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markets somewhat, and the flight-to-safety reflex started to benefit the growing fixed-income proportions of GAlNs mandates. However, equity market ETF returns still ranged from an abysmal -6.5% for **Claymore US Funda-mental Index ETF (C\$ Hedged)** (TSX: CLU) to the just above breakeven of +1% for **PowerShares FTSE RAFI Emerging Markets Portfolio ETF** (NYSE: PXH). The net result was that all

GAlNs models declined again in June, with more aggressive profiles underperforming more conservative ones for the second consecutive month.

While the sharp reversal in the second quarter meant losses for all GAlNs mandates to date in 2010, all profiles except PIE were still positive on the previous 12 months, and GAlNs Tactical Growth remained well ahead of the Croft RWI Growth

benchmark on a two- and three-year basis.

In July we substituted the dividend-focused **Claymore S&P/TSX Canadian Dividend ETF** (TSX: CDZ) for all Canadian equity, effectively increasing the fixed-income exposure above 50% for all mandates, while still ensuring significant opportunity to take advantage of a possible summer equity rally. ■



R.N. Croft Financial Group Inc.
218 Steeles Ave. East
Thornhill, ON
L3T 1A6

Telephone: 905-695-7777
Fax: 905-695-9777
Toll-free: 1-877-249-2884
E-mail: info@croftgroup.com
Website: www.croftgroup.com

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Key Croft Share Classes

Name	Value	Return % (at June 30, 2010)				
		3-Mo.	6-Mo.	1-Yr.	3-Yr.	Inception
CFG Custom Portfolio Corporation Core Portfolios						
Class A-1 Global Balanced Share	\$7.77	-2.2	-5.8	-5.4	-	-8.7 (12/31/07)
Class B-1 Income Shares	\$8.90	1.5	0.4	8.0	-1.0	0.1 (10/31/06)
Class C-1 Equity Share	\$7.62	-4.3	-1.6	7.3	-8.3	-5.4 (10/31/06)
Class E-1 Option Writing Share	\$11.10	-2.5	-1.6	2.6	-	9.0 (3/31/09)
Class F-1 Speculative Share	\$10.13	-5.6	-2.9	0.2	-	1.4 (8/31/07)
CFG Custom Portfolio Corporation Active Management Portfolios						
Class A-3 Canadian Conservative Equity	\$9.38	-3.4	3.4	18.4	-	-2.0 (5/30/08)
Class B-3 Canadian Diversified Equity	\$7.50	-5.3	-2.9	18.2	-	-11.0 (5/30/08)
Class C-3 Canadian Growth Equity	\$7.34	-6.5	-6.7	12.4	-	-12.6 (5/30/08)
Class D-3 Income	\$9.90	0.2	1.7	11.6	-	1.8 (5/30/08)
Class E-3 Morris Financial Balanced Income	\$10.34	-1.1	1.1	-	-	3.4 (10/31/09)
Class F-3 Morris Financial Balanced Growth	\$10.14	-2.2	-0.04	-	-	-0.5 (10/31/09)
PIE Portfolio Index Evolution Corp. (Series I)						
PIE Income Fund	\$10.56	0.5	0.3	3.6	-	6.4 (11/25/08)
PIE Canadian Equity Fund	\$10.72	-6.1	-2.4	8.0	-	13.3 (11/24/08)
PIE US Equity Fund	\$10.11	-7.8	-3.9	1.8	-	0.7 (11/25/08)
PIE International Equity Fund	\$9.02	-9.6	-12.1	-8.6	-	-6.3 (11/25/08)
PIE Emerging Markets Equity Fund	\$10.30	-3.3	-1.2	15.0	-	13.2 (11/25/08)
PIE Alternative Strategies Fund	\$13.34	5.6	1.4	23.3	-	20.0 (11/25/08)
Stock Indexes¹						
S&P/TSX 60 Composite Index	11,294.42	-6.2	-3.8	8.9	-	-
S&P 500 Composite Index	1,093.17	-8.0 ¹	-6.3 ¹	9.4 ¹	-	-
MSCI EAFE Index	1,429.81	-11.1 ¹	-13.6 ¹	-0.2 ¹	-	-

1. In C\$.

All metrics as at 6/30/2010. Performance is not guaranteed. Portfolio values change frequently, and past performance may not be repeated. Performance is based on actual fee-adjusted returns to 6/30/2010. Performance data have not been audited and are for illustrative purposes only. R.N. Croft Financial Group Inc. is a licensed Portfolio Manager serving individual and institutional clients throughout Canada. Valuations and performance results are reported in Canadian dollars. Performance is also calculated net transaction fees. Additional information regarding calculating and reporting performance is available upon request.

CROFT

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HOW TO REACH US

R.N. Croft Financial Group Inc.

Richard N. Croft
President,
Portfolio Manager
905-695-2310

Mark Taucar, CFA
Vice President,
Portfolio Manager
905-695-2314

Robyn Thompson, CFP
Vice President
905-695-2320

Christopher Croft
Analyst
905-695-2318

Croft Capital Management Inc.

Kathy Quinn
President
905-695-2312

Diane Bode
Vice President, Operations
905-695-2315

Angie Mondino
Manager, Client Services
905-695-2317

www.croftgroup.com

Eurozone crisis triggers market retreat through second quarter

Richard Croft

Investors got no reprieve from the synchronized global stock market slide that took market indexes into correction in an event-filled and volatile second quarter. Against a backdrop of a slowdown in the pace of economic recovery just about everywhere, investors got busy adjusting earnings projections that seemed, through the first quarter, to have no place to go but the moon. But those pipe dreams all came to an abrupt end as investors increasingly sought assorted safe havens. And that search continued apace in June.

Canada's April gross domestic product report (data released in June by Statistics Canada) provides a microcosm of activity the world over. For the first time in eight months, Canadian output recorded no growth month over month in April, although it still added up to a 3.3% year-over-year rate of increase. The retail sector was the worst performer, joined by mining, manufacturing, and residential real estate.

Global manufacturing indexes, typically released

in the first days of each month, paint a picture of pretty much synchronized slowdown in the pace of expansion. Now, this is quite a different thing from saying "contraction." For example, the US Institute for Supply Management's widely followed manufacturing index recorded a reading of 56.2 in June. Anything above 50 is considered to be expansionary in the manufacturing sector, so US factories are still gathering momentum. However, that reading is down from the 59.7 recorded in May – and that's what's been concerning market watchers. Because the slowdown in the pace of manufacturing has been repeated just about everywhere, from China and the rest of Asia (except Japan) to the eurozone and Canada.

Are we on the cusp of the second dip of a double-dip recession? That's the question preoccupying the deep thinkers on Bay and Wall Streets these days. The answer appears to be a resounding "We don't think so!" The venerable Alan Greenspan, formerly Chairman of the US Federal Reserve Board, and

now often blamed in part – probably with at least some justification – for the financial meltdown that began in 2008, weighed in last week with his opinion that the economy is simply undergoing a "typical pause" in a recovery.

Let's hope he's right. June's tepid US private payrolls report doesn't give much encouragement, though private hiring in June actually rose 83,000 compared with 33,000 in May. However, more disconcerting was the total non-farm payroll figure, which fell 125,000 jobs. The unemployment rate slipped to 9.5%, but only because a large number of workers left the labor force altogether.

Consumer confidence dropped sharply in both Canada and the US in June as well, as worries about job growth continued to cast a shadow over the labor market.

The lower readings on these economic datapoints led to much speculation about central bank actions in coming months, particularly in Canada, where the Bank of Canada just raised

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its benchmark target overnight lending rate 25 basis points, to 0.50%, in early June. The Bank itself has not telegraphed any particular change in policy, and the deep thinkers seem divided on what the Bank's next move is likely to be after

July's rate hike to 0.75%. With second-quarter GDP expected to grow about 3% annualized and core inflation hovering just shy of the Bank's 2% mid-point target, there seems no pressing reason for the BoC to back off from its plan for monetary policy normalization.

However, our own view, since it's only fair that we weigh on this with the rest of the market, is that the BoC will not be in a rush to raise rates, waiting instead for clearer data from our neighbors to the south. It's just more evidence, as if we needed it, that we are living in a global market and need to adjust our position with an eye beyond our borders.

South of the border, "monetary policy normalization" isn't even close to being reintroduced to the Fed's lexicon. The president of the Atlanta Fed said in June that "inflation isn't much of a current worry," but that "if anything, there is a small risk of deflation that must be monitored." There you have it, straight from the horse's mouth.

Not too surprising really, given the continuing shadow of the eurozone debt crisis, which may eventually be resolved with Greece and perhaps Spain leaving the monetary union, although that would be only the very last resort. Then, there's the active efforts of China's government to cool red-hot economic growth, and attendant inflation, with measures that include restricting lending, removing stimulus, and most recently, loosening the yuan's peg to the US dollar. Yields on 10-year US Treasury bonds last week dropped to their lowest levels since

2009, presaging a faltering recovery in the months ahead.

Markets in retreat

And that brings us full circle back to the stock markets, which, if anything, are an ultra-sensitive barometer of investor sentiment. That sentiment has been on the downswing for the past quarter, and showed little sign of letting up in the early days of July.

The S&P/TSX Composite Index ended June with a 4% month-over-month loss, adding up to a 6% drop from the close of the first quarter, and a year-to-date loss of 3.9%.

New York's Dow Jones Industrial Average ended June with a monthly loss of 4.0%, for a quarter-over-quarter retreat of 10%. The DJIA was down 6.3% year-to-date to the end of June.

The broad-based S&P 500 Composite Index closed June with a 5.4% monthly loss, and ended the quarter down 11.9%, for a year-to-date loss of 7.6% in the first half of the year.

The story was the same the world over, with global markets suffering losses across the board. The broad MSCI World Index lost 3.6% month over month in June, for a 13.3% quarter-over-quarter retreat, and a 10.9% loss year to date to June 30.

Crude oil closed on June 30 at US\$75.63 per barrel, down 4.7% year to date, while gold ended the first half at US\$1,245.50, up 13.7% year to date. The Thomson Reuters/Jeffries CRB Index of commodity futures is down 8.8% in the first half of the year.

The correction continues. ■

MANAGER'S VIEW

Short-term equity reversals impact GAINs portfolios

By Ken Mulders, CFA

one-, three-, and six-month periods to June 30, 2010. The greatest level of outperformance was posted by the Series I units (TCG645), outdistancing the return of the S&P/TSX Composite Index by 11.09 percentage points in the first half of the year. We believe this fund to be a necessary component to any portfolio for its ability to mitigate overall market volatility.

News Notes

In order to reduce portfolio duplication, streamline holdings, control costs, and increase management efficiency, the **CFG Custom Portfolio Corporation Class C-1 Equity Share** has been discontinued, with assets merged into the **Class E-1 Option Writing Share**. The merged fund will continue to be called the Class E-1 Option Writing Share. Clients previously holding the Class C-1 Equity Share will now hold the Class E-1 Option Writing Share, with holdings in the Class E-1 Option Writing Share prorated to the same dollar value of their holdings in the discontinued share class as of the transition date.

This transition is effective immediately and comes at no cost to clients of R.N. Croft Financial Group Inc.

In addition, the **Class F-1 Speculative Share** has been discontinued. ■

Coming out of the strong recovery to the end of March 2010, and combined with a continuing bear-market in fixed-income investments, all GAINs mandates entered the second quarter adjusted to maximum equity exposure (95% for **GAINs Tactical Growth**). Unfortunately, the growing uncertainty over a euro fiscal crisis in April led to outright panic in May, hitting the still-aggressively-

profiled GAINs mandates hard, with all equity ETFs used declining between 3% and 9%, and leading to a greater than 5% loss for **GAINs Tactical Growth** (vs about -2.5% for **GAINs Conservative** and **PIE Conservative/Growth**.) By June, the hasty assembly of a €750 billion credit facility had calmed

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



Courtesy Yahoo! Inc.

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



Courtesy Yahoo! Inc.

CHART 3—MSCI WORLD INDEX, 1 YEAR



Courtesy Bloomberg LP.



Global Asset Investment Strategies

GAINs Portfolios

Combines the benefits of balanced, globally-diversified portfolios with a proprietary tactical asset allocation strategy.

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MANAGER'S VIEW**Volatility challenge in Q2**

By Mark Taucar, CFA

**Active Management Portfolio Program**

Custom portfolios built from a selection of actively managed funds

**Core Custom Portfolio Programme**

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

The second quarter saw a resumption of the uncertainty that we've been writing about for the past few issues of *Portfolio Matters*. As discussed in our previous commentaries, our aim has been to shield the portfolios we manage from uncertainty (that is, from "volatility") sooner rather than later. Consequently, many of our Share Classes have exhibited relatively good performance against their benchmarks.

Growing concerns about the resiliency and robustness of the economic recovery have elicited suggestions of a potential double-dip recession from assorted media pundits and deep thinkers.

Complicating the matter has been the day of reckoning for the profligate spending habits of several European countries, which has resulted in the eurozone credit crisis. The incestuous nature of credit buying and concentration of sovereign debt issues of member nations has precipitated worries of further credit contagion in the region.

The second-quarter decline in European equity markets came as a result of worries that corporate profits and fiscally devastated European countries would weigh on equity returns far into the future.

Income

Our Income share classes, having allocations of equity, real estate, preferred shares, and fixed income, have underper-

formed relative to their fixed income benchmarks. However, given our concern about volatility in portfolios, we have generally increased exposure to bonds. Despite the heavier allocations to "higher-risk" securities like preferreds and blue chip dividend equities, our Income funds still produced positive returns despite the retracement of many of these sectors through the quarter. Over the longer-term, we feel that heavier allocations to income strategies will create enormous value relative to market performance, because manager skill in selecting good dividend-paying companies will now be paramount in building and maintaining well-diversified portfolios.

Domestic Equity

Four of our six Canadian-based Equity funds have produced exceptional numbers relative to their benchmarks on a three-month basis. These are the **CFG Custom Portfolio Corporation Class C-1 Equity Shares, Class A-3 Canadian Conservative Equity Shares, Class B-3 Canadian Diversified Equity Shares, and the Class E-1 Option Writing Shares**. All of these share classes focus on mitigating the risks in the market through selected option-writing strategies against long-only share positions in companies that have fundamentally sound business models. Option-writing strategies tend to work best in volatile mar-

kets, which we anticipate will prevail for the second half of the year.

The **PIE Portfolio Index Evolution Corporation Class A-1 Canadian Equity Fund** marginally underperformed its benchmark, because its heavier weighting to small- and mid-cap Canadian equity weighed down overall performance.

Global Equity

The **CFG Custom Portfolio Corporation Class A-1 Global Balanced Share** class has performed exceedingly well over the course of the past six months, outperforming its benchmark by almost 400 basis points on a six-month basis and by 650 basis points on a three-month basis. Higher cash values in conjunction with allocations to volatility strategies mitigated much of the 10% drop in the benchmark.

The **PIE Portfolio Index Evolution Corporation Class C-1 US Equity Fund, Class D-1 International Equity Fund, and Class E-1 Emerging Markets Equity Fund** marginally underperformed relative to their benchmarks over the past quarter. However, the **PIE Class C-1 US Equity Fund** has posted better six-month returns relative to its benchmark.

Alternative Equity

The **PIE Portfolio Index Evolution Corporation Class F-1 Alternative Strategies Fund** has been the star of the cast, as asset holding are negatively correlated to broader equity indexes, resulting in strong returns over

PIE Fund reviews**PIE Class A-1 Income Fund**

After telegraphing such a move in April, the Bank of Canada hiked its benchmark target overnight lending rate by 25 basis points in early June, to 0.50%. It was the first of the major G-7 group of wealthy industrialized nations to do so after the 2008 credit crisis forced central bank rates to near zero in the developed world.

The BoC believes Canada's economic growth will be robust enough that the 2% inflation target will become a key concern. In its April Monetary Policy Report, the BoC said it expects gross domestic product to grow 3.7%, higher even than the International Monetary Fund's 3.1% forecast in its April World Economic Outlook.

However, the Bank followed up with a statement saying that "further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments." This was believed to be in reference to the growing global flight to quality through the second quarter, driven by the eurozone debt crisis, rising geopolitical tensions in the Korean Peninsula, and the growing potential for a disinflationary period in the US.

As a result, both the broad bond market and preferred shares slipped through April before staging

a rally in late May through to the end of June, to close the quarter just about flat, which was reflected in the Fund's slightly negative second-quarter performance. Performance weakness was mitigated somewhat by exposure to the broad bond market, as represented by the Fund's holding of **Claymore Advantaged Bond ETF** (TSX: CAB), which remained ahead about 1.7% year to date. In addition, the Fund's holding of **iShares DEX Real Return Bond Index ETF** (TSX: XRB) gained about 1.8% quarter over quarter in the second quarter, and remained about 2.3% ahead for the year to date, cushioning second-quarter weakness in conventional bond and preferred share markets.

PIE Class B-1 Canadian Equity Fund

In the second quarter, the Canadian economy appeared headed for a third consecutive quarter of growth after staging a 6.1% annual real rate of growth in the first quarter. Surging exports, inventory rebuilding, and residential construction supported most of the growth in the first quarter, but that may be slowing in the second quarter, as global fiscal tightening programs begin to kick in.

Although Canadian productivity numbers rose only 0.7% in the first quarter, more people found jobs as well, with employment rising 0.7%, according to Statistics

Canada. StatsCan's composite leading indicator rose 0.9% in May over April, as manufacturing rose. The housing index fell 1.2% however, for the first time in more than a year, as the residential real estate market begins to cool.

In its April *Monetary Policy Report*, the Bank of Canada suggested that the economic recovery has been gaining steam more rapidly than it had first projected, and it revised gross domestic product to grow 3.7% in 2010 before slowing in 2011.

Statistics Canada's index of leading economic indicators rose for the 12th consecutive month in May, powered by growth in manufacturing. However, while corporate profits were up about 17% year over year in the first quarter, much of that was the result of higher prices for resources and exports. The largest positive earnings surprises came from the Consumer Discretionary, Financials, and Telecom Services sectors. Materials and Energy sectors disappointed, with first-quarter earnings coming in below estimates.

The Fund's dominant exposure to the S&P/TSX 60 Index reduced overall performance in the second quarter through its holding of the **iShares S&P/TSX 60 Index Fund** (TSX: XIU), which slid about 4.3% from the first quarter. Year to date, the index finished the first half down 6%. The Fund's weighting to the



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Claymore Canadian Fundamental Index ETF

(TSX: CRQ) also contributed to second-quarter sluggishness, sliding about 7% quarter over quarter, for a total retreat of 2.8% year-to-date.

PIE Class C-1 U.S. Equity Fund

Faced with high unemployment, low core inflation, plunging new home sales, and considerable slack in the economy, the US government resisted calls to remove stimulus in the second quarter, and in fact planned on adding more.

Producer prices fell 0.3% month over month in May, as lower food and energy prices combined with high unemployment and excess capacity to hold inflation in check. However, US industrial production rose 1.2% in May, mainly in utilities and autos, as capacity utilization rose to 74.7% in the month, still considerably shy of the 80% average over the past 20 years.

US Federal Reserve Board Chairman Ben Bernanke continued to signal that the Fed isn't quite ready to pull the trigger on interest rate hikes anytime soon. He indicated that the US economy now appears to have developed enough momentum to avoid a double-dip recession, while stimulative monetary policy continues to provide support. He also made no bones about the fact that the Fed will continue to cooperate internationally to ensure stability in the face of the eurozone crisis,

indicating also that the effect of that crisis is "likely to be modest" if financial markets continue to stabilize.

Against this backdrop, then, the US Federal Reserve Board left its benchmark fed funds rate unchanged in the second quarter, at between 0% and 0.25%.

Stock markets declined broadly in the second quarter, as the eurozone credit crisis triggered a "flight to quality" and cut investors' appetite for riskier asset classes. The Fund's high weighting to US diversified equities through its holding of the **SPDR S&P 500 ETF** (NYSE: SPY) and the **Claymore US Fundamental Index ETF (C\$ Hedged)** (TSX: CLU) suppressed performance as the Standard & Poor's 500 Composite Index slipped 3.5% (in C\$) quarter over quarter in the second quarter. Mid- and small-cap value style-based indexes also fell in the quarter, and Fund performance was weighed down by a 5.3% (in C\$) quarterly decline in the **iShares Russell MidCap Value Index Fund** (NYSE: IWS) and a 6.7% (in C\$) drop in the **iShares Russell 2000 Value Index Fund** (NYSE: IWN).

PIE Class D-1 International Equity Fund

Fears of "fiscal contagion" rippled across Europe regardless of the European Union's planned trillion-dollar debt-guarantee backstop, as Italy and Spain began to implement "fiscal austerity" plans and the government of Greece put portions of a few of its infrastructure

holdings up for sale. Still, the euro continued to weaken against the US dollar through the second quarter, while the three-month London Interbank Offered Rate spiked to 0.53%, the highest since last July.

The European Central Bank (ECB) began buying up junk debt from its fiscally-troubled members. But the tide of liquidity flooding into Europe is beginning to raise concerns that the ECB has pretty much abandoned the rigid stance on inflation it adopted through the recession, with the fear that inflation will rise, even as governments are forced to tighten fiscal policy and economic growth remains fragile. And that, in turn, could lead to higher bond yields as investors demand a higher risk premium – a vicious circle.

The eurozone troubles also filtered into Asia in the second quarter, as manufacturing growth cooled somewhat from its previous red-hot pace. With a weaker euro, Asian goods became more expensive in Europe, and raised concern that Japanese exports to Europe, already crimped by the global financial crisis over the past two years, would shrink even more. However, Japan's exports to China, its leading export market, continued to show strength.

Australia's economy, meanwhile, continued to benefit from Asian growth and strong commodity prices, leading the Reserve Bank of Australia to continue focusing on the potential for rising inflation. The RBA raised its key cash rate by a total of 50 basis points in the quarter, to

4.50%.

Continuing concerns about widening fiscal and credit problems in the eurozone weighed on the Fund's exposure to Europe, Australasian and Far East (EAFE) diversified equities, as its holdings the **iShares MSCI EAFE Index Fund** (TSX: EFA) declined 17% quarter over quarter. The **Claymore International Fundamental Index ETF** (TSX: CIE) also weighed on Fund performance, with a 14.2% retreat in the quarter.

PIE Class E-1 Emerging Markets Equity Fund

The eurozone's fiscal troubles filtered into Asia in the second quarter, as manufacturing growth cooled somewhat from its previous red-hot pace. With a weaker euro, Asian goods became more expensive in Europe, and raised concern that exports to Europe, already hit by the global financial crisis over the past two years, would shrink even more. Although emerging country stock markets have mostly lost ground in the first half of the year, economic expansion has been robust.

China's gross domestic product expanded 11.9% annualized in the first quarter and seems on pace to produce double-digit expansion in the second. The rapid post-recession recovery is mirrored in other Asian emerging economies, including India, Korea, and Taiwan. Brazil's output rose 11% annualized in the first quarter, as strong demand from China and growing domestic demand put the country on track for a similar second-quarter GDP growth.

Despite strong economic growth, emerging stock markets for the most part ended the second quarter flat or down on the quarter, and most are in the red in year-to-date terms, including Asian and South American markets. The Shanghai Exchange, however, dropped 23% (in local currency) as the Chinese government allowed the yuan appreciate and began to implement domestic lending restrictions in an effort to cool the housing market.

The Fund's heavy weighting to Emerging Market diversified equity ETFs, each in turn with significant exposure to China, weighed on second-quarter performance. For example, in the Fund's two largest holdings, the **Vanguard Emerging Markets ETF** (NYSE: VWO) ended the second quarter with a 5.9% loss (in C\$) quarter over quarter, while the **PowerShares FTSE RAFI Emerging Markets Portfolio ETF** (NYSE: PXH) fell 6.7% (in C\$) in the quarter.

PIE Class F-1 Alternative Strategies Fund

The Fund's investment objective is to provide long-term capital appreciation by investing in a diversified portfolio of publicly listed issues whose business or assets are exposed largely to real estate, with the remainder to a cross-section of commodities, including precious metals, agricultural commodities, energy related assets, exchange-traded commodity funds, and commodity index funds.

Canadian REITs faced an uphill struggle in the second quarter, even though market activity continued to grow following the slowdown through 2009. Both office and retail activity picked up in the quarter as the Canadian economy continued to post solid growth and both consumer spending and residential housing markets saw some strength. Industrial property markets also saw some improvement against a backdrop of growing industrial production and firm commodity prices. However, a vacancy rates have generally risen in all sectors as increased supply from 2009 overhangs the market.

The Fund's roughly 30% allocation to commodities weighed on overall performance, however, as commodity prices eased on fears that the eurozone debt crisis would begin to erode the strength of the global recovery. With the exception of gold, most commodity prices slipped during the quarter.

The Fund's heavy weighting to the Canadian REIT sector helped mitigate the slide in commodities through the second quarter, and contributed to the Fund's marginally positive return in the quarter. Holdings of the broad commodity index through **iShares S&P GSCI Commodity-Indexed Trust** (NYSE: GSG) slipped 6.9% (in C\$); however, the Fund's holding of the **iShares S&P/TSX Global Gold Index Fund** (TSX: XGD) advanced 21.4% in the quarter, also helping to mitigate overall weakness in the commodity sector. ■



“Although emerging country stock markets have mostly lost ground in the first half of the year, economic expansion has been robust.”