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# Markets searching for a bottom

By Richard Croft and Mark Taucar

Mad as a March hare. That pretty well describes stock markets in the final weeks of the first quarter. All the major markets rallied to end the month with a gain, though not enough to climb out of the hole for the first quarter.

So what happened? Did someone ring the proverbial bell and declare the bear market at an end? Was it because US President Barack Obama said it was now a good time to buy stocks? Or was it because Citigroup Inc. said that it was profitable in January and February, raising hopes that it might actually eke out a profit in the first quarter? Maybe it was because Standard & Poor's downgraded General Electric Co. less than had been expected, to AA+ from AAA.

Those may have contributed to the rallies, along with a slightly more encouraging retail sales report that indicated better-than-expected consumer spending in the first two months of the year. Whatever the immediate reason, investors staged a buying spree and brought a little respite

to markets, which seemed to have come to expect steady decline as the natural state of affairs.

But is the stock market floating on hot air? Many observers believe that it is, given that most of the big global stock indexes advanced handsomely through March, mostly on expectations. But the stock markets

are, of course, all about expectations.

What seemed to propel investors into a month of buying in March was the expectation that plans by governments and central banks around the world, but mostly in the US, to thaw credit markets and put a floor under falling gross domestic

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**CHART 1—S&P 500 COMPOSITE INDEX, 3 MONTHS**



Courtesy BigCharts.com.

**CHART 2—S&P/TSX COMPOSITE INDEX, 3 MONTHS**



Courtesy Globeinvestor.com.

product would actually bear fruit. By, in essence, printing money to rescue failing financial institutions and engaging in a program of deliberately massive deficit financing, governments hope to avoid the worst of all possible financial scenarios – a deflationary depression.

And through March, governments around the world jumped on the “stimulus” bandwagon, tooting their horns and thumping their tubs, and generally throwing coins to the masses as the parade rolled by.

The whole gaudy spectacle culminated in the now long-forgotten Group of 20 economic summit photo-op in London, where the communiqués flew thick and fast and blinded many a poor reporter in a blizzard of econo-bafflegab.

One of the biggest bits of Barnum & Bailey hucksterism came in the form of a pledge to quadruple the financial capacity of the 185-nation International Monetary Fund to – believe

it or not – US\$1 trillion. This is designed to head off financial crises in developing nations, presumably because of the IMF’s “stellar” record of doing so since its creation in 1944. Along with this boost to its balance sheets, world leaders agreed that the IMF should monitor whether G20 nations are engaging in enough “stimulation” and whether they are interfering sufficiently in the workings of their private markets.

Another resolution in principle would authorize the IMF to provide early warnings about incipient financial crises (we imagine that crystal ball manufacturers somewhere are now happily dusting off their order books).

And in a sop to China’s demands for a new world reserve currency, the IMF plans to ramp up its program of “special drawing rights,” a kind of IMF bank draft that can be exchanged for hard currencies or assigned by holders to basket-case nations unable to manage their own finances.

Other G20 declarations and resolutions call for a gen-

eral tightening of financial regulation, including domestic registration and oversight of hedge funds, a plan that is sure to have fairly significant unintended consequences down the road – mostly involving the evisceration of the hedge fund business and a dilution of its influence on global markets, which is probably the intention of G20 governments – at least of the European and some Asian members, anyway.

**Promises, promises**

In fact, the promises, declarations, and agreements in principle of G20 communiqué, as with so many high-minded resolutions born of grip-and-grin photo opportunities, depend on vague accords, agreements, and domestic plans to be resolved sometime in the future.

Still, markets appeared to take heart from even these gaseous effusions.

It’s instructive to take a quick peek at the behaviour of investors during market downturns. Oddly, bear markets tend to be characterized by lower overall volume (see Chart 3), almost as if the market auction process has been abandoned, as sellers will take any price from the dwindling, and largely unenthusiastic, pool of buyers. Then, by some mysterious process, at a certain level – often called a “support” level by technical analysts – buyers become interested again and begin competing with each other for any stocks that are on offer, bidding up prices as a result. Not only are prices bid up, but more shares change hands – that is, volume increases. Technical support and attendant increases in volume tend to occur at key junctures in trading cycles. And they always occur at bear market bottoms.

Alas, such phenomena are evident only when plotted on a timeline and viewed in hind-

**CHART 3—DOW JONES INDUSTRIAL AVERAGE, 10 YEARS**



sight. But the trend is remarkable in its consistency. In the accompanying graph of the Dow Jones Industrial Average, for example, you can see it developing in the 2000-02 bear market.

Trouble is, the market rallied after just such a spike in volume in late 2001, only to slide to a new low – which turned out to be the real bottom – about a year later. We've seen the same thing happening with this bear market, as each successive support level is pierced in short order, followed by a new low at a new support level. The spikes in volume over the past weeks are particularly noteworthy, however, if only because of their frequency, and could herald something other than just another stopping point on the down elevator.

### Risk appetite

More rallies are not out of the question at this stage, with investors looking for any excuse to exit dicey bond positions and buy back into stocks at bargain prices. The big question is whether stocks are, in fact, bargain-priced. By some estimates, S&P 500 earnings for 2009 are down to around US\$64, from about US\$113 a year ago. At a recent close of around 757, that gives the S&P 500 a price-earnings multiple of around 12, almost spot on its historical average. So, apparently no bargain there yet.

At a "bargain" multiple of, say, 10, with recent forward estimates, the S&P 500 would have to drop to 640, a further 15% decline from current levels. A recently revised bearish estimate from Goldman Sachs, however, puts forward S&P earnings at US\$40, for a p/e multiple of about 19 at current levels –

obviously way too high. Adjusting for a "bargain" p/e multiple of 10, Goldman's estimate implies an S&P level of 400, down 47% from recent levels!

We'll never say "never," because that would be tempting fate. But it does seem highly unlikely that we'd see the S&P collapse to 400. It would be a 74% drop from its high in July 2007. And it would probably be the end of the world as we know it.

### A long finish

Though we believe the market is bottoming, we've said this would be a long and arduous process, full of danger and volatility. It's going to take some time before the tsunami of newly minted money reflate the economies of the world (and, incidentally, in the process triggers a whole new set of problems). But eventually it will happen, and we believe we'll see the first indications of this in the second half of this year.

In the meantime, credit problems continue to bedevil the global financial system, as the London Interbank Offered Rate (Libor) remains elevated. The high cost of interbank lending indicates a degree of risk in credit markets. Indeed, the anxiety surfaced in the geopolitical sphere, when China's Premier Wen Jiabao publicly expressed concern about the safety of US debt, given the Obama administration's early proclivity towards free-form spending and preposterously large fiscal deficits, which it is financing by issuing mountains of new bonds.

China is the US government's largest creditor, holding US\$696 billion in US Treasury debt at the end of

2008, or about a fifth of total foreign US debt. Naturally, it's concerned about the solvency of its largest borrower. US administration officials rushed to assure the Chinese Premier and any other interested parties that all was well with the world and that US growth would resume shortly – all those wind turbines, carbon cap and trade systems, new taxes, regulations, playgrounds, town halls, and alternative theatre groups are sure to do the trick, this time.

Though the gasbags in London helped float stock markets with great G20 expectations through the March rally, there were a few other more tangible signals that contributed to the markets' raised expectations.

### Meaningful metrics

The Institute for Supply Management reported that its US manufacturing index increased in March for the third consecutive month, to 36.3. While still well below a reading of 50 that would indicate expansion in the sector, the pace of contraction has slowed, as businesses draw down inventories and prepare to start the assembly lines again.

The ISM's new order index rose 25%, a trend confirmed by the Commerce Department report that new orders for manufactured products rose 1.8% in February. The Commerce Dept. also reported a 3.5% gain in durable goods orders.

Other economic metrics that have recently showed less-bad-than-expected results included consumer spending, consumer confidence, retail sales, and auto sales. In the all-important



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housing sector, there appeared to be glimmers of hope as both existing and new home sales posted increases in February, signaling that prices may have sunk low enough (down 19% in January) – and that credit is becoming more available – to begin attracting buyers in meaningful numbers again.

In China, the CLSA Purchasing Managers Index fell to 44.8 in March, down from 45.1 in February, the eighth straight monthly decline. However, China’s housing market showed signs of life as both home sales and construction starts advanced in the first two months of the year, as buyers begin to take advantage of low prices and falling mortgage rates.

**Remaining risks**

Despite all the expectations driving the markets through March, a number of significant negatives still exist on the liability side of the ledger. These have not just simply evaporated and cannot just be wished away.

Slumping world trade is

a major negative that is expected to persist through the rest of this year, as the global economy shrinks. The Organisation for Economic Co-operation and Development (OECD) expects the global economy to contract 2.75% this year. The US is into its 17th month of official recession, as unemployment rises relentlessly, jumping to 8.5% in March.

**Deflation lurks**

And deflation still lurks as a threat, especially in Europe, where just about every economic indicator from industrial production to unemployment rates to exports signal that the severe recession continues. Bowing to these realities, the European Central Bank cut its key interest rate to 1.25%, and is setting the stage to follow the UK and the US with a policy of quantitative easing – that is, massive reflation.

Then, of course, let’s not forget those all-important credit spreads. Despite all the huffing and puffing in London, there wasn’t much easing to be seen in the TED Spread, which measures the gap between 3-month Libor

and the 3-month US Treasury bill rate. The TED Spread is often used as a gauge of risk. Though down from recent extraordinary highs, it’s still about twice its historical average of about 0.5% (see Chart 4).

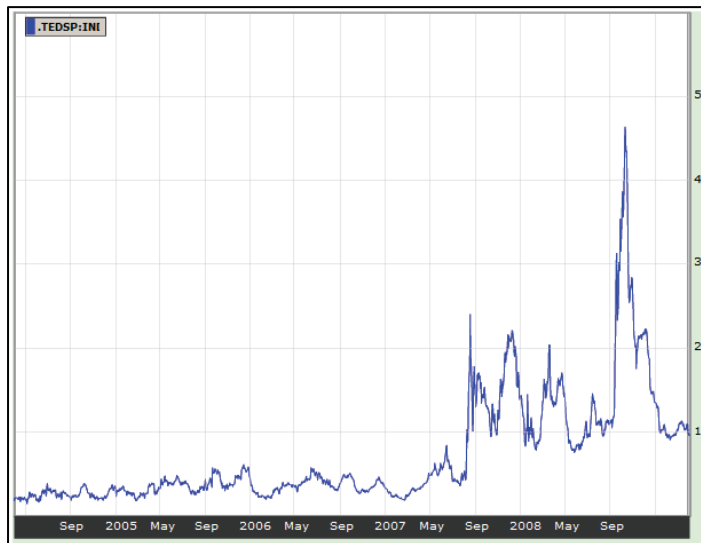
Those negatives will doubtless reassert themselves another day. For now, investors can revel in the fact that stock markets have had their best four-week run in a long, long time, as investors tested the waters for more risk. Indeed, by the end of the first quarter, the Dow Jones Industrial Average had posted its best four-week run since 1933 with a 21% advance. The DJIA posted a 7.7% advance on the month, but still ended the first quarter down 13.3% for the year to date (in US\$).

By the end of March, the S&P 500 Composite Index had trimmed its year-to-date loss to 6.7% (in US\$). The broad large-cap index recorded an 8.5% month-over-month gain in March, but still ended the first quarter with an 11.7% loss.

And in as harbinger of spring, Toronto’s resource and financial-heavy S&P/TSX Composite Index advanced 7.4% month over month in March, but also ended the first quarter with a year-to-date loss of 3%.

Volatility will remain elevated as this bear market bottoming phase continues. As a consequence, we’re likely to see the markets gyrate through rallies and selloffs like these for a few months yet. In the meantime, keep the ballast handy. ■

**CHART 4—TED SPREAD, 5 YEARS**



Courtesy Bloomberg LLP

# Sector reviews

## Income

Governments and central banks around the world expanded their efforts to thaw credit markets through the first quarter, using a wide array of fiscal and monetary tools. The Bank of Canada cut its target for its benchmark overnight rate by 50 basis points, to a record low 0.5%, in March. Since December 2007, the BoC has cut its key rate by 400 basis points, and indicated that its target rate would remain at least at this level until there are clear signs that excess supply in the economy is beginning to tighten up, and that total CPI inflation is returning to the 2% level.

More importantly, however, the BoC indicated that it will provide additional monetary stimulus if required. With its target rate near zero, the Bank said it would resort to "quantitative easing" to inject more money directly into the banking system. This entails expanding the BoC's balance sheet to buy assets directly in the market, including government and corporate bonds, and asset-backed securities. The purchase of long bonds would have the effect of pushing down yields as prices rise on dwindling supply.

The iShares CDN Bond Index Fund, which tracks the DEX Universe Bond Index, ended the first quarter flat on a quarter-over-quarter basis. Similarly, the S&P/TSX Preferred Share Index gained 1.2% in the first quarter, as Canadian bank and other preferred dividends remained stable.

## Canadian equity

Large-cap Canadian stocks ended the first quarter just about flat, following a turbulent three months of trading that saw the S&P/TSX 60 Index touch a 52-week low of 451.61, before staging a rally that saw the index end the quarter with only a 2.4% loss from the end of the previous quarter. The Dow Jones Canada Select Growth Index gained 2% over the same period, while the Dow Jones Canada Select Value Index finished the quarter just with a 4.2% loss.

Heavily weighted to the both financial and resource issues, Canada's large-cap index reflected investor anxieties in both of these sectors. Canadian financials were buffeted by headwinds generated by the fragile state of the US financial sector, where both the US Federal Reserve Board and the new White House administration raced to devise plans to stimulate the economy and relieve troubled banks of the overhang of unsalable assets that are dragging down balance sheets across the board.

Though Canadian banks' capital positions have not been eroded nearly as badly as their US counterparts, plenty of exposure to bad debt remained, but is not expected to exceed historic levels. Indeed, each of Canada's five big chartered banks posted positive earnings in the first quarter, although concerns remain about the extent of loan losses in coming months as well as the value of off-balance-sheet conduits.

Resource issues also helped buoy the large-cap in-

dex in the first quarter, as energy, precious metals, and base metals prices firmed in a largely sentiment-driven response to early fears of resurgent inflation arising from the US government's trillion-dollar deficits and the Fed's aggressive program of quantitative easing. Underlying fundamentals did not yet indicate any significant growth of commodity demand, especially from Asia, and thus the first-quarter Canadian large-cap index performance remained muted.

## US equity

Business conditions in the US remained under severe stress through the first quarter, as credit remained tight and demand continued to slide. A steady downward spiral of earnings estimates pushed the S&P 500 Composite Index down through the first quarter, to a new 52-week low in early March, breaching even the previous 2000-02 bear market low. The S&P ended the quarter with a 9% quarter-over-quarter loss (in C\$). Facing the same headwinds, the Russell 1000 Value Index lost 8.5% (in C\$) in the quarter. Indeed, all the major style and capitalization indexes ended the first quarter with a loss from the end of the previous quarter.

A host of deteriorating economic and financial fundamentals contributed to the markets' slide in the first three months, including severely depressed manufacturing, sharp increases in unemployment, and unresolved balance sheet problems in the banking sector.

Equity markets firmed up through March as early signs of an end to the financial crisis began to appear, includ-



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**“Although emerging nations across Asia have cut interest rates and rolled out significant fiscal stimulus, significant systemic risks remain.”**

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ing rising oil prices, and unexpected increase in durable goods orders, and a slow-down in the rate of decline in US house prices.

Markets were further buoyed into a strong rally late in March on the Treasury Department’s announcement of a US\$1 trillion public-private plan to clean up toxic assets weighing bank balance sheets. However, systemic risks remain high, as global demand remains depressed and credit markets remain frozen. Other risk factors include the potential inflationary effects of aggressive monetary easing and the estimated decade-long fiscal deficits.

### **International equity**

Facing a deepening global recession, stock markets in Europe and Asia came under heavy selling pressure and ended the first quarter with further losses. The MSCI Europe, Australasia & Far East (EAFE) Index posted a 12% quarter-over-quarter decline (in C\$) in the first quarter, led by financial stocks, which faced increased weakness owing to the weight of toxic assets that still clogged up the balance sheets of many of the largest European banks. The MSCI EAFE Growth, Value, and Small Cap indexes all suffered similar declines in the period.

While governments and central banks in the European Union followed US policies in bailing out tottering financial institutions with various loan guarantees and direct asset purchases, economic fundamentals continued to deteriorate across the region, with waning exports, crumbling industrial production, falling domestic spend-

ing, and rising unemployment rates.

Both the European Central Bank and the Bank of England have slashed their benchmark administered rates to historic lows, while the BoE also implemented a seldom-used program of “quantitative easing.”

The world’s second-largest economy, Japan, slipped deeper into recession in the first quarter and edged closer to the brink of deflation as consumer price inflation dropped to zero and retail sales fell further than expected in February. The slump in world trade has wreaked havoc on Japan’s export-reliant economy, as February exports dropped an astonishing 49% from the previous year, the fifth consecutive monthly decline. Although the Bank of Japan jumped on the quantitative easing bandwagon, with interest rates near zero and political gridlock impeding a speedy fiscal response, the Japanese GDP outlook remained grim for the first quarter, and weighed heavily on every country in the tightly interlocked Asia-Pacific area.

### **Emerging markets**

The MSCI Emerging Markets (EM) Index ended the quarter with a 3.4% quarterly advance (in C\$) from the fourth quarter of 2008. Stock markets in emerging markets generally outperformed those of the industrial world (generally, markets comprising the 30-nation Organisation for Economic Co-operation and Development). Individual stock markets in Brazil, Argentina, China, and Taiwan, for example, finished the quarter well into the black, while

their large European and US counterparts sank into the red by double-digit amounts.

This apparent decoupling of global stock markets through the first quarter can be attributed to growing investor interest in the export- and commodity-based economies of developing nations, which historically have staged strong rallies at the early signs of economic recovery. Oil and base metals showed indications of finding a price floor in the first quarter as inventory overhang began to be worked off, while prospects for new supply remained constrained by the negative impact of the global recession on capital spending, exploration, and development in the resource sector.

Although emerging nations across Asia have cut interest rates and rolled out significant fiscal stimulus, major systemic risks remain. These include further deterioration in global trade, which is expected to drop 9% in 2009, according to the World Trade Organization, as well as the considerable savings imbalances that still exist between developing Asian nations, particularly China, and the US.

In China, the world’s largest emerging market, the economic outlook remained uncertain in the first quarter, as manufacturing continued to shrink, albeit at a slower pace. In addition, China’s trade surplus fell to the lowest point in three years in February, as merchandise exports plummeted over 25%. Despite aggressive monetary easing and major fiscal stimulus, the economy remained under pressure. In addition, February consumer prices fell 1.6% from a year earlier, the first such decline in six years, sharpening anxieties about a potential

deflationary cascade through the Asia-Pacific region.

### Alternative strategies

Both commercial and residential real estate remained under pressure through the first quarter. The global credit crunch, the deepening recession, and plummeting commercial real estate values weighed on the values of real estate investment trusts in North America and abroad. The S&P/TSX Capped REIT Index dropped 10.7% in the first quarter.

Commodities, especially the key energy and base metals sectors, showed indications of finding a price floor in the first quarter as inventory overhang began to be worked off, while prospects for new supply remained constrained by the negative impact of the global recession on capital spending, exploration, and development in the resource sector.

A renewed interest in both food and energy commodity groups provided a measure of price stability after a lengthy period of decline. A combination of falling grain stocks and steady consumption, despite the recession, have given food prices an inflationary push.

And despite near-record level US crude oil stockpiles, prices remained around US\$50 per barrel as contracts for future delivery found some support in the possibility of an economic recovery starting as early as the second half of 2009.

As a consequence, global commodity indexes showed signs of support through the first quarter as the rate of price decline slowed considerably. ■

## Portfolio highlights

This quarter's results highlight that old piece of market wisdom that over the long term, the best way to make money is to "buy and hold." The first quarter of 2009 saw both the lowest point in this recessionary market (so far) to the strongest market bounce since 1933. It can be said, without too many misgivings, that investors' emotions ruled the day, cycling through extremes of pessimism to a minor case of irrational exuberance on the flimsiest evidence of any good news.

Though our exposure to equities left us vulnerable to some extent to the stock market's mood swings through the first quarter, returns in our portfolios have been driven primarily by both stabilization and strengthening of yield instruments. Securities like preferred shares, income trusts, and bonds all recovered over the period. Income trusts benefited most from a firming trend in commodities prices.

Over and above some of the general strengthening we saw in income-based assets through the first quarter, we can report specific good news: Our strategy of buying core businesses that produce highly certain yields has begun to pay off.

As we said in our previous update, "We fully expect our income strategy will outpace bonds significantly during the recovery." It has done precisely that. Our income pool advanced 3.12% in the first quarter, while the broad bond index increased

only 1.77%. We feel this augurs well for our diversified income portfolio against a pure bond portfolio, as equity prices begin to reflate and bonds lose traction in an environment of low or stagnant economic growth.

### Canadian equity portfolios

Given massive government support for both credit markets and the banking system, equity markets may well be in the arduous process of forming a bottom. In the opening weeks of the year, the financial system seemed to teeter on the edge of complete collapse, and stock markets plunged to new lows, raising

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### Key Croft Share Classes

Name	Value*	Return
<b>CFG Custom Portfolio Corporation Core Portfolios</b>		
Class B-1 Income Shares	\$7.72	3.12% <sup>1</sup>
Class C-1 Equity Shares	\$6.44	-1.35% <sup>1</sup>
Class A-1 Global Balanced Shares	\$7.33	-13.12% <sup>1</sup>
<b>CFG Custom Portfolio Corporation Active Management Portfolios</b>		
Class A-3 Canadian Conservative Equity	\$6.98	-6.99% <sup>1</sup>
Class B-3 Canadian Diversified Equity	\$5.91	-7.24% <sup>1</sup>
Class C-3 Canadian Growth Equity	\$6.60	-3.57% <sup>1</sup>
<b>Portfolio Index Evolution Corp.</b>		
PIE Income Fund	\$10.12	2.01% <sup>2</sup>
PIE Canadian Equity Fund	\$9.81	2.30% <sup>2</sup>
PIE US Equity Fund	\$8.95	-6.70% <sup>2</sup>
PIE International Equity Fund	\$9.30	-2.04% <sup>2</sup>
PIE Emerging Markets Equity Fund	\$10.25	10.10% <sup>2</sup>
PIE Alternative Strategies Fund	\$9.10	-5.46% <sup>2</sup>
<b>Stock Indexes<sup>1</sup></b>		
S&P/TSX Composite Index	8720.39	-3.0%
S&P 500 Composite Index	797.87	-9.0% <sup>3</sup>
MSCI EAFE Index	1036.10	-12.0% <sup>3</sup>

\* As at March 31, 2009

1. 3-month return to March 31, 2009.

2. Return to March 31, 2009, since inception Nov. 4, 2008.

3. In C\$.

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fears of a market crash of the kind last seen in 1929.

Governments everywhere appeared to be floundering, lacking both vision and any coherent action plan. What seemed to be (and probably were) desperate and makeshift measures to avert a global credit collapse resulted in a severe selloff in equity markets as confidence dropped as if tethered to a 10-tonne anchor and investors sought safer harbours.

However, the newly sworn in Obama administration found its feet through March, providing firmer policy direction to the Treasury and the US Federal Reserve Board. That resulted in an epic government spending spree combined with a tidal wave of monetary easing. Monetary authorities and governments around the world followed suit, as even the tight-fisted European Central Bank faced reality and cranked up the monetary printing presses. Equity markets surged on the belief that a floor to downward earnings estimates may have been in sight. Then, surprise positive earnings guidance from Citigroup Inc. juiced stock markets worldwide right through to the end of March. Through the period, the market roller-coasted through a wild aggregate swing of 33% from its early-January high to its early-March low and back again.

Given our active approach using covered call strategies, the equity pool outperformed

its benchmark by 47 basis points. Having written options earlier in the year and not overlaying an options position on the rebound gave our equity pool a cushion of outperformance. As markets continue to cycle through this current bottoming phase of momentum-driven volatility, we will continue to look for tactical option-writing opportunities with the objective of outperforming the benchmark.

### **Global equity portfolios**

Good news also comes from our Global Equity Pool, which outperformed the market on a non-currency adjusted basis. Factoring in currency, the Global Equity Pool slightly underperformed as the strength of the US dollar eroded the allocation of part of the fund's assets in Canadian dollar terms.

We believe the US dollar could see some softening over the course of 2009. Our strategy is to repatriate some US dollar investments. Even if we're a little early, we believe it's still an appropriate move given our concern for potential devaluation of the greenback.

### **Actively managed portfolios**

Our Actively Managed Pools underperformed their respective benchmarks for the first time since inception. This underperformance, which is strictly a short-term effect, can be attributed to our insistence on earnings clarity, which has been in

short supply in recent months. In addition, the Actively Managed Pools held a significant number of commodity-related issues, which as a sector underperformed the market.

Despite some short-term setbacks, we believe these pools are well positioned to benefit from any return of confidence to the market as well as from any small signal of positive momentum creeping back into earnings.

### **Portfolio mandates**

Note that in our pre-set portfolio mandates, actual performance may depend on fees, withdrawals, and deposits.

**Conservative.** Our Conservative Mandates, in general, did very well against their benchmark. The current mix of assets outperformed benchmarks by approximately 140 basis points.

**Balanced.** Our Balanced Mandates outperformed their benchmark, as the Real World Balanced Index dropped by 2.48% and our balanced portfolio mandates slipped only approximately 1.00% – again, a testament to the wisdom of diversification and appropriate weighting by asset-class risk profile.

**Growth.** In general, our strategy for our Growth Mandates also bore some fruit as the current mix of growth assets outperformed the benchmark by approximately 30 basis points. ■



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