

Continued from Page 7

GAlnS PIE Conservative Growth model up in the month (but not in the trailing 12 months), mainly on the recent strength of the **PIE Class F-1 Alternative Strategies** shares.

While nervous pessimism still made the headlines in September, driving gold to a new record and pushing government bond rates down slightly, the tone of economic analyses leveled to neutral, with at least as many predictions of a normal, if muted, recovery as a double dip. The

equity markets, however, definitely voted for recovery, with gains in every region, and the best US returns of 2010. All GAlnS models showed significant increases in September, with all except the PIE models now relatively flat year-to-date and over the trailing 12-months.

The substitution in July of the dividend-focused **Claymore S&P/TSX Canadian Dividend ETF (TSX: CDZ)** for all Canadian equity allocations paid off handsomely. Effectively, it increased the fixed-

income exposure above 50% for all mandates, while still ensuring significant opportunity to take advantage of the third-quarter equity rally. Quarterly returns for GAlnS profiles ranged from about 3% (Conservative Growth) to 8% (Tactical Growth). Both 9-month (year-to-date) and 12-month-trailing returns (except for GAlnS PIE models) were relatively flat, representing a significant improvement on the second quarter. ■



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Key Croft Share Classes

Name	Value	Return % (at Sept. 30, 2010)				
		3-Mo.	6-Mo.	1-Yr.	3-Yr.	Inception
CFG Custom Portfolio Corporation Core Portfolios						
Class A-1 Global Balanced Share	\$8.31	7.1	4.7	-1.9	-	-5.7 (12/31/07)
Class B-1 Income Share	\$8.99	5.7	7.3	7.1	0.3	1.5 (10/31/06)
Class E-1 Option Writing Share	\$11.06	1.1	-1.5	-2.5	-	8.2 (3/31/09)
CFG Custom Portfolio Corporation Active Management Portfolios						
Class A-3 Canadian Conservative Equity	\$9.73	6.4	2.9	15.5	-	0.9 (5/30/08)
Class B-3 Canadian Diversified Equity	\$7.81	6.0	0.3	10.7	-	-7.6 (5/30/08)
Class C-3 Canadian Growth Equity	\$7.54	3.3	-3.4	3.4	-	-10.1 (5/30/08)
Class D-3 Income	\$10.28	5.6	5.7	8.6	-	3.9 (5/30/08)
Class E-3 Morris Financial Balanced Income	\$10.78	4.8	3.6	-	-	8.3 (10/31/09)
Class F-3 Morris Financial Balanced Growth	\$10.56	4.5	2.2	-	-	6.0 (10/31/09)
PIE Portfolio Index Evolution Corp. (Series I)						
PIE Income Fund	\$10.85	2.8	3.3	3.7	-	7.1 (11/25/08)
PIE Canadian Equity Fund	\$11.65	8.8	2.2	9.7	-	16.6 (11/24/08)
PIE US Equity Fund	\$10.89	7.7	-0.8	4.7	-	4.8 (11/25/08)
PIE International Equity Fund	\$10.22	13.3	2.3	-0.6	-	1.2 (11/25/08)
PIE Emerging Markets Equity Fund	\$11.50	11.7	7.0	6.5	-	10.0 (11/25/08)
PIE Alternative Strategies Fund	\$14.55	9.1	15.2	15.5	-	22.7 (11/25/08)
Stock Indexes¹						
S&P/TSX 60 Composite Index	12,368.65	9.5	2.7	8.5	-	-
S&P 500 Composite Index	1,141.20	7.5 ¹	-1.0 ¹	3.7 ¹	-	-
MSCI EAFE Index	1,561.01	12.4 ¹	-0.4 ¹	0.5 ¹	-	-

1. In C\$.

All metrics as at 9/30/2010. Performance is not guaranteed. Portfolio values change frequently, and past performance may not be repeated. Performance is based on actual fee-adjusted returns to 9/30/2010. 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.

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Markets stage third-quarter stealth rally as investors overcome anxieties

Richard Croft

For investors, September is often the cruelest month. Not this time though. Stock markets rallied through September, capping three months of gains through an at-times volatile summer market. Market advances came in fits and starts, overcoming intense investor anxieties about, well, anything at all. Yet eurozone sovereign debt troubles, the fading US recovery combined with eye-glazing chatter about the dreaded triple-D (deflationary double-dip), and growing global currency friction failed to put a damper on what turned out to be an unexpected third-quarter stealth rally. Investors turned a blind eye to deteriorating US economic data, and instead started high-fiving the US Federal Reserve Board's announcement that it would implement another round of quantitative easing, if necessary. That intention was further bolstered by William Dudley, President of the New York Fed. He

said in September that the current outlook for inflation and employment remains "unacceptable," adding that the Fed has "the tools that can provide additional stimulus at cost that do not appear to be prohibitive." As for the likelihood of using those "tools," Mr. Dudley all but confirmed that the Fed would reinstate asset purchases, unless things improve radically for normalizing both inflation, which is widely perceived to be too low, and the unemployment rate, which at around 9.6% is too high.

That put a buzz in stock markets, as a fresh wave of newly-minted money is about to wash over the financial markets.

Gold also moved to record highs. At over US\$1,380 per ounce, gold is once again behaving as a classic crisis hedge and store of value. The weakness of the US dollar against a basket of major currencies is one reason that's frequently trotted out for gold's smart advance through

the third quarter. Another is strong demand from rural India's farmers just coming off a prosperous harvest. Another is the potential for the dreaded deflationary double-dip. Another is the potential for rising inflation in the not-too-distant future as the US monetary base is set to expand yet again. Then, of course, there's the ever-present speculative buying that bets on any and all of these factors. To some degree, all of it goes into the stew that is refined as the London gold fix at noon GMT each day.

But the biggest factor of all right now may be the devaluation of global currencies. Although Dominique Strauss-Kahn, head of the IMF, downplayed the risks of an all-out global currency war – in which countries actively intervene in currency markets to prevent domestic currencies from appreciating against trade rivals' currencies – the reality is that the currency war has been un-

Continued on Page 2

Continued from Page 1

derway for some time, with the US leading the way. It's no secret that latent protectionism lurks in the US Congress, whether Democrat or Republican. And Treasury Secretary Geithner has been under intense pressure for well

over a year to let the greenback weaken to protect domestic industries. Hence all the carping about China's "currency manipulation" and recent proposed legislation by Congress in an attempt to penalize what it sees as China's unfairly devalued currency.

Japan has already intervened in currency markets, for the first time in six years, selling the Chinese yuan in an effort to kick-start exports and support domestic growth. Grumbling from other Asian and Latin American countries about the US and China spiked into outright warnings of a currency war by Brazil's finance minister last Monday.

Over in the eurozone, the rift between the core and periphery widened even further last week. Germany, the region's largest economy, continues to show strength, as exports surge and unemployment declines. Germany's unemployment rate fell to 7.5%, the lowest rate in more than 18 years, lifting consumer sentiment to a three-year high. On the other hand, concerns about Ireland's banking system flared again last week, as the Irish government sought to persuade investors that it would and could bail out troubled Anglo Irish Bank Corp. without dipping into the European Union's emergency reserve fund. That put other peripheral eurozone nations like Portugal and Spain back un-

der the microscope, and contributed to the third-quarter flight to safety – including to gold.

Equity investors remained seemingly oblivious to the assorted "currency wars" and "flights to safety" taking place elsewhere. Instead, investors gradually drove up stock prices, albeit on low summertime volumes and quiet implied volatility.

Toronto's S&P/TSX Composite Index saw steady advances through the third quarter, with boosts from gold and improving base metals prices, like copper. As of Sept. 30, the S&P/TSX Composite gained 3.8% for the month, 9.5% in the third quarter, and 5.3% for the year to date.

In New York, the Dow Jones Industrial Average posted a 7.7% advance in September over the previous month's close, a 10.4% quarter-over-quarter gain, for a 3.5% year-to-date advance.

And the S&P 500 Composite Index similarly gained 8.9% month over month in September, for an 10.7% quarter-over-quarter advance. Year to date, the S&P 500 was ahead 2.3%.

Stock markets keep advancing, but only by inches (centimeters in Canada), as investors focus increasingly on fundamentals against a backdrop of widely divergent growth rates between the developed and emerging world, an increasingly tense global trade environment, and a giant question mark hovering over the eurozone. But then, stock markets always did "climb a wall of worry." ■

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.

MANAGER'S VIEW

GAIInS portfolios advance on third-quarter equity rally

By Ken Mulders, CFA

While the not-so-good economic news continued relatively unabated into the early summer, economic commentators and financial markets seemed to grow tired of pessimism in July, preferring to view the glass as half full rather than half empty. Despite continued variability, equity markets turned positive, while fixed-income returns remained neutral (Canadian) to positive (global government

bonds), and all GAIInS equity ETFs reversed their losses of the previous month or so. The net result was that all GAIInS models in July more than made up their June declines, with more aggressive profiles outperforming again after two consecutive months of underperformance.

Financial markets returned to a state of nervous pessimism in August, latching on to each new piece of news both manically and

arbitrarily (in outlook). The only clear trend in August was a steady and relentless decline in long government bonds, as bond markets appeared to bet on double-dip and deflation. But the economic indicators were mixed enough to have some pundits ruling it a "bond bubble." All GAIInS models, netted out relatively flat in August and over the trailing 12-months period, with the

Continued on Page 8



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MANAGER'S VIEW

Income share classes shine with strong third-quarter results

By Mark Taucar, CFA

Income

The income share classes offered by both CFG Custom Portfolio Corporation (CFG) and PIE Portfolio Index Evolution Corporation (PIE), with allocations to equity, real estate, preferred shares, fixed-income, and option writing, have all outperformed relative their benchmarks.

Despite our concerns about future volatility in portfolios and with increased exposures to bonds in the portfolios (thereby limiting upside), our income share classes posted strong third-quarter performance. Income share classes of both the CFG Active Management Portfolio Program and the CFG Core Custom Portfolio Program produced the greatest degree of outperformance, with almost a difference of nearly 400 basis points.

These returns were primarily a result of allocations to preferred shares, blue-chip dividend equities, and real estate.

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 divi-

dend-paying companies will now be of paramount importance to well-diversified portfolios.

Domestic Equity

All of our Canadian Equity funds fell short of their respective benchmark, the S&P/TSX Composite Index. The PIE Funds were very close to benchmark returns. However, the larger-cap bias tended to be a drag on the overall performance. All of these funds continue to focus on mitigating the risks in the market with the use of option-writing or targeted long-only strategies that invest in shares of companies with fundamentally sound business models.

We believe these models to be well positioned for a potentially turbulent fourth quarter and early 2011. Our focus will remain on mitigating potential economic "hiccups" that could be the catalyst for future market losses.

Global Equity

The CFG Class A-1 Global Balanced shares performed exceedingly well over the course of the past six months – indeed, well enough to outperform the benchmark by almost

400 basis points over the period, but falling short in the third quarter. Higher allocations to volatility-based strategies mitigated much of the volatility exhibited over the quarter. The PIE Class C-1 US Equity and PIE Class E-1 Emerging Market shares matched their benchmarks, give or take 50 basis points. However, the PIE Class C-1 US Equity shares posted a better six-month return relative to the benchmark. The PIE Class D-1 International Equity shares marginally underperformed their benchmark, by less than 200 basis points over the past quarter.

Alternative Equity

The PIE Class F-1 Alternative Strategies shares have been the star of the cast, as allocations to this class have resulted in strong returns for portfolios over the course of the past 1-, 3-, and 6-month periods, with the 6-month return posting the widest level of outperformance, bettering the S&P/TSX Composite's 4.18% return by 10%. We believe this fund to be a necessary component of any portfolio for its ability to alleviate the market's volatility on portfolios. ■

PIE Fund reviews

PIE Class A-1 Income Fund

Against a backdrop of flagging economic growth, the Bank of Canada nevertheless hiked its target overnight rate twice in the third quarter, by 25 basis points to 0.75% in July and again to 1.00% in September. While acknowledging that the global economic recovery remains on track but uneven, the BoC said it expects economic activity in Canada to be slightly more gradual than its earlier forecasts.

The rate of inflation, which is the BoC's key concern, remained subdued in the third quarter, as the headline all-items consumer price index eased slightly in August, to an annual 1.7% from 1.8% in July. The core inflation rate, which excludes volatile items like food and energy, remained unchanged at 1.6%. Although there is still considerable slack in the economy, with very little wage pressure, the BoC sees the economic recovery progressing, and points out that financial conditions have tightened only very modestly in the third quarter and remain "exceptionally stimulative."

Accordingly, because sluggish growth tends to be a positive for bonds, the fixed-income markets pushed up prices of government bonds (cutting yields, as prices move inversely with yield), espe-

cially at the long end of the curve. So much so that five-year bond yields actually fell below dividend yields in the quarter.

As a result, both the broad bond market and preferred shares rallied through the third quarter before easing back somewhat in September. The upside was reflected in the Fund's stronger third-quarter performance as the Fund's key holding of Claymore Advantaged Bond ETF (TSX: CAB) gained 1.6% quarter over quarter, while the Fund's major preferred share holding, Claymore S&P Canadian Preferred Share ETF (TSX: CPD) advanced 3.6%.

PIE Class B-1 Canadian Equity Fund

Because Canada is America's largest trading partner, a slowing US recovery through the third quarter began to take its toll. Canada's current account balance had already dropped into deficit in the second quarter, as a strong Canadian dollar suppressed exports. That trend continued into the third quarter as well. In addition, everything from a slowing housing market to slowing consumer credit and a cooling labor market (as public-sector and construction job creation slow) conspired to slow the growth of Canada's recovery.

The rate of inflation, which is the BoC's key

concern, remained subdued in the third quarter, as the headline all-items consumer price index eased slightly in August, to an annual 1.7% from 1.8% in July. The core inflation rate, which excludes volatile items like food and energy, remained unchanged at 1.6%. Although there is still considerable slack in the economy, with very little wage pressure, the BoC sees the economic recovery progressing, and points out that financial conditions have tightened only very modestly in the third quarter and remain "exceptionally stimulative."

Despite the gathering clouds on the economic horizon, the Canadian stock market advanced in the third quarter, buoyed by the surging price of gold, which touched a record high, and strong third-quarter gains in the Materials, Metals & Mining, and Gold sectors. The Fund's heavy weighting to representative large-cap issues on the S&P/TSX Composite Index through individual holdings and major positions in ETFs such as the Claymore Canadian Fundamental Index Fund and the iShares S&P/TSX Completion Index Fund contributed to the Fund's third-quarter gains.

PIE Class C-1 U.S. Equity Fund

As third-quarter economic data increasingly



A unique portfolio service, giving you access to a wide variety of diversified, tax-efficient, index-based strategies

Continued from Page 3

told a story of faltering recovery, the US Federal Reserve Board signaled its willingness to resume a program of quantitative easing if necessary to keep the wheels from coming off the recovery.

After a first-quarter rebound in economic activity, driven by massive government spending and record-setting budget deficits, the pace of recovery slowed to a snail's pace in the third quarter. Consumers remained intent on deleveraging, as both consumer credit and bank lending stayed depressed. The US housing market continued to languish, while unemployment remained locked at a stubbornly high 9.6%.

The Fed's statements have kept Treasury trading volatile as investors continue to speculate on the timing of a resumption of bond buying by the Fed. Speculation on potentially falling long-term yields has rallied prices of 10-year Treasury notes, pushing yields down to a recent 2.6%.

Against this backdrop the Fed left its benchmark fed funds rate unchanged in the third quarter, at between 0% and 0.25%.

Meanwhile, US stock markets advanced broadly in the third quarter, buoyed by the Fed's resolve to stimulate the economy with another round of quantitative easing if necessary, and a weakening of the US dollar against a basket of major currencies. The

Fund's high weighting to US diversified equities through its holding of the **SPDR S&P 500 ETF** contributed to the Fund's positive third-quarter performance as the Standard & Poor's 500 Composite Index advanced just under 8% (in C\$) quarter over quarter in the third quarter. Mid- and small-cap value style-based indexes also fell in the quarter, and Fund performance was also buoyed by a 7.2% (in C\$) quarterly gain in the **iShares Russell Mid-Cap Value Index Fund** (NYSE: IWS) and a 5.1% (in C\$) advance in the **iShares Russell 2000 Value Index Fund** (NYSE: IWN).

PIE Class D-1 International Equity Fund

Global growth continued cooling in the third quarter, as the heady rush of stimulus spending begins to fade. Emerging markets like India, China, and Brazil continue to show positive economic growth, though perhaps not at quite the blistering pace seen through the first three quarters of 2010. European growth remains hampered by a weak labour market and commensurately soft consumer demand. The 1% GDP reading for the eurozone in the second quarter is likely to fade in the third, as ongoing fiscal austerity measures are continue to weigh on both consumer and business confidence.

Manufacturing indexes in both the UK and the eurozone lost some mo-

mentum in August. While still indicating manufacturing expansion, the UK's CIPS/Markit PMI slipped to 54.3 in August from 56.9 in July, while the eurozone's Markit PMI fell to a six-month low of 55.1 from 56.7 in July. The European Central Bank, meanwhile, held its key interest rate at a historic low of 1%, and extended its liquidity backstop for peripheral countries like Greece, Spain, and Ireland. Still, led by strong German growth, eurozone GDP expanded 3.9% year over year in the second quarter, outpacing the 1.6% rate posted in the US.

International markets, however, posted gains in the third quarter as the threat of eurozone defaults eased. The Fund's third-quarter performance was supported exposure to Europe, Australasian and Far East (EAFE) diversified equities through holdings of the **iShares MSCI EAFE Index Fund** (TSX: EFA), which advanced 15.7% quarter over quarter. The **PowerShares FTSE RAFI Developed Markets ex-US ETF** (TSX: PXF) also buoyed Fund performance, with a 16.4% gain in the quarter.

PIE Class E-1 Emerging Markets Equity Fund

Global growth saw a cooling trend in the third quarter, as the heady rush of stimulus spending began to fade. Emerging markets like India, China, and Brazil continue to show strongly positive eco-

nomical growth, though perhaps not at quite the blistering pace seen through the first two quarters of 2010.

Indeed, part of what weighed on markets through the summer months was the fear that a slump in China's manufacturing would have ramifications for global growth, as demand for both commodities and equipment would erode. With the hairline increase in Chinese manufacturing in August, however, those fears were allayed somewhat.

The same story is repeated in Brazil, where strong economic growth, credit availability, and a healthy labour market continued to support consumer spending through the third quarter. However, a slowdown in China, which is Brazil's largest market, contributed to declining industrial output in August.

With inflation building in much of emerging Asia, and interest rates moving higher, currency issues came onto investors' radar during the quarter. Flows of money attracted by higher yields in emerging markets have forced up many emerging-market currencies against the US dollar, which in turn stifles export growth, and increases political pressure for intervention. Currency uncertainty affects earnings projections and can inject increased volatility into emerging-market stocks going forward.

The Fund's heavy weighting to Emerging

Market diversified equity ETFs, each in turn with significant exposure to China, help buoy the Fund's third-quarter performance. For example, in the Fund's largest holding, the **Vanguard Emerging Markets ETF** (NYSE: VWO), ended the third quarter with a double-digit quarterly gain of 16% (in C\$), while the **PowerShares FTSE RAFI Emerging Markets Portfolio ETF** (NYSE: PXH) advanced 13.2% (in C\$) in the quarter.

PIE Class F-1 Alternative Strategies Fund

The Fund's investment objective is to provide long-term capital appreciation through investments in commodity and real estate-related assets. These assets saw robust gains in the third quarter, helping propel the Fund to a healthy quarter-over-quarter advance.

By the end of the third quarter, the price of gold had reached a record high above US\$1,300 per ounce. Fears of a double-dip recession in the US were reignited by the US Federal Reserve Board in September when it signaled its willingness to resume a program of quantitative easing if necessary to keep the wheels from coming off the recovery. The spectre of deflation – a general drop in prices – and renewed downward pressure on the US dollar were enough to send hedgers, traders, and speculators back into the gold market in Sep-



“With inflation building in much of emerging Asia, and interest rates moving higher, currency issues came onto investors' radar during the quarter.”

tember. That, combined with vigorous seasonal demand for gold from India, served to push gold to new highs.

Canadian real estate investment trusts enjoyed another strong quarter of gains, as low interest rates favored Canadian REITs willing to use leverage to make acquisitions that are accretive to earnings. Rio-Can REIT, for example, acquired two more shopping centres in the third quarter. It reported that the value of its income properties and properties under development would likely increase to about \$6.9 billion under new reporting standards, while total asset value is expected to climb to \$7.5 billion.

The Fund benefited from the spike in the price of gold through its heavy weighting to the gold mining sector, with a heavy allocation to the **iShares S&P/TSX Global Gold Index Fund** (TSX: XGD), which advanced 4.6% in the quarter. Fund performance was further boosted by a quarterly gain in the Fund's allocation to Canadian REITs, primarily Rio-Can REIT (TSX: REI.UN), which advanced 20% in the quarter. ■