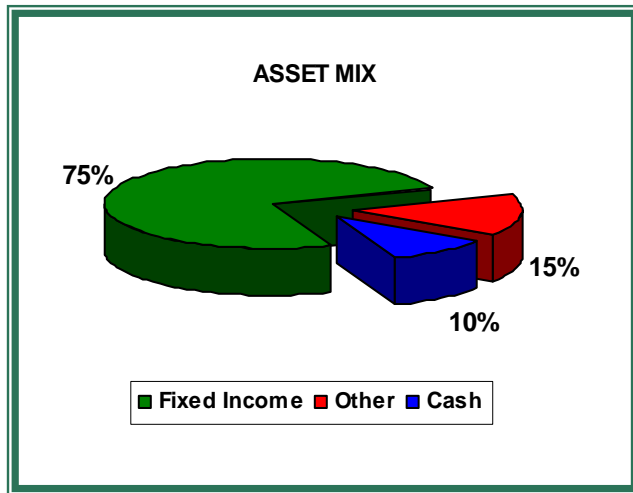


## NEXUS NORTH AMERICAN INCOME FUND QUARTERLY REPORT – September 30, 2007

So much for summer doldrums! Against an economic backdrop of strong global growth, capital markets began the quarter coping with a rising tide of higher global interest rates, and ended the quarter dealing with abrupt interest rate cuts and the prospect of more to come. Simplistically, the cause of this turnabout in sentiment was the rapid decline in credit quality emanating from the sub-prime housing sector in the United States. Although this sector is only a small part of the U.S. economy, fears that the asset quality of the global banking system had been over-estimated, drove a severe widening of credit spreads and, indeed, a dramatic reduction in the willingness to lend at any price. The crises in credit markets also affected equity markets – initially through the realization that tighter credit conditions would derail LBO and M&A activity, but also as investors came to appreciate that capital market confidence and economic growth in the developed world were more fragile than many had suspected. After a long period where investors have been well rewarded for assuming more risks, a sudden preference for lower risk developed. Equity markets retreated from the record highs they had made in early July and prices rose (interest rates declined) for less risky treasury bills and government bonds.

Early in the quarter, in a widely anticipated move, the Bank of Canada raised interest rates 25 basis points. However, as the quarter unfolded and credit concerns came to light, Canadian interest rates fell, especially in shorter maturity instruments. While the official Bank rate has not yet moved lower, the Bank



of Canada has been taking extraordinary actions in the money market to provide liquidity to the banking system. Essentially, the Bank is using purchase and re-sale agreements to provide credit to finance the short-term loans, commercial paper and securities of the domestic banking system until the situation stabilizes.

In the U.S., where the sub-prime worries are most extreme, the Federal Reserve has had to move more decisively. The Fed dramatically lowered rates by 50 basis points on September 18th, partially reversing a trend of interest rate increases. This move reflected a global effort on behalf of the Central Banks to steady markets in the face of the extreme uncertainty that was undermining confidence in the global banking system. While at the root the excesses of the sub-

prime mortgage business are troubling, there can be no doubt that the lack of transparency in financial markets is exaggerating the scope of the problem. Our global financial system requires trust and confidence amongst its participants. This is not only true for individuals with chequing and savings accounts, but also true for institutional participants managing substantially larger sums of money. Over the past many years, the financial markets have developed increasingly complex derivative and structured investments. As a virtue, this has allowed a broad distribution of risk but, in a time of crisis, the ability to identify and isolate the problem has clearly been impaired.

Thankfully, we managed to navigate these troubled conditions without serious losses or impairment in our holdings. Over the quarter, the Fund increased by 1.5%<sup>1</sup> - a combination of interest income as well as capital appreciation in our fixed income holdings. The portion of the Fund allocated to “other income securities” was also a contributor, although the strength of the Canadian dollar meant that the return from

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

our small allocation to two U.S. holdings was negative over this period. Our investment results slightly trailed the performance of the PC Bond Universe Index (PCBUI) which rose 1.7% over the same period. The Fund continues to maintain its out-performance relative to the PCBUI over longer time periods. In the past twelve months, the Fund has generated a return of 3.4%, while the PCBUI has returned 1.6% over the same period.

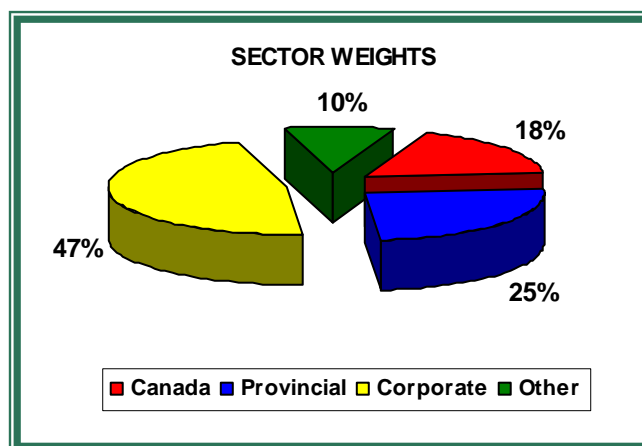
## Asset Mix

Our cash position continues to grow and is now 10% of the portfolio. While there may well be an opportunity to take advantage of wider credit spreads in the bond market, we also believe that the period of tumult is not yet behind us and that it is wise to be positioned with an emphasis on safety and capital preservation. Our weighting in traditional fixed income is 75%, and the allocation to other income producing securities, at 15%, remains below our limit of 20%.

## Fixed Income Summary (75% of Assets)

We continued to make small reductions to our corporate bond exposure this quarter, substituting provincial and Canada bonds in their place. In our last report, we noted that credit markets had anticipated much of the bad news associated with BCE's plan to be taken private by an investment consortium led by Ontario Teachers Pension Plan and that the official credit rating would likely change only after shareholders voted their approval. As BCE was clearly no longer investment grade, rather than re-categorize our two bond holdings as "other income securities", we sold them. We will generate better returns using either equities or income trusts than by holding our BCE issues to maturity.

The most important story in capital markets in many years has been the implosion in the U.S. sub-prime mortgage market and its consequent effects on asset-backed securities and money markets. While the crisis has subsided for the moment, it is too early to conclude that it is behind us. Despite a reduction in short-term policy interest rates, mortgage rates have actually risen. Counterintuitively, at the same time that housing prices are declining, for many people the cost of housing is actually rising. In fact, one of the major contributors to the current crisis has been the re-setting of Adjustable Rate Mortgages (ARMs) at higher interest rates than the original, ultra-low "teaser" rates that had lured borrowers into assuming too much mortgage debt in the first place. Worryingly, the amount of ARMs that are due to reset increases every month until May of 2008, so it is very likely that the weakness in the housing sector, as well as the issue of troubled credit quality, is not yet past. The pricing of securities, bonds and equities, anticipates some continued bad news, but it is prudent to be prepared for a set of outcomes that is worse than the market discounts.



At almost any other time, the leading theme of a report such as this would be the appreciation of the C\$. While much of this strength has been the result of US\$ weakness, our currency has also advanced very strongly against our major trading partners. Weighted by the amount we trade with all countries, not just the U.S., the C\$ has appreciated 11.5% in the year to date.<sup>2</sup> The rate of appreciation of the loonie is truly staggering – so fast, that many industries most directly affected are only just waking up to the dramatic impact it will have on their competitiveness and profitability. While in the long run, a strong currency is a

<sup>2</sup> Bank of Canada – Canadian-Dollar Effective Exchange Rate Index (CERI).

desirable part of economic management, a sudden change such as this is fundamentally disruptive. When combined with the risks of a slowing U.S. economy spilling over into our export and manufacturing industries, it requires a direct policy response. As a result, we expect that the Bank of Canada will need to directly address the level of the currency with as many as two interest rate cuts in the coming quarters. Accordingly, we have positioned the portfolio in anticipation of short and medium term interest rates falling more than longer term rates.

## Other Income-Oriented Securities (15% of Assets)

Quarterly results in this sector were again excellent and added to performance. Late in the quarter, we tendered our units in Canadian Hotel Income Properties REIT. This business is being taken private by British Columbia Investment Management Corporation. CHIP REIT had been an original holding of the Fund, and we are delighted with the valuation that was paid for it.

In the coming quarter, we likewise expect to tender a more recent holding, CCS Income Trust, to a private equity consortium led by the current CEO of the Trust. When this occurs, our holdings of trusts will be only 3% of the Fund, so there is ample room to add to this sector on any further equity market weakness. Our other holdings remained concentrated in banks and utilities and stable businesses structured as trusts, many of which we added to as the Fund grew over the quarter.

