

Educators Financial Group October-December 2009 Update

Market Review

There was no shortage of turmoil in the year 2009 from an investment perspective. The year began with the lows of the economy being experienced in the first quarter of 2009. Stability began to appear in the markets by mid second quarter as massive central bank intervention began to have its effect on the economy and latterly on the markets.

Through the end of 2009, inflation remained contained in Canada and GDP has improved slightly but there is concern that the strength in the Canadian dollar will hamper economic growth. Employment continues to show weakness both in Canada and in the U.S. Canadian Unemployment finished 2009 at 8.5%, and the US was worse closing the year at 10.0%.

Equity markets rebounded globally from the 2008 debacle. In Canada, the S&P/TSX Total Return Index was up an impressive 35.1%. This was led by the Financials sector which was up over 45% for the year. In addition, the CRB Commodity Index, which had suffered badly in 2008 as the global recession attacked commodity prices, was up 23%. This helped to fuel the Energy sector and the Materials sector as they were up 39% and 34% respectively in the year. In light of the fact that the S&P/TSX Composite component weights in these three sectors represents over 75% of the market, it is no surprise that Canada performed well in this recovery.

In the fixed income market, interest rates were higher across the yield curve, in both Canada and the United States. As the year wore on, market participants began to be concerned about the positive momentum in the leading economic indicators, and the over-supply of government bonds necessary to finance the fiscal stimulus packages. In addition, as credit conditions stabilized, bond managers sold government bonds to buy corporate bonds, putting further upward pressure on rates. This is the exact opposite of what happened in the latter half of 2008 when corporate bond buyers sold credit and took refuge in government bonds. Returns in the broader bond market were 5.4% in 2009, but the corporate bond sector returned slightly over 16%.

Outlook

Going forward we are positive on equity returns for 2010 but are being realistic, believing that we will likely see returns in the high single digits. We see price earnings multiples in the 15 times range as representing fair market value. We have found that a lot of companies took a strong dose of medicine in the late

2008 / early 2009 time frame in terms of expense management. Productivity improvements drove earnings surprises in 2009. For 2010 we will need to see a profit margin follow-through but with more emphasis on revenue growth. Notwithstanding a sub-optimal economic recovery, we still see plenty of opportunity for earnings growth for the market as a result of a strong recovery in commodity prices.

We remain positive on fixed income returns for 2010. There are headwinds however. We expect corporate bonds to continue to outperform the government sector, but there will be a return to more normalized performance as corporate spreads approach their long term equilibrium levels. North American central banks are committed to their accommodative stance on monetary policy until at least the end of the second quarter, if not longer, depending on the performance of the broader economy. Inflation expectations remain muted, coupled with low resource utilization, and continued slack in the labour market supporting bank policy. As such, we believe the government curve will remain in a tight range through the first half of 2010, with small upward pressure on rates to close out the year.

Educators Diversified Fund

During the fourth quarter the fund saw very good performance contribution from investments in the Energy, Consumer Discretionary, Materials and Industrials Sectors. Top performers were Bankers Petroleum, Red Back Mining, SNC Lavalin and Potash Corp. On the flip-side, the fund was negatively impacted by a couple of investments in the Financial Services sector. This included a large weight in Manulife Financial, which unexpectedly raised over \$1bn in new equity capital to shore up its balance sheet. Sun Life Financial, while not nearly in the same position as Manulife, suffered as well. We believe this performance impact is behind us, and remain comfortable with the investment merits for both these names – believing that in 2010 these stocks will outperform their peers. We were also negatively impacted by our investment in gold producer Agnico Eagle Mines, which presented a revised operating plan over the next five years to the investing public that was lower than our (and the market's) expectations. As a result the stock hurt our performance in the quarter. We remain confident that the portfolio is well positioned to benefit from a recovering economy in 2010.

Educators Balanced Fund

On the bond side, performance was strong versus peers and the broad market due to the significant overweight in the corporate sector. The portfolio benefitted from increased demand for corporate bonds and the resulting upward pressure on rates.

The fund's equity holdings performed below the benchmark during the fourth quarter. The fund's overweight position in the financial sector was the largest detractor from equity performance, including holdings such as Manulife Financial and Toronto-Dominion Bank. The largest positive contributions to equity performance in the fourth quarter were from the energy sector, including Enbridge Inc, and from the materials sector, including Potash Corp.

Going into 2010, the fund continues to emphasize stocks over bonds as we see better upside potential in the equity markets. On the fixed income side, our portfolio remains biased towards corporate bonds, and other yield producing sectors.

Educators Money Market Fund

The fund underperformed its benchmark due to its increased weight in government guaranteed holdings. While safer, these securities provide less overall yield to the portfolio. At the end of 2008 and into the first half of 2009, the fund only held Government of Canada treasury bills and provincial guarantee paper. In early June we added a 10% position in R-1 High, bank-sponsored ABCP to the portfolio. We have continued with this strategy throughout the second-half of the year.

As we enter 2010, we are starting to see some stability in the commercial paper market; however, until we feel that we are being adequately compensated for buying credit in the short-end we will continue with our current strategy.