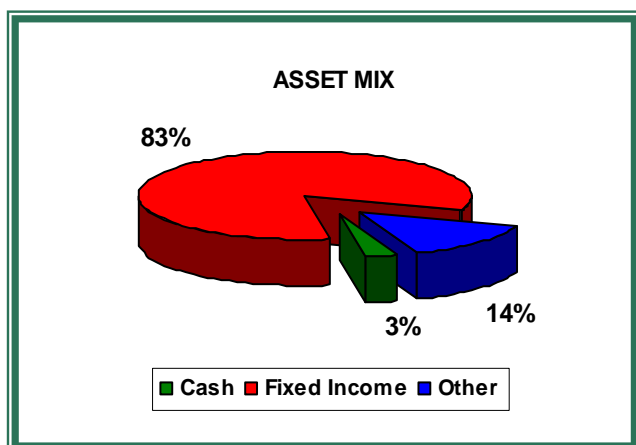


NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – June 30, 2005

Interest rates moved very sharply lower in Canada this past quarter and, as a result, fixed income markets performed very well - outperforming even the major equity indices. For almost two years, there has been a tug of war in the bond market between inflationists and disinflationists. During this most recent quarter disinflationists, who recognize the moderating effect on prices of emerging economies such as India and China, seem to have won out over the inflationists who worry about the size of the U.S. current account deficit as well as the apparent inflation in asset prices such as real estate. For now, interest rates in Canada are at record low levels and the disinflationists seem to have won the day. We remain unenthused with the arguments of both camps. However, for those who believe in efficiently priced capital markets, the message from the bond market is clear; inflation is not a worry at this time.



In the U.S. the Federal Reserve raised interest rates twice this past quarter, the last occasion being on June 30th. These increases have been widely anticipated and the widespread understanding that monetary stimulus will be removed has encouraged many buyers of longer-term maturities that inflation will not get out of hand. On the other hand, the Bank of Canada has remained on the sidelines through this period, continuing to talk publicly about the inevitability of higher administered rates, but as yet unwilling to move for fear of pressuring the Canadian dollar even higher. Canadian rates remain much lower than U.S. rates for all but the

longest maturity bonds. Over the quarter the spread between short Canadian interest rates and U.S. rates widened by almost 50 basis points. This brought about a welcome reprieve to the C\$ which drifted lower by about \$0.01 over the quarter. Canadian 10-year bond yields fell by almost 60 basis points, finishing at a yield of 3.74% - a historic low.

Over the quarter, the Fund returned 4.5%¹ keeping pace with the Scotia Capital Bond Universe Index (SCBU) which also increased 4.5%. The Fund is up 13% in the last 12 months, above the SCBU's return of 12%.

Asset Mix

There continues to be good growth in new subscriptions to the fund. Generally, we have added pro-rata to bonds and other income producing securities such as trusts and stable dividend paying stocks. Our cash position has increased slightly, but remains low. It is worth noting that given the flattening of the yield curve caused by higher short rates and lower longer rates, there is now much less of a "penalty" for holding cash than has been the case since the Fund was started.

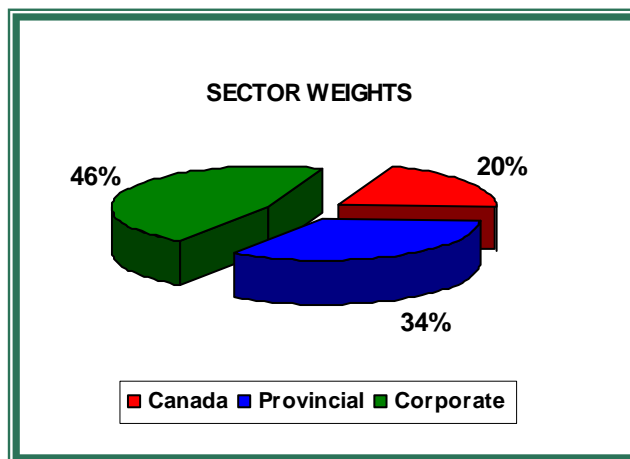
¹ Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

Fixed Income Summary (83% of Assets)

After a run-up in bond prices such as we have had, and a consequent decline in yields to historic lows, it is worth wondering if interest rates could still go lower. Despite the substantial reduction in interest rates this past quarter, in a global context North American interest rates actually appear high. In Europe, 10 year bonds issued by Germany and France and denominated in Euros yield about 3.2%. In Japan, 10 year bonds denominated in Yen yield only 1.25%. Not surprisingly, U.S. 10 years yielding 3.91% look attractive, as do Canadian 10 years yielding 3.74%. Despite the ultra-low interest rates abroad, both the Japanese and European economies continue to deliver sub-optimal economic performance. Indeed, recent developments in Europe reflect a softening of their economy, and policy makers at the European Central Bank seem to be preparing the markets for an interest rate reduction. As hard as it may seem for investors who cut their teeth in the '70s and '80s, there is evidence that still lower rates are not without precedent.

In North America the economy is stronger than the rest of the developed world, but growth is by no means robust. As we have argued for some time, the manufacturing and goods producing sectors of the North American economies continue to feel the weight of direct competition from the emerging world such as China and India. Despite reasonably satisfactory economic growth, the level of job creation, as well as the quality of the jobs, continues to disappoint. It appears that we remain "addicted" to low borrowing rates and high debt levels. In Canada, the picture is brighter, mostly due to the energy and materials sectors of the economy, which are prospering. The pattern of growth and activity remains very uneven, with strength concentrated in the west and more economic difficulty in central Canada.

It is somewhat perplexing that these ultra-low bond yields have come at a time when both the Bank of Canada and the U.S. Federal Reserve are widely understood to be in a process of raising short term-interest rates. Although the economic picture is far from clear, central bankers in North America believe that monetary policy is too stimulative at current levels and that low rates are encouraging consumers to assume more debt than is otherwise responsible and creating bubble-like asset inflation in real estate. Real estate bubbles and towering debts levels create systemic risk to the economy, and as a result policy makers want to move pre-emptively, returning interest rates to neutral levels before any problems develop.



The phenomenon of rising short rates and dramatically falling bond rates has been called a "conundrum" by Alan Greenspan and almost certainly defies conventional explanation. In large part it owes to the relative attractiveness of our North American interest rate structure and the voracious accumulation of government bonds by Asian Central Banks. However, it seems likely that there are other reasons as well.

Greenspan and others have mused that at least part of the cause may be a fundamental mismatch between the assets of pension funds (equities, real estate and bonds) and their long-term liabilities (pension obligations). As many will be aware, there is a growing systemic pension underfunding issue in the U.S. Pension funds have been too heavily weighted in equities during a period of low equity returns and plan sponsors are now being forced to make larger contributions and allocate more of their assets to bonds. It is likely this is at least a contributing factor to the strength in the bond market.

A third and less palatable reason to feel rates should stay at these levels would be that as the economic picture becomes clearer in the months ahead, the fundamentals will show that we in North America have the same economic problems that the aging populations of Europe and Japan have and that “ultra-low” rates are natural in lower growth economies.

Our positioning in the bond market reflects our middle of the road opinion. We see the sense in raising rates from levels that might be considered artificially depressed, but we also suspect that economic resilience to higher interest rates may be low. It is quite possible that the experience of other developed economies could occur here in North America and that as investors, we will need to learn to live with sluggish economic growth and low bond yields for some time to come. Accordingly, we are waiting for further evidence before we declare for one side or the other, and we continue to position our holdings in securities concentrated in 5 to 10 year maturities.

Income Trusts and Equities (14% of Assets)

Our holdings in banks and utilities did well this past quarter, and after a weak first quarter, our income trust selections responded positively to better operating results as well as to the generally lower levels of interest rates. This remains a “hot” sector of the Canadian capital markets with all sorts of new offerings being brought to market on a regular basis. Despite the plethora of choice, we have added only one new name to our holdings, Aeroplan Income Fund, and that came only very late in the quarter.

We continue to hold a number of different names in order to achieve an appropriate measure of diversification. We own 11 income trusts and 8 equities.

