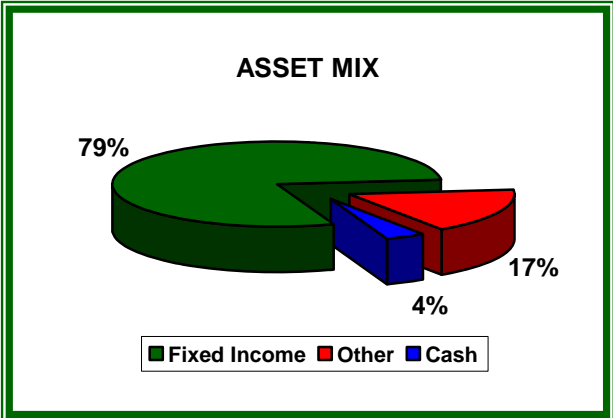


# NEXUS NORTH AMERICAN INCOME FUND

## QUARTERLY REPORT – December 31, 2009

What a difference a year makes! 2009 was a year of vibrant recovery in capital markets with significant positive returns accruing to bond and stock investors alike. At the end of 2008, there remained real concern for the solvency of the global financial system, but over the course of 2009 extraordinarily stimulative monetary policy, together with massive fiscal intervention, has calmed most investor fears of a global financial meltdown. While some, including Nexus, may worry about the future consequences of current government fiscal and monetary policy, the settling down of the hysteria and fear that had gripped markets earlier in the year will now allow policy decisions to be made more thoughtfully than would have been possible just a few months ago.

While 2009 was a year of notable market recovery, it remains unclear whether it presages a period of economic recovery of similar significance. Optimistically, almost every kind of measure of economic activity shows sign of improvement as the year comes to a close. For example, in the United States, housing prices seem to be stabilizing, and in Canada, to the surprise of many, prices are actually higher on the year. Likewise, job losses in the U.S are stabilizing at their lowest level in two years and, in Canada, new jobs have been created in three of the past five months. Measures of consumer sentiment have improved on both sides of the border, although they remain at historically low levels. Business confidence seems to reflect an improvement in attitude that, if accurate, will lead to a rebound in investment in capital equipment as well as inventories. Despite conflicting, but equally convincing, arguments for either future deflation or



inflation, actual measured inflation, the scourge of long-term investors, seems to be well under control for the time being.<sup>1</sup>

There is undeniable evidence of economic and market recovery, but it is not yet clear whether it is time to let down our guard as investors and assume a typical cyclical economic recovery is at hand. There remain a number of unresolved risks and imbalances in the global economy that make a 'normal economic recovery' still very much up for debate. At the very least, after a contraction in economic output such as we have just experienced, and in the face of U.S. fiscal stimulus amounting to almost 14% of GDP, some rebound in activity is to be expected. In short, zero percent interest rates, record debt and deficit levels, and massive trade imbalances remain worrisome aspects of the global economy. If 2008 was a year of crisis, and 2009 was a year of intervention, then 2010 may well need to be the year of normalization.

Certainly, the most pressing issue for investors in the coming year will be the relative success or failure of policy makers to restore normal monetary and fiscal policies without impairing the fragile recovery underway. In December, Bank of Canada Governor Mark Carney and Finance Minister Jim Flaherty each warned about the effects that an inevitable rise in interest rates would have on Canadians carrying too much debt. Unsurprisingly, ultra-low rates have encouraged Canadians to carry high levels of credit card and mortgage debt. A return to a more normal interest rate environment could easily derail consumer participation in this recovery – especially if wage and income gains remain subdued.

For now, changes in interest rates appear to be a matter of policy decisions by central banks. However, based on the extraordinary amounts of government spending and borrowing now planned, it is quite

<sup>1</sup> The 12 month change in Canada's All-Items CPI was 1.0% in November and 1.8% in the United States.

possible that the determination of interest rate policy may well end up being forced on governments and central banks, in particular those of the U.S. and the U.K., by providers of capital to the global bond markets. While many economists see the merits of the sort and scale of fiscal stimulus being utilized currently, investors in government debt will need to believe that there is a credible plan in place both to reduce the developing debt burden and to wean economies from relying on such extraordinary intervention. It is possible that, sometime in 2010, worry that a major country will be unable to repay its debts will come to a head and provoke another crisis in capital markets. Over 60% of U.S. Treasury bonds are held by international investors,<sup>2</sup> and 40% of all Treasury debt outstanding matures in the next 12 months.<sup>3</sup> As such, there is a requirement to refinance a massive amount of debt and it is essential that a plan to manage the debt burden be explained to investors so as to maintain their confidence and willingness to invest in the U.S. Treasury market. We are watching with interest the situation of Greece, recently downgraded to BBB status by Fitch, and that country's response to a growing international worry about the deterioration in its public finances.

We continued to have excellent returns in the Fund and in the past quarter we generated positive returns despite a decline in the overall bond market. The Fund gained 1.2%<sup>4</sup> in the last quarter, and was up 10.7% in the last 12 months. The DEX Universe Bond Index declined 0.2% over the quarter and increased 5.4% in the last 12 months.

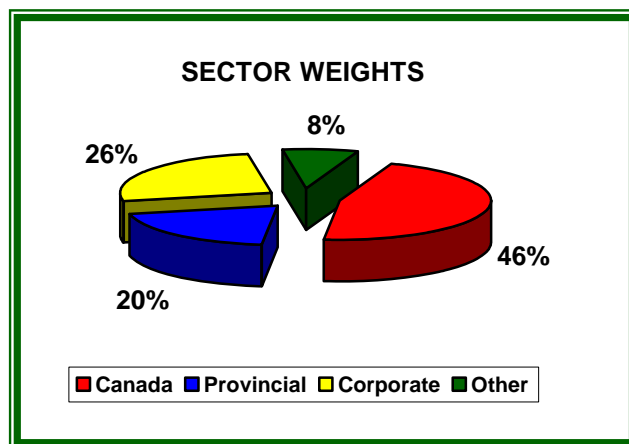
## Asset Mix

We increased our allocation to 'other income-oriented securities' again this quarter, moving the weighting from 15% to 17%. We also added to the cash position which now stands at 4%. The allocation to bonds is 79%, a reduction of 5% from where we stood at the end of the third quarter.

## Fixed Income Summary (79% of Assets)

An index return of 5.4% for 2009 masked a wide discrepancy in performance between government and corporate bonds. Despite a reduction of 1.25% in the Bank Rate this year to 0.25%, 10 year Canada bonds actually rose in yield by almost 1.0% in the past 12 months. A higher yield (lower price) for longer maturity bonds is evidence of the concerns discussed above regarding an increased supply of government bonds. The sub-index of government bonds generated only a 1.6% return for all of 2009. On the other hand, as evidence that an economic recovery was taking hold, worries of corporate defaults declined, reducing the deemed credit risk of corporate bonds. Despite a record amount of corporate bond issuance in Canada last year, and in the face of a general rise in government rates, yields of these securities declined substantially in the last 12 months, producing a return of 16.3% for the corporate bond sub-index.

As we cast forward for what this sector might return in 2010, we predict that returns are likely to be more modest than was the case in the past year. We maintain our rather unexciting interest rate forecast, expecting only modest increases to the level of interest rates. As a result of this forecast, we have a portfolio duration (5.2 years) that is slightly shorter than the index (5.9 years) and we continue to hold few bonds with more than 10 years to maturity.



The Canadian bond market remains an excellent safe-haven for worried investors, but returns will be low in the next year or so. The key to long-term success in this asset class has been to avoid any permanent

<sup>2</sup> *Guide to the Markets*, J.P. Morgan Asset Management Q1, 2010.

<sup>3</sup> *Reckoning Delayed*, National Post, January 5, 2010.

<sup>4</sup> Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

losses arising from corporate defaults and the erosion of the capital value of longer-dated maturities that arises when either inflation concerns creep into the market or central banks aggressively tighten policy. We maintain a very high standard of credit quality in our corporate bond holdings and our portfolio duration reduces our exposure to an unexpectedly sharp rise in interest rates. A large weighting in Canada bonds and an emphasis on credit quality means that, for now, the running yield on our portfolio is not as high as it might be. On the other hand, our holdings are extremely liquid allowing us to re-position the portfolio quickly, and without material transaction costs. We prefer to maintain this flexibility for now for what could be challenging times ahead.

The Fund's bond returns continue to be very satisfactory. The Fund's fixed income returns were +0.2% for the quarter and +7.4% in the last 12 months. By comparison, the DEX Universe Bond Index declined 0.2%, and rose only 5.4% for the same periods.

## Other Income-Oriented Securities (17% of Assets)

We remain below our maximum permitted 20% allocation to this sector, but again increased our allocation this past quarter. We established a position in Brookfield Infrastructure Partners LP, a business that owns and operates infrastructure assets in Canada and around the globe. Generally speaking, its investments are in high-quality infrastructure assets, such as power or pipeline projects, with little competition or high barriers to entry. Typically, these investments have low maintenance capital requirements and generate stable and growing cash flows. Currently providing a distribution yield of slightly more than 6%, we think that with only modest growth, Brookfield Infrastructure Partners could well generate almost 10% returns per year for many years.

Again this quarter, our allocation to 'other income-oriented' securities had a very positive impact on the Fund, rising 6.6%. Over the past 12 months these holdings were up 41.9%. We own 13 different securities spread across 7 industrial sectors and continue to believe that an allocation to these securities will enhance long-term returns to unit-holders.

