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## Range-bound fourth quarter caps year of gains

By Richard Croft and Mark Taucar

In its semi-annual *Financial System Review* released in early December, the Bank of Canada said, "While indicators point in different directions, various measures, such as forward price-earnings ratios, suggest that equity prices may have increased more than warranted in the context of an expected slow recovery." The Bank's musings about the market indicates a level of concern about the potential for asset bubbles that it hadn't shown in its communications over the previous year, most of which dealt with systemic liquidity and bank credit issues.

And if more evidence were necessary that the BoC is becoming concerned about the consequences of super-easy monetary policy, it also turned its attention to household debt. The Bank warned that Canada's rising household debt – mostly mortgages at historically low rates – poses the biggest risk to the country's financial system, saying, "Households need to assess their ability to service these debt obligations over their entire maturity, taking into account likely changes in both income and interest rates."

In a larger sense, of course, the BoC's concerns may be well-founded. Trouble is, the Bank is largely the author of our own misfortunes, whether overbought stock markets or overleveraged homeowners fuelling a real estate bubble. That's because there's no *deus ex machina* that sets interest rate policy in this country apart from the self-same Bank of Canada.

The Bank may argue that it's at the mercy of larger international financial forces, primarily the giant one south of the border – and it is. To a large degree, the BoC must slavishly follow policy set at a little outfit called the US Federal Reserve Board. It's been doing just that these past couple of years, essentially letting go all restraints on money supply short of quantitative easing, which some would argue is taking place anyway in everything but name.

Interest rates near zero, which the BoC confirmed again in its last rate announcement of 2009, are bound to result in certain very specific types of behaviour by consumers and by investors. It's unavoidable. For the BoC – and indeed other central banks around the world who joined in the

sermon last week – to warn us all about the dangers of debt and overheated markets seems more than a little disingenuous, considering that it was the architect of the current monetary environment in the first place.

For those fond of hidden agendas and deeper meanings, it could be argued that the BoC and other central banks are not really expanding their mandates in order to act as Chief Financial Planners. In reality, they may just subtly be setting the stage for a spate of interest rate hikes in 2010. In other words, they're saying, don't be surprised when equity markets dip and variable-rate mortgages have to be painfully re-set after rates rise this year. And those rate hikes may come earlier in the year than expected.

Stock markets, as irrationally exuberant as the grand poobahs of government might deem them to be, have already been discounting some sort of wider monetary policy action early next year. A look at the accompanying charts shows that the big North American indexes have been moving "sideways" in the last quar-

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 ter of 2009, unable to pierce upside resistance or downside support in any meaningful way. And a look at the MSCI World Index (Chart 3) shows the pattern isn't lim-

ited to North American stocks.

Meanwhile, stock markets around the world rallied to new highs in December, but closed New Year's Eve without extending their gains. Apparently Santa Claus finished his business on Christmas Eve and handed investors a gift-wrapped gain for the previous week. But he returned to the North Pole without leaving a much-anticipated rally for the final week of the year.

That pretty well paints the picture for the entire fourth quarter – three months without any big economic surprises and no trend-setting or trend-breaking market moves in either direction. Volatility abated in the fourth quarter oscillating in a fairly narrow band. At the same time, the US dollar showed a little strength against the major currencies and commodity prices eased somewhat.

Some positive economic data added to the growing body of evidence that economic recovery is becoming more firmly entrenched. In the US, claims for jobless benefits for the week ending Dec. 19 fell by 28,000 from the previous week, more than twice as much as prior guesstimates of a decline of only 10,000 in claims.

Durable goods orders – those expected to last five years or more – rose in 0.2% in November, less than the 0.6% that had been expected, but still on the positive side. The US National Association of Realtors reported that existing home sales rose 7.4% in November from the previous month, while the median sales price rose for the first time since June.

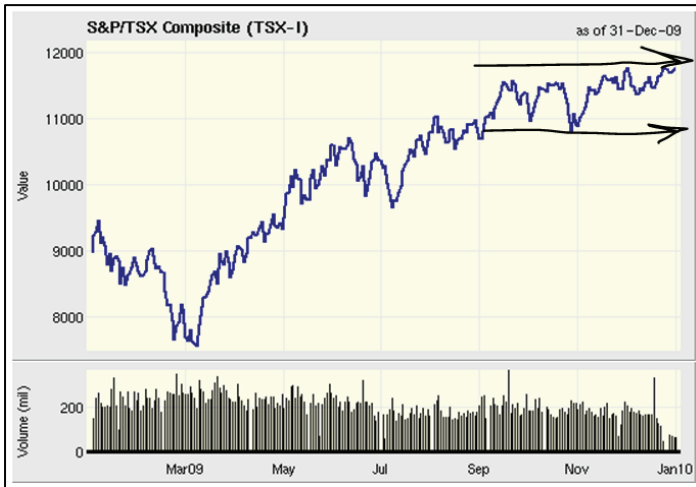
The Commerce Dept. confirmed that the US economy grew in the third quarter, but not by quite as much as originally estimated. The final estimate for gross domestic product came in at 2.2%, down from the earlier estimate of 2.8%, mainly because of subdued consumer spending and slower business investment. Still, the positive number after four consecutive quarters of shrinking GDP indicates a solid return to growth, and sets the stage for even stronger growth for the fourth quarter.

In Canada, gross domestic product expanded 0.2% in October, the second consecutive month of growth, as 15 of the 18 broad industry sectors tracked by Statistics Canada stayed at or above the break-even point. Rock-bottom interest rates and a tidal wave of government stimulus money helped to kick-start the housing market with knock effects on consumer spending and auto sales. On the downside, however, mining and manufacturing output readings were disappointing, following a strong handoff from September. Still, consensus puts Canada's GDP on track for fourth-quarter growth of around 4%.

Of course, this is the season to make predictions and attempt to assess the outlook for the coming year with a view to setting general investment policy. So here are a few trends we believe are worth watching for 2010.

**Bank credit.** With very few notable exceptions, such as Australia, bank credit is still plugged up in the developed economies. That is unlikely to change until banks get a handle on their exposure to impaired assets. Much of European and US central bank monetary largesse has gone to bail out banking institutions that have failed to pass on their increased deposits to pri-

**CHART 1—S&P/TSX COMPOSITE INDEX, 1 YEAR**



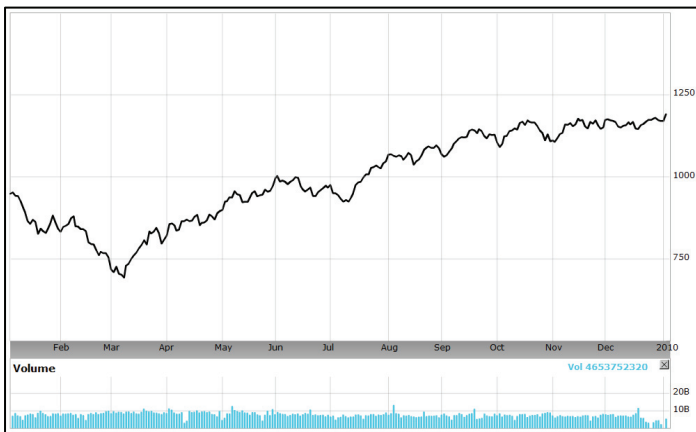
Courtesy CTVGlobemedia.

**CHART 2—S&P 500 COMPOSITE INDEX, 1 YEAR**



Courtesy Bloomberg LP.

**CHART 3—MSCI WORLD INDEX, 1 YEAR**



Courtesy Bloomberg LP.

vate-sector lenders. Instead, the money has gone to prop up the banks' off-balance sheet entities (such as structured investment vehicles, or SIVs), which led to the crisis in the first place. The bank credit story is the seven eighths of the financial crisis iceberg that remains to be resolved. It's esoteric. It's hidden. And yet it will decide the fate of the global economy in 2010.

**State intervention.** That massive government intervention in the private economies of countries is still considered, somehow, to fall in the "free market" model will be a major theme in 2010. Developed-world governments faced with unmanageable debt, black-hole fiscal deficits, and wholesale Keynesian intrusion in the economy will face a taxpayer tipping point, as stimulus is removed. At some point, cen-

tral banks will begin tightening, government spending will be cut, and taxes will go up. The kind of restiveness lately seen in Greece may be simply the tale told in miniature for what's about to beset the rest of Europe, and perhaps the US as well. Politics and economics make for strange bedfellows, and we're about to see plenty of strangeness in 2010. That tends to increase equity market nervousness (and volatility) and raise the prices of hard assets (that is, commodities of all kinds, including the big three: gold, oil, and real estate.)

**The rise of Asia.** Oddly, as the developed economies descend into a kind of slow-growth bumbling Keynesian fever dream, the emerging economies of Asia, particularly the giants China and India, are increasingly finding ways to loosen their socialist

shackles and liberalize their economies. It's a slow, laborious process, but it's one that will continue implacably as emerging markets' growth surges again in 2010, outpacing developed markets, probably by a wide margin. One trend worth watching is the realignment of Japan under its new government away from the US and towards Asia, particularly China. This may be the answer to Japan's economic malaise, but it may also heighten geopolitical tensions in the region.

There are other themes and trends, of course, but these are likely to be the backdrop for markets in 2010. ■

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## PIE Fund reviews

### Income

Although Canadian inflation crept upwards in the fourth quarter, the Bank of Canada left the target for its key overnight rate unchanged at 0.25%. November's Consumer Price Index rose by an annual rate of 1%, up from a relatively low 0.1% rate in October, as prices rose across the board, led by food and transportation components. The Core Consumer Price Index, which excludes volatile prices for such items as food and energy, slipped to an annual rate of 1.5% from 1.8% in October.

While announcing that its target overnight rate would remain at 0.25% until

the end of the first half of 2010, the Bank of Canada reiterated its views from the October Monetary Policy Report, namely that a recovery in economic activity in Canada is underway, boosted by both fiscal and monetary stimulus. However, it said that both heightened volatility and the strong Canadian dollar are weighing on growth and subduing inflationary pressure.

The fourth quarter saw a slow return to growth as gross domestic product grew 0.2% month over month in October, the second consecutive month of GDP growth. The employment picture also improved somewhat in the fourth

quarter, as November's 80,000 gain in jobs provided some indication that the labor market is stabilizing.

The US dollar gained strength towards the end of the fourth quarter on growing fears of sovereign debt downgrades among some smaller member of the European Union. After faltering a bit, the Canadian dollar regained some strength in the final weeks of the year to end the year up 15.9% against the US dollar, at US\$0.9515. Because of Canada's relatively stronger fiscal position, Canada bonds don't command the higher risk premium that similar US bonds do. Two-



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**“It all adds up to a picture of subdued economic recovery through the fourth quarter, with rising consumer spending but a still-weak labor market, and no upward pressure on wage growth...”**

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year Canadas closed 2009 at C\$99.57 to yield 1.48% (33.7 basis points over 2-year US Treasury), while 10-year bonds closed at C\$101.10 to yield 3.61% (22.6 basis points under 10-year US Treasury).

The **iShares CDN Bond Index Fund** (TSX: XBB), which tracks the DEX Universe Bond Index, rallied to a 12-month high in the fourth quarter before giving back all its gains through December, to close the quarter below breakeven, with a 1.2% loss from the previous quarter. Still, XBB advanced a marginal 0.6% for the year. After initial weakness early in the fourth quarter, the S&P/TSX Preferred Share Index advanced 1.5% quarter-over-quarter, as preferred shares regained lost ground in the quarter. The index posted a 19.5% gain for the year, buoying the **PIE Income Fund**'s overall annual performance.

### **Canadian Equity**

Canadian equities consolidated somewhat in the fourth quarter, following a strong advance since bottoming in March. Sovereign debt problems among weaker members of the European Union helped the US dollar stage a comeback in the final weeks of the year as investors returned to the relative safety of US Treasury issues. That put downward pressure on commodity prices, most of which are denominated in US dollars. As a consequence, the Canadian dollar's advance towards parity with the greenback lost some steam, while the S&P/TSX Composite Index, which is heavily weighted to resource issues, experienced more volatility than it did in the second and third quarters, even while touching a new 12-month high in De-

ember.

Meanwhile, the growing economic recovery helped boost investor confidence, despite growing concerns over rising inflation (up 1% annually in November) and over potential asset bubbles developing in the real estate market. Canadian gross domestic product grew for the second straight month in October, up 0.2% from September, spurred by a surge in existing home sales, revived consumer spending, and a recovery in auto sales. The all-items consumer price index rose 1% in November, while homes sales surged 73%, as prices gained 17% year over year.

Canadian industry appeared to be on the path to recovery, as factory sales rose 2% in October, marking the fourth gain in five months.

The **iShares CDN Large-Cap 60 Index Fund** (TSX: XIU), which tracks the S&P/TSX 60 Index, gained 1.8% quarter-over-quarter, even though the Index rose to a new 52-week high in early December. For the year, XIU gained 27.8%. During the quarter, the **PIE Canadian Equity Fund** replaced holdings of the **iShares CDN Growth Index Fund** (TSX: XCG) and the **iShares CDN Value Index Fund** (TSX: XCV) with the **Claymore Canadian Fundamental Index ETF** (TSX: CRQ). This move was based on the managers' conclusion that the mechanism used to create CRQ creates a greater degree of diversification when coupled with XIU. Therefore, at least for the foreseeable future, the Claymore Canadian Fundamental Index ETF will be a core piece of the PIE Canadian Equity Fund.

The Fund continues to take advantage of option-writing opportunities on the

iShares CDN LargeCap 60 Index Fund, a strategy that is expected to continue to reduce portfolio risk.

### **US Equity**

The US economy grew in the third quarter, but not by quite as much as originally estimated. The final estimate for gross domestic product came in at 2.2%, down from the earlier estimate of 2.8%, mainly because of subdued consumer spending and slower business investment. Still, the positive number after four consecutive quarters of shrinking GDP indicates a solid return to growth, and sets the stage for even stronger growth for the fourth quarter.

Durable goods orders – those expected to last five years or more – rose in 0.2% in November, less than the 0.6% that had been expected, but still on the positive side. Both US housing starts and existing home sales grew again in November in all parts of the country.

In a sign that US factories are starting to roll again, industrial production rose 0.8% in November from October's level. And capacity utilization rose to 71.3% from 70.6% in October.

Along with a 1.8% jump in the US producer price index in November, and a 1.8% jump in the all-items consumer price index for November, these data points also tend to spotlight a shift to inflation worries, which leads again to speculation about the “when” and the “how much” of the Fed's next rate move. In the fourth quarter, however, the Fed maintained the status quo, keeping its target benchmark overnight rate at 0% to 0.25%.

The unemployment rate ticked down to 10% in November from 10.2% in Octo-

ber. That, in turn, was underpinned by positive manufacturing surveys that have shown a slow but steady increase in new orders and manufacturing activity over the past four months.

It all adds up to a picture of subdued economic recovery through the fourth quarter, with rising consumer spending but a still-weak labor market, and no upward pressure on wage growth.

Although some of the momentum the S&P 500 Composite Index had sustained since the March bottom evaporated in the fourth quarter, the index closed the year at 1,115.10. The **Standard & Poor's Depository Receipts** (NYSE: SPY), which track the S&P 500 Composite Index, and the **PIE US Equity Fund's** largest holding, gained 3.0% (in C\$) quarter over quarter, and advanced 5.5% on the year (in C\$). Mid- and small-cap growth and value style-based indexes also advanced in the quarter. The **iShares Russell 1000 Value Index Fund** (NYSE: IWD), the Fund's second-largest holding, gained 1.0% quarter-over-quarter, but dropped 1.0% for the full year (in C\$), while the **iShares Russell Midcap Value Index Fund** (NYSE: IWS) advanced 1.8% in the fourth quarter and 11.0% for the year (in C\$).

### International Equity

Eurozone markets were rattled late in the fourth quarter by Dubai's debt payment delay and by the downgrade of the creditworthiness of Greece's sovereign debt. The events sent year-end jitters through the European bourses as fears spread that fiscal troubles in Portugal, Ireland, Italy, and Spain might prompt similar sovereign debt downgrades in

those countries. The euro fell against the US dollar, giving up most of its advance over the fourth quarter.

Although the eurozone emerged from recession in the third quarter, the recovery remained fragile through the fourth quarter. Industrial production remained weak, and indeed fell 0.6% in October from September, the first such drop since March. Germany's credit crisis worsened and manufacturing orders dropped 2.1% in the month. Meanwhile, eurozone bank lending remained weak as household lending fell in October at a record-breaking pace. Inflationary pressures remained subdued, advancing at an annual rate of only 0.8% in December, up from 0.3% in November. The European Central Bank left its key rate unchanged at 1%. And in the United Kingdom, stronger readings in manufacturing activity were offset by a contraction in the services sector in the three months ending Oct. 30. A rising budget deficit, however, put downward pressure on UK bond prices (bond prices move inversely to interest rates), as Moody's Investors Services indicated a debt downgrade may be in the offing.

Despite strong third-quarter growth, Japan continued to wrestle with strong deflationary pressures, as November's core consumer price index dipped 1.7% from a year earlier. Against a backdrop of weak consumer demand and rising fiscal deficits, the unemployment rate crept up to 5.2% in November from 5.1% the previous month. In an attempt to prevent a double-dip recession, Japan's new government announced an US\$80 billion stimulus package, while the Bank of Japan planned to inject a further ¥10 trillion in

the financial system through low-interest loans.

In Australia, a booming resource sector fuelled by Asian demand and climbing household income have underpinned a rebound in business confidence and resulted in surging employment growth. As inflation concerns make a comeback, the Reserve Bank of Australia raised interest rates by 25 basis points for the third consecutive month in December, to 3.75%.

Concerns over the sustainability of a recovery in the eurozone dampened performance of the **PIE International Equity Fund's** key holding of the **iShares MSCI EAFE Index Fund** (NYSE: EFA). EFA slipped 1.3% (in C\$) quarter over quarter, but gained 5.3% for the year (in C\$). Growth style holdings also contributed to Fund performance, as holdings of the **iShares MSCI EAFE Growth Index Fund** (NYSE: EFG) gained 1.8% in the quarter and 3.6% for the year (in C\$). The value style lagged in the fourth quarter, as the **iShares MSCI EAFE Value Index Fund** (NYSE: EFV) dropped 4.0% in the period, but advanced 6.1% for the year overall (all in C\$). The **iShares MSCI EAFE Small Cap Index Fund** (NYSE: SCZ) posted a 3.7% quarterly loss in the final quarter but rose 13.8% on the year (in C\$).

### Emerging Markets

It became clear as the year progressed that emerging markets were leading the global economic recovery. The trend continued in the fourth quarter as emerging economies responded to aggressive fiscal and monetary stimulus programs with robust revivals in both consumer spending and indus-



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trial output. In general, emerging economies, particularly in Asia, showed falling unemployment rates, while consumers have lower debt levels. Even more significantly, bank credit is expanding in contrast to most developed economies where it is largely still shrinking.

The MSCI Emerging Markets Index advanced 7.3% (in US\$) on a quarter-over-quarter basis through the October-December period. Of the 22 countries comprising the index, only four posted a negative return in the fourth quarter. For the full year, the index gained a stunning 73%, with 19 of the 22 markets posting full-year returns of more than 65%. The biggest gainer was Brazil, whose MSCI index advanced 130% in the year.

China's recovery continues to lead the Asia-Pacific region, as industrial output surged 19.2% year-over-year in November, with heavy industry leading the way. A key Chinese purchasing managers' index posted a reading of 55.2 in November, for a ninth consecutive month of expansion. A strong rebound in consumer spending has spurred 15% year-over-year growth in retail sales this year, even though domestic consumption comprises a little over a third of economic activity, compared with over 50% in other Asian economies. Reflecting the stimulus-driven return to growth, China's consumer price index rose 0.6% in November, the first such increase since January.

India's third-quarter gross domestic product grew 7.9% year-over-year in the third quarter. Fed by robust government stimulus programs and low interest rates over the past year, the manu-

facturing and mining sectors have surged, as demand for steel, cement, and autos ballooned. October's inflation rate jumped to 1.34%, raising concerns of an interest rate hike early in 2010.

Fuelled by surging exports to China and robust domestic demand, Brazil's economy expanded 1.3% in the third quarter. Indeed, industrial capacity usage had climbed to 80.5% in October. But with a rapid return to growth, Brazil's inflation rate is also rising. In December the central bank warned of increasing inflation risk, although it kept its Selic base rate unchanged at 8.75%.

The Fund's key holding of the broad **iShares MSCI Emerging Markets Index Fund** (NYSE: EEM) advanced 4.1% (in C\$) quarter over quarter and gained 42% on the year (in C\$). The Fund's regional holdings also provided support for the fund with quarter-over-quarter index advances as the **Claymore/BNY BRIC ETF** (NYSE: EEB) lost 6.5% in C\$ quarter over quarter (but advanced 57.1% for the year), the **SPDR S&P International Small Cap ETF** (NYSE: GWX) posted a 6.7% quarterly loss (but gained 13.0% in the year), and the **iShares MSCI Latin America 40 Index Fund** (NYSE: ILF) rose 8.7% in the quarter and 60.4% for the year (all in C\$ terms). Following the bearish sentiment in Chinese equities, however, the **iShares FTSE/Xinhua China 25 Index Fund** (NYSE: FXI) posted quarterly return of 0.8%, with an annual gain of 24.2% (in C\$).

### Alternative Strategies

Canadian real estate investment trusts extended their strong rally off March lows through the fourth quarter as healthy yields lured investors

away from lower-yielding fixed-income assets. Canadian REITs were never in the kind of peril faced by US REITs during the global credit crunch, owing to the quality of their income-producing assets. When feared payout cuts failed to materialize, Canadian REITs recovered strongly, outpacing the broader market indexes. And the attraction of REITs for yield-hungry investments continues to grow as other types of income trusts disappear from the market because of a change to the tax rules. As a consequence, Fund's largest Canadian REIT holding, the broad **iShares CDN REIT Index Fund** (TSX: XRE) posted a 5.4% advance quarter over quarter in the October-December period, and closed the year up 41.8%.

US REITs piled on more gains in the fourth quarter as US commercial real estate begins to stage a recovery. The Fund's largest US REIT holding, the **iShares Dow Jones US Real Estate Index Fund** (TSX: IYR), for example, gained 5.1% (in C\$) quarter over quarter, and finished the year with a 5.4% annual gain. Internationally, however, the Fund's holding of **iShares EPRA/NAREIT Developed Real Estate ex-US Index Fund** (NASDAQ: IFGL) slipped 4.0% quarter over quarter (in C\$), while still advancing 13.1% on the year.

The Fund's key commodity index fund holding, the **iShares S&P GSCI Commodity Indexed Trust** (NYSE: GSG), which tracks the broad S&P GSCI Index, gained 4.7% quarter-over-quarter (in C\$), but lost 5.0% (in C\$) on the year as commodities in general slipped as the US dollar showed some strength against the Canadian dollar in the fourth quarter. ■

# Manager's view

By Mark Taucar, CFA

Of paramount importance to any investment philosophy is time. It's analogous to such comestible products as wine, scotch, or my favorite, port. How? Why? From the artisan's perspective, time embodies the effort, know-how, and discipline needed to create an exceptional product. Nowhere, and at no time, am I aware of a connoisseur asking for these aforementioned luxuries to be the newest of releases, last year's crop, or freshly tapped from unseasoned barrels. (As an aside, I've yet to come across anyone who views the 2008 vintage as a good-year – maybe the markets sour more than just dispositions; they may also sour grapes.) In this vein, investments take time, and as such, it's this passing of time that gives the artisan, oenologist, or, in our case, the investor perspective from which to take inventory of methodology and quality.

Applying the above discussion to our funds, we can't yet declare they are all vintage; however, the results of a solid methodology and steadfast adherence to a philosophy are beginning to make themselves known. Again, over the past quarter, the majority of our funds have performed admirably against their benchmarks, with 8 of our 13 core funds beating their benchmarks.

## Income funds and pools

Our income funds finished off 2009 with an exclamation point. Each fund beat its respective benchmark – that is, the **iShares CDN Bond Index Fund (TSX: XBB)** as our proxy. In the fourth quarter, bonds softened while preferreds, dividend stocks,

and option writing all showed gains, culminating in strong performance for our **Core Pools, Active Management Portfolios, and PIE Funds**.

As we've said before, we expect these areas to be strong; however, the magnitude of outperformance relative to bonds is likely to begin to shrink as increased volatility raises the risk to our 2010 outlook for income-producing assets like bonds, preferreds, and dividend-paying stocks.

## Domestic funds

As with our income-based product, so too have our core equity products shone with four of the six funds and pools

outperforming their respective benchmarks. Our Active Management portfolios scored the largest margins of outperformance of all of our fund products. That's because our adherence to the discipline of buying quality – and then sticking with it – has paid off over the course of the year.

This past quarter was no exception. Products that focused on option writing suffered slightly as the rebound in equity markets far surpassed premiums available on covered-writing strategies. The result was that any fund using covered calls underperformed, but also exhibited much less volatility over the same measurement period. Our covered-option strategies will remain in effect as we see potential up-

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## Croft Model Core Portfolios

Discretionary asset management utilizing both strategic and tactical asset allocation within a tax-efficient framework.

## Key Croft Share Classes

Name	Value	Return % (at December 31, 2009)				
		3-Mo.	6-Mo.	1-Yr.	3-Yr.	Inception
<b>CFG Custom Portfolio Corporation Core Portfolios</b>						
Class B-1 Income Shares	\$8.87	1.0	7.6	23.3	0.5	-0.5
Class C-1 Equity Shares	\$7.75	1.9	9.1	21.0	-8.3	-8.3
Class A-1 Global Balanced Shares	\$8.75	-2.8	0.4	-2.06	-	-8.1
<b>CFG Custom Portfolio Corporation Active Management Portfolios</b>						
Class D-3 Income	\$9.74	1.2	9.7	17.5	-	1.3
Class A-3 Canadian Conservative Equity	\$9.07	5.0	14.6	2.4	-	-4.6
Class B-3 Canadian Diversified Equity	\$7.72	7.5	21.7	26.5	-	-12.6
Class C-3 Canadian Growth Equity	\$7.87	7.2	20.5	18.3	-	-12.5
<b>PIE Portfolio Index Evolution Corp. (Series A)</b>						
PIE Income Fund	\$10.51	0.2	2.5	5.5	-	7.4
PIE Canadian Equity Fund	\$10.81	2.9	9.7	17.2	-	20.4
PIE US Equity Fund	\$10.03	0.8	4.9	0.3	-	0.3
PIE International Equity Fund	\$10.47	-0.6	3.2	-1.7	-	4.4
PIE Emerging Markets Equity Fund	\$11.83	2.2	3.9	18.5	-	20.2
PIE Alternative Strategies Fund	\$13.05	4.1	20.6	24.8	-	30.5
<b>Stock Indexes<sup>1</sup></b>						
S&P/TSX Composite Index	11,746.11	3.1	13.2	30.7	-3.1	
S&P 500 Composite Index	1,115.10	3.9 <sup>1</sup>	9.9 <sup>1</sup>	6.7 <sup>1</sup>	-10.8 <sup>1</sup>	
MSCI EAFE Index	1,580.77	0.2 <sup>1</sup>	9.8 <sup>1</sup>	10.4 <sup>1</sup>	-11.7 <sup>1</sup>	

1. In C\$.

All metrics as at 12/31/2009. Performance is not guaranteed. Portfolio values change frequently, and past performance may not be repeated. Performance is based on actual fee-adjusted returns to 12/31/2009. Performance data have not been audited and are for illustrative purposes only. R N Croft Financial Group Ltd. is a licensed Portfolio Manager serving individual and institutional clients throughout Canada. A complete listing and description of the firm's composites are available upon request. Portfolios of all sizes were included in calculating returns. Valuations and performance results are reported in Canadian dollars. Portfolio returns are net of all withholding taxes. Performance is also calculated net transaction fees. Additional information regarding calculating and reporting performance is available upon request.

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heaval in the markets in coming quarters. In the next few months, covered-call writing will become the ballast to help keep our ship steady as we navigate the turbulent markets yet to come.

### International funds

A continuing challenge in managing our international portfolios is the management and control of currency risk. Few managers have ever exhibited outperformance over a sustained period of time while managing currency, and we are no exception. So much of the currency market is dictated by the ebbs and flows of momentum trading and less by the underlying fundamentals – at least in the short term. While many academic studies have attempted to unravel the relevance of currency effects in portfolios,

little has been resolved.

Our international funds have shown smaller growth in relation to their underlying benchmarks, primarily owing to the fact that all use some level of option writing to mitigate volatility. Over the course of the quarter only two of our international funds exhibited positive performance: the **PIE US Equity Fund** and the **PIE Emerging Markets Equity Fund**, with option writing the culprit for the underperformance of this fund grouping.

### Specialty funds

Both of the Croft specialty funds posted some of the largest gains across the Croft offering. Our **Core Speculative Pool** posted a massive 40.18% return. This pool is primarily driven by speculative option strategies on both US and Canadian equities. Our belief is that

speculative components should not comprise a large portion of a portfolio, but used in the right quantity, they can add value by further diversifying away risk and potentially enhancing return. On the fourth quarter, the Core Speculative pool was off by a little more than 9%.

The **PIE Alternative Strategies Fund** also posted a significant return (close to 25% for the year and over 4% for the fourth quarter). In 2009, the Fund targeted the real estate sector to take advantage of historically low prices. We believe the real estate sector's rebound is now coming to a close, and we will seek alternative sectors to shift into over the coming year.■

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## Banks still profitable in 2009

*By David Horton*

In November, Canadian insurance companies reported 9-month earnings (to the end of September). Earnings at three of the big insurers that I track are down significantly year-over-year, although all remain profitable. Here's a rundown:

**Great-West Lifeco Inc.** earned \$1.184 billion (\$1,184,000,000), down 21% from \$1.493 billion in 2008.

**Manulife Financial Corp.** experienced the largest decline, earning \$490 million against last year's \$2.365 billion (down 79%).

**Sun Life Financial Inc.** reported earnings of \$238 million, down 64% from 2008 (\$656 million).

As for the Canadian banks, there was earnings news from them in the fourth

quarter, too – their year-end is October 31. Like the insurers, the banks mostly checked in with lower year-over-year profit numbers. Here's a summary:

**Bank of Montreal** earned \$1.787 billion in fiscal 2009 compared with 2008 earnings of \$1.978 billion the previous year (down 10%).

**Canadian Imperial Bank of Commerce** reported net income of \$1.2 billion for 2009, compared with a 2008 loss of \$2.1 billion.

**Royal Bank of Canada** earned \$3.858 billion, down 15% from \$4.555 billion a year ago.

**Toronto-Dominion Bank** earned \$3.120 billion compared with \$3.833 billion in 2008 (down 19%).

Bank of Nova Scotia was the exception, and reported

higher 2009 earnings of \$3.547 billion, up 13% from \$3.140 billion the year before.

So for the banks, another year is in the books, with generally lower earnings. Like a few other things in life, when the banks are good, they're very good; when they're bad, they're, well, not so bad. In the worst economic times since the Great Depression, we're at \$13.52 billion in combined profit for 2009. Let's hope 2010 unfolds as predicted, that is, slightly better than 2009. As a customer, the Canadian banks can make your blood boil; as a shareholder, you have to love them for staying largely profitable and maintaining their dividends.■

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### Active Management Portfolio Program

Custom portfolios built from a selection of actively managed funds