NEXUS

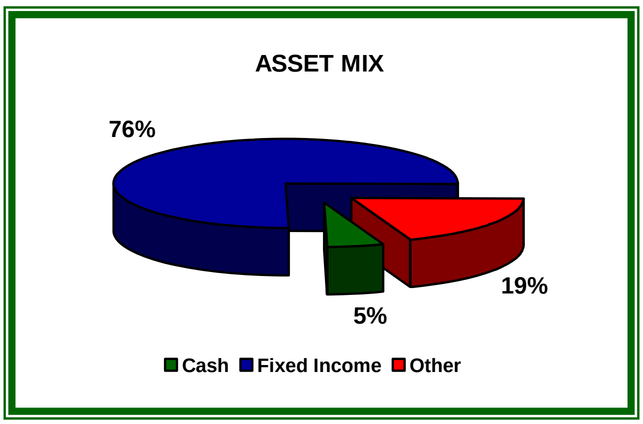
Portfolio Management & Financial Counsel

NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – June 30, 2012

After a strong start to 2012, the latest quarter proved more difficult for investors. While fixed income returns have provided a low but steady return over this period, the returns from being an equity investor, although positive, have been much more volatile. There are three primary sources of concern: an unsettled political and economic situation in Europe, worry of a possible economic slowdown in the U.S. (exaggerated by fiscal retrenchment and political mismanagement), and concerns that developing world economies are also slowing.

Given how connected we are to the rest of the world by trade, Canadian economic performance has held up remarkably well in the first half of the year. Despite highly stimulative monetary conditions, inflation is well contained, economic growth this year should exceed 2%, and labour market conditions are continuing to improve, albeit at a modest pace.[1]



Europe dominates the business headlines and has provided the greatest day-to-day influence on markets. European events are impacting not only Europe, but also the rest of the world. There is a negative effect on the real economy as business leaders postpone investment and hiring decisions and consumers rein in their spending out of concern for the future. At this point, the problems are well known: many countries lived beyond their means for too long and are now having to deal with unsustainable debt burdens. The required de-leveraging – across households, the banking system and the government sector – is magnifying an economic slowdown and risks plunging the continent into an economic depression. It has torn at the social cohesion of Europeans, pitting the countries of the periphery (Spain, Greece, Portugal and Italy) against the countries of the core (primarily Germany but also Finland and the Netherlands). We continue to believe that, over time, a solution to these problems will emerge. Late in June, to the surprise of many and the great relief of the markets, a substantial first step towards a lasting solution appears to have occurred. At their 20th summit in 30 months, amongst a number of important initiatives, the European heads of state seemed to have agreed on a framework that would provide for a pan-European plan to shore up the EU financial sector. This plan may be a precedent that establishes greater integration (read German oversight and control) in exchange for 'risk sharing' (read German financial backing) and is an important precedent for tackling other important issues that the EU faces, such as loan guarantees or stimulus spending. Time will tell if this latest agreement represents a turning point in the Euro crisis or is just another of many false hopes.

In North America, the primary area of concern is the dire state of U.S. government finances and the lack of urgency to deal with impending policy changes that will, if implemented, subtract 3% to 5% from GDP in 2013.[2] This debacle arises from the failure of a bipartisan committee of Republicans and Democrats to create and pass legislation that would address the federal budget deficit. Instead, in 2013, payroll tax cuts will expire, taxes on investment income will increase, and there will be substantial across the board spending cuts. On their own, each of these measures has the effect of slowing economic growth. Taken together, economists have named the impending phenomena a 'Fiscal Cliff', and worry that it will contribute to a sharp slowdown in economic activity. Until the results of the Presidential election are known in November, it is unlikely that any progress will be made on this issue. In the meantime, economic performance is decidedly mixed. Indicators of sentiment show that both business and consumer confidence have faltered, at least in part a consequence of the unsettled conditions in Europe. However, there are other indications that the latest slowdown may only be a pause and not the start of more meaningful economic weakness. Housing, a persistent source of weakness for many years, seems to be making a bottom. Home sales are up, mortgage delinquencies are declining and home prices have stopped falling. Consumers also stand to benefit from a decline in food and energy prices that will improve discretionary purchasing power over the rest of 2012. Interest rates are low, making the purchase of ‘big ticket’ items affordable. Businesses and consumers have done an excellent job of improving their balance sheets in the last two years and there is some pent-up capacity to spend, especially with rates so low. What is needed is an improvement in business and consumer confidence, which will come only with further progress in Europe and on the political front in Washington.

We continue to watch the deceleration of economic growth in China closely. As the second largest economy in the world, China is crucial to the performance of the global economy. Evidence of an impending slowdown there is abundant but we think stops short of a ‘hard-landing.’ To state the obvious, China’s economy is unlike the economies of Western Europe or North America. Investment, not consumption, drives economic activity and this investment in infrastructure, housing, and machinery is funded by domestic savings, not external borrowing. In short, in a command economy, centrally controlled in Beijing, investment spending will continue to be strong. However, we know that there are some commentators who maintain a darker view of economic performance in China and we are alert to the downside risks should our current opinion prove to be too sanguine.

After an excellent start to the year, this quarter the return of the Fund was +1.2%[3], a result which trailed the DEX Universe Bond Index (DUBI) return of +2.3%. This return was due to lower bond returns than the DUBI, as well as the drag of slightly lower prices of our ‘other income producing securities’ which had performed so well in the first quarter. In the last 12 months, returns lagged the DUBI, but were very satisfactory on an outright basis – the Fund returned +7.2% and the DUBI increased 9.5%.

Asset Mix

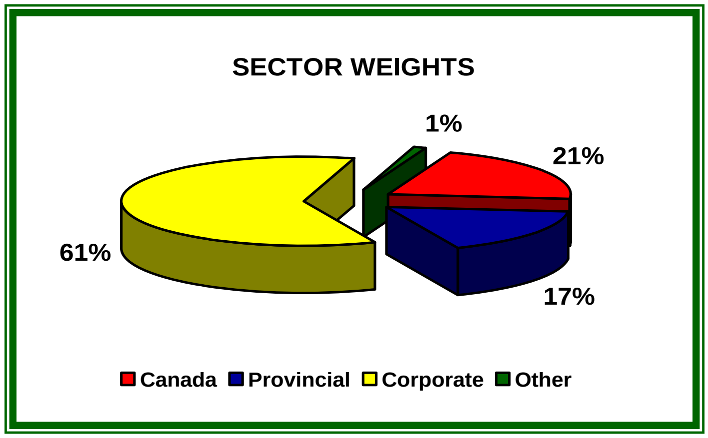
With an allocation of 19%, we continue to be close to our maximum allowable allocation to ‘other income-oriented securities’. Our cash position is 5%, which is high as compared to history. However, we earn a little more than 1% on our cash so the opportunity cost of maintaining liquidity is low when the yield of 5 year Canada bonds is just more than 1.25%.

Fixed Income (76% of Assets)

Yields of longer maturity bonds fell more than those of shorter maturities this quarter. This was the result of an unprecedented investor preference for safety-at-all-costs, rather than any policy changes coming from the Bank of Canada. Over the course of the quarter, 10 year Canada bonds moved from 2.11% to 1.76%, a decline of 35 basis points, while the 1 year rate declined from 1.09% to 0.99%, a decline of only 10 basis points. Governor Carney has continued to deliver a message reminding Canadians that current low interest rates are unsustainably accommodative and that a normalization of monetary conditions is not far off.[4] Likewise, Governor Bernanke has been explicit in stressing that further economic progress in the United States has to be the result of sensible fiscal policies that put Federal government finances on the path to sustainability, and not solely an effort of the Federal Reserve’s zero interest rate and quantitative easing policies.[5]

We have kept a maturity profile that is shorter than the DUBI Index, due to our belief that prospective returns in the bond market could well be significantly negative should inflation accelerate and interest rates rise. Rates at today’s levels represent a historic opportunity for borrowers to raise capital and, conversely, a particularly inopportune time for investors to tie up their capital.

We think the *purchase* of bonds is a somewhat discretionary decision on the part of investors. Depending on the rates offered, the risk tolerance of the buyer and other motivations (perhaps regulatory requirements), demand ebbs and flows. The *issuance* of bonds is much less discretionary. In particular, governments must regularly borrow in the bond markets in order to roll over debt maturities and finance new deficits. Nowhere is this more evident than with the Province of Ontario, a borrower of prolific

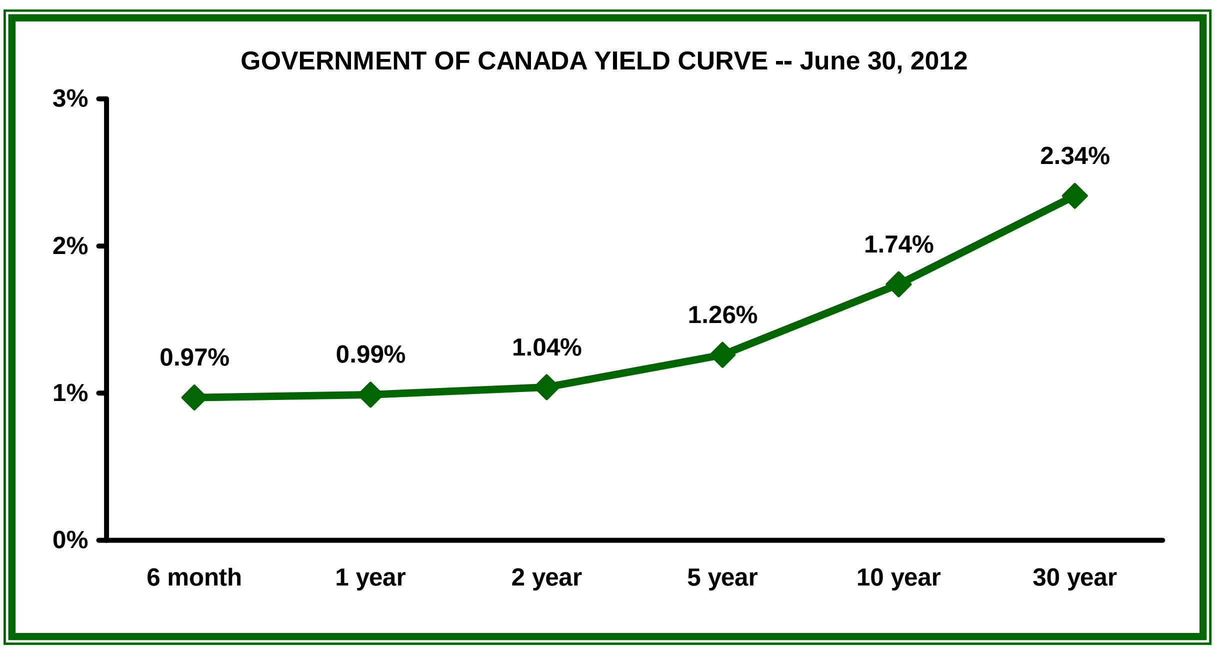


expertise and size. In the current fiscal year, Ontario must borrow $35 billion and a similar figure is expected for at least the following three years. Hardly a week goes by, that Ontario doesn't bring an issue to market in Canada or in some other currency or market elsewhere around the globe. It comes to market not out of opportunity but because it has to. Ontario maintains a AA (low) credit rating and, for now, we are not really worried about its capacity to pay interest. Rather, to us, there is risk it wears out its welcome and that investors will demand a higher yield in order to keep adding to their positions. At present levels, paying an extra 1% over the rate of ten year Canada bonds, the extra yield one earns is not enough to offset the risk that Ontario spreads could widen substantially and erode the capital value of its bonds. This quarter we dramatically reduced our exposure to Ontario, switching into higher yielding corporate bonds, Canada Housing Trust bonds and the bonds of other provinces that have lower borrowing requirements.

Last quarter, our bond portfolio generated a positive return of +1.8%, while the DEX Universe Bond Index (DUBI) increased +2.3%. In the last 12 months, our bonds generated a return of +7.5% while the DUBI was up 9.5%.

Other Income-Oriented Securities (19% of Assets)

In the wake of sharply lower equity prices in Canada, the return from our portfolio of income-producing, stable companies decreased by 0.7%. We continue to have a strong belief that there is better long-term opportunity with these securities than there is in the bond market. It remains a sensible way to add to long-term returns without introducing undue risk to the portfolio.



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1 Latest economic releases: The rate of change of Canadian CPI was 1.2% in May, monthly GDP growth in April was a surprising 0.3% and the unemployment rate was 7.3% in June.
2 'Economic Effects of Reducing the Fiscal Restraint That is Scheduled To Occur in 2013', Congressional Budget Office May 22nd 2012.
3 Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.
4 'Financing the Global Transition', Remarks to the Atlantic Institute for Market Studies, June 21, 2012.
5 'Economic Outlook and Policy', Testimony Before the Joint Economic Committee, U.S. Congress, June 7, 2012.