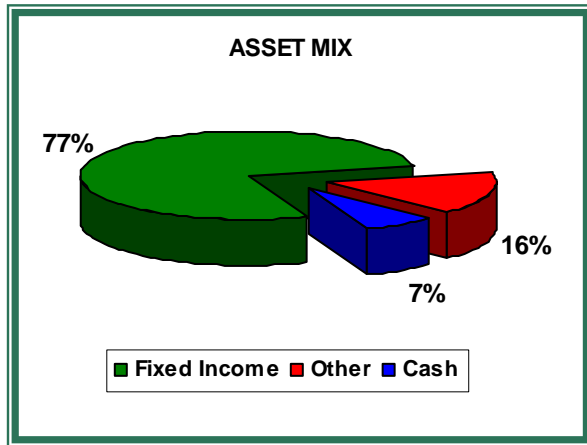


NEXUS NORTH AMERICAN INCOME FUND QUARTERLY REPORT – June 30, 2007

The second quarter began as the first quarter ended, reasonably calmly and uneventfully. 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 30th a year ago.

In Canada the yield curve remains incredibly flat. Two year Canada bonds and ten year Canada bonds each yield a little more than 4.50%. 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. Our holdings of income trusts and equities again added value and as a result, although the Fund's return this quarter was negative, the total return of the Fund comfortably exceeded that of the PC Bond Universe Index.



The proximate cause for the change in interest rates is actually fairly complicated. Normally, abrupt changes in interest rates are triggered by surprising economic data that alters market perception of economic fundamentals. In looking at the recent changes in rates, no such cause can be readily identified. Instead, a confluence of small but important developments were behind the move. These changes surprised a complacent investor base that had become fixated on the tepid domestic economy in the U.S.

In fact, while the U.S. economic data continued to reflect a soft economy, developments internationally were changing rather quickly. In Europe, evidence of economic strength, as well as

higher inflation, were rattling their capital markets. Both the European Central Bank and the Bank of England, were having to talk tough and follow-up their concerns with higher rates. In fact, the Governor of the Bank of England was required, by law, to write the Chancellor of the Exchequer to notify him that inflation had exceeded the top end of the official target band (3%). Higher rates in Europe inevitably put pressure on rates in North America, and particularly so for the United States which finances so much of its deficit by selling bonds to foreigners.

Elsewhere internationally, concerns that other central banks, particularly in Asia and the Middle East, were diversifying their foreign exchange reserves out of U.S. Treasury bonds changed the relative supply and demand balance in the domestic bond market, forcing rates higher. Notable interest rate bulls, such as Bill Gross of PIMCO, the largest bond manager in the world, as well as Merrill Lynch and Goldman Sachs all revised upwards their forecasts of U.S. interest rates. This change in sentiment sparked a round of interest rate hedging by mortgage lenders, which pushed rates higher still. As interest rates rose, more selling was required - yet all the while, economic data releases continued to reflect a reasonably soft economy in the U.S.

The Canadian dollar 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 any more than perhaps 0.25%. Indeed, although the Bank of Canada left the Bank Rate unchanged at 4.25% at its May 29th 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 10th.

So although interest rates have risen 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 component of the economy, representing almost 70% of U.S. GDP, will underperform.

The rest of the North American economy remains in fairly good shape. Company balance sheets are healthy and corporate profitability has remained 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.

There are other risks as well. In our last report, we described the woes of the sub-prime mortgage market in the United States. It is clear that this problem is serious, but has yet to have made much impact on the broad economy. We will watch this situation very closely, as it will have effects on construction activity and employment, consumer spending and even asset quality in the financial system.

As mentioned above, the capital value of our bond positions eroded. Despite an increase in the value of our other income producing securities, the Fund declined 0.7%¹. This result was substantially better than the decline of 1.7% experienced by the PC Bond Universe Index (PCBUI) formerly the Scotia Capital Bond Universe Index for the same period. The Fund continues to maintain its out-performance relative to the PCBUI over longer time periods as well. In the twelve months, the Fund has generated a return of 7.1%, while the PCBUI has returned 4.8% over the same period.

Asset Mix

Early in May, we reduced our bond holdings, and increased our cash position substantially. At 7%, our cash position is as high as it has been in many years. Our weighting in traditional fixed income was reduced to 77%. The allocation to other income producing securities, at 16%, remains below our limit of 20%.

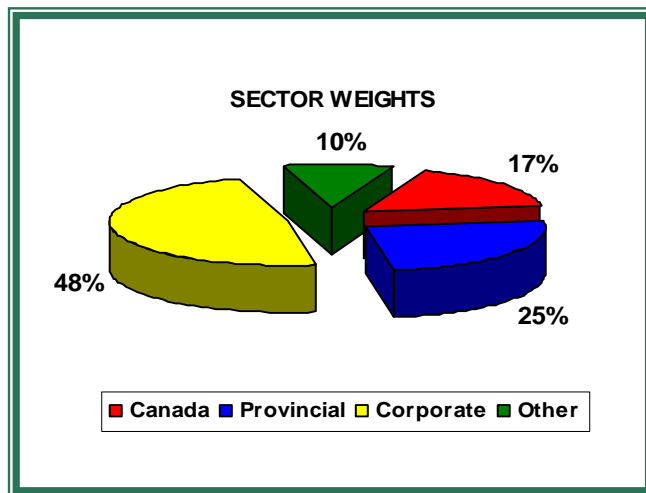
Fixed Income Summary (77% of Assets)

We continued to reduce our exposure to corporate bonds this quarter, substituting provincial bonds in their place. Despite having improved the credit quality in the portfolio and reduced our exposure to corporates, the Fund still 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

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

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. Our holdings will end up being rated below investment grade and, if we continue to hold them we will re-classify them, as part of our “other income-oriented” allocation.

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.



Other Income-Oriented Securities (16% of Assets)

We had a very good quarter with our holdings in this sector. Our holdings remained concentrated in banks, utilities and stable businesses structured as income trusts. While our financial services and utility positions have felt the effect of higher interest rates, two of our income trust holdings, UE Waterheater Income Fund and CCS Income Trust each have been the beneficiaries of private equity led buy-outs that lifted their prices significantly.

While UE Waterheater had been a long-term successful holding, CCS Income Trust is a holding that was only purchased in May. The price paid for UE Waterheater was in excess of our estimate of fair value and we were pleased to be sellers. On the other hand, CCS Income Trust is a business where we expected to enjoy the rewards of being an owner for a long time. Although the premium offered is substantially higher than both its market price and the price we paid for it, we are not nearly as pleased at the prospect of having to sell it at this time. 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.

