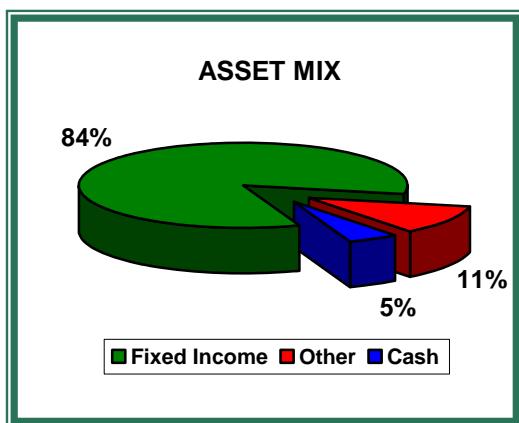


NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – September 30, 2008

It is an uneasy time for investors in global capital markets. Concerns regarding financial integrity and solvency of the banking system have continued to escalate and the quarter has been marked by a number of large institutional failures, near failures and forced re-organizations. A crisis of confidence has overtaken the global banking system, severely curtailing lending and threatening the already softening economic outlook. The list of failed entities is long, and notable. It includes: Fannie Mae and Freddie Mac, the two large mortgage bankers who effectively underwrite more than 50% of the home mortgage market in the U.S.; AIG, the world's largest life insurance company; and Lehman Brothers, a Wall Street investment bank which had survived more than 100 years of market gyrations. Although these developments are most acute in the United States, by no means are they restricted to it, as serious issues also face a number of European banking and financial institutions. Thankfully for now, Canadian institutions have only been swept up in the side-effects: wider borrowing spreads and lower share prices, but not the fundamental issues of asset impairment and liquidity concerns.

The causes of the present crisis are many, but for simplification, two reasons stand out. The first is the quality of the assets in the banking system. Primarily this refers to loans and other assets backed by residential and commercial real estate. Beginning in January 2007, after many years of steady price improvement, housing prices in the U.S. began to fall. This decline continues without relent. The latest reading (-16% year over year)¹ would suggest that prices across the U.S. have not yet touched bottom. As a result of this decline, many trillions of dollars of home equity have been wiped off the balance



sheets of individuals, while at the same time devastating the collateral value of these home loans on bank balance sheets. The second reason is the extent to which excess leverage has become prevalent, not only at the institutional level of the global financial system, but also in the fabric of household behaviour. In the institutional setting, assets of all types were piled high on balance sheets. In order to finance these assets, it was common to use a wafer thin slice of equity and then lever it up more than 30 times. As a result, even a small decline in the value of the asset had a devastating effect on an entity's equity. In the household setting, it is now clear that families became inured to the risks of purchasing homes with little or no money down and carrying the debt load with little regard for the risk of higher interest rates or declining disposable incomes. When interest rates rose and higher energy prices began to pinch spending, the ability to remain current on mortgage payments was greatly undermined. It is estimated the inventory of foreclosed homes is now 2.75% of the total stock of housing in the U.S. and that almost 6.5% of all mortgages are overdue one or more payments.²

The integrity of the global financial system seems as precarious now as it has at any time in history. In the present environment, a pervasive lack of confidence has created a self-reinforcing decline in the value of bank assets. Recent changes to financial reporting rules require that lower asset values be reflected in the financial reporting of the owner and these losses, often unrealized, require more capital

¹ Case-Shiller Home Price Index as of July 2008.

² U.S. Mortgage Bankers Association as reported by Bloomberg.

to be raised in order to stay within regulatory guidelines or to maintain depositor confidence and forestall withdrawals. Since the crisis began in the summer of 2007, almost \$600 billion has been written off by banks and other financial institutions. At the same time, these same institutions have raised almost \$450 billion in new capital. At the time of writing, we await confirmation that the U.S. Congress will authorize a further \$700 billion to be made available to shore up the assets of the U.S. banking system. While this present undertaking, dubbed TARP (Troubled Asset Relief Program) expands deposit insurance in the U.S. to reduce worries of depositors, its most important characteristic is to provide for the sale of troubled assets. Because it is funded by the U.S. Treasury, it can be counted on with certainty, and should go a long way to stem the worry of systemic failure that pervades the system currently.

TARP will not be a final solution for the ailments of the global capital markets, but it is a necessary step toward a healthier environment. As we look beyond the problems of the financial system, some traditional economic worries are looming ahead. After many years of strong global economic expansion, growth is slowing. This slowdown is unlike many other economic cycles. Conventionally, economies slow for one of two reasons: either after an extended period of excess production which produces a glut of inventories, or after a period of excess demand generates the fear of inflation, causing central banks to raise interest rates to curtail demand. In the current instance, demand is slowing as a massive de-leveraging occurs across the globe. At the centre of the scene are U.S. consumers, who for years relied on rising housing prices to provide for their financial security. Consumption was funded by widespread and cheap credit, often secured by their home. It is estimated that, since 2001, U.S. consumers have withdrawn US\$ 4.4 trillion through bank loans and lines of credit.³ As a result of declining house values, not only is there less equity value in the stock of housing, but also there is the looming issue of repaying what has already been borrowed.

Just as the U.S. consumer is scaling back, so too are the consumers of the developing world. Consumption in the developing world doubled between 2001 and 2007 and now accounts for a very meaningful 28% of total global consumption. But the same issues that befall consumers in North America also affect those in the developing world. The burgeoning middle classes of India, China and South America must also deal with rising credit costs, and those further down the economic continuum have been particularly affected by rising fuel and food costs. After rising more than 10% in 2007, it is now estimated that global consumption will be up little more than 3% in 2008 – a significant slowdown.⁴ This slowing trend around the globe is already being felt here in Canada, resulting in lower export demand for both raw and finished goods, as well as weaker commodity prices.

The Fund declined 0.3%⁵ in the last quarter, and is now up 0.9% for the year-to-date. The DEX Universe Bond Index (DUBI) was lower by 0.4% for the quarter and increased 1.8% so far this year. Our bond results remain ahead of the DUBI this year; a decline in the value of our holdings of 'other income-producing securities' is the cause of our trailing performance so far in 2008. The Fund continues to maintain its out-performance relative to the DUBI over longer time periods.

Asset Mix

Our asset mix has remained basically unchanged over the quarter. Our allocation to traditional fixed income is 84%, our holdings of cash equivalents is now 5% and the balance of 'other income-producing' securities remains at 11%.

³ Stifel, Nicolaus, as reported by Bloomberg.

⁴ Bank of America, as reported by The Financial Times.

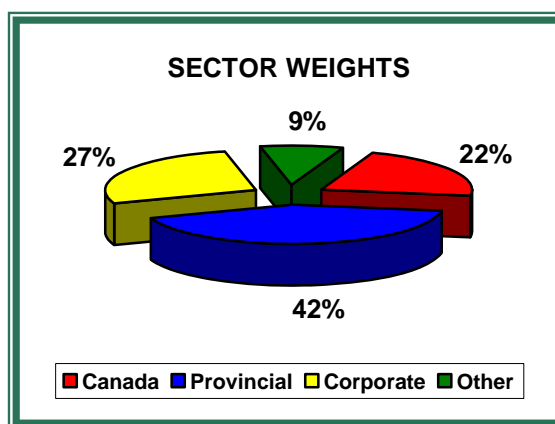
⁵ Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

Fixed Income Summary (84% of Assets)

Government interest rates remained steady to lower this quarter. Rates for maturities longer than ten years were basically unchanged, while rates for shorter maturities declined in anticipation of future reductions in the Bank of Canada's target for the overnight rate.

However, the story in the bond markets has not been the changes to government borrowing rates, but rather the significant increase in the cost of borrowing for companies of all credit qualities. A consequence of the de-leveraging in the economy and the preference for lower risk, is that companies that regularly borrow need to pay more. Although in the most recent quarter government interest rates were generally lower or steady, in fact the cost of credit in the economy increased. This is true across all maturities, and for borrowers of all credit qualities – affecting not only the rates companies pay for 30 day Commercial Paper, but also the rate that Provinces must pay on 30 year bonds. Since the middle of 2007, the spread between five year bank bonds and government bonds has widened 2.25%. So, despite a decline in government rates of almost 1.50% over the same period, the cost of borrowing for the banks has actually increased significantly. In the last quarter alone, the spread between Canadian five year bank bonds and government bonds has widened 0.75%.

Over the course of the last 18 months, the central banks of the world have been addressing the crisis in the banking system in a co-ordinated fashion. Around the globe, official interest rates have been kept low. In Canada, as elsewhere, special borrowing facilities for members of the financial system have been put in place in order to shield the system from collapse. In effect, the Bank of Canada is offering to finance many of the assets of the banking system until this current crisis in confidence passes. We have retained an emphasis on higher quality credits and have benefitted from increasing our weightings in Provincial bonds as well as Canada bonds.



While some worry that this period of easy money is sowing the seeds of future inflation, we remain more sanguine. As the de-leveraging unfolds, we expect that inflation rates will subside. In a world of worry, inflation does not keep us awake at night.

Other Income-Oriented Securities (11% of Assets)

The broad decline in equity prices this past quarter affected the value of our holdings in this area, detracting from performance in the Fund. There are two developments of note, one good, and one bad. On the 'good' side, one of our holdings, Teranet Income Fund, is the subject of a takeover offer. While the increase in value has been welcome, many, including Nexus, believe the takeover offer does not give enough credit for the quality and stability of Teranet's business. Even in times such as this, we think it is worth more, and we expect a superior offer to emerge in the coming months. On the 'bad' side is one of our other holdings, Arctic Glacier Income Fund. It is a maker of packaged ice that has been successfully expanding across Canada and the United States in the past few years. Unfortunately, earlier this year, it was announced that the U.S. Department of Justice was investigating competitive practices within the industry. Arctic Glacier's share price has been under a cloud ever since. In situations like these, companies can say very little other than that they are co-operating with the investigation, but in the present unsettled times, and with the burden of substantial legal costs, the company has suspended its distribution and the share price has fallen dramatically. It remains as a very small holding of the Fund.

While our allocation to these 'other income-oriented' securities has had a negative impact on the Fund in the year to date and the last quarter, we continue to believe that an allocation to this sector will enhance long-term returns to unit holders.

