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PORTFOLIO MATTERS

CROFT FINANCIAL GROUP

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Looking In The Rear View Mirror

"Past performance is not necessarily indicative of future performance"

The sub-text in this articles' title is the warning label that accompanies mutual fund marketing material.

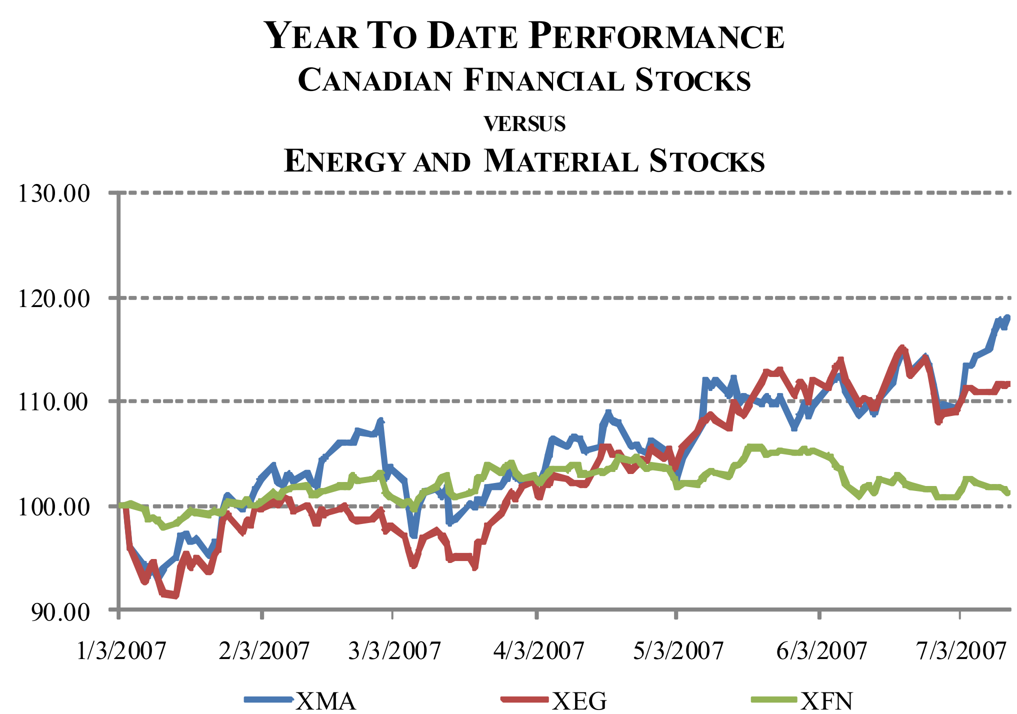
Regulators understand and the industry knows that investors make decisions based on looking in the rear view mirror. That investors need to be constantly reminded of the fallacy of such a strategy, goes to the heart of investor psychology.

Warren Buffett, CEO of the famous holding company Berkshire Hathaway Inc., reminds us that most investors spend too much time looking in the rear view mirror.

Paradoxically, pension fund managers, who have the longest time frame, tend to look in the mirror the longest.

In hindsight it is all too easy to see the market as half full or half empty. When stocks are soaring in price, and true value is scarce, investors cram as much money into markets as they can. Today we are seeing that with Canadian energy and commodity stocks. Why? Because when you

Figure 1: Year to Date Performance Comparison XFN, XEG and XMA



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look into the rear view mirror, energy and commodity stocks is where we have seen the best results.

All too often investors make decisions based on the recent past believing, incorrectly, that the past represents the future. Suppose, for example, that you were holding an over-weighted position in Canadian bank stocks. You would be collecting a decent dividend on your holdings, and in fact, would have received a bump up in your dividend payout this year.

But the banks are considered interest rate sensitive stocks. And while the banks have not had a terrible year, they have dramatically underperformed energy and commodity stocks. And by extension, have dramatically underperformed the Canadian equity market as measured by the S&P TSX composite index.

The financial sector as measured by the iShares Canadian Financial Sector Services (symbol XFN) is up 1.21% year to date. Energy stocks represented by iShares Canadian Energy Sector (symbol XEG) is up 11.68% year to date and basic materials, represented by the iShares Canadian Materials (symbol XMA) is up 18.13% year to date.

So we have it, banks and interest rate sensitive issues have been flat to lower on the year, and they are over-weighted within your portfolio. The question, if you are in a mood to evaluate how we have performed based on the rear view mirror, is to examine whether the performance of the assets that have done so well year to date will continue to be the assets that out-perform going forward.

Let's examine things into the future from that perspective.

To begin this discussion, note that market only began to re-value interest sensitive assets around the beginning of May and continued to do so through the end of June. Mainly because the economic data at the time strongly suggested that the Bank of Canada would raise interest rates in July. Which is exactly what happened.

On a year to date basis prior to that, Canadian bank stocks had kept pace with the Canadian equity market. So, our rear view mirror tells us that the underperformance really occurred in the eight weeks leading up to your quarterly review. Please read that last sentence again. Carefully! Because, it represents the metrics of looking in the rear view mirror.

That your portfolio has underperformed your Real-World benchmarks as of the end of June, is the result of an eight to eleven week variance in performance speaks to how quickly such a disparity can be corrected.

If, over the next eight weeks, the market reassesses its view on Canadian interest rates, we may see a rebound in financial stocks with a slip in energy stocks. Poof... you out-perform the Canadian market over the next quarter. Short term distortions and even year to year results simply don't tell the whole story. Which supports the warning label; past performance is not necessarily indicative of future performance.

It certainly does not lay a foundation to make wholesale changes. To do so, is the very definition of buying high and selling low.

We make investment decisions based on long term trends, and future fundamentals. We do not make wholesale changes based on historical performance. For example, to over-

Prior to the May sell-off in the banking sector, the performance of our portfolios was pretty tight to the performance of the Real World Benchmark. Please read that sentence again! Carefully! It goes to the very heart of quarterly performance reporting.

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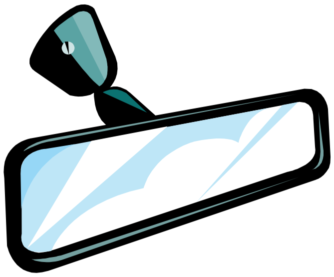

The US Federal Reserve has already said they are comfortable with current rate levels. Most economists believe that the next move in the US, will be to lower rates. How do we have another 75 basis point hike when the US may actually cut rates?
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weight oil and material stocks today, you have to believe that oil will continue to rise over the next year (that is rise above the current US$74 per barrel level). Probably to the US$85 per barrel level, and even if that happened, we would have to believe that price level was sustainable. Only sustainable price levels filter to the bottom line of energy companies.

Similarly in the material sector, you have to believe that more Alcan type buyouts are on the horizon. Maybe... maybe not!

On the other side, if you are to exit interest sensitive issues, you would have to believe that interest rates will rise, probably by another 75 basis points. An aggressive position that is held by only a few influential economists such as RBC assistant chief economist Paul Ferley.

According to Ferley, RBC remains comfortable with its view that another 25-basis-point hike will likely be necessary in September, followed by another similar sized move before the end of the year, plus one final rate increase is expected early in 2008, bringing the overnight rate to a near-term peak of 5.25 per cent. That is what is being priced into interest sensitive issues today.

Is that reasonable? The US Federal Reserve has already said they are comfortable with current rate levels. Most economists believe that the next move in the US, will be to lower rates. How do we have another 75 basis point hike when the US may actually cut rates?

Even if Ferley is correct, you have to believe that the market has not factored in this worst case Canadian interest rate scenario. Again that's a stretch. The pound of flesh that has been taken out of interest sensitive stocks was, in fact, premised on a 50 basis point hike in July (the actual rate hike was 25 basis points) and another 50 basis point hike in September. Already we are seeing economists retract those assumptions.

Finally there is the role of dividend cash flow. On a long term basis, reinvested dividends represent 63% of the market's total return. Don't forget that the dividend rate being paid out by banks is significantly higher than the dividend rate paid out by energy and material stocks. And as Figure 1 demonstrates, the risk in the banking sector (as measured by the standard deviation of returns) is significantly less than the risk in energy and material stocks. Note the downturn in energy and material stocks at the beginning of the year. In other words, clients sleep better at night with our portfolios than they would with an over weighted position in energy and material stocks.

Buffett makes an analogy with hamburgers. In his house, he says, when the price of burgers goes down, "we sing the 'Hallelujah Chorus'… when hamburgers go up, we weep." He points out that it's pretty much the same for everything. Everything, that is, except stocks. "When stocks go down and you can get more for your money, people don't like them anymore."

Bottom line; if you are making investment decisions on the basis of what you see in the rear view mirror be aware that objects are larger than they appear.

The Role Of Cash Flow

Generating tax Efficient cash flow with covered call writing

As you can see from our "Looking In The Rear View Mirror" article, we are not about to change direction. We are very comfortable with the medium and long term potential from our current positions. We are comfortable with the risk level in our client portfolios, and are very comfortable with the regular cash flow being deposited into our client accounts.

We believe over time our strategy will prove to be the right strategy. And to augment that stance, we have engaged in a series of short term covered call writes in our equity share class pool. Covered call writing adds tax efficient cash flow to your portfolio when a sector that is over-weighted is flat, and it provides a partial hedge should the equity markets decline. We call that risk management.

For the record, covered call writing is a strategy where we sell a call option against stock we own. Selling a call option obligates us to deliver the shares to the call buyer at a predetermined price by a predetermined date.

For example, suppose we owned 100 shares of XYZ Inc. at $50 per share. We sell the XYZ 6-month 55 call option. With this strategy, we have agreed to sell the 100 shares of XYZ to the call buyer at $55 per share until the option expires. For this privilege, the call buyer pays a premium of $3 per share, which is ours to keep no matter what happens to the stock. That $3 per share premium is taxed as a capital gain. In effect, we have reduced the cost of our underlying stock to $47 per share.

Once the position is in place, one of three things will happen; The first scenario would see the stock rise above $55 per share over the next six months. In this case, the call will be exercised, and we will sell our stock for $55 per share. We keep the $3 premium. The total gain on the position is $8, or a 17% semi-annual gain (8 divided by 47 equals 17%).

In the second scenario, the stock remains unchanged. The call option is not exercised and expires worthless. We still own our shares. We keep the $3 premium, a semi-annual gain of 6.4%.

The third possibility has the stock declining below $50. Again, the call option is not exercised and expires worthless. We still own our shares but perhaps at a loss. Although, we are still better off than an investor who never sold a call option. Because the $3 per share premium has reduced the cost base of the stock by $3 per share. Only if the share price falls below $47 do we begin to lose money.

What the covered call write does is define a set of parameters. The upside limit is $55 per share, the strike price of the call. The premium reduces your downside risk to $47 per share. And the portfolio receives tax advantaged cash flow.

We are very comfortable with the medium and long term potential from our current positions. We are comfortable with the risk level in our client portfolios, and are very comfortable with the regular cash flow being deposited into our client accounts.

When we invest a small percentage of one's portfolio in strategies that historically have had low, and sometimes negative correlation, to traditional asset classes, we are able to dampen overall volatility within the portfolio. For clients, that means lower risk.

New Offerings

Launching Alternative Investment Share Class and Speculative Share Class

At the beginning of August, we will be opening two share classes in our Corporate Class Pool. The first is the Alternative Investment Share Class (AISC), where we will move some client assets during August.

The investment objective of the AISC is to earn superior equity or equity type returns through a diversified portfolio of securities that are not correlated to major stock market indices. The AISC intends to achieve its investment objective by purchasing hedge funds, using hedge type strategies such as long / short strategies and / or convertible hedge strategies (i.e. long convertible securities or synthetic convertible securities and short underlying stocks). The strategies will generally have low correlations with equity stock market indices. The AISC may also invest in structured products that generally have a low correlation to major stock market indices.

What makes the Alternative Investment Share Class useful within the context of a portfolio, is that it seeks out strategies that have a low correlation with traditional assets such as stocks and bonds. When we invest a small percentage of one's portfolio in strategies that historically have had low, and sometimes negative correlation, to traditional asset classes, we are able to dampen overall volatility within the portfolio. For clients, that means lower risk.

It is similar to the way Hedge funds are managed, but at much lower fees. Traditional Hedge funds charge upwards of 3% in management fees, plus a share of profits if the fund delivers a minimum acceptable return (MAR). The AISC has no performance bonus based on MAR.

The AISC simply provides another layer of diversification, designed specifically to dampen downside volatility. Since we have had a four year bull run, I believe the time is right for this new share class.

We will also be opening our Core Speculative Share Class (CSSC) for clients who are interested in having a small part of their portfolio invested in more aggressive assets. We will not move client assets into this share class on a discretionary basis. We will invest client assets on request up to limits defined in the Managed Investment Account Agreement (MIAA). The investment objective of the CSSC is to earn high returns by investing in high risk securities and strategies.

The CSSC intends to achieve its investment objective by investing in small capitalization (market capitalization that is less than $ 1 billion Cdn.) companies that trade on recognizable Canadian or foreign stock exchanges, or the Canadian Venture Exchange. The Class may invest in venture capital situations either through direct investments or through funds or pools that provide exposure to this market. The Class may employ strategies that will benefit the Class during periods where equity markets are declining, and may invest in high risk option strategies such as leveraged call or put buying.

An investor in the CSSC pays a Portfolio Management Fee to Croft Financial Group as provided in the MIAA between the investor and Croft Financial Group. Each Class (other than Class A-1 Cash) pays a Management Fee to Croft Financial Group equal to 0.25% per annum which is calculated and accrued monthly.

In addition, the CSSC pays Croft Financial Group a Performance Bonus on an annual basis in respect of a fiscal year of the Class not later than 90 days after each fiscal year equal to 20% of the amount by which the aggregate of: (a) the Net Asset Value per Share of CSSC at the end of such fiscal year (without regard to any accrual of the Performance Bonus); and (b) any distribution per CSSC declared during such year; exceeds the Class Net Asset Value per Share of CSSC at the beginning of such fiscal year; provided that no Performance Bonus shall be payable with respect to any fiscal year of CSSC unless the Class generates an annual return on investment of at least 10% in such fiscal year.

For this purpose, "return on investment" in respect of CSSC for a fiscal year shall be calculated by dividing (i) the amount by which the aggregate of the CSSC Net Asset Value per Share of CSSC at the end of such fiscal year and any per Share distribution declared during such year in respect of the Shares of the CSSC exceeds the CSSC Net Asset Value per Share for the CSSC at the beginning of such fiscal year by (ii) the CSSC Net Asset Value per Share of CSSC at the beginning of such fiscal year.

The estimated Performance Bonus, if any, will be accrued on each Valuation Date as a liability of the CSSC, reducing the Net Asset Value and therefore the price at which Shares of the CSSC may be redeemed, notwithstanding the accrual of such Performance Bonus may subsequently be reversed.

For what it is worth, Richard Croft and his family will be investing $250,000 in the CSSC as initial seed capital.

BCE Past and Present

No longer for widows and orphans ***By David Horton***

Over the Canada Day weekend, BCE Inc. (i.e. Bell Canada, symbol BCE) accepted an offer of $51.7 billion ($42.75 per share) from a group of investors led by the Ontario Teachers Pension Plan. The teachers already owned 6% of Bell, so with this deal, their ownership stake rises to 52%.

Many Canadians, including the Horton family, have owned shares of BCE at one time or another.

BCE built its reputation as a "widows & orphans stock" by reliably paying a dividend through the decades when it enjoyed "regulated monopoly" status.

Having no competition, BCE was the only choice for local & long distance phone service and the federal government regulated telephone rates. If BCE needed more money, it simply applied to the government for a rate increase. The government generally approved, and widows and orphans received their dividends.

It is about 20 years since the Horton family held BCE shares. My Mom &

BCE built its reputation as a "widows & orphans stock" by reliably paying a dividend through the decades when it enjoyed "regulated monopoly" status.

Dad owned debentures of Daon Development Corp. That company was bought by BCE & renamed BCE Development Corp. My parents (as did other debenture holders) believed that BCE was guaranteeing BCE Development debentures. So much for fine print.

In the late 1980s, when the real estate market went into a prolonged downturn, BCE Developments became insolvent. BCE, the parent company did not guarantee the debentures, and in time the debentures became worthless.

Disillusioned with BCE, we sold our remaining BCE shares, and never forgot nor forgave.

In 1998, I co-authored a booklet with a Scotia McLeod broker entitled; "Disciplined Common Share Investing."

In it, we examined the growth of the BCE dividend from 1980 to 1998. Not only did it fail to keep up with inflation, it actually grew at an absolutely miniscule rate of 0.75% compound annually. Just as deregulation was taking root.

My late Aunt Miriam was aware of this lack of growth, but only in an anecdotal way. In the early 2000's she shared with me how she use to be able to pay for her hair-do's and pampering with her BCE dividend. But today, it takes her BCE dividend plus her Bank of Montreal dividend.

When I showed my aunt figures to prove that the BCE dividend had not kept pace with inflation, she finally consented to selling her shares.

Many BCE shareholders, especially those of my aunt's generation, continued to regard Bell as the staid "widows & orphans stock" long after deregulation repositioned it into one of the most competitive industries in the world.

The Ontario Teachers Pension Fund is a sophisticated investor. In this case, willing to pay $42.75 per share for a company whose share price, for the last five years, was range-bound between $25 and $30.

Time will tell as to the wisdom of their decision .As for today, don't be surprised if some of that $51.7 billion shows up on the bid side of the Canadian banks and insurance companies.

The Fruitless Search For 'Certainty'

One of the more overused aphorisms these days is that "markets hate uncertainty." I don't know how this bit of so-called wisdom evolved, but it strikes me as blindingly obvious, astonishingly irrelevant, and just plain wrong.

Of course markets hate uncertainty. Everyone does. You don't lock in a ten year mortgage because you love the ebb and flow of the yield curve. Investors are like everyone else. You want a good return, preferably guaranteed. Absent a guarantee, you're willing to take some risk, provided you're compensated for it. Hence the whole concept of discounted present value of a buck in the future.

That "markets hate uncertainty" also means nothing by itself. You cannot formulate an investment policy based on your dislike of uncertainty. If you did, you'd bury your money in a cookie tin in the backyard. Even then, you'd be plagued with uncertainty. To be sure, the mice wouldn't be able to get at it, but inflation would just as surely nibble it away to scraps in a couple of decades.

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What matters is your level of tolerance for uncertainty. In other words, your tolerance for risk. Some of us can live with more risk than others. Skydivers and commodity futures traders, for example, thrive on it. Retirees and those on fixed income abhor risk. Those are the extremes.

In the broad middle are those who seek long-term gains from inherently "riskier" assets like equities, while hedging against risk by holding fixed-income and cash assets.

Saying that "markets hate uncertainty" is wrong in another important sense. I believe that markets thrive on uncertainty. Because if they didn't, there would be no sellers, and hence, no market.

The options and futures markets exist as a way to manage uncertainty. In a way, then, "uncertainty" makes possible both the markets and the liquidity they need to operate smoothly.

Last week was an exemplary period of "uncertainty." Will the US sub prime lending market continue to implode. Will the Bank of Canada raise interest rates again in September?

Against this backdrop, it would be simplistic indeed to ascribe market movements to a couple of earnings surprises or a single CPI report. In intra-day trading, of course, anything goes. But we have to probe deeper to explain longer-term trends.

On a global basis, there is China's on again off again efforts to slow down their economy. Middle east tensions along with the slow-motion implosion of the U.N. as it continues its post 9/11 spiral into irrelevance.

Macro issues include the US trade deficit, the slipping value of the US greenback, and by extension, the surge in the loonie.

In terms of portfolio policy, it comes down to managing the relationship with the market's "uncertainty principle." The goal is to adapt to the unknown, by dealing with what we know. That portfolio diversification reduces risk.

If you're more comfortable with that principle of uncertainty that we all love to hate, then you'll have a portfolio measurable against the Real World Growth Index. The Real World Growth Index is influenced mainly by its heavy equity allocation, driven by the iShares S&P/TSX 60 Index Fund and the Standard & Poor's Depositary Receipts.

Those with less taste for life in the fast lane will have portfolios more like the Real World Balanced or Real World Conservative indexes. These have heavier allocations to fixed-income as a way of mitigating risk.

Although, as investors are well aware, fixed-income assets have over the past two years, been negatively impacted by Canadian interest rate hikes.

The constant ebb and flow of a global economy means that markets will always be subjected to uncertainty. Prognosticators will take their best shot at explaining market turbulence. They will continue to predict the future with a well thought out thesis, and occasionally will demonstrate a propensity to correctly predict the future.

The problem is determining when they will be right and when they will be wrong. Unfortunately, we can't say for certain.