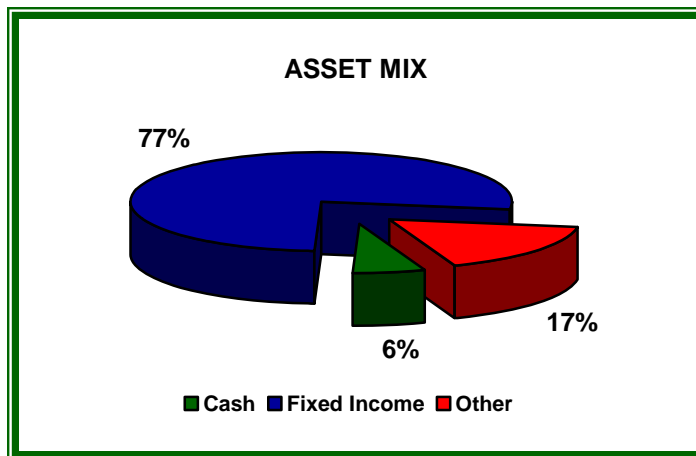


## NEXUS NORTH AMERICAN INCOME FUND

### QUARTERLY REPORT – June 30, 2010

The first half of 2010 has proven to be as challenging a start to a year as any in recent memory. After quietly building strength in the first quarter, the global economy appears to have lost momentum, renewing the worry of a second leg of economic contraction. The causes of concern are many. As the quarter unfolded, a range of economic indicators proved disappointing: employment, particularly in the U.S., was weak; consumer confidence and business sentiment both subsided; and the U.S. housing market showed no sign of recovery.



We are in a period of economic transition. For much of the last 12 months, the economic recovery in Europe, the U.S. and Canada was led by government fiscal stimulus and private sector inventory rebuilding. As the fiscal stimulus subsides (and it must) and as businesses restore inventories to desired levels, growth in economic activity will have to come from increases in personal consumption and business spending on capital equipment. This hand-off from government to the private sector is never easy, and in an environment where individuals are deleveraging (saving more and spending less) it is proving to be more difficult than

usual. The state of the labour force will remain the key determinant of whether the transition from public to private sector is successful, and this will be judged not just by the number of new jobs created, but also by the length of the workweek and the wages earned.

In our assessment, particularly in the U.S., corporate profitability and balance sheets are in very good shape. Businesses are lean. However, the work-week has lengthened, reflecting a pick-up in demand for labour. It is likely that further increases in demand for either goods or services will require the addition of more workers. Interest rates are low, making the acquisition of capital equipment affordable. While the economies of the developed world have stumbled a little, robust growth in South America, India and China remains intact and so, for Canadians, end markets for raw materials remain reasonably healthy.

By conventional economic criteria, these would be the necessary pre-conditions for continued economic recovery. However, the issue of sovereign debt burdens continues to cast a dark shadow over the global economic scene. What started out as a large problem in a small country Greece, now appears to be more widespread. Amidst the mayhem of the G8 and G20 meetings, our political titans managed to craft a resolution to address the growing unease that investors feel for the safety of their capital, acknowledging both the recent unsustainably large fiscal initiatives as well as the necessity for committing to credible plans for correcting the situation. The commitment to halve fiscal deficits by 2013 and to stabilize debt to GDP ratios by 2016 ought to offer some comfort to investors, but only as programs are actually put in place and the intentions are acted upon. Such evidence will unfold over years and not months and so, as we have said for some time, we expect the investing environment to continue to be volatile and difficult.

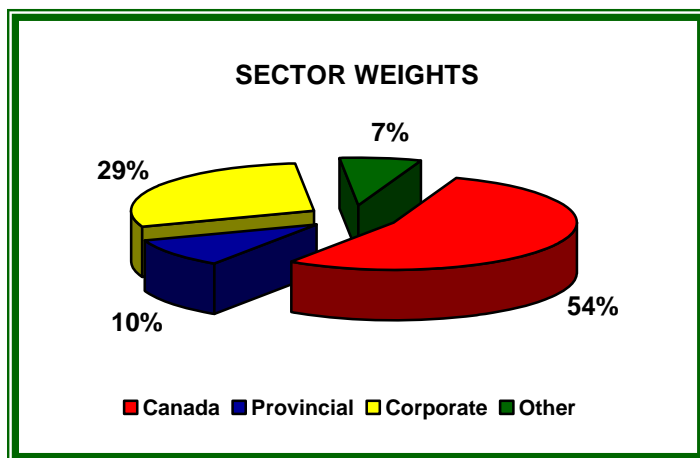
After finishing the first quarter rather strongly, equity markets gave back their gains this quarter and are now down for the year to date. Bond returns remain positive, reflecting the preference of investors, in this kind of environment, for the safety of fixed income investments.

The quarterly return of the Fund was modestly positive, trailing the benchmark due to our more conservative positioning. The Fund gained 1.7%<sup>1</sup> in the last quarter, and was up 9.2% in the last 12 months. The DEX Universe Bond Index (DUBI) increased 2.9% over the quarter and increased 6.9% in the last 12 months.

## Asset Mix

We reduced our allocation to “other income-oriented securities” this quarter, from 19% to 17%. The change arose largely as a result of the firm-wide sale of one holding, Bell-Aliant Regional Communications Regional Communications Income Fund. Our cash position has grown to slightly over 6%, the largest in many years, but still relatively modest. While there is an opportunity cost from holding low yielding cash assets in the short-run, we expect that there will be chances to re-deploy our cash reserves in more attractive longer-term assets. The allocation to bonds is at 77%, slightly below where it was when the quarter began.

## Fixed Income (77% of Assets)



Bond returns were positive this quarter and although short-term rates were higher, interest rates for bonds with maturities longer than one year declined to levels not seen since the height of the credit crisis 18 months ago.

As anticipated, the Bank of Canada raised the target for the overnight rate on June 1st from 0.25% to 0.50%. At the time, there was widespread opinion that the rise in rates was the start of a normalization of interest rates that eventually could send the policy rate back to a less stimulative level of around 2.0%. The decision to raise rates was really a follow-through from the

Bank of Canada's semi-annual Monetary Policy Report released in April, which noted the favourable global economic growth conditions at that time. Almost since the day of the release, economic data have tended to disappoint. The current strength in government bond markets reflects both a demand for the safety of government bonds, the so-called “flight-to-safety” trade, as well as a growing sense that a softer economic recovery would mean more economic slack in the economy than had been anticipated, leading to reduced inflationary pressures in the future.

A theme of the past quarter, and indeed the past two years, has been Canada's better economic performance relative to other developed economies. Whether it is the state of our public indebtedness, the strength of our financial system, or the relative stability of our housing sector during the crisis, Canadian assets have increasingly been seen as a safe alternative in a dangerous world. Indeed, since the beginning of the year a number of central banks, including those of India and China, have announced that they would utilize Canadian bonds more broadly in their reserve accounts.

Central banks and individual investors have entirely different investment goals. While it is nice as a Canadian to know that foreign central banks are accumulating Canada's bonds, current bond yields present very little investment opportunity. Canadian ten year bonds yield 3.08% and, with the contraction in corporate spreads over the year, good quality corporate bonds yield only 4.25% or so. In our estimation, there is little appeal in longer-maturity bonds, so we have preferred to hold shorter maturity bonds and our portfolio duration is less than the benchmark index. We have also favoured Government of Canada guaranteed bonds over corporate and provincial bonds, content to earn a little less in yield so that we can be more confident in the liquidity of our holdings. As a result, in the last six months we have given up some return due to the safety and quality of our portfolio.

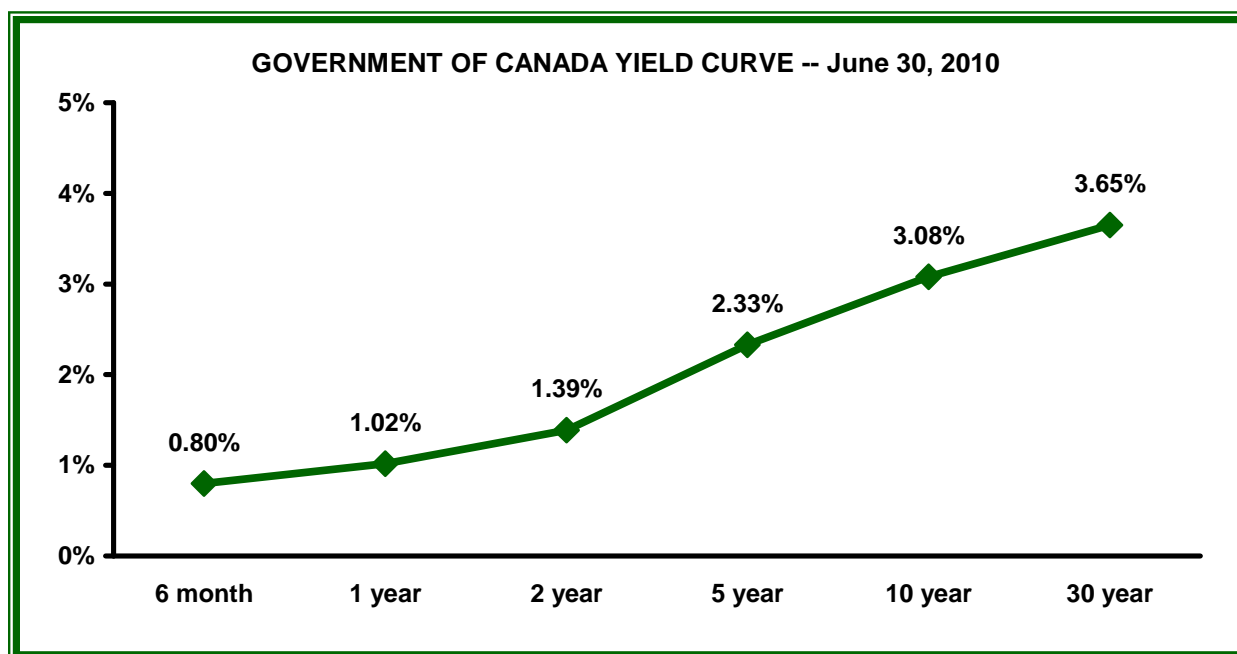
As we look ahead to the end of 2010, we continue to anticipate that Canadian interest rates will rise somewhat from their current levels. However, given the economic weakness, any continued tightening of the Bank of Canada's official target rate above 1% seems unlikely. For now, we expect that all central banks will be watching the effects of fiscal austerity measures as they are implemented. Co-ordination and co-operation between governments and central banks is essential to ensure that the economic drag of tighter fiscal conditions is not made worse by overly tight monetary conditions.

The decision to de-emphasize the use of corporate and provincial bonds affected the Fund's bond returns this quarter. The Fund's fixed income returns for the second quarter of 2010 were +2.5%, which trailed the DEX Universe Bond Index (DUBI) return of +2.9% for the same period. In the last 12 months, our fixed income return of +7.3% continues to run ahead of the DUBI, which was up 6.9%.

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

We reduced our allocation slightly to this sector this past quarter. Part of the reduction arose from the decision we made to sell our position in Bell-Aliant Regional Communications Income Fund (BA). BA is a well-run, high-yielding trust with a realistic and achievable plan to operate as a corporate entity in 2011 when the tax rules for business trusts change. It has an appropriately conservative capital structure and a generous distribution history. It operates the wire-line phone business east of Manitoba and outside the Quebec City to Windsor corridor. Traditionally, it was accepted that its operating territory would be less appealing to the expansion of other wireless and cable competitors but that, inevitably, the march of technology would catch up and BA's business would feel the effects of greater competition. In early May, we decided that time had come and that the level of business risk was increasing. In the time we owned it, BA provided a small capital gain and a payout of close to 12% on an annual basis – quite satisfactory given the environment.

The decline in equity markets this quarter, generated a negative return for our holdings in this sector of the Fund, but our "Other Income-Oriented Securities" category continues to add value over longer periods. 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 unitholders.



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