

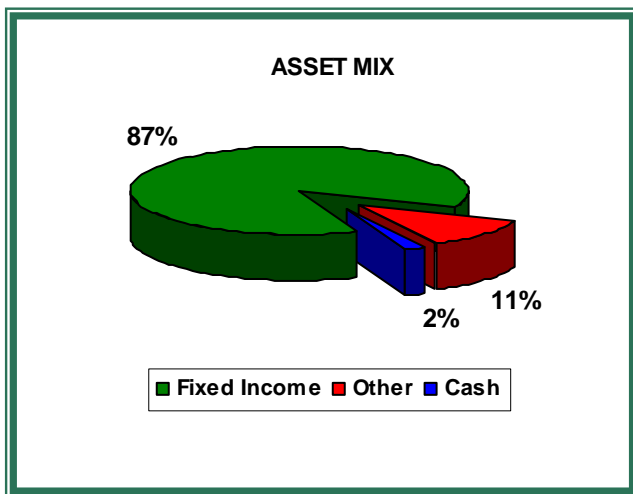
## NEXUS NORTH AMERICAN INCOME FUND

### QUARTERLY REPORT – March 31, 2008

North American capital markets began 2008 with no reprieve from the volatility that characterized the end of 2007. If anything, the unease at the start of the year has increased, as investors and the public at large come to grips with both the extent and the complexity of the worries in financial markets. The issues of excessive borrowing, lax lending standards and inadequate risk controls that we have described in earlier reports have clearly spread from Wall Street to Main Street in the United States. Likewise, in other developed economies, these same issues too have moved from being financial industry issues to problems that are dragging the developed world to the brink of recession.

Thankfully, the secular story of continued strong growth in the emerging world (China, India and South America) remains largely intact. While there is a risk that these economies slow markedly from their recent levels, in all but the most dire of forecasts, the emerging world will provide a measure of stability and necessary offset to the problems being worked through in North America and Europe. This is especially relevant to Canadians. Historically, due to our proximity to the United States, as well as to important policy agreements such as the NAFTA accord, Canada's economic fortunes have risen and fallen with the ups and downs of the U.S. economy. While this continues to be largely true, this time the effects of economic disruption will be softened in two ways. Firstly, the demand for raw materials outside of North America (energy and basic materials, such as metals) remains elevated, providing significant support to a large section of our economy. Secondly, years of fiscal restraint in Ottawa have generated considerably more policy flexibility to manage through this difficult period than has been true in the past. Low inflation, balanced budgets and a strong currency give policy makers a number of choices to offset the effects of any cyclical slowdown in the United States, or for that matter the rest of the world. This is not to say that

Canada will sail through this period unscathed by the serious issues affecting other economies, but rather to say that we are in as good shape as we have ever been to cope with developments as they arise.



What began as a U.S. mortgage lending problem has spread to the broad economy. Led by a weakening consumer sector, over the course of this quarter economic evidence has built that the U.S. is teetering on the brink of recession. There are many causes for this weakness. While the unemployment rate has remained very low, payroll employment (that is the actual number of people working) has actually fallen in each of the past three months. Unsurprisingly, home prices in almost all regions and at almost all price levels have also declined, defying the experts<sup>1</sup> and

creating conditions where many homeowners have little or no equity in their homes. A continued escalation in energy prices (heating costs as well as gasoline prices) has also pinched the wallets of consumers. As a result, measures of consumer and business sentiment are low.<sup>2</sup>

<sup>1</sup> Unfortunately, the experts also include many credit rating agencies who never 'modeled' a significant decline in home prices when grading securities backed by residential mortgages.

<sup>2</sup> The Reuters /University of Michigan Consumer Sentiment Index, released March 28<sup>th</sup>, was 69.5 – a 16 year low, while the Institute of Supply Management reading for February was 48.3, a level associated with economic contraction.

Compounding these negative economic developments has been a steep decline in the U.S. dollar. This quarter the trade-weighted U.S. dollar fell by 8% and now sits 17% below where it was at the start of 2007. In simple terms, this is the result of declining global confidence in the might of the U.S. economy and years of structural trade imbalance, particularly with China in manufactured goods, and with the Middle East in oil. More recently, a sense among investors of indifference in Washington to the consequences of a weakening dollar has emboldened speculators and worried foreign central banks. Many central banks use the U.S. dollar as the major component of their foreign exchange reserves and invest in U.S. treasury securities with these balances.

Fixed income markets and equity markets have now discounted a lot of bad news. While the level of pessimism may yet be proven justified, especially through to the end of the year, we believe that it is also an environment where investors will be able to establish positions that prove very rewarding over the long-term. The best defense in times such as these is a solid emphasis on quality, within both bond and equity selections. Investors should be mindful that interest rates, especially on government bonds, have fallen to levels where they provide only the important characteristic of capital preservation, not a real return. On the equity front, many companies are now valued for a period of never-ending disruption. Future long-term investment success will arise from being able to survive this current period with capital largely intact in order to be positioned for opportunities and a general market recovery, whenever that may be.

Over the quarter, the Fund returned 2.1%<sup>3</sup>. Solid results in the core bond portfolio were somewhat offset by a capital loss in the portion of the Fund allocated to “other income-producing securities”. As a result, our investment results trailed the performance of the DEX Universe Bond Index (DUBI) which rose 3.0% over the same period. In the past twelve months it trailed the DUBI, generating a return of 4.3%, while the DUBI returned 5.8% over the same period. The Fund continues to maintain its out-performance relative to the DUBI over longer time periods.

## Asset Mix

The dramatic decline in interest rates in shorter-term securities has meant that there is a significant opportunity cost to holding high levels of cash. As was begun last quarter, the Fund continued to increase the allocation to bonds in the portfolio, at the expense of our allocation to both our cash position and our allocation to other income-producing securities. Our cash position is now less than 2% of the portfolio and our weighting in traditional high-quality fixed income is 87%. We are positioned conservatively with room to take advantage of widening spreads in the credit markets or attractive opportunities with high-quality dividend paying stocks.

## Fixed Income Summary (87% of Assets)

There was a precipitous decline in official interest rates this quarter, as the U.S. Federal Reserve raced to liquify the capital markets and ease the cost of borrowing for financial institutions, mortgage borrowers and consumers. The Bank of Canada lowered the Bank Rate from 4.25% to 4.00% in January and then to 3.50% in March. Normally a steep decline such as this would provoke a dramatically weaker Canadian dollar, but as the U.S. Federal Reserve was also driving its own rates even lower, the C\$ weakened only slightly over this period. In fact, the speed with which the U.S. Federal Reserve has lowered the target Federal Funds rate is astonishing. Since the start of the year, it has declined from 4.25% to 2.25%. Many observers expect that a rate of 1.5% is possible before the end of the year.

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<sup>3</sup> Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

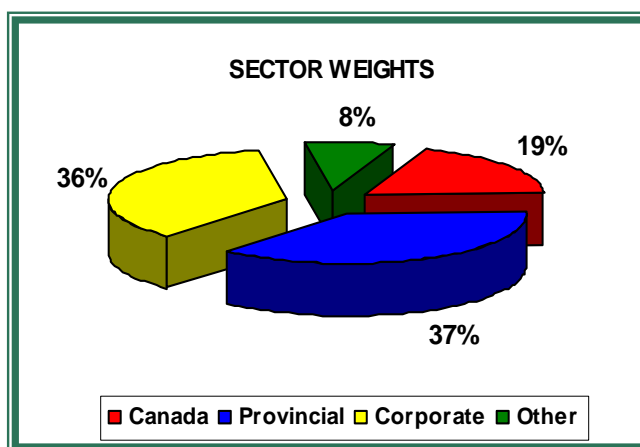
Despite these dramatic declines in policy rates, the effective cost of borrowing in the public markets for many companies and consumers declined very little or not at all over this period, effectively thwarting the efforts of the central banks. This unintended result arose from a heightened level of risk aversion amongst investors and financial institutions that has resulted in borrowers paying a larger interest spread over government rates than in the past.

After years when investors made no allowance for the remote risk of insolvency of familiar names in the corporate bond market, we are now in a period where such fear, irrational or not, is driving the spreads of corporate borrowers to extremely wide levels compared to their corresponding government benchmarks. Issuers as sturdy in repute as Canada Housing Trust (a full and complete guarantee of the Government of Canada) have had to issue securities at a 0.60% premium to government bonds. In the corporate bond market, every Canadian bank has seen the spread between their borrowing rates and the government curve widen dramatically. Typically, in periods of upheaval such as this, the major Canadian banks would have the flexibility to wait out the disruption. However, in this instance, because of significant foreign acquisitions by the Royal Bank, Bank of Nova Scotia and the TD Bank, as well as asset write-downs at CIBC and the Bank of Montreal, all of these institutions have had to raise capital and “take their medicine” by borrowing at much wider spreads than would be the norm for issuers of their credit standing.

Except in the event of insolvency, such spreads as are now available between top quality corporate issuers and Canada bonds, probably represent good relative value in the fixed income markets. This past quarter the Fund maintained an overweighting in corporate bonds, but did reduce its exposure to longer dated financial and non-financial issuers in order to buy provincial bonds of shorter maturity.

There is an important distinction to be made at this time between insolvency and illiquidity. Insolvency, such as has brought Bear Stearns to collapse, is a condition where the value of one's assets is less than one's liabilities. In the instance of Bear Stearns, lenders lost the confidence that the assets held on Bear Stearns' balance sheet were worth the value at which they were being carried. Despite many aspects of the Bear Stearns business being quite successful, the company was deemed at serious risk of insolvency and effectively collapsed.

On the other hand, illiquidity is when, despite satisfactory asset quality and earnings capability, a borrower cannot re-finance loans as they mature. This distinction, which is of particular relevance to the U.S. banking system, currently is front and centre as the U.S. Federal Reserve, and to a much lesser degree the Bank of Canada, provide emergency lending facilities to the financial system. As this quarter ended, the U.S. Fed was introducing unprecedented new lending measures that allowed many U.S. financial institutions to borrow at low rates from the U.S. Federal Reserve and pledge as collateral securities that were unwanted as collateral by other participants of the global financial system. These new measures presuppose that the collateral the Fed accepts proves credit-worthy. Not since the '30s has this sort of intervention been undertaken. Extraordinary circumstances are making for extraordinary measures, and the Federal Reserve clearly believes that the remaining major participants in the system are illiquid and not insolvent.



The dramatic reduction in policy rates in North America has 'steepened' the yield curve – a condition where interest rates of shorter maturities are lower than for longer maturities. We have had the right positioning in such a market, with our core holdings concentrated in maturities between 5 and 10 years. The composition of the our holdings is of very high quality, and the portfolio is positioned to provide considerable capital preservation and some income generation.

While we expect that both the Bank of Canada and the U.S. Federal Reserve will continue to push official interest rates lower, the market has already anticipated this. Accordingly, we think that further substantial interest rate reductions are unlikely from this level. In fact, rates for longer maturities could rise under pressure from foreign investors demanding higher returns to protect them from currency declines. When financial markets and economic conditions normalize, we expect considerable contraction in the spread between corporate bonds and the relevant government benchmark. While this could yet be many months away, it would be positive for the Fund when it occurs.

## Other Income-Oriented Securities (11% of Assets)

This quarter, we also re-configured our financial services holdings, selling our interest in the Bank of Montreal and adding to our positions in the three other Canadian banks we own (Royal Bank, Scotia Bank and TD). While attractively valued and offering a generous dividend, credit write-downs and lower levels of profitability handicap the Bank of Montreal from being able to cope with present market conditions the way the other banks can. Prospectively, we think the banks we purchased offer better long-term growth opportunities as well as superior capabilities to adapt to a period of financial market instability.

While they had a negative impact on the Fund over the last year, we continue to believe that an allocation to this sector will enhance long-term returns to unit holders. Our investments in this sector remain concentrated in banks and utilities, as well as four stable income trusts.

