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PORTFOLIO MATTERS

CROFT FINANCIAL GROUP
INVESTMENT COUNSELLORS-PORTFOLIO MANAGERS

CROFT FINANCIAL GROUP
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Light at the end of the tunnel

By Richard Croft and Mark Taucar

We doubt whether there's any investor who was not happy to see the curtain fall on 2008. The collapse of the US subprime mortgage house of (credit) cards in 2007 precipitated the onset of a vicious recession in 2008, preceded by an equally vicious equity bear market. Credit markets seized up completely as confidence evaporated, and that culminated in an international banking crisis the likes of which hasn't been seen for nearly 80 years.

Unprecedented monetary easing saw the US Federal Reserve Board (the Fed) cut the target for benchmark federal funds rate to near zero at the end of the year from a level of 4.25% at the end of 2007. Central banks around the world followed suit, injecting massive amounts of liquidity into the global financial system in an effort to stave off a deflationary financial collapse.

In addition to these emergency monetary measures, governments around the world also established fiscal programs through treasury activities to recapitalize ailing financial institutions by purchasing or guaranteeing unmarketable debt instruments, easing lending restrictions, and taking outright equity positions.

These moves came too late to save some of the more storied names in the financial sector, like Lehman Brothers Holdings and Bear Stearns Cos., which crumbled before the subprime mortgage default onslaught earlier in 2008, before either the market or the monetary and regulatory authorities realized that these companies represented only the tip of the proverbial iceberg.

It's customary in these year-end and New Year's reviews to display charts of key stock market index performance through the year. You've probably already had your fill of these horror shows. And you won't escape unscathed in these comments either. We'll display our version of these charts a little later.

Continued on Page 2

CHART 1 - TED SPREAD 2008

Chart Courtesy Bloomberg LP.

Don't wait till spring! Start tax-time planning now

Tax-filing season is fast approaching. Don't leave your tax-planning to the last minute! Take advantage of all the tax credits, deductions and writeoffs you have coming to you in the 2008 tax year.

To set up a tax-planning consultation, call Robyn Thompson today.

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Right now, though, there's a chart in our opinion that is more important than any other graph. It's the so-called TED Spread chart (Chart 1), which graphs the difference between the yields on "risk-free" three-month US Treasury bills and the three-month London Interbank Offered Rate, or LIBOR (the average of interest rates on three-month dollar-denominated loans offered between banks in the London interbank).

From an historic peak of 4.64% in October, the TED Spread narrowed to a more normal 1.4% by the end of the year. This is crucial because it indicates that the huge risk premium banks attached to loans among themselves has faded as government monetary interventions and liquidity injections began to shore up confidence. After all, if banks couldn't risk lending even to each other, then there literally was no hope for the rest of us. And this is why the TED Spread graph is so crucial. Because, as we've (re)-discovered over the past year, it's not money that makes the world go 'round; it's credit.

The shrinking TED Spread doesn't mean that suddenly all's well with the world. That won't happen until business and consumer lending begins to show renewed signs of life, probably not until the second half of 2009 at the earliest. But it is an indication that financial markets have stepped back from the precipice and that some measure of institutional confidence has been restored.

It will still take some time for that confidence to spread to the broader economy. Yields on lower-rated corporate bonds are still sky-high, for example. And both consumer and business lending remain tight.

Those extremely tight credit conditions continue to reverberate through the economy, as the deepest recession since the 1930s rolls on. It came as absolutely no surprise to anyone that US manufacturing activity dried up in December 2008. The widely-watched index of manufacturing activity published at the end of each month by the Institute of Supply Management confirmed everyone's worst fears. December's index reading plunged to 32.4, the worst since 1980. Yet stock markets celebrated the first trading day of the New Year with triple-digit gains.

The reason, of course, is that stock markets are discounting machines. They are also frequently said to be pricing mechanisms and weigh scales. They are all three, in fact, and a whole lot more, including at times a pychoanalyst's couch, reflecting investors' aggregate fear, greed, and aspirations.

Through 2007, greed was ascendant as momentum-driven trading threw prudent fundamental value to the winds and took markets to new highs – in Canada, that lasted until mid-2008. Then through most of 2008, fear gripped investors – not just the mild anxiety associated with a slightly-less-than-spectacular earnings announcement, but the gut-wrenching, mind-numbing terror oozing out of a Stephen King novel. Investors ran screaming from the theatre, so to speak, unable to hold either their wind or their water. When all was said and done, the frenzied selling had markets testing their October

S&P/TSX Composite Index - 2008

Chart Courtesy Yahoo Inc.

2002 lows.

The Canadian stock market continued to decline in the fourth quarter, pressured by falling commodity prices, weakness in the financial sector, and declining earnings estimates. The 0.1% monthly decline in Canadian gross domestic product in October signaled that the Canadian economy was likely to see an overall contraction in the fourth quarter as the recession in the US begins to bite. Aggressive action by the Bank of Canada saw the target for the key overnight rate drop to 1.5%, as it sought to mitigate the effects of the declining housing sector and a severe slowdown in manufacturing activity, particularly in the hard-pressed automotive industry.

In the fourth quarter, the S&P/TSX Composite Index slumped 24%, and closed the year with an overall 35% annual loss. However, the index's peak-to-trough loss from its June high of over 15,000 was a dramatic 48%, as it fell to as low as 7,724 on Nov. 20.

But note this well: Since that November 2008 low, the Toronto index has rallied 16%, closing the year at 8,897. In the first trading session of the New Year, the S&P/TSX closed at 9,234, up 11% from the previous week's Christmas Eve closing level, as gold and energy stocks led a broad New Year's rally.

The heaviest downward pressure on the Canadian market through the final quarter came from resource and financial stocks, which make up about three quarters of the index's market capitalization. The plummeting price of crude oil and base metals drove the energy, mining, and materials sectors to new lows, while the global credit crisis continued to wreak havoc on the financial sector.

Even gold came under selling pressure in the final quarter of 2008 as hedge funds unwound positions into a declining market. The price for an ounce of the yellow metal for January delivery dipped as low as US$700, but recovered by year-end to US$883. No doubt gold will recover even more, as the current central bank mania for printing money resolves into an inflationary monster we haven't seen for decades. But that won't even begin to be a problem until, say, 2010-11.

We have warned of intense volatility during this market-bottoming phase. But we believe that it *is* a bottom, with the lows having been reached around Nov. 20, 2008. Valuations of many stocks have indeed overshot to the downside and are currently at bargain-basement levels. It's going to take nerves of steel to be a buyer in this kind market. But if markets are building a base now, gains later in 2009 could well be swift and spectacular.

Income Pool

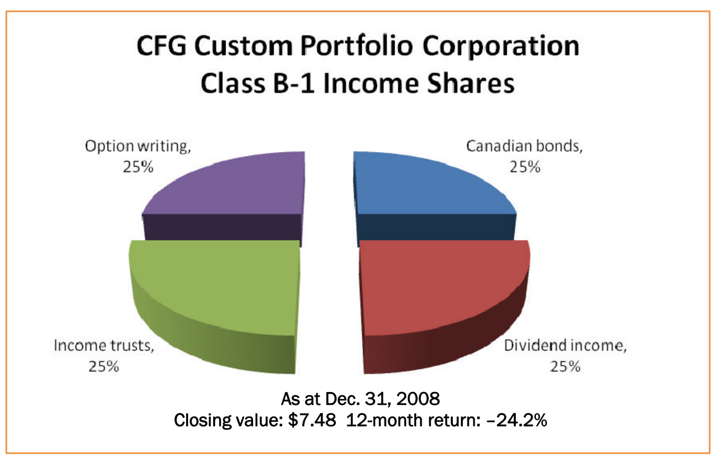
It was the year (and the quarter) of the credit squeeze. Investment performance in virtually every asset class was suppressed primarily by the difficulties being experienced in the credit markets, especially in credit instruments at the heart of the crisis, ranging from asset-backed commercial paper (ABCP) to derivative swaps to plain vanilla government and corporate bonds, as well as preferred shares.

The good news is that funds and investments managed by R.N. Croft Financial Group Inc. (Croft) avoided financially distressed instruments such as ABCP and credit derivatives. The bad news is that regardless of the presumed safety of any credit investment, everything was tarred with the same broad credit-risk brush.

During the course of the fourth quarter of 2008, Croft held preferred securities of major Canadian banks. In pricing of these securities, the market shifted from its usual focus on interest rate anticipation as the key pricing driver to a near-obsessive concern with business risk. This caused preferreds, which normally trade with volatility similar to bonds (i.e., relatively low), to trade with volatility almost equivalent to their underlying stock. Owing to this shift, our income pool traded down almost 13%, with the key downside impact coming from preferred shares.

The good point – the one we'll have to wait for -- is that most of the preferred shares that we own have call features that come due within the next three to five years. If interest rates remain low, preferred issuers will be looking to refinance these preferreds at lower rates. To

Continued on Page 4



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do so, they must call the preferreds at par value, which for most of our holdings is about 20% to 30% higher than current values. In addition, all these preferreds still pay their dividends, and we continue deploy these cash disbursements into cheaper equities.

More good news. We should see the income pool respond positively to the flood of fiscal and monetary stimulus being offered up by governments around the world in coming months, which will result in the revaluation of financial sector issues over the course of 2009. We fully expect that our income strategy will outpace bonds significantly during the recovery.

Equity Pool

The collapse of credit markets in 2008 impacted every equity without discrimination. If it traded on a stock exchange, it was viewed with the same disdain reserved for the hardest hit sectors. Through 2008 and well into the fourth quarter investors' main anxiety was the impact that frozen credit markets would have on bank lending and therefore on the overall economy. It was these worries that influenced market performance and by extension our Equity Pool. We continued aggressively to take advantage of the high option premiums in the market by writing covered calls. Volatility spiked to unusually high levels, pricing options richly and enhancing our premium-income strategy.

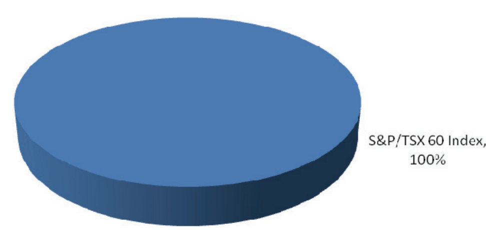
The result of our option strategies mitigated the 23% decline in the broader market – cushioning the blow to our Equity Pool by about 3 percentage points.

US contraction

South of the border, the US economy continued to contract through the fourth quarter, as consumer confidence hit a record low in December on increasing worries about the labour market and business conditions. The US housing market also stayed on the downward track through the quarter, as October home prices fell 2.2% in the month, for an 18% annualized decline, the steepest drops on record.

An aggressive policy of monetary easing by the US Federal Reserve Board (Fed) saw the target for the federal funds rate cut to a record low of between 0% and 0.25% in December, as 91-day Treasury bills were priced to yield close to 0%. Aggressive moves to guarantee or extend loans to financial institutions, including mortgage giants Fannie Mae and Freddie Mac, were supplemented by the implementation of a US$700 billion gov-

CFG Custom Portfolio Corporation
Class C-1 Equity Shares



As at Dec. 31, 2008
Closing value: $6.53 12-month return: –22.9%

Dow Jones Industrial Average - 2008

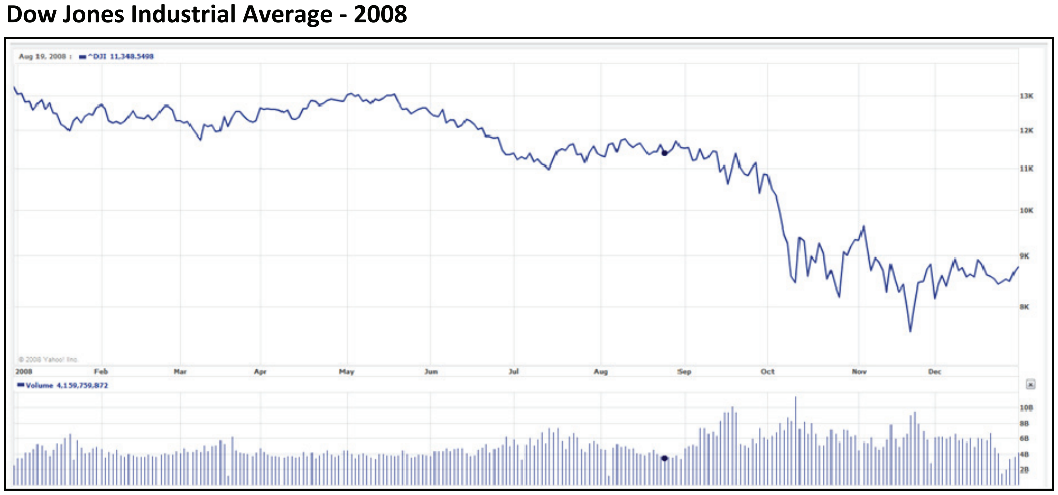


Chart Courtesy Yahoo Inc.

ernment bailout program called the Troubled Asset Relief Program to provide recapitalization of impaired balance sheets through direct equity purchases. Additional rescue funding in the fourth quarter came in the form of a US$17 billion loan package for the troubled domestic carmakers.

With the Fed's administered rate at 0% for all intents and purposes, focus has shifted to other tools at its disposal to keep deflation at bay. The buzzword of the day for these tools is "quantitative easing." It's usually defined as adding to the supply of money rather than to its cost (interest rates). It's still just bad, old-fashioned inflation – or currency debasement -- and it's how the US will deal with the monster debt and deficits now being gestated. It's the time-honoured way that governments everywhere throughout history have reneged on debts without appearing to do so – spend like crazy now, and simply pay off the massive fiscal debt in the future with money that's worth less. Talk about your Ponzi schemes! The $50 billion con that US prosecutors say was perpetrated by one-time Wall Street wonder boy Bernard Madoff will be as nothing compared with the high-stakes monetary game yet to come.

It's a dangerous game. It used to be called "monetizing the debt" before Milton Friedman and the monetarists were declared *personae non grata* and John Maynard Keynes and the Keynsian bailout train rolled into the White House behind the steam engine of Obamanite "change." Change that largely involves building a few bridges, switching your lightbulbs, and sorting your garbage into ever smaller containers. Now it's called "fiscal stimulus."

One might say, perhaps a little cynically, that the financial brainpower in Washington, Ottawa, London, Tokyo, Beijing, and Brussels these days knows full well the eventual outcome of the liquidity tsunami encircling the globe. On the other hand, these are the same brains who (with one or two exceptions) somehow missed predicting the consequences of the explosion in ultra-leveraged credit instruments backed by, well, nothing at all. Trouble is, it's difficult to say which of the alternatives is scarier: That they knew nothing then, or that they know nothing now.

As investment counsellors, we often inveigh against investors' attempts at market timing. What the Fed and other central banks now propose is a really, really high stakes version of market timing, claiming the ability to withdraw all that liquidity when the economy begins to recover, and thus head off an explosion of inflationary expectations. This assumes they'll know exactly the right point to begin "quantitative tightening."

Do they have a crystal ball? Can they know so precisely where the tipping point is? If they did, they'd soon have all the money in the world. Wait, they *do* have all the money in the world, and they still don't know.

Neither does anyone else. But markets are reacting, as they always will. By year-end, the US dollar had crumbled against the euro, ending a period of strength against the world's major currencies. With US interest rates near zero, the appeal of holding US-dollar denomi-

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S&P 500 Composite Index - 2008

Chart Courtesy Yahoo Inc.

“...we’re within the parameters of a typical bear market lifespan.”

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nated instruments has faded markedly, an indication perhaps of investors’ eroding faith in the US Fed’s ability to time the effects of its hugely aggressive monetary policy. On the other hand, long-dated Treasurys rallied on expectations of continuing yield declines to below 2% for 10-year and 30-year maturities, and of imminent Fed purchases – part of that quantitative easing that’s now become the order of the day.

Meanwhile, all that fiscal stimulus by non-Fed agencies keeps building steam. The US administration announced a US$17.4 billion loan package for Detroit’s big three ailing carmakers, Ford, General Motors, and Chrysler. Canadian federal and provincial government loans are expected to add another $4 billion to the pot. It won’t make any difference, though, according to Moody’s Investor Services. The rating agency said in December that Detroit’s big three carmakers are headed for bankruptcy regardless of any bailout package. It also warned of trouble for Canadian banks if one or more of the carmakers goes bankrupt, because of the banks’ exposure to the auto sector and the hit that Ontario’s manufacturing-dependent economy would take.

It’s becoming increasingly evident that some sort of insolvency proceeding will be the ultimate fate of the once-mighty US carmakers. Whether it’s through Chapter 11 bankruptcy protection and restructuring moves, forced mergers, or outright nationalization by the US and Canadian governments, the Big Three will look at lot different at the end of 2009 than at the beginning. Most of the transformation will probably take place in the first quarter of the New Year.

The major US equity indexes closed the year deep in the red as price-earnings multiples continued to shrink on downwardly revised earnings estimates through the fourth quarter. The Dow Jones Industrial Average ended the fourth quarter with a 19% quarterly decline and closed the year with a 34% loss. The S&P 500 Composite Index lost 23% in the fourth quarter, ending the year with an overall 38% decline (in US$).

Since touching new lows on Nov. 20, however, the US indexes, like their Canadian counterpart, staged impressive rallies. Both the Dow Jones Industrial Average and the S&P 500 Composite have rallied 16% from their November bottoms.

The trading patterns are telling, as the major stock indexes bounce in volatile swings in a trading range along a bottom. Still, caution is warranted. The 2000-02 bear market bottomed after 18 months of gruelling losses. This one’s been hacking away at valuations for about 14 months, so we’re within the parameters of typical bear market lifespan.

It’s worth noting, too, that since rallying from that November bottom, North American indexes have been trading in a sideways range neither gaining nor losing much ground. Until Friday, that is. That’s when bargain hunters came back into the market after a two-week holiday hiatus and began snapping up issues across the board, with energy and Much of that action is a result of the massive stimulus package poised to take effect on Jan. 21, the day after Barack Obama is sworn in as the next US President. Until then, it’s possible that markets will undergo a mini “Obama” rally through January.

We said at the outset that markets are discounting mechanisms. True to form, the appalling macro-economic news on display in the ISM’s manufacturing index for December had already been discounted by equity markets some weeks ago. Shrinking earnings forecasts, dividend reductions, and deep cost cutting have, we believe, also already been discounted by the market. Hence the seeming lack of interest in the headlines of the day, and the almost counterintuitive triple-digit gain on Jan. 2.

Indeed, the Canadian and US stock markets may have bottomed, as the last drops of both fear and greed have been wrung out of markets. However, we will need some confirmation in March, when taxpayers begin filing their returns. That will tell us a lot about the depth of the recession.

The end of the first quarter will also mark the end of the Presidential honeymoon period, and at about the same time, we will get a handle on the costs associated with those underfunded defined benefit pension plans. That number could be in the trillions, on top of everything else that has been spent to revive this economy. This combination could throw cold water on a rally, which is why we are telling all who will listen to be willing to hedge their bets sometime in March.

After that, when you tie

in the massive spending programs, the market's discounting, pricing, and weighing function will increasingly drive performance. A US recovery is expected in the last quarter of 2009, which is when the trillions of dollars of pump priming should filter through to the US consumer.

So with both Canadian and US stock valuations relatively cheap, we see a rally into February, followed by a short-term correction or consolidation period. After that, we have confidence that stocks can sustain a longer-term rally through the second half of the year.

Global recession

The major Asian economies, which have been the largest consumers of raw materials for the past few years, are only now beginning to feel the chill of global recession. China, for example, chopped interest rates by 108 basis points late in 2008, the deepest such cut in 11 years. The World Bank predicted that China's GDP would slip to 7.5% in 2009, below the 8% level that China's economists believe to be an acceptable rate of growth. The interest rate cut is a clear signal of the extent to which the Chinese economy has slowed.

In fact, GDP growth forecasts have been cut around the globe. The Organisation for Economic Co-operation and Development (OECD) issued a report last week, revising its outlook downwards again. It now expects the combined GDP of the 30-member group to shrink 0.4% next year. And that's because, the 15-country eurozone, already in recession, will contract 0.6% in 2009, while the U.S. economy will shrink 0.9% and Japan's 0.1%. None of which, incidentally, looks tremendously good for base metals demand for the foreseeable future.

The MSCI Europe, Australasia & Far East (EAFE) Index posted an 20% decline in the fourth quarter, as the index closed out the year with a 12-month loss of 45% (in US$). The spreading financial crisis deepened through the year as the credit crunch began to erode real economic activity through Europe and Asia. Both external trade and domestic demand faltered badly across all regions, pushing all economic indicators deep into the red.

With many member nations already in recession through the second and third quarters, the 15-nation eurozone faced increasingly grim economic data through the fourth quarter. Business and consumer confidence indexes have plummeted to their lowest levels in 15 years. And both manufacturing and service purchasing managers indexes for December indicated economic contraction for the eighth consecutive month. Credit conditions remain tight despite an early December rate cut by the European Central Bank to 2.5%. An economic recession and very tight credit conditions in the UK also spurred the Bank of England to cut its key rate by a very significant 100 basis points, to 2%, in December.

With Japan's export-oriented economy in a recession since July, the Bank of Japan had little choice left but to follow the US lead and cut its key policy rate to a near-zero 0.10% in December. Japan seems once again beset by a perfect storm of intractable economic problems, including collapsing exports, the sharpest industrial slowdown since the 1970s, a slumping housing market, weaker consumer spending as wage gains lose momentum, a softening labour market, and tight credit conditions.

Australia's resource-based economy, while not yet in recession, faced powerful headwinds as the global recession began to bite down under. In an effort to mitigate the damage and head off a recession the Reserve Bank of Australia cut its key lending rate by 300 basis points through the year, to a 12-year low of 4.25%. And the government announced a pre-Christmas stimulus package of A$10 billion. However, domestic demand and busi-

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Selected Croft Share Classes — 2008

Name	Value*	Return
CFG Custom Portfolio Corporation Core Portfolios		
Class B-1 Income Shares	$7.48	–24.2%[1]
Class C-1 Equity Shares	$6.53	–22.9%[1]
Class A-1 Global Equity Shares	$8.44	–13.22%[1]
CFG Custom Portfolio Corporation Active Management Portfolios		
Class D-3 Income Shares	$8.65	–13.5%[2]
Class A-3 Canadian Conservative Equity	$7.51	–25.0%[2]
Class B-3 Canadian Diversified Equity	$6.38	–36.2%[2]
Class C-3 Canadian Growth Equity	$6.84	–31.6%[2]
Portfolio Index Evolution Corp.		
PIE Income Fund	$10.15	+1.5%[3]
PIE Canadian Equity Fund	$10.29	+3.0%[3]
PIE US Equity Fund	$9.86	–1.4%[3]
PIE International Equity Fund	$10.48	+4.8%[3]
PIE Emerging Markets Equity Fund	$10.13	+1.4%[3]
PIE Alternative Strategies Fund	$10.36	+3.6%[3]
Stock Indexes		
S&P/TSX Composite Index	8987.70	–35.0%
S&P 500 Composite Index	903.25	–24.0%[4]
MSCI EAFE Index	1237.42	–32.0%[4]

* As at Dec. 31, 2008
1. 12-month return to Dec. 31, 2008.
2. Return to Dec. 31, 2008, since inception May 12, 2008.
3. Return to Dec. 31, 2008, since inception Nov. 4, 2008.
4. In C$.

Continued from Page 7

ness activity have slowed to a crawl owing to slumping demand for key commodities from China.

The MSCI Emerging Markets (EM) Index ended the year down 55%, following a 28% decline (in US$) in the fourth quarter. With statistics showing the 30 developed nations comprising the Organisation for Economic Co-operation and Development (OECD) on track for a recession, emerging nations have been hard-pressed to avoid the fallout of collapsing demand on their export-dependent economies. A financial vice consisting of rising borrowing costs and sliding currencies on one side and slowing economic output and collapsing stock markets on the other forced many emerging nations to seek emergency loans from the International Monetary Fund through the second half of the year.

Any thought of global decoupling was abandoned as emerging nations with large deficits that require foreign financing, such as Hungary and Pakistan (both of which are components of the MSCI EM Index), faced the possibility of sovereign default. The IMF moved to help developing nations facing liquidity problems weather the financial crisis by easing lending policies that required deep domestic fiscal policy changes. Emerging market countries like Mexico, Brazil, and Eastern European nations without large current account deficits would benefit most from these relaxed rules. Russia, meanwhile, has fallen into recession as it grapples with soft crude oil prices, a mainstay of its recent economic growth.

As the global economic slowdown widened through the third and fourth quarters, emerging Asian giants China and India also began to feel the effects of slowing exports. Although this was initially partially offset by still-positive domestic demand, capital spending saw significant decline, and unemployment rates rose as export-dependent factories began to close down. China's GDP slowed to an annual 9% in the most recently reported third quarter, down from a peak of 11.9%, and appears headed for growth of around 7% in the fourth quarter. An annual rate of 8% is considered the threshold of growth for China.

Global Equity Pool

We're pleased to report that our Global Equity Pool gained almost 2.60% overall in one of the most challenging quarterly periods since Great Depression. The Global Equity Pool outperformed its benchmark by 21.42%, or 6.84% adjusted for effects of currency exchange.

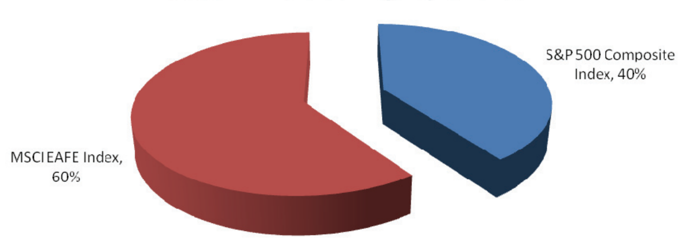
We achieved this result by holding significant cash during the tremendous downside volatility from September to November and shifting to full investment during the early part of December.

The Global Equity Pool also took advantage of massive premiums for options by committing to a regimented covered-call writing strategy throughout the course of the last four months of 2008. This mitigated almost 25% of the drop felt by the general market. Those covered calls expired in November and were not rolled over into the next month, so that the Global Equity Pool was well positioned to benefit from the subsequent rally off the bear market bottom.

We're already beginning to hear speculation about whether this will be a "U-shaped" bottom, or a "V," or a "W." In truth, it's impossible to consistently pick the bottom – or top – of any market, whether it's a single stock, an entire index, or a commodity. The key is in asset allocation and rebalancing.

Those with portfolios diversified by asset class and defined by solid risk parameters won't be unduly worried about bottoms, whether shaped like a "U," "V," or "W." They are already optimally positioned for the coming rally, and are cushioned from the worst of the market's downside volatility.

CFG Custom Portfolio Corporation
Class A-1 Global Equity Shares



As at Dec. 31, 2008
Closing value: $8.44 12-month return: –13.2%

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