

PORTFOLIO MATTERS



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Shanghaied?

Big picture risks needn't mean big picture headaches

Mark February 27th, 2007 on your calendar. The day China's Shanghai Composite Index tumbled 8.84 percent. For the record that is the largest one day decline in this market in a decade. More important than the size of the decline – 5% declines are not uncommon in this market - was its impact on the rest of the world.

For clarity, it is important to recognize that not all Chinese stock markets panicked on February 27th. You might even argue that in the region, Shanghai was the exception rather than the rule. A case in point, Hong Kong's blue-chip Hang Seng Index lost just 1.8% on the day.

So what is the domestic Chinese (i.e. Shanghai) stock market?

According to Jim Jubak of MSN Money, “the Shanghai stock market

is essentially a domestic market for the A shares of China's publicly traded companies: Overseas investors are by and large not allowed to buy and sell A shares (although the rules have been relaxed a bit lately).” The domestic market is made up of roughly 82 million Chinese investors or out of every twenty Chinese citizens.

So what we witnessed was a mixture of naive investors getting their first taste of the fruits of capitalism. The Shanghai Stock Market has become, writes Jubak, “a stock speculator's wildest dream come true, with that speculator's worst nightmare waiting in the wings.” So much so that according to a recent study by J P Morgan Chase, of thirty seven Chinese companies listed on both the Shanghai and Hong Kong stock exchanges, eight traded in Shanghai at twice the valuation

they had on the Hong Kong exchange.

The Chinese domestic market is supported by a sizeable individual investor base, who has access to easy money, is driven by irrational expectations while chasing a limited number of stocks. Not to mention the Chinese government, which at last count, owned the majority stake in most if not all publicly traded domestically listed companies. In retrospect the Shanghai Stock Market was at best, a frothy market in need of a healthy correction, at worst, a “rigged game.” Most likely, a bit of both.

Most analysts agree that the Feb 27th decline was orchestrated by the Chinese government. Perhaps with the best of intentions. According to John Maudlin of www.investorinsight.com, “the Chinese government was become



What's interesting says Mauldin, is that the "glut in [so-called] investment money drives up the cost of commodities and adds industrial capacity without actually producing anything of much use.

increasingly concerned about levels of investment in its economy or, more accurately, the sheer amount of money that is chasing projects. State firms with limitless access to subsidized capital from state banks have used that access to launch thousands of nonprofitable firms."

What's interesting says Mauldin, is that the "glut in [so-called] investment money drives up the cost of commodities and adds industrial capacity without actually producing anything of much use. In the end making life more difficult for the average Chinese and unduly harming relations with foreign powers that face a glut of otherwise noncompetitive Chinese goods."

So we end up with stock values that bear no relationship to the fundamentals. Not that China is the only market to experience excess valuations... remember the 1990s internet craze or the 15 year Japanese bull market that ended in 1989?

Much like Japan, we are seeing supposedly blue chip Chinese banks trading at price-to-earnings ratios well above blue chip names like Deutsche Bank and Chase. Can

you say excess? How else can you explain this unbridled enthusiasm for banks with woeful management, and a history of highly questionable lending practices.

To China's credit the government took notice. On February 26th, write Mauldin, "China's State Council launched a new special task force that accurately could be referred to as the get-those-idiots-to-stop-borrowing-to-gamble-on-the-stock-exchanges team. Its express goal is to get the Chinese domestic security brokers to lay off such speculative decision-making, while also putting a crimp in the source of the subsidized capital."

In the West, we would expect it to be some time before a new committee would have an impact. But in China, results were immediate, which is understandable when you recognize that the government controls more than half the outstanding stock and therefore, controls supply and demand. If the Chinese government wants to take a shot across the bow - which is exactly what it did on February 27th - it simply sells more shares than the market can support.

The problem, which I doubt the State Council anticipated, was the impact it would have on international markets. Writes Jubak, "China has become a trendsetter in the global stock community." Whereas historically, the U.S. exchanges or EAFE set the tone for global trading patterns, you can now add China into the mix. And for the first time, global investors will have to deal a government that has a history of making domestic policy - on political and economic issues - with little regard as to how it might impact the rest of the world.

Mind you, that could change. It is always easier to make decisions in a vacuum. But with Chinese market capitalization around US \$1.3 trillion, the Chinese wall that protected international exchanges from Chinese policies is gone. February 27th was simply the exclamation point.

If China really believes that domestic growth is a serious domestic threat, then the Chinese government will take whatever action is necessary to slow things down.

Look for more so-called shots across the bow, because the initial shot provided only a

temporary reprieve as the Shanghai market actually ended higher on the week.

Maudlin sees two potential problems; The rest of the world “is going to chew on the fact that Beijing did this intentionally. They will either agree with the Chinese that the exchanges are overvalued and that additional measures are needed, or they will be

terrified that Beijing did this intentionally and not care about the reasons.” I lean more to the former than the latter.

Secondly, “trading in 800 of the 1,400 stocks on the Shanghai exchange was suspended during the sudden drops of Feb. 27.”

They did not necessarily succumb to the sell-off. Does that mean they will

have their day in the rain, or has the recovery of last week, dampened the risks of further decline. We will see.

Of course for those of us who believe in the portfolio approach, global actions are less likely to drive us to make wrong decisions.

We can read about the risks, but don't have to experience the full brunt

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Is Google The New Microsoft?

Is the search engine to the Internet what Windows is to the PC?

Google is growing earnings at twice the rate of Microsoft according to recent earnings numbers. Reminiscent of the earnings numbers that Microsoft churned out in the 1990s. Numbers that over time made Microsoft the world's largest company by market cap.

With Google close to \$475 per share (all prices and values in US dollars) and more than \$150 billion in market cap, it got me to thinking about the similarities with today's Google and the early days of Microsoft. More importantly, from a macro basis, what that might mean to the technology sector going forward. So is Google the new Microsoft?

I recall back in the early nineties, when Windows 3.0 revolutionized the desktop, by bringing point and click to the PC world. Something I might add, that Apple customers had been using for some time.

For the PC though, it was the move to GUI (graphical user interface) with the release of Windows 95 that delivered a near death blow to Apple.

More interesting than the battle for desktop supremacy was the impact Windows had on other software companies.

In the late 1980s, Word Perfect was the word processor of choice, Microsoft Word was a distant second. Lotus

was the dominant desktop spreadsheet software, excel was not even in the game.

The Windows operating system provided Microsoft with a seamless platform on which to market their products and one by one, software makers fell by the wayside. The point is, Microsoft's control of the PC desktop allowed it to control the delivery of desktop software solutions.

I even recall how Microsoft was slow to pick up on the potential of the Internet. Before Mr. Gates could turn his attention to the subject, Netscape had entrenched itself as the favourite portal to the Internet. But again, this was a soft-

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The comparison between Google and the early days of Microsoft begins with an understanding of platforms. Is the search engine to the Internet, what the desktop is to the PC? If it is, then does the best search engine control the platform, in much the same way as Windows controlled the desktop?

ware solution to get someone from the desktop to the internet seamlessly. It did not take long for Microsoft to launch Internet Explorer which to no ones surprise, worked better than Netscape on the Windows platform. Not to mention the fact that Internet Explorer came at no cost to the user, and was embedded as part of the Windows package. The rest is history.

What's interesting, is that Microsoft has not been nearly as powerful a competitor without the advantage of a platform. For example, MSN.com while successful, is not dominant on the Internet. Xbox 360 is still not a profitable division and remains well behind industry leaders like Sony and Nintendo. Microsoft's Zune music player came out in mid-November to soft reviews, and is struggling to meet its goal of one million units by June 2007.

I raise this, because as investors, we need to recognize that size does not by itself, make a formidable competitor. Especially in an environment where size does not control the platform.

So we come full circle to

Google. The comparison between Google and the early days of Microsoft begins with an understanding of platforms. Is the search engine to the Internet, what the desktop is to the PC? If it is, then does the best search engine control the platform, in much the same way as Windows controlled the desktop? And finally, if one has a superior search engine – which most users concede Google does – does that open the door to other markets, in much the same way as Windows opened the door for Microsoft Office and Internet Explorer?

We are already seeing the impact on direct competitors such as Yahoo! Inc, AOL and MSN. All of which have been losing market share and advertising revenue to Google.

Other markets that Google is just beginning to tap remind me of the markets Microsoft began to tap when it released Office. Think about the possibilities for Google. Take eBay as a case in point.

Could Google develop an auction based business that competes with eBay, by driving customers to its auction site using its superior search

engine? Further, does an auction based site with a superior search engine give users a superior online experience? If the answer is yes, then eBay begins to look a lot like WordPerfect and the results could be the same.

What about Google's online marketplace? Will that compete with Amazon.com? And again, are there advantages to having a superior search engine at the front end of the site, just as Windows sat at the front end of excel. Does Amazon.com become the Internet's version of Lotus?

What about Google's acquisition of YouTube? Could this be a death blow to network television in much the same way as Internet Explorer was to Netscape?

Even Bill Gates sees the potential of online video content. At the world economic forum, Gates talked about how, within five years, the Internet will revolutionize TV, due to an explosion of online video content and the merging of PCs and TV sets.

Says Gates, "I'm stunned how people aren't seeing this. Five years from now, people will laugh at what we've had."

The rise of high-speed Internet and the popularity of video sites like Google's YouTube has already led to a worldwide decline in the number hours spent by young people in front of a TV set.

Gates believes the trend will continue as viewers embrace the flexibility offered by online video. Being able to choose which event or program to watch, while abandoning conventional broadcast television, with its fixed slots and advertisements that interrupt shows. The best example of this is the Olympics, where traditional broadcasters move from event to event. With online content, you can choose what to view and when to view it. Advertising does not interrupt your viewing experience, and

advertisers need only pay for results, based on users who click their ad.

There are other areas where Google may not fare as well. In much the same way as Microsoft's lukewarm performance in businesses that were not tied to its operating platform.

Google for example, is offering free versions of internet based word processing and spreadsheet solutions. There are possibilities with this, in much the same way as there were possibilities with Sun Microsystems Java. But Google's search engine adds no real value in a space dominated by Microsoft.

If Google is the new Microsoft, then Google's meteoric rise may only be the beginning. When

Microsoft came public a mere twenty years ago (March 13th, 1986), its' stock was priced at US 9.722 cents per share (after adjusting for all subsequent stock splits).

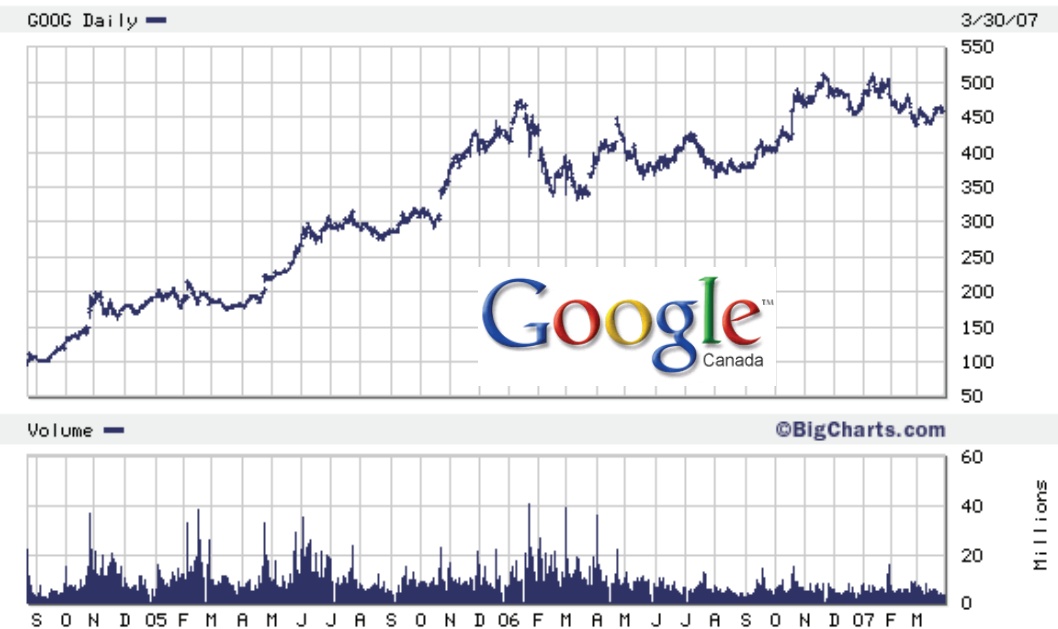
Even with the ups and downs through the technology bear market, Microsoft has returned more than 30,000% since inception, not including dividends. Put another way, it has returned more than 31% compounded annually, again, not including dividends.

Google is up 375% since it came public on August 19th, 2004 at \$100 per share (there have been no stock splits).

If you look at the Microsoft's metrics, and if the similarities are real, US \$475 per share may be a bargain.



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We maintain a historical performance database on all three FPX indexes on our website under "Benchmarks." Use the calculator to calculate the return of any of the FPX indexes, over whatever time period you choose. You can get performance data as a compound annual return or a total return

A Spring Ritual FPX Rebalancing

The FPX Indices version of April Fools

Fear not, spring is on the way. This winter, like the stock market generally, has been unseasonably warm and long. But a warmer spring will come soon, along with its spirit of bringing in the new and, perhaps, cleaning out the old.

Since 1997 the FPX indexes have stood the test of time as portfolio benchmarks. There are three model portfolio benchmarks, the FPX Income Index, the FPX Balanced Index and the FPX Growth Index.

If you follow these portfolio benchmarks, you know that on April 1st we rebalance the indexes back to near their target weights. The goal is to bring it back into line from deviations caused by fluctuations in market values. We say 'near' to the target weights because the reallocation is not precise. We do not, for example, purchase fractional shares, bonds or units.

Why is an annual rebalancing necessary? There are really two answers to that question: a simple one and a more complicated one.

The simple reason is that

over time the cash, fixed income and equity asset classes move at different speeds, and sometimes even in different directions. At the end of the year, then, one asset class may have a disproportionately large representation in the portfolio, while another has too little. Rebalancing the indexes back to their original percentage weightings is akin to lining up the horses at the starting gate before the next race begins.

The more complex reason, for rebalancing the FPX indexes in particular, comes from the reason they were created in the first place. They were designed as investable, diversified, passive and realistic portfolios with an assumed portfolio size of \$100,000, which was at the time they were created, representative of the average investment portfolio held by Financial Post readers.

More importantly, they were designed as a benchmark against which an investor could measure the performance of their investment advisor, portfolio manager, or even themselves. The

portfolios must be reset, then, to provide a consistent benchmark for measuring the performance of alternative approaches.

This year, the rebalancing of the three portfolios will mean increasing the amount of fixed income securities held in each, and decreasing the equity component. Think about that for a minute. We are going to sell from the asset class that has done well, and buy the asset class that has done relatively poorly. In other words, we're going to sell high and buy low.

What active portfolio managers call dynamic asset allocation and some investors call the contrarian method is, in this passive portfolio case, nothing more than a simple rebalancing. It is not meant to be a recommendation. Although, if you feel that this is also a very wise move at this point in the market (and you may be right), the FPX indexes can serve as your benchmark a year from now to see if you were right. Just remember, this rebalancing is a reaction to the past year's market, not a suggestion for next year's.

What's Better?

Low risk value stocks, or high beta covered call writing candidates

When building portfolios, most money managers prefer to employ a value approach to investing. Buy good quality well managed companies that pay a dividend. And try to buy them at a discount.

There is merit to this approach, although some would argue that such a strategy can lead to lengthy periods where portfolio returns are

dividend payout) and none that have done much lately for long term investors (see figure 1).

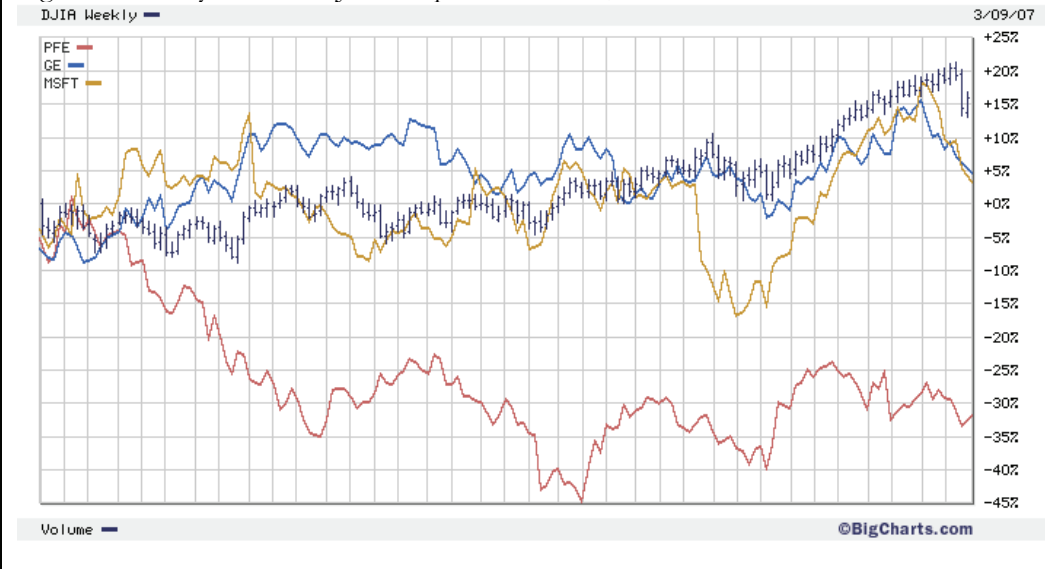
The problem with value stocks is that there is very little volatility, which presumably, is why you buy them. But low volatility also means low option premiums. Because options are priced based on the volatility of the underlying stock.

Some would argue that cash flow from the option premiums is worth more than the dividend income. Especially for Canadian investors in US stocks. The premium income is taxed as a capital gain, while dividends from US companies do not receive any preferential tax treatment.

Clients have personally experienced this through

There is merit to the concept of value investing, although some would argue that such a strategy can lead to lengthy periods where portfolio returns are dampened.

Figure 1: Three year chart DJIA compared to MSFT, GE and PFE



dampened. Names like Microsoft (symbol MSFT), General Electric (GE), and Pfizer (PFE) come to mind. All excellent companies, paying good dividends (I am counting Microsoft's special dividend as part of their two year

Another approach that we look at stocks that are more volatile, but also have higher option premiums. At least with higher option premiums, you can write covered calls and collect income while you wait.

their managed portfolios. At least with high beta stocks (another word for more volatility) I have - excuse the pun - options.

Take the Chicago Mercantile Exchange (symbol CME, recent price US \$567.96) as a



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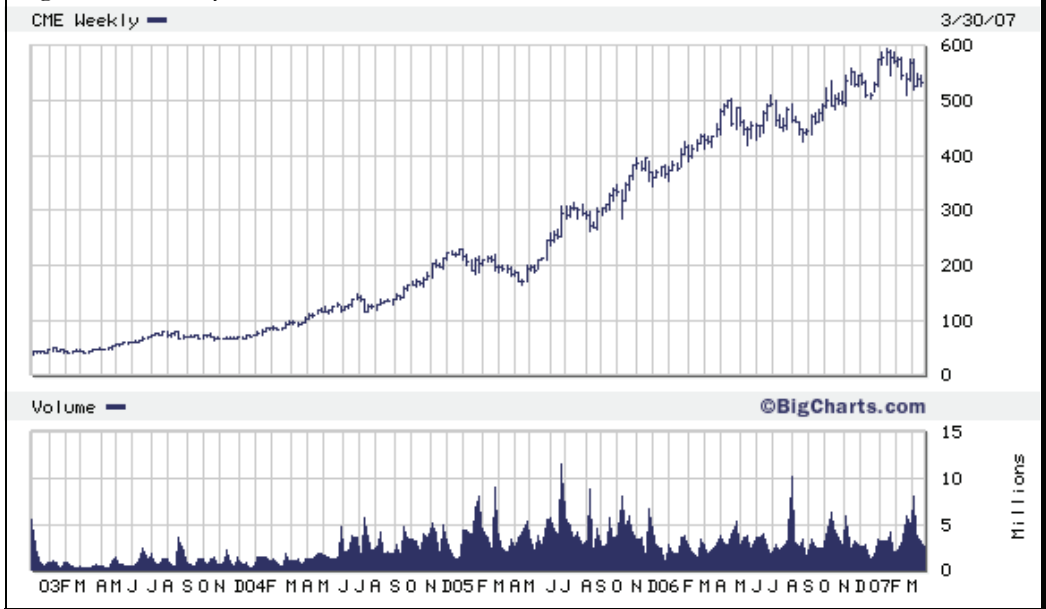


case in point. The stock, like most of the publicly traded stock exchange groups, has been a serious mover in the last couple of years. Both up and down, more down in the last few weeks (note from figure 2).

sold, that was eventually assigned. Notice from figure 2, that at that price, we bought near a recent high. Although the premium from the put sale made our adjusted cost somewhat lower.

I have had similar experiences with stocks like the New York Stock Exchange Group (symbol NYX), the Nasdaq Stocks Market (NDAQ), Google (symbol GOOG) and Goldman Sachs (GS).

Figure 2: Three year chart of CME



From a value manager's standpoint, it is difficult to justify an investment in a high priced stock. High priced, in terms of its price to earnings multiple. On the other hand, the volatility has made it an excellent candidate for covered call writing. Even if you bought prematurely, as in just before it started to decline.

I purchased CME recently in our corporate share class Equity pool at a cost of US \$600. The purchase was the result of a \$600 put option we

Since then, we have written two consecutive call options, both at lower prices, and have reduced our out of pocket expense for the stock to the US \$550 range. It may or may not get called away at US \$560 in March, which is the option we are currently short. But even at that price, I have made a return that beats most value managers holding so-called value stocks that are simply trading water and paying dividends.

All purchased at what would be considered higher prices, but all with cost bases that are below current prices.

The point is, covered call writing allows us to deal with volatility in a meaningful way. With most low volatility value stocks, that is not, pardon the pun, an option.

So for us, it makes more sense to build stock portfolios with a back up plan. In our case, the back up plan is covered call writing.