Educators Financial Group

Portfolio Commentaries

Quarter Ended December 31, 2009

HSBC

Global Asset Management

Economic Review and Outlook

Review

Consensus view is that crisis is all over. Many of the world's emerging nations are doing very well indeed, but for the West, difficulties lie in store. We believe there are some significant inconsistencies in the consensus view. The idea that we're on the brink of a return to decent growth, a pick-up in inflation to more "normal" rates and a very modest tightening of policy is too good to be true. There are surprises ahead, and we fear that not all of them will be pleasant.

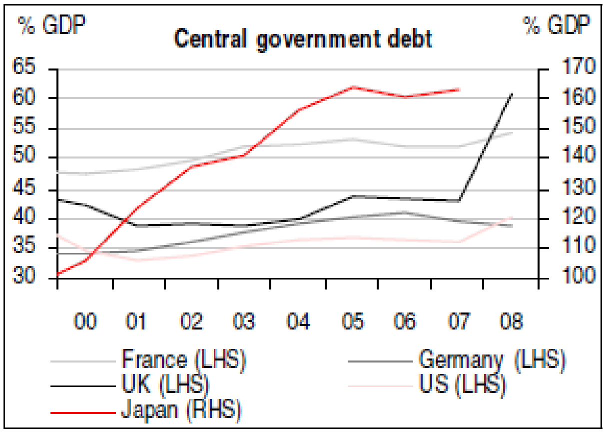
If growth really does recover, and inflation returns to "target", it's plausible to argue that interest rates will be a lot higher in a year's time than the consensus suggests. Alternatively, if there is no interest rate response to a pick-up in growth, it's likely to be a reflection of remarkably low inflation. Indeed, our own worries are focused not so much on the idea of higher rates but, instead, on the possibility of growing deflationary pressures. For us, the risk is that policymakers will have to keep Western economies on life support for the simple reason that any recovery is likely to be exceedingly fragile and riddled with deflationary forces.

In the short term, upside surprises to demand cannot be ruled out. The most obvious source is inventories. So far, we've mostly seen an end to de-stocking. Any moves towards serious re-stocking in, for example, the US could lead to some major upside surprises to economic growth. However, the evidence increasingly suggests that companies are deliberately holding inventories at unusually low levels, in part because of an ongoing absence of decent credit. As a result, one of the typical recovery drivers appears to have gone missing.

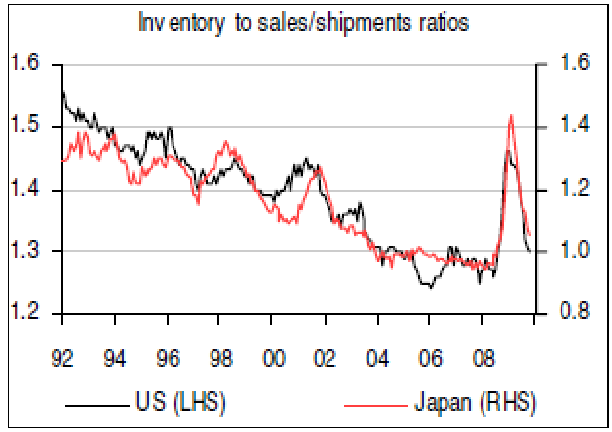
But there are also longer-term concerns. It's increasingly accepted that the crisis has led to a loss of "supply potential" which, other things equal, should reduce supply capacity within the economy and, hence, raise capacity utilization. From a cyclical point of view, this is typically taken to imply a smaller output gap and, hence, an early resumption of inflationary pressures. We're not convinced this argument is right.

Japan provides the obvious lesson. Throughout much of the 1990s, output in Japan remained above productive potential, yet inflation went down rather than up. Excessive debts in the corporate sector needed to be paid off. As they were, demand softened, money supply growth weakened and policy became increasingly impotent. Meanwhile, asset values persistently fell, leading to further balance sheet adjustment.

The Western world's economic woes can usefully be assessed in this Japanese context. High levels of household debt suggest further upward pressure on savings ratios. Rapidly deteriorating fiscal positions point to austerity, whether in 2010 or beyond. And, all the while, inflation threatens to turn into deflation. The UK is an exception, partly reflecting sterling's earlier weakness but, for most of the Western world, inflation is persistently surprising on the downside. Real interest rates are in danger of ending up too high. Fiscal positions will be more difficult to deal with. And, as with all balance sheet deflations, the obvious danger is that the prices of risky assets will come under downward pressure once more.



Note: excludes state and local government debt and social security funds.
Source: OECD.



Source: Thomson Financial Datastream, HSBC.

In Canada low rates are supporting the continued consumer binge on credit. All measures of consumer credit are heading higher. Total household credit is growing at 7.1%, year-over-year, while total consumer credit is up 7.4%. These growth rates need to be considered against the background of an already extremely high level of outstanding credit. The debt-to-disposable income ratio has recently hit a record high of 142%, up from 134% a year ago, and the figure looks set to go higher still. Although economic growth is not expected to soar, the Bank of Canada (the “BoC”) may need to address this cheap cost of credit that is driving consumer leverage to very high levels.

Outlook

While the Western world will have to cope with austerity, deflation and default – the classic hangover symptoms from a debt-fuelled period of bubbly growth – the emerging nations are in much better health. Earlier fears that growth might be choked off as a result of a globalization of the credit crunch have faded. Instead, emerging nations are increasingly benefiting both from higher volumes of trade with each other and also from the remarkably loose monetary conditions stemming from their currency linkages to the US dollar.

One consequence of this has been a relatively elevated level of global commodity prices. This, in turn, has led to a major redistribution of the benefits and costs of the crisis. Previous Western recessions were typically associated with collapsing commodity prices which, in turn, would send shockwaves out to many emerging nations. This time, with China acting as a counterweight to Western economic weakness, commodity prices have held up well. The burden of economic adjustment has therefore remained with the Western nations while, for many commodity producers, economic life has been unexpectedly pleasant.

Obvious winners include some of the Latin American nations, the Middle East, South Africa and the developed world’s commodity-producing enclaves.

From a policy perspective, we can see few reasons for acting with any urgency to exit from the currently very supportive set of monetary policy arrangements. With deflationary pressures refusing to go away, we believe long-term interest rates will remain low, despite the gentle hum of the monetary printing press. Equities may rally in the short term but may be vulnerable to later setbacks as growth refuses to take off. Meanwhile, in the foreign exchange market, we like many of the emerging currencies alongside the currencies of the world's major commodity producers.

Investment Strategy

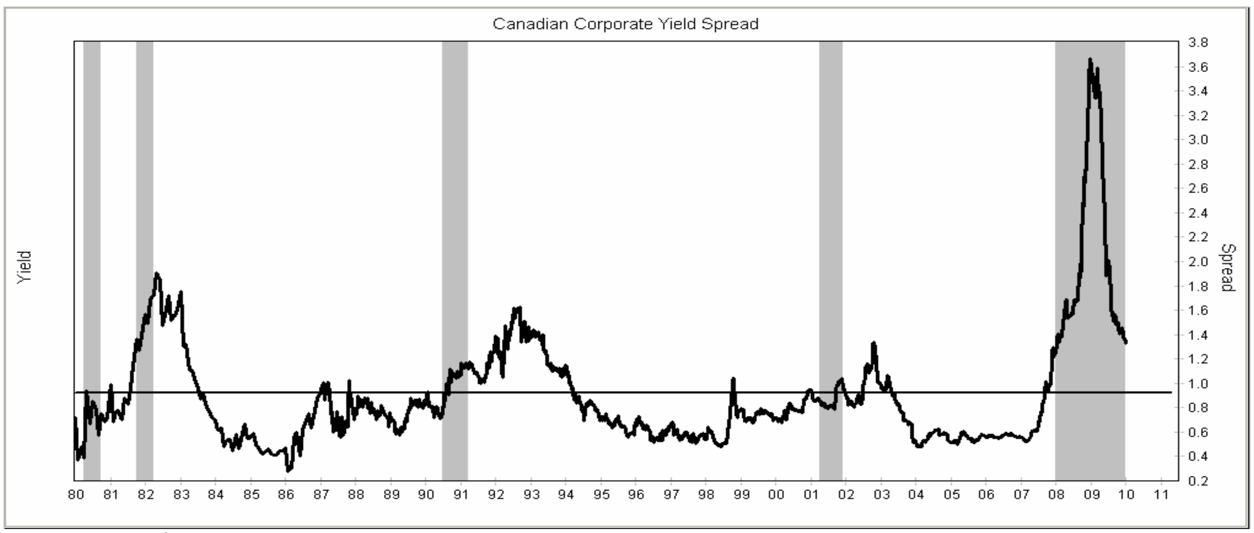
The extraordinary intervention by governments at the global level in capital markets during the last year is helping reduce market volatility and improve investor confidence, but it will take time to impact the broad economy, suggesting caution against aggressive allocations in risky assets.

We continue to recommend a defensive positioning with strong focus on diversification. Valuations for equity markets remain reasonable from a long term historical perspective. Within fixed income, we remain overweight corporate debt, focusing on higher quality issues.

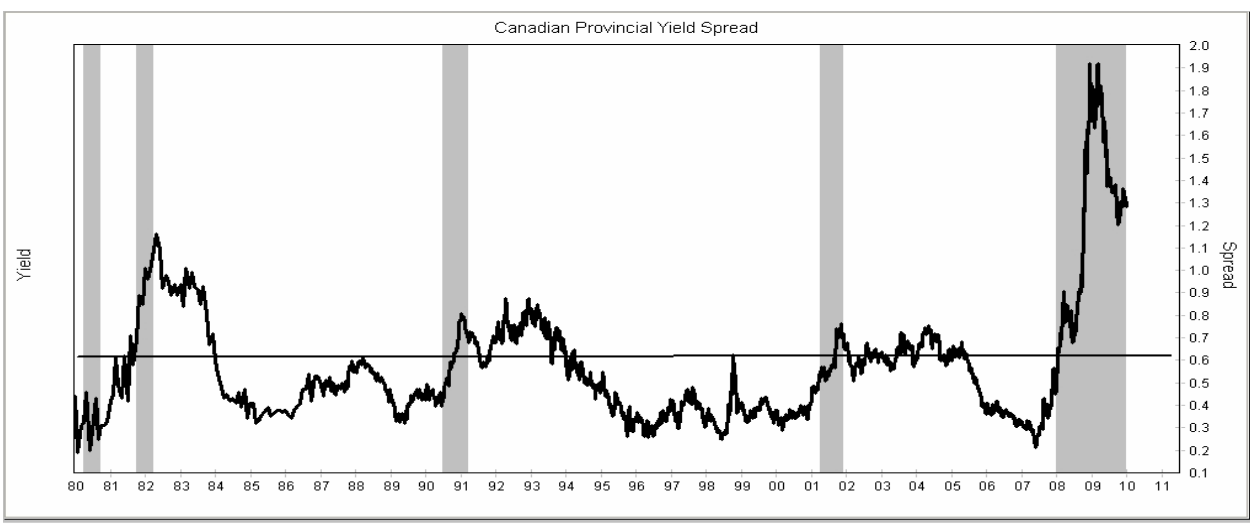
Educators Mortgage and Income Fund Commentary

Review

Many of the key themes that emerged within financial markets in the second and third quarters gained further momentum during the fourth quarter. The recovery process in credit markets continued, the global economy stabilized further, and the return of risk appetite from investors intensified. For fixed income markets specifically, we saw further improvement in market liquidity and continuing declines in the compensation demanded by investors for assuming credit risk, albeit at more rationale pace. While overall yields were slightly higher on the quarter, there continued to be a dramatic divergence in the performance of the different sectors of the market. Corporate bonds outperformed government of Canada bonds, while provincial bonds were the worst performing sector due to their longer average term-to-maturity.



Source: PC Bond



Source: PC Bond

Since the end of the third quarter, the overall yield in the market has risen modestly from 3.17% to 3.32%, with total returns falling 0.16%. Federal government debt declined 0.45% during the quarter, as improving economic fundamental prompted investors to begin discounting higher interest rates in 2010. Attractive valuations and further tolerance for risk buoyed the corporate sector on the quarter. Corporate debt returned 0.99%, making it the best performing sector, while provincial government debt fell 0.89% in the fourth quarter. In 2009, the Canadian bond market returned a solid 5.41%, with sector returns again dramatically varied. Federal government, provincial government and corporate bonds returned -0.21%, 4.72% and 16.26%, respectively. Over the past quarter, the shape of the yield curve was little changed, as yield movements were relatively uniform across the maturity spectrum. The difference in yield on a 2-year Government of Canada bond versus a 30-year bond widened from 257 basis points at the end of the third quarter to 260 basis points on December 31st.

Attribution

The Fund's security selection within corporate bonds and overweight position in corporate bonds added value, while duration, which was in-line with the index for most of the quarter, and yield curve positioning had little impact on performance.

Outlook and Strategy

The process of stabilization and ultimately recovery in the global economy appears to be underway. The substantial policy response from central banks and governments around the world has righted financial markets and has led to an improvement in economic activity. We believe this will continue and that economic growth should return to being positive next year. That said, following a significant contraction in 2009, we expect the positive economic growth in 2010 to be fairly modest. On the positive side, the commitment to very low interest rates for an extended period of time by the Bank of Canada and other central banks combined with fiscal policy initiatives from governments will assist in stimulating better activity in the coming quarters. However, consumer, continued to be hampered by a difficult labour market, will increasingly focus on debt reduction and increased savings. Businesses will continue to pursue cost cutting to protect profits in a difficult environment for revenue generation. At this point, with longer term yields expected to rise modestly over the next year, the objective will be to maintain the Fund's interest rate exposure in-line with that of the benchmark in the near term. While valuations in credit markets would now be considered "fair value" after being historically very cheap early in 2009, we continue to prefer provincial and corporate bonds over government of Canada bonds. However, we will look for opportunities to take profit, while remaining overweight these sectors overall.

Educators Global Fund Commentary

Review

The MSCI World Index was up 1.69% (in Canadian dollar) for the quarter. Global equity markets rose, registering exceptional performance for the year on back of encouraging signs of economic recovery. Macro economic data showed signs of stabilization and recovery. The market also benefited from **Bank of America's** announcement that it will repay its entire $45 billion investment provided under the Troubled Asset Relief Program (the "TARP"). **Citigroup** and **Wells Fargo** were part of many large financials that announced that they will pay back the TARP. Furthermore, China announced its plans to maintain the current economic policy and spend USD 86.2 billion in 2010 on stimulus projects. However, the good news was partly offset by concerns over Eurozone's public finances causing the credit rating downgrades of Greece, Ireland and Spain.

MSCI World Index: performance over 1-year (CAD)

Source: Bloomberg

HSBC Global Asset Management

Attribution and Investment Activity

Over the fourth quarter, the Fund slightly underperformed the benchmark. Country allocation and stock selection were both positive contributors to the relative performance. The Fund's country allocation benefited from its overweight to the US and Singapore, which out-performed the benchmark, and its underweight to Greece and Japan, which were among the worst performers over the quarter. Greece underweight was limited but the counter-performance was significant, triggered by the country's rating downgrades. In Japan, banks suffered from their low capital quality and exporters suffered from historical high yen levels. Stock selection was profitable in the UK, with active positions in materials; and in the US, where the selection was positive in the technology and financial sectors, with underweight to Citigroup.

Outlook and Strategy

The Institutional Brokers' Estimate System (the "I/B/E/S") consensus expects a strong earnings recovery in the developed markets in 2010 (from –8% in 2009 to +31% in 2010). According to the I/B/E/S, the MSCI World Index's 12-month forward price earning ratio is currently at 14x, in-line with its long-term average. We believe that higher profitability combined with undemanding valuations multiples should lend support for equity markets in 2010. Relative to the benchmark, we are overweight the US; and are underweight Japan.