

PORTFOLIO MATTERS



INSIDE THIS ISSUE

<i>Bear calling</i>	1
<i>Portfolio Matters: Second Quarter 2008</i>	2
<i>Bank stock gyrations spell opportunity</i>	5
<i>Croft's new Active Management Portfolio Program</i>	5
<i>Market discipline for the long term</i>	6

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Bear calling

By Richard Croft

Dare we say the word “bear”? Well, we do, but you wouldn’t know it from most of the financial services business. Wall Street and Bay Street are notorious for their head-in-the-sand approach to market realities.

Banks, brokerage firms, mutual funds, indeed money managers of all kinds, remind me of nothing so much as the ridiculous “Black Knight” from hilarious motion picture *Monty Python and the Holy Grail*. The Black Knight would not let anyone cross over a bridge without a fight. However, upon having his limbs lopped off by King Arthur in a particularly gruesome scene, he hopped around proclaiming, “ ’Tis nothing but a scratch,” while loudly declaring the hero to be “yellow” and challenging him to further combat.

The fact is that professional financial types are eternally optimistic. They pretty much have to be in order to stay sane. However, that optimism occasionally does descend into farce, when,

as we saw at the end of the second quarter, the world’s biggest stock indexes slid close to or right into bear market territory. What else can you say when many (if not all) brokerage, bank, and fund-employed economists, analysts, and strategists are already calling this an astounding investment opportunity, with a major rally just around the corner? (“ ’Tis nothing but a flesh wound!”)

At R.N. Croft Financial Group Inc., your managers prefer to deal with the way the world really is. We don’t “carry a brief” for the market. It does what it does, and mostly that involves a serious amount of fluctuation. We are not interested in talking up the market or hyperventilating about “astounding investment opportunities” – just when the Dow Jones Industrial Average is playing bear.

What we *do* carry a brief for is *your* portfolio. And we are vitally interested in ensuring that your longer-term

investment objectives are met by adhering to our philosophy of creating portfolios using strategic and tactical asset mix allocations defined by *your* risk tolerance and investment objectives. Where you fit into those parameters will define to what extent stock market action – bull market, bear market, or day-to-day fluctuations – will affect your portfolio.

Yes, the Dow Jones Industrial Average entered bear market territory at the end of June, having dropped 20% from its high close of 14,164 last October. The S&P 500 Composite Index had slid about 18% from its high point

Continued on Page 2

We're moving!

Please note that effective **August 15, 2008**, the offices of R.N. Croft Financial Group Inc. and Croft Capital Management Ltd. will be located at:

**218 Steeles Ave. E. east
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of 1,465 last October, not into the bear's den quite yet, but clearly standing at the opening.

The second quarter gave investors plenty of reason to become anxious about stock valuations. Economic activity continued to soften in the US. The New York-based Conference Board's Consumer Confidence Index dipped to 50.4 in June from 58.1 in May, while the expectations index fell to a record low of 41.0. The collapse of the housing market has not yet run its course, with the S&P Case-Shiller home price index posting a 15.3% decline in April, bringing

prices back to 2004 levels. Initial weekly jobless claims have held steady above 350,000 since the end of April, and have been above 380,000 for the better part of June – typical of a recessionary environment. The knock-on effect on consumer spending was clearly visible in flat durable goods growth, which remained unchanged in May from April's 1% decline.

Also, let's not forget that prices for gasoline and food show no signs of cooling off either, with recent consumer price inflation somewhere north of 4% annualized.

That's all by way of

pointing out that consumers are feeling the squeeze, with a combination of job losses and higher prices.

The Fed is already well and truly on the moral hazard path. With 12-month CPI at over 4%, and the target Fed funds rate at 2.5%, the real interest rate is negative. While putting on a wonderful public relations show of easy money that it said would contain the global credit crisis, the Fed has in effect stimulated inflationary increases in commodity prices, especially energy and food. The very existence of car companies and airlines is at stake. Not

US\$ Exchange Rate

To value your US dollar holdings as of the end of the first quarter, please use the exchange rate for June 30, 2008, as supplied by the National Bank Correspondent Network:

C\$1.00 = US\$1.019

PORTFOLIO MATTERS

Second Quarter 2008 Report

Canadian equities remained a strong investment over the second quarter of 2008, ending the quarter higher, driven by strength in commodities and an approximately 40% increase in the price of oil. The resulting 10.24% increase in the S&P/TSX 60 Index softened much of the negative impact of foreign investments.

The Canadian economy's resilience towards inflation remained intact as strength in commodities, which in turn drives the Canadian dollar, continued to buffer Canadian import price from rising energy prices.

Foreign markets reacted negatively to rising inflation fears. Projected slower growth and continued writedowns arising from the subprime crisis elicited a migration from equities to inflation-protected fixed income products. During this period, foreign equity had dropped -3.83%, a slide that was further compounded to the downside by a strengthening Canadian dollar, which amounted to an aggregate pullback of 4.55%.

The US markets remained volatile as dispersion in oil, GDP growth, and US dollar forecasts had widened beyond any seen in recent memory. The second quarter was marred by continued noise leading to volatility in equity markets. This volatility was evidenced by large swings in trading both in commodities and in equities – each seemingly to trade as mirror images of the other. Oil's impact on inflation weighed heavily on the US equity investor and was followed by selling and repositioning assets into safer bonds and Treasuries. The end result was a drop in US equity markets of 7.23% to 7.85%, factoring the effect of currency.

Lastly, Canadian bonds ended slightly lower as increased inflation sparked fears that interest rate increases were possible. Investors sold bonds to protect against the possible effect of interest rate increases – protecting themselves against the resulting interest rate risk. All told, bonds ended the quarter slightly lower, having decreased 0.32%

Our pools remain conservatively positioned to take advantage of the volatility via covered option writing. We remain steadfast in our philosophy of concentrating on holding companies (for the long-term) that offer steady and stable earnings and cash-flow despite the bias to short-term, sentiment-driven trading exhibited in the market. We continue to remain optimistic for renewed strength in equity markets in the not too distant future.

Did you get mail from the CRA?

The summer months typically bring a variety of mailings from the Canada Revenue Agency, including Notices of Assessment, Reassessment and Audits of your last tax return.

Be aware that a Reassessment or Audit could have significant implications for your taxes payable. And remember, too, that the CRA is *not always right!*

Don't overpay your taxes! Call Robyn K. Thompson at R.N. Croft Financial Group for a tax evaluation or to make an appointment to discuss any tax or financial planning questions you have.

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only does that work into even more pressure on the US dollar but it also weighs heavily on the US consumer.

But is raising interest rates to offset inflationary expectations during an economic downturn in an election year a real option? No. And so the Fed held rates at the end of June, trying instead to jawbone inflationary expectations down. The prospects for two consecutive quarters of negative growth in the US this year increased substantially. At the very least, a protracted bout of stagflation is in the cards. And that's never good for stock markets.

As you'd expect, the markets' woes weren't limited to the US indexes. European and Asian exchanges also felt the cold shoulder of investor disdain, as the MSCI EAFE Index, a broad stock index covering Europe, Australasia, and the Far East, had slid some 18% from its October high of 2,388. Softening economic activity combined with advancing inflation is the poisonous brew that's behind the increasingly weak data coming out of both Europe and Asia, reflecting and amplifying what's been happening in the US.

Credit markets remain very precarious as investors demand higher yields for even platinum-rated triple-A debt, never mind the riskier corporate and commercial overnight

stuff. Global financial giants like Deutsche Bank, UBS, Société Générale continue to struggle with massive writedowns. In the US, Lehman Brothers Holdings Inc., Citigroup Inc., and Merrill Lynch & Co. Inc. top the list of a recent litany of woe in the financial sector.

Markets slide

With varying degrees of exposure to both EAFE and US markets, virtually every investor will have seen some deterioration in their portfolios. Those with greater exposure to specific sectors, such as the financial sector, will have experienced some pretty steep declines. That's the position we find ourselves in with some of some of our income portfolios, which have a higher weighting to Canadian financial institutions.

The Financials are the second largest sector by weight in the S&P/TSX Composite Index and traditionally the most stable, with growing earnings and increasing dividends. Since last summer, when the subprime mortgage market in the US cracked up, this group has lost about 23% of its value, as most of the majors reported hefty subprime-related writedowns.

Let's not forget, however, that we're talking about the oligarchical Canadian

bank sector, with a near-monopoly wrap on the Canadian marketplace and a perception that they are jointly and severally just "too large to fail." Hence, we have maintained our exposure to this sector with our strategic pool allocations, using option strategies to wring extra income from these holdings while we await the inevitable rally – which, by the way, we expect to be a rip-snorter when it comes, the sector being significantly oversold at this point.

Of course, there are those investors who have been beating out a tattoo (in the Scottish fife-and-drum-band sense, that is) with oversize boots on their own backsides for not investing in the broader Canadian market index. The S&P/TSX Composite Index is down a paltry 4.4% from its all-time high-water close of 15,073 on June 18 – nowhere near playing bear. And as of the end of June, the main TSX index was still ahead, oddly, some 4.3% in the year to date. In fact, of all the developed market indexes that Morgan Stanley Capital International tracks, Canada's market was the only one posting a positive return (in both US dollars and local currency terms) for year-to-date and 12-month periods.

There's no particular mystery about the reason for this outperformance: oil, namely the huge Western oilsands



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resources. Yes, the same stuff that's causing central bankers to have conniption fits about inflation and economic tea-leaf readers to go cross-eyed trying to guess when a recession will start (or end), if at all. Canada has a bottomless well of the stuff, so to speak, and given current global supply tightness, this helps underpin strength in the Canadian resource sector, by far the largest component of the TSX.

It should come as no surprise, then, that the Croft Model Portfolios caught some of the chill of the US market downdraft. But we should emphasize here the qualification "some." That's because our model portfolios are built on a firm foundation of diversification. Assets are allocated broadly among cash, fixed-income, and equity, with individual

sector allocations made according to the specific risk mandate of the model portfolio.

The one model that we are monitoring most closely is our conservative portfolios, which have a higher exposure to income type assets – i.e., bonds, preferred shares, income trusts, dividend paying common shares (i.e., banks), and option writing strategies.

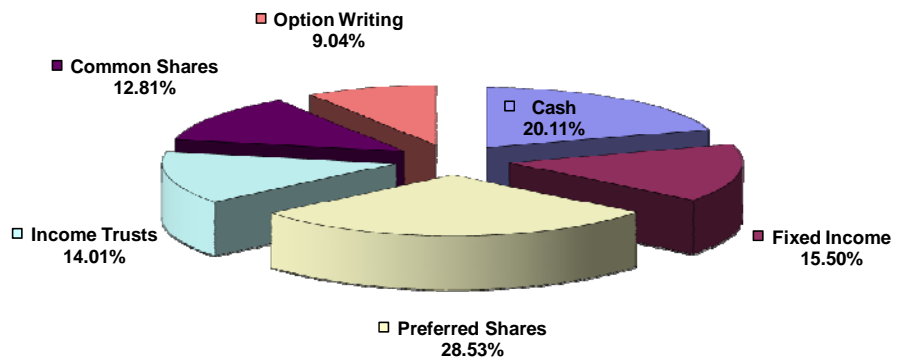
The income component within the conservative portfolio has declined more than one might have thought if our income strategy were being compared to a bond portfolio. But we believe that comparison misses the point. The longer-term, low-risk exposure to broad cross section of income-producing strategies provides a tax-advantaged

income stream, which over the longer term will outperform bonds (see accompanying chart for breakdown of the current strategies in the Class B-1 Income Shares). Having said that, we also recognize that any strategy with exposure to equity (in this case the Croft Class B-1 Income Shares, the portfolio of which holds financial stocks and has in place some equity-based option writing strategies) will over short periods experience bouts of underperformance, such as we have witnessed this year.

The point is that this is a short-term issue that will right itself over time, something we expect to occur during the second half of the year if our moral hazard macro view plays out. ■

Richard Croft is President of R.N. Croft Financial Group Inc.

**Croft Core Income Share Class
Asset Mix - June 30, 2008**



Bank stock gyrations spell opportunity

By David Horton

Who would have thought that Canadian financial stocks could behave like thinly traded junior mines on the Venture Exchange? Yet that's precisely what has happened through the first half of 2008 as writedowns related to the credit crunch took a big bite out of most banks' earnings. Bad as it is, it's not necessarily *all* bad.

True, share prices of the Canadian banks and insurance companies declined in the first six months of 2008. Bank of Montreal and Sun Life Financial are down 25%, CIBC dropped 20%, Great West Lifeco fell 18%, Manulife skidded 13%, Royal Bank retrenched 10%, TD slid 9%, and Bank of Nova Scotia dipped 7%. (It's amazing how many

synonyms and euphemisms there are for "loss"!)

It hasn't been all a straight-line drop, either. Share prices gyrated widely through the quarter: At the end of May, TD was actually up 3%, Royal was at breakeven, ScotiaBank and CIBC were within pennies of their Dec. 31 close. But the 30 days of June saw TD decline 12%, Royal 10%, Scotia 6%, and CIBC 20%. Bank of Montreal and CIBC closed June trading at prices not seen since 2003.

The drop in share prices, the volatility, the talk of recession, and the unending emphasis on the negative can be overwhelming. But it's

always dangerous from an investment portfolio standpoint to take precipitate action on transient short-term phenomena (and I believe that for the Canadian banks and insurance companies, this is a short-term thing). It is time for some balanced reporting. Let's examine our companies based on our investment criteria – their credit rating plus their earnings growth plus their dividend growth.

➤ **Credit ratings.** In the past 12 months, the Canadian banks and insurance companies have maintained their Standard & Poor's credit rating, while a US bank in our universe (that's right, a US bank), Wells Fargo, received a two-level

New information sheets now available

New information sheets for the **Croft Core Model Portfolios** and the **Croft Market Match Portfolios** are now available. Detailing investment objectives, risk level, asset mix, and fees, the sheets contain a wealth of information for both advisors and investors.

They're available on our Website under the "Products" tab.

Website

www.croftgroup.com

Or call our office for more information:

416-752-7991

Introducing Croft's new

Active Management Portfolio Program share classes

In order to expand and diversify our asset management capabilities, R.N. Croft Financial Group is pleased to announce the addition of a number of new share classes to its Corporate Class Platform.

The Active Management Portfolio Program comprises six new share classes that are primarily focused on selecting stocks with high dividend yields and low price betas. Moderate importance is also placed on upward estimate revisions as well as quarterly earnings momentum. The shares may also use options strategies and leverage to enhance income or provide downside protection.

Class A-3 Canadian Conservative Equity

Class B-3 Canadian Diversified Equity

Class C-3 Canadian Growth Equity

Class D-3 Income

Class E-3 US Diversified Equity

Class F-3 International Diversified Equity

Shares of the Active Management Portfolio Program are sold by offering memorandum. Contact our office at 416-7527991, or visit our Website at www.croftgroup.com.

Continued from Page 5

upgrade to AA+ from AA-.

☛ **Earnings.** CIBC's 10-figure dollar loss made page-one headlines, but CIBC is the exception. Fiscal 2008 earnings are down between 3% and 27% at the remaining four banks, but all are very profitable nonetheless. Our three insurance companies had record profits in 2007.

☛ **Dividends.** The less-publicized reality is that over the first six months of 2008, Bank of Nova Scotia and Manulife upped their dividends by 9%, Sun Life delivered a 6% hike, Great West Lifeco came through with a 5% boost, and TD rewarded shareholders with a 4% increase. Only Bank of Montreal, CIBC, and Royal Bank chose not to increase their dividends, but they had done so in the second half of 2007.

☛ **Dividend Reinvestment Plan** (DRIP). Many studies confirm the positive impact of dividend

reinvestment plans on portfolio growth. I use a home-made spreadsheet (ahem, I mean, a *proprietary model*) to monitor DRIP efficiency. In April 2007 (just before the decline) the CIBC Dividend Reinvestment Plan required a minimum of 144 shares to be efficient. With a higher dividend and lower share price, only 73 shares are required today. Manulife is down about 13% since April 2007, yet when combined with the 20% growth in dividends, the minimum number of shares has dropped to 163 from 224. The lower the number of shares required, the more effective your Dividend Reinvestment Plan becomes.

Our investment criteria do not guarantee eternal and everlasting success without end. There have been cases in the past where companies lose their investment grade credit rating and/or their ability to increase

earnings, and as a result they have proven to be unsound investments. More often than not, however, our criteria provide a first line of defense against such pitfalls, while simultaneously providing a basis for generally acceptable results.

On another topic, it was this time last year that the proposed privatization of BCE was announced. The deal appears to be going ahead, and now is scheduled to close by December of this year. Although there has been speculative buying and selling, let's hope that significant quantities of shares are still owned by widows and orphans, and that by year-end they will redeploy their BCE cheque in bank stocks. ■

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Market discipline for the long term

Your investment managers at R.N. Croft Financial Group Inc. maintain a disciplined investment philosophy when it comes to individual stock selection, based on the convincing evidence that equities outperform every other asset class over the long term.

We hold fundamentally sound companies with strong franchises that we fully expect will be in business for the next 20 years.

These companies command the spending dollars of Canadians, regardless of the market outlook, and are found primarily among the Consumer Staples, Financials, and Energy sectors.

Given time and patience, the noise and volatility of the market – which can often make investing in equities a nerve-testing effort – are the very factors that lead to future steady gains and returns. This however, can be achieved only via continuity of philosophy, being steadfast in our approach, realizing that tomorrow's return comes by ignoring today's noise, and ignoring both today's volatility and the emotional upheaval that comes with short-term market uncertainty.



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