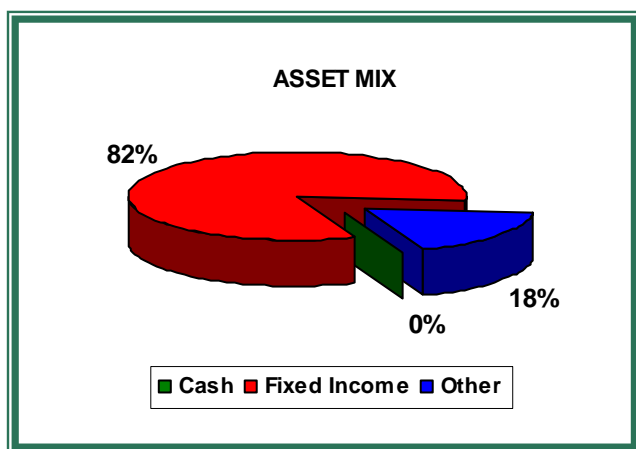


NEXUS NORTH AMERICAN INCOME FUND QUARTERLY REPORT – December 31, 2005

There was little excitement and only modest, positive returns for bond investors this past quarter - continuing the pattern of the past year. As expected, the Bank of Canada and the U.S. Federal Reserve guided short-term interest rates higher. At the same time, and somewhat surprisingly, interest rates of longer bonds actually declined over this period, leading to a flattening of the yield curve. Overall, this activity was consistent with our belief all year that interest rates would remain low and in a narrow range. What we did underestimate, however, was the degree of flattening in the yield curve, and our reluctance all year to own longer maturity bonds (>15 years) at low nominal yields has meant that we have not been invested in the area of the yield curve that has provided the best returns. As a result, our bond performance, although positive, slightly lagged the return of the Scotia Capital Bond Universe. Thankfully, this shortfall was more than offset by the excellent returns from our allocation to income trusts and other equities.

Another important development of this past quarter was the conclusion (maybe?) to the federal government's threat to alter the tax treatment of Flow Through Entities (Income Trusts and Limited Partnerships). Instead, what Finance Minister Goodale has proposed is an adjustment to the tax treatment of dividends paid by traditional corporations that should remove much of the comparative advantage that was enjoyed by businesses that were constituted as FTEs. This "solution" was what we had considered most likely, although the timing of the announcement came to us and the market as a surprise.

As for the economy, we remain worried about the effect that higher short-term interest rates will have on consumer borrowing and consumption. It has become clear that in the United States, the effect of 13 interest rate hikes has finally cooled activity in the housing market. Bubbling house prices created an environment that encouraged consumers to borrow against the equity in their homes and use the proceeds for consumption. In the coming year this source of economic strength will surely subside from the levels of the last few years. Likewise, a moderation in the housing market will also remove the support that had come from vigorous activity in the construction sector, an area that Goldman Sachs estimates accounted for over 90% of the new jobs created in the U.S. since 2001.



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Contributing to our concern with the consumer is the effect of higher energy prices as the winter unfolds. For the time being, prices for natural gas, heating oil, and gasoline are well off their highest levels, but

they remain at levels that will surely impact the discretionary spending of millions of Canadians and Americans. As the early appraisals of the Christmas shopping season are reported, it appears that consumers have been feeling the pinch and that consumer activity on both sides of the border has been somewhat disappointing.

The economic scene remains interesting but challenging to forecast. Practitioners of the dark arts of bond trading and economics know that a flattening of the yield curve, such as has occurred, can portend a slowing of economic growth, although such a development is not guaranteed. We feel comfortable in predicting a period of slower but positive growth in the year to come, an opinion that leads us to an expectation of modest bond returns.

In Canada, the strength of commodity markets, particularly energy, remains a strong support to the C\$. Surging exports of energy, particularly natural gas, are set to continue as both demand and the pipeline capacity to transport it to markets are sure to grow. The effect is steady upward pressure on the C\$, that creates a corresponding drag on exports for manufacturing-oriented economies such as Ontario. Expect to hear a lot more in the coming year on the complicated policy approaches in Ottawa to address this challenge. In our opinion, if the trade situation continues on its present course, forecast interest rate increases by the Bank of Canada will be less than the market currently expects.

Over the quarter, the Fund returned 0.9%¹, slightly ahead of the modest 0.7% return of the Scotia Capital Bond Universe Index (SCBU). The Fund is up 6.4% in the last year, marginally below the SCBU's return of 6.5%.

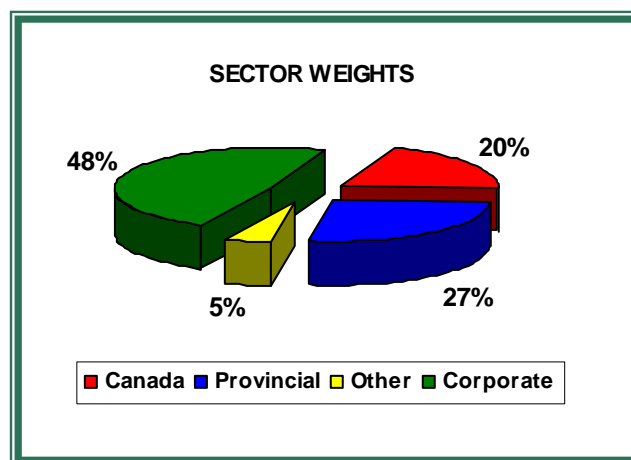
Asset Mix

This past quarter, the allocation to stocks has been increased by almost 4%, bringing it close to our guideline limit of 20%. This move was made in the wake of the announced changes to the treatment of dividends previously discussed above. For taxable investors, the returns from patient, long-term investments in stable dividend-paying stocks such as utilities and bank shares will be better as a result of these changes. In contrast, the attractiveness of alternatives such as long-term corporate bonds is relatively less appealing. Over time, we would expect the proposed dividend tax changes to improve the valuation of utility and bank shares, benefitting both taxable and non-taxable investors in the Fund.

Fixed Income Summary (82% of Assets)

As expected, the Bank of Canada increased the Bank Rate twice during the course of the past quarter, bringing it to a level of 3.25%. These increases were widely expected by the market. Two year maturities rose in yield by a similar amount, but ten year securities closed the year within 1 basis point of where they had ended the 3rd quarter, and 30 year bonds were actually lower in yield by almost 20 basis points. Long-term bonds in Canada are now at multi-decade lows and this level of rates certainly seems to reflect that inflation fears are very subdued.

The story on inflation is worth examining. Driven by higher energy and materials prices, headline rates of inflation (CPI) have generally been running at 2.5% per year. However, core CPI, an economic series that excludes 8 components which are predominantly energy related, is very much better controlled - running at a level of about 1.5%. Between these two measures of inflation, core CPI is the economic series preferred by economists as it is thought to better represent the true trend in pricing. Many investors are surprised to discover that, over the course of the past 10 years, core CPI has averaged 1.8% and is trending



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

lower. There are a number of reasons to believe this experience will continue. Many of the driving forces of low inflation - global competition, open trade and technology - all seem likely to continue their restraining effect on price inflation. Rather than declare victory in the fight over inflation and rush out and buy long bonds, it is probably more relevant to assume that low interest rates may well be with us for a long time, and that investors needing income and capital preservation should adjust their return expectations accordingly.

In an environment of ultra-low bond yields, we have made two adjustments of note. Firstly, we have continued to run a large overweighting in corporate securities, ensuring we earn a higher yield. As we have all year, we continue to favour higher quality corporates. Many of our holdings are rated AA or better. Secondly, we have not committed to the long end of the bond market. Instead we are holding shorter maturities with slightly lower yields but less price volatility. The duration of our portfolio is 6.0 years, while the duration of the index we are benchmarked against, the SCBU, is 6.5 years. It seems sensible for now to avoid the longer end of the market at historically low yields. Investors with good memories will know that several years ago we were beneficially over-weighted in longer dated securities given the large pick-up in yield that was then available in the market. Given the flat shape of the yield curve today, the case for long bonds is less compelling.

Our outlook for interest rates remains fairly unexciting. As the effect of higher short-term rates and a subdued housing market are felt by the consumer, we would expect late in 2006 the market will begin to expect some easing from both the Bank of Canada and the U.S. Federal Reserve. This should have the effect of "normalizing" the slope of the yield curve and should favour our positioning with a portfolio concentrated in maturities of 5 to 10 years.

Income Trusts and Equities (18% of Assets)

After languishing early in the quarter, our income trust holdings finished very strongly – the result of Finance Minister Goodale's surprise announcement on November 23rd that he would leave the tax treatment for FTEs in place and instead alter the manner that dividends were taxed. It remains likely that this proposal, as yet not law, will be a "floor" to investor expectations. Any government that is formed as a result of our upcoming election will certainly not do anything less favourable in the eyes of investors. We now own 9 income trusts and 10 common stocks.

