

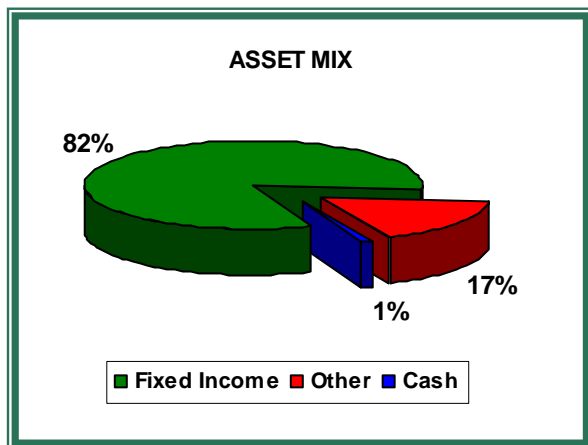
NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – March 31, 2007

It has been a reasonably calm period in capital markets to begin 2007. Interest rates were virtually unchanged and particularly stable this past quarter, finishing slightly higher than where they had started the year. The shape of the yield curve remains remarkably flat – one year treasury bills and 30 year bonds are within one basis point of each other. These circumstances are consistent with our long-held view that interest rates in both Canada and the U.S. were unlikely to change very much. Our bond performance narrowly exceeded the Scotia Capital Bond Universe and, thanks to the positions in income trusts and equities, the total return of the Fund comfortably exceeded that of the Universe.

An economic slowdown is underway in North America, and capital markets in Canada and the U.S. have spent the past quarter trying to come to terms with whether it will be moderate or perhaps something worse. In late February, while speaking in Hong Kong, former chairman of the U.S. Federal Reserve, Alan Greenspan, mused about the potential for recession in the United States. This casual reference sparked a flurry of excitement in both debt and equity markets. Bonds rose, stocks fell and market volatility jumped noticeably for a period of time. Eventually, both markets reverted to their previous trends and volatility

subsided. However it demonstrated that over the past few years, investors have been lulled into a sense of comfort that slow and steady economic growth would lead to equally predictable positive returns. We share the general opinion that a recession is unlikely (particularly in Canada) but are mindful that expectations and positioning for a recession are not priced in to markets at this time.



If there are risks to the general opinion that economic growth will remain positive and modest, it most surely emanates from the U.S., and particularly the continued unraveling of mortgage lending in the 'sub-prime' housing market. Nexus has long worried about the disruptive effect that rapid house price escalation was having in the U.S.

economy. The bubble mentality that swept America created significant distortions in its economy. As homeowners perceived the value of the equity in their homes to have risen, they financed extra consumption by borrowing against their homes with lines of credit (HELOCs) and second mortgages. Originally, our worry centred around the dampening effect on consumer spending that would occur once home prices stabilized or even subsided to values more in keeping with long-term demographic and economic trends. However, a new concern has arisen in the last few months which could be more destabilizing, and this concerns the amount of debt loaned to people of lower credit quality, an area called the 'sub-prime' market.

During the feverish run-up of housing prices between 2003 and 2005, many people of limited means, or with checkered credit histories, clearly felt that the prospect of ever owning a house was getting out of reach. At the same time, financial intermediaries, primarily banks but other lenders as well, began to feel the pressure to maintain their growth rates. As a result of these complementary circumstances, mortgage loans were made to people who historically would not have qualified for credit. What was once a small section of the market mushroomed in size. In 2000, mortgage lending to sub-prime borrowers was 2% of total mortgage loans outstanding, by the end of 2006, it accounted for almost 14%.¹ Unsurprisingly, when a niche market grows this quickly, errors and abuses of standard loan underwriting procedures occurred. Two greatly simplified examples: first, loans have been made to individuals based on little or no proof of income, and second, in order to encourage borrowers to take on larger loans, interest rates were set to begin at very low levels, creating artificially low monthly payments. As these payments subsequently re-set to normal levels, the borrower is frequently unable to repay.

¹ NBF Financial.

At this time, the problem continues to get worse. We will watch whether it remains confined to the sub-prime market or whether it insidiously creeps into other areas of the housing market and contributes to a decline in confidence and a slowdown in consumer spending. It is tempting to draw a comparison in Canada given that we have had our own boom in housing prices. Thankfully, it appears that excesses have been largely avoided here, and prospective weakness in our housing sector is not nearly the concern for either lenders or the economy that it appears to be in the U.S.

After weakening to begin the year, the C\$ has since recovered to the level it was in early January. The currency remains a drag on those sectors of the economy oriented to manufacturing exports. However, firm pricing for commodities, which represent approximately 50% of merchandise trade, has kept the currency well supported. Although our close ties to the U.S. economy remain very much a factor in determining Canada's economic fortunes, as one of the most open economies in the G8, Canada continues to benefit from the positive trends in global growth - not only a slow recovery in Europe and Japan, but also the more secular growth story in China, India and much of the developing world.

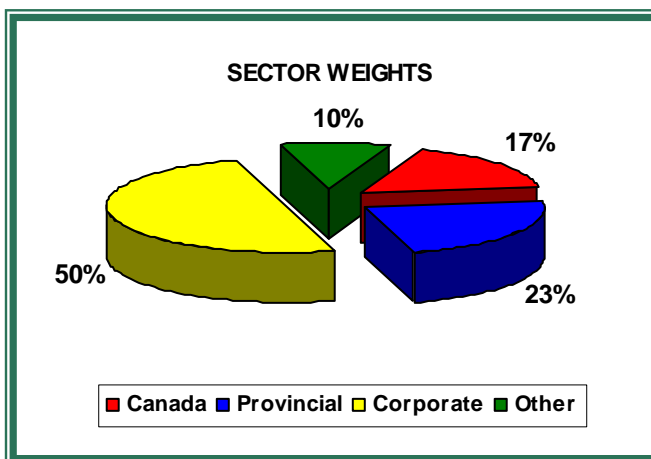
Over the quarter, the Fund returned +1.2%², made up of interest earned, some appreciation from our equity holdings, and offset by a small capital erosion in the value of our bonds. This was better than the return of +0.9% from the Scotia Capital Bond Universe Index (SCBU) for the same period. The Fund continues to maintain its out-performance relative to the SCBU over longer time periods as well. In the last year, the Fund has generated a return of 6.9%, while the SCBU has returned 5.5% over the same period.

Asset Mix

At 1%, we have kept our cash position low and our weighting to traditional fixed income has increased this quarter to 82%. The allocation to other income producing securities at 17% remains slightly below our limit of 20%.

Fixed Income Summary (82% of Assets)

Both the Bank of Canada and the U.S. Federal Reserve are dealing with economies that are beginning to slow from levels of very high resource and capacity usage. Inflation in both countries remains well controlled, but somewhat higher than its trend of the past few years. Unless the economy slows dramatically and employment falters, we expect official interest rates in both countries will be left unchanged, at least for the coming year. Absent a crisis caused by the housing situation in the U.S., both the Bank of Canada and the Fed may yet surprise the markets with their attention to inflation and may be willing to live with more economic weakness than many expect until inflation begins to revert to lower levels.



We have improved the credit quality of the portfolio this past quarter by substituting provincial, Canada and other government bonds for corporate bonds. The sizeable reduction in our allocation to corporates, brings us much closer to a market weighting in this sector. Spreads between corporate bonds and Canada bonds remain at historically narrow levels, and it is likely that in the coming months we will continue to take advantage of this and add to our higher grade positions.

² Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

As the Canadian bond market has evolved, a growing number of foreign entities are using our market to raise capital. This sector of the market is now known as the Maple market, and the credit quality of the issuers ranges widely from sovereign entities with AAA ratings to ordinary foreign corporations. As investors in the Canadian market, we benefit from investing in a more diversified range of businesses and avoiding the concentration of exposure that has been a feature of the Canadian market historically. We own four Maple issues; one is KFW, an agency of the Republic of Germany, another is SEK, which is owned by the Kingdom of Sweden. Both KFW and SEK are agencies that act very much like Canada's Export Development Corporation in their respective countries. Our other two holdings are issues of JP Morgan Chase.

Interest rates were very slightly higher this past quarter and, as mentioned above, the yield curve is flat. The duration of the portfolio has been extended slightly to 6.2 years with a concentration in maturities of between six and ten years. This exposure remains shorter than the index against which we are measured and, as a result, we should be prone to slightly less capital fluctuation than the underlying index.

Income Trusts and Equities (17% of Assets)

Our holdings in this sector remained concentrated in banks, utilities and stable businesses structured as income trusts. The storm of controversy in the income trust sector is gradually subsiding. As investors, we have certainly adjusted to an expectation that Minister Flaherty will implement, without material change, the amendments to the preferential status they once received.

This quarter, we added to our holding of Teranet Income Fund, a position that had been established before the changes were made known at Halloween. As a result, the most recent purchase was made at levels below where we had originally established our position, and well below its level at the end of October. Teranet was established in 1991 in order to convert Ontario's land registry system from paper to digital form. It went public in September 2006, on the back of an excellent operating record and a stable business model that we felt was well suited to an income trust structure. By virtue of an exclusive right to the land title data until 2017, it operates as a monopoly. Competitively its hold on the market is further secured as a result of its incorporation into the training of all paralegals in Ontario who search title as part of their work. The business has very high margins and there remains some room to grow in the years ahead, both as remaining land parcels still handled with the old-fashioned paper land registry are transferred to digital format and, as Teranet's expertise in manipulating data is considered for other applications, perhaps in the healthcare sector.

