

## NEXUS NORTH AMERICAN BALANCED FUND QUARTERLY REPORT – June 30, 2007

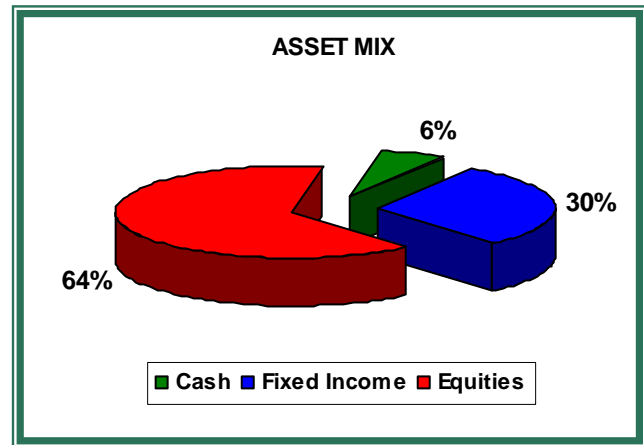
Returns were positive again this quarter, but ended on a softer note as all major asset classes posted negative returns in the month of June. On the interest rate front, bond markets began the second quarter quietly, just as they ended the first quarter. However, that all changed in mid-May, as interest rates in both Canada and the U.S. began a move that, over the course of the next month, took them 0.50% higher, back to the levels of June 30<sup>th</sup> a year ago. In the context of the last ten or twenty years, interest rates remain low, and a move higher by 50 basis points such as we have had is not particularly notable and remains broadly consistent with our long held neutral outlook. That said, this change in rates has surprised us. Although we had reduced our allocation to bonds and increased our cash position before the change in rates, the duration of our bond portfolio was such that we suffered a negative return in our bond holdings for the quarter.

Perhaps the most notable capital market development of the past quarter has been the strength of the Canadian dollar. Over the quarter it has been very strong, advancing almost 9% from US\$ 0.865 to US\$ 0.94. Many observers, including Nexus, had believed that this strength, which acts as a drag on the economy, would be used by the Bank of Canada to resist raising interest rates. Indeed, although the Bank of Canada left the Bank Rate unchanged at 4.25% at its May 29<sup>th</sup> policy meeting, in the press release associated with its decision, the Bank sounded a surprisingly hawkish note. The release said:

“...there is an increased risk that future inflation will persist above the 2 per cent inflation target and that some increase in the target for the overnight rate may be required in the near term to bring inflation back to the target.”

As a central bank with an explicit inflation target, the message was clear – the Bank Rate will be going higher and, indeed it did on July 10<sup>th</sup>.

Although interest rates rose in the past quarter, the concerns we have had about sluggish economic performance in the U.S. and Canada remain. In the U.S., the primary risk to growth remains with the consumer. After years of being the core strength of the economy, the consumer now looks to be a risk to economic growth. Although employment levels remain high, in the period ahead consumers will have to deal with higher debt payments, higher gasoline prices and declining wealth from lower home prices. It is likely that this sector of the economy, representing 70% of GDP, will underperform.



The rest of the North American economy remains in fairly good shape. Company balance sheets are healthy and corporate profitability remains high. Notwithstanding these circumstances, somewhat worryingly, measures of business investment in software, machinery and equipment, and for durable goods have been on the weak side. As we consider the future, if this recent cautious corporate behaviour spills over into the labour market, the high rates of employment, which have been a very solid feature of this economic cycle, may get weaker.

During the quarter, the Fund's unit value increased 0.9%.<sup>1</sup> The Fund is up 13.5% in the last 12 months.

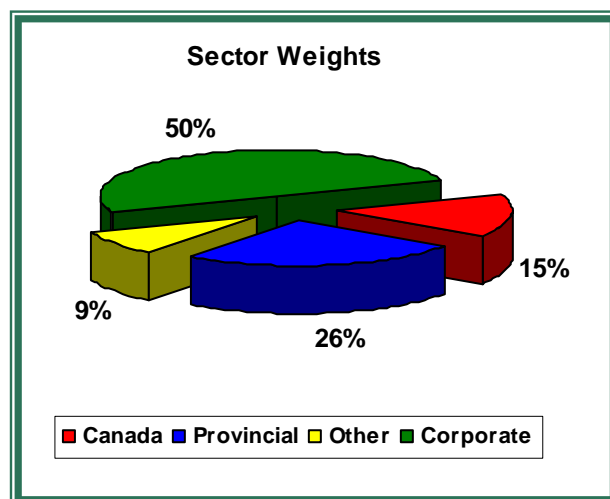
<sup>1</sup> Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

## Asset Mix

Early in May, we reduced our bond holdings, and increased our cash position substantially. At 6%, our cash position is as high as it has been in many years. Our allocation to equities remains unchanged. On that front, we remain overweight Canada and underweight the U.S.

## Fixed Income Summary (30% of Assets)

We continued to improve the credit quality of the portfolio this quarter. Nonetheless, the Fund owned two issues of BCE bonds, each of which has declined by more than 10%. This dramatic decline in value is a consequence of the pending private equity strategy being considered by the company. An irony of the private equity 'mania' that is sweeping global financial markets, is that some of the best candidates for a private equity approach are companies that have a history of conservatism and balance sheets that align with such traditions. While some older BCE debt issues had strong credit protection written in to their bond indentures, our holdings did not. In essence, the bidders for the company have been able to engineer a transfer of \$1 billion of value from debt holders to equity holders as a result of the private equity strategy being considered. At this time, it appears likely that a highly leveraged private equity take-out will occur. We expect our holdings will end up being rated below investment grade and, if we continue to hold them, we will consider them as part of our equity allocation rather than as fixed income.



An unfortunate by-product of prudent diversification has meant that we own other bonds that potentially could be private equity targets - especially true in the utility and pipeline area. However, the vast preponderance of our corporate exposures are in financial services companies or special purpose companies that should not be prone to this trend. Although interest rate spreads between corporate and government bonds have widened somewhat in the last month or so, spreads remain historically narrow. It is likely that our tactic of selling corporates to buy provincial bonds will continue.

The Fund's fixed income returns were -2.2% for the quarter and +4.2% in the previous 12 months. By comparison, the PC Bond Universe Index (formerly the Scotia Capital Bond Universe Index) was -1.7%, and +4.8% for the same periods.

## Canadian Equity Summary (43% of Assets)

Ten Largest Holdings	
Royal Bank	3.0%
Bank of Nova Scotia	2.8%
Rogers Communications	2.7%
TD Bank	2.4%
Manulife	2.4%
Telus Corp	2.1%
Suncor Energy	2.0%
EnCana	1.9%
Bank of Montreal	1.7%
Enbridge	1.6%

It has been another quarter of positive returns for our holdings with news in equity markets continuing to be dominated by the emergence of private equity buyers for a wide range of businesses. Higher interest rates have not yet derailed the trend, described in our last report, of merger and takeover activity. The current market opinion, that almost any business is worth more after a capital restructuring that replaces debt for equity, remains very much the driving factor in equity valuations at this time. Despite signs that poor lending practices and too much easy credit have led the U.S. sub-prime mortgage market into a crisis, there is as yet no difficulty in funding any leveraged buy-out scheme.

As interest rates normalize around the globe and central banks drain the liquidity that was required after the last crisis, eventually the music will stop. Our core holdings, with their emphasis on retail banking and energy exploration and production aren't particularly reliant on this trend. We feel confident that our selections will continue to do well when inevitably the market goes through a more difficult period.

Notwithstanding our belief that things on the private equity side are getting a little overdone, we have actually been beneficiaries of a number of deals that have been announced and completed. Most notably, a long-term holding, UE Waterheater Income Fund, was taken private at the end of this quarter at a valuation that greatly exceeded our own assessment of its true value. When this deal was announced, based on speculation that another deal could be possible, there was a jump in price of a comparable business, Consumers Waterheater Income Fund, which was also a holding. We were skeptical that it was a compelling takeover target, so we sold it into the market at a rich valuation while we had the chance.

In mid-May, after completing a period of study and research, we purchased CCS Income Trust. CCS is a company operating in Canada and the U.S. that provides waste disposal, well servicing, energy marketing and storage to the oil and gas industry. It has a strong management team, a dominant market share and a conservative capital structure. As things would happen, less than six weeks later, it was announced that management, with strong external financial backing, intends to take the company private at a substantial premium to where we had just purchased it. As we consider our other holdings, there are surely some that could potentially be considered as private equity targets. Possibly they will be taken out. But if not, we will be pleased to be owners and benefit over a long time period from the profitability of these businesses.

The Fund's Canadian equity returns were +5.3% for the quarter and +20.9% in the last 12 months. By comparison, the TSX Composite was +6.3% and +22.7% for the same periods.

## U.S. Equity Summary (14% of Assets)

It was another quiet quarter with no new additions or dispositions from the portfolio. We remain underweight U.S. equities - fortunate at a time of strong appreciation in our own currency.

At the end of this last quarter, Tyco International finally completed its long awaited restructuring. Tyco has been a long and frustrating holding of the Fund. We have owned it as a successful industrial conglomerate, lived with it through its period in the spotlight as a study in corporate malfeasance, and latterly as it has been re-made under new leadership.

Beginning in July, it will be split into three companies. The first company will continue with the name Tyco International, and will concentrate on security products and services, fire protection and detection products, valves and controls, and other industrial products. The second company will be known as Tyco Electronics and will specialize in engineered electronic components, network solutions, and wireless systems worldwide. Finally, the third company will be known as Covidien. Covidien is a global manufacturer of medical supplies, diagnostic imaging agents, pharmaceuticals and other products in the healthcare space. This latest transformation hopefully concludes a difficult period and re-launches the three major businesses towards greater corporate success. In the coming quarter we will likely re-balance our positions in these three businesses.

Ten Largest Holdings	
<b>CVS / Caremark</b>	<b>1.5%</b>
<b>Navteq</b>	<b>1.3%</b>
<b>Lincare Holdings</b>	<b>1.3%</b>
<b>CIT Group</b>	<b>1.2%</b>
<b>DaVita</b>	<b>1.2%</b>
<b>Bank of America</b>	<b>1.1%</b>
<b>Waters Corporation</b>	<b>1.1%</b>
<b>Baxter International</b>	<b>1.1%</b>
<b>Exxon Mobil</b>	<b>1.0%</b>
<b>Edwards Lifesciences</b>	<b>1.0%</b>

Investment returns from U.S. equities were negative this quarter, a result of the sharp appreciation in the Canadian dollar weighing on investment returns from outside this country. Our Fund returns slightly lagged the S&P 500 index this quarter and remain even with the index over the last 12 months. The Fund's U.S. equity returns in C\$ were -2.6% for the quarter, and +15.0% for the last year. By comparison, the S&P 500 (in C\$) declined 2.0%, but is up 15.0% in the past year.

## Other Investments (7% of Assets)

Our 7% weighting consists of a 6% weighting in the JPMorgan *Equity International Investment Trust* (EQIT), with the balance invested in Wal-Mart de México (Walmex).

This quarter EQIT broke even after the effects of the rising Canadian dollar are considered. In the past year, it has increased 18.3%. This continues to be an excellent investment for the Fund, providing both diversification and strong outright returns. We continue to view this as a core holding.