financial Analysts program, ask the Canadian Securities Institute to stop promoting this “pile of bunk?”

Well before I do that, let’s examine Mr. MV’s argument, and... oh yes, respond.

For the record I appreciate MV’s passion. However, a couple of points to consider; 1) he is using a single data point to make the case that traditional portfolio models don’t produce, and 2), he is only looking at the return side of the equation.

When we talk about efficient markets we are always talking about risk adjusted return. Assets that produce higher returns over long periods tend to be riskier than lower returning assets. Stocks are riskier than bonds, bonds are riskier than cash, etc.

To measure risk, the investment industry typically uses a statistical measure known as standard deviation. In

fairness to Mr. M.V., this measure has come under some interesting scrutiny from academics in the past five years. Some experts discount standard deviation because it measures both positive and negative returns. In the real world, there is a train of thought – which by the way, I subscribe to – that the only meaningful measure of risk is the variation of negative returns. Nobody has any problem with a high standard deviation if the returns are positive. But, I digress.

For our purposes, standard deviation is an acceptable measure and it is appropriate for this discussion.

Over the past ten years, the FPX Income Index had an annual standard deviation of 5.44%, compared with 10.66% for the FPX Growth Index. Using that metric, over the past ten years, the FPX Income Index earned a return similar to the FPX Growth Index with half the risk. And since all the FPX indices are passive index based portfolio models, the difference in risk is by definition, a function of the asset mix.

If we then use M.V.'s line of reasoning, that asset mix does not

produce, why would anyone invest in the riskier portfolio (i.e. FPX Growth). If asset mix does not produce, then the expected return from either portfolio should be the same (as demonstrated in the performance over the past ten years) and therefore, no one would ever buy the riskier asset.

That is clearly not the case. Just look at the marketplace filled with investors who are constantly searching for riskier assets, in the pursuit of higher returns.

The problem with M.V.'s position, is that he is making a stance using a single data point in history. If I use that metric, then I can make almost any case using any series of data points.

For example, the FPX Indices began in April 1996. All three indices started with a base value of 1000. Three years later (April 1999) the FPX Growth Index was at 1509.73 with the FPX Income Index at 1400.34 (a difference of 109.39 points). The gap widened to 282.60 points by the five year mark (April 2001), with the FPX Income Index at 1613.97 compared to 1896.57 for the FPX Growth Index.

The performance between polar opposite portfolios narrowed when equities fell prey to the second longest bear market in history, and the worst bloodletting in stock values since the 1970s.

And by the way, if we examined the difference in the returns of polar opposite portfolios during the 1970s, I suspect we would see results similar to what we saw with polar opposite FPX indices over the past ten years.

Having said that, there would have been wide gaps in the performance of polar opposite portfolios during the 1980s and 1990s. Over that twenty year period, the Dow Jones Industrial Average advanced 1100% from 1000 in 1980 to 11,000 by 2000. Even the S&P TSX composite index, weighed down by oil and commodity stocks, rose more than 600% during that same twenty year bull market. Bonds also had decent returns during this period, but they paled in comparison to the equity freight train.

Perhaps rather than trying to de-value the role of the asset mix, we would be better off trying to understand why

Over the past ten years, the FPX Income Index had an annual standard deviation of 5.44%, compared with 10.66% for the FPX Growth Index. Using that metric, over the past ten years, the FPX Income Index earned a return similar to the FPX Growth Index with half the risk.



1315 Lawrence Avenue East,
Suite 408
Toronto, Ontario,
Canada
M4A 1R9

Phone: 416 752 7991
Fax: 416 752 4895
E-mail:
rcroft@croftgroup.com



WWW.CROFTGROUP.COM

A Pile Of Bunk...

Continued from previous page

the gap in performance of polar opposite portfolios was so narrow during the past decade.

The most obvious reason was the hit stocks took during the bear market. Less obvious, was the stellar return that bonds produced during this period, as interest rates fell from more than 10% to less than 4%.

The real question is this; do you think that bonds will produce the same kind of returns over the

next ten years. For that to happen, interest rates would have to fall to the 1% level.

For rates to get that low, inflation would have to be in negative territory which would imply a depression.

Personally, I think the economy will likely grow over the next ten years with some obvious bumps along the way.

I think a more likely scenario will see a return

to the norm, where higher risk assets produce superior returns. In that environment, a 70% / 30% equity / fixed income mix, will do much better than a 30% / 70% fixed income / equity mix.

But that too will take us full circle, and back to the real issue; will the higher risk portfolio produce better risk adjusted returns. Something we always strive for.

Your Pool Calculator is Now Available

Know what you own inside your pool

Want to know what you are holding inside your new Corporate Share Classes? Just go to our website **Calculator** and you can find the answer.

When visiting our new expanded website click the Corporate class logo on the Home Page.



Corporate Class

That will take you to our new **Custom Portfolio Pools** page, which has a PDF version of the Corporate Share Class Offering Memorandum and the **Calculator**.

Click the **Calculator** and it will take you to a pull down menu.

The pull down menu on the left will ask you to click on the Pool that you own.

The right pull down menu will ask you to input the number of

shares that you own. The **Calculator** will then display a page that will show your pro-rated ownership of all the securities that are currently in that pool.

The security list is updated weekly, if there have been changes inside the pool.

