

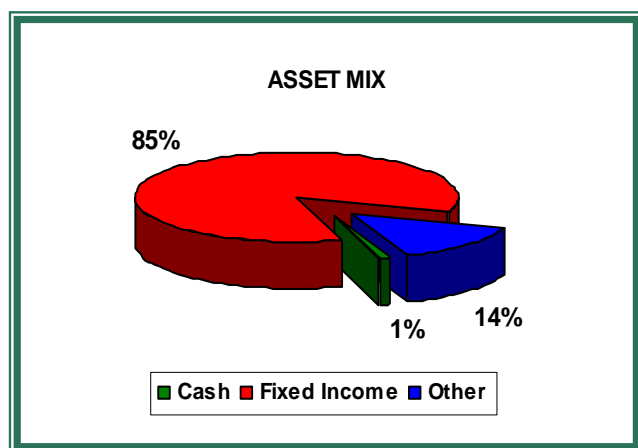
NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – September 30, 2005

After having moved quite sharply to record low levels at the end of the second quarter, interest rates generally reversed a portion of the previous descent in a steady fashion throughout the 3rd quarter. Early in the quarter, the “summer doldrums” were alive and well, with volumes and secondary trading activity generally light. That said, there remained a steady flow of quality new issues in the government and corporate sectors and we were able to add some of the new issues to our list of holdings as the quarter passed.

Another important development of this past quarter was talk of altering the tax treatment of Flow Through Entities (Income Trusts and Limited Partnerships) from policy makers in Ottawa. While the potential for negative developments on this issue exists, the consequences to the Fund so far have been limited. The issue is discussed in more detail below, but investing always includes an element of unknown risk and we were pleased to have weathered the effects without material consequences to the Net Asset Value of the Fund.

Interpreting the economic scene remains a challenge. In Canada, the strength of commodity markets, particularly energy, has been a strong support to the C\$. While some of this interest is speculative and could prove ephemeral, there is undoubtedly genuine, patient capital making its way to Canada in search of long-term investment opportunities, particularly in the energy and infrastructure sectors. However, for those non-energy sectors oriented to the export market, the ascent of the C\$ presents a challenge. The disparity between the fortunes of the resource-rich western provinces and the more manufacturing-oriented economies of Ontario and Quebec is increasingly stark.



Further complicating the economic scene are the effects of hurricanes Katrina and Rita on the North American economy. Damage to the energy infrastructure in the Gulf of Mexico has caused a sharp spike in gasoline and natural gas prices. Expenditures on energy are largely non-discretionary, so there is a worry that

consumers will curtail spending in other areas as a result. When added to the scenes of human devastation, it is likely that consumer sentiment across the U.S. has suffered and that economic growth may feel the effects. Closer to home, consumer sentiment and economic activity in central Canada are anything but robust, yet measures of inflation seem to be picking up. While this is partly explainable by surging energy prices, it is clear that the risk of inflation being re-kindled is a little higher now than earlier in the year.

Over the quarter, the Fund returned 0.2%¹, keeping pace with the modest 0.1% return of the Scotia Capital Bond Universe Index (SCBU). The Fund is up 9.7% in the last 12 months, above the SCBU's return of 9.0%.

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

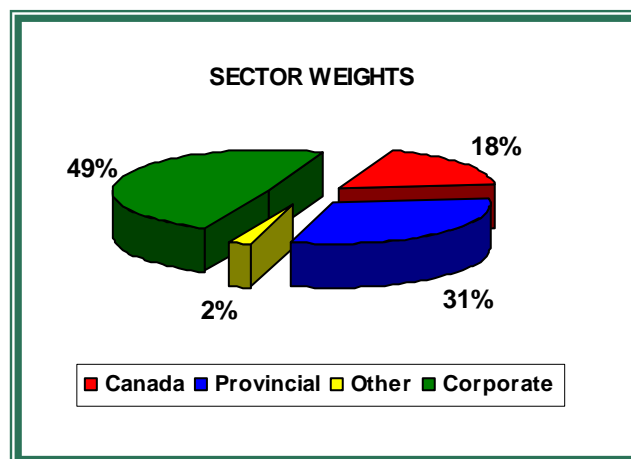
Asset Mix

There continues to be good growth in new subscriptions to the fund and we have chosen to keep the mix between bonds and other income producing securities, such as trusts and stable dividend paying stocks, at the same levels as the previous quarter. The yield curve has continued to flatten as short-term interest rates, anticipating Bank of Canada rate increases, move higher more than longer-term rates.

Fixed Income Summary (85% of Assets)

After having left the Bank Rate unchanged for almost a year, Governor Dodge and his colleagues at the Bank of Canada finally moved the Bank Rate higher (from 2.50% to 2.75%) in September. This increase was widely anticipated, as are at least two more before year-end. Strong energy and commodity prices, as well as international awareness that the Bank of Canada was finally “underway” caused a sharp appreciation in the currency. Over the quarter the C\$ moved from US\$ 0.815 to US\$ 0.86, and was even stronger when compared to the Yen, Euro or British Pound. Two year Canada bonds rose in yield by almost 50 basis points, while ten year yields rose about half that amount. The U.S. Federal Reserve raised rates twice this past quarter, from 3.25% to 3.75%, and another quarter point increase is widely anticipated in early November. The rise in short-term interest rates should provoke a necessary de-leveraging of the North American economy and a slowdown in consumer spending activity. In our estimation, this process, combined with the strength in the C\$, should keep inflation in check.

Despite the modest increase in interest rates this past quarter, the absolute level of bond yields remains low. For much of the last year we have favoured a slightly higher weighting in shorter maturity bonds, but recently we have lengthened term in the belief that the rise in rates, especially for longer maturities, is nearing its peak. Interestingly, despite short rates being higher on the quarter, 30 year Canada bond yields were completely unchanged. Our forecast continues to be that there will be little in the way of change to interest rates over the coming year, especially in longer maturities.



Our allocation to corporate securities remains high and within this area we continue to emphasize the best credits. Spreads between corporate securities and government bonds remain tight. During the quarter, Encana, Canada’s largest energy company, as well as Precision Drilling, a large oilfield services company, each called for redemption a number of their outstanding bond issues. Early corporate bond redemptions are a rarity and are only done at financially-advantageous prices to investors. The surge in cash flows in the energy sector has now made this a sensible use for excess liquidity. While we did not own any of the issues called by either company, spreads in other corporates tightened, partly as investors redeployed their money in other issues.

Earlier this year, Canada relaxed the restriction on foreign content in pension and retirement accounts. A consequence of this policy has been that a number of international issuers have been able to issue securities priced in Canadian dollars for sale in our local market. The first issuers to take advantage of this have been regular borrowers in the Euro-markets, typically agencies of foreign governments. This quarter we purchased a holding of KFW 4.95% of October 14, 2014. KFW is the short form for

Kreditanstalt Fuer Wiederauf, a AAA-rated agency of the Federal Republic of Germany. Essentially it is a German version of a cross between our Export Development Corporation and the Business Development Bank of Canada. The bonds were issued at a spread (extra yield) of 0.35% to comparable Canada bonds and wider than where the lesser-rated Province of Ontario issues trade. We would expect to add to these sorts of securities in the coming year – at the expense of our Provincial holdings in all likelihood.

Income Trusts and Equities (14% of Assets)

In the final month of the quarter, the Income Trust sector was roiled by uncertainty. Over the course of the month valuations across this area have declined precipitously with some issues down 15% or more. The reasons for the decline began in early September with the initiation by the Department of Finance of a public consultation on the role of Flow Through Entities (FTEs) – a development that began only a modest sell-off in the sector. Largely because the consultation period does not conclude until December 31, and because it was generally felt that a Federal election was not far away, many participants under-reacted to the gravity of the situation. A subsequent decision by CRA to stop issuing advance tax rulings with regard to companies re-organizing into trusts sparked a sharp correction in prices.

As many readers will know, the income trust sector has been a distinguishing feature of the Canadian stock market, and has provided many years of luxurious returns. In the last three or four years it has attracted all sorts of interest; including Canadian retirees, Canadian pension funds, as well as foreign and domestic hedge funds, to name but a few. Based on the way most observers described it, it was a suitable destination for both “hot money” and patient investors alike. To use street parlance, everyone was leaning the same way on this sector. The Fund has emerged from this latest adjustment largely unscathed due to our reasonably modest weighting in the sector of about 7.5%. At this time, based partially on our overall concern for equity markets as well as this regulatory risk, we are not inclined to “buy the dip”, nor are we in a mood to sell indiscriminately.

As we cast forward as to what may develop in the future in this area, it is worth considering that approval from Ottawa has always been begrudging. Policy makers’ support has been undermined by a justified worry about the effect of these structures on capital allocation, tax revenues and economic growth. Specifically, the Finance Department is considering limiting the deduction of interest expenses, taxing FTEs like similar corporate entities, or improving the integration of Canada’s personal and corporate tax systems (adjusting the dividend tax credit). This last alternative will likely benefit steady dividend-paying companies, such as banks and utilities. We recently added a new holding of Royal Bank partly for this reason. Future policy will be determined by both economics and politics - making any forecast of outcomes risky. At this time, our approach is to favour the side of caution.

