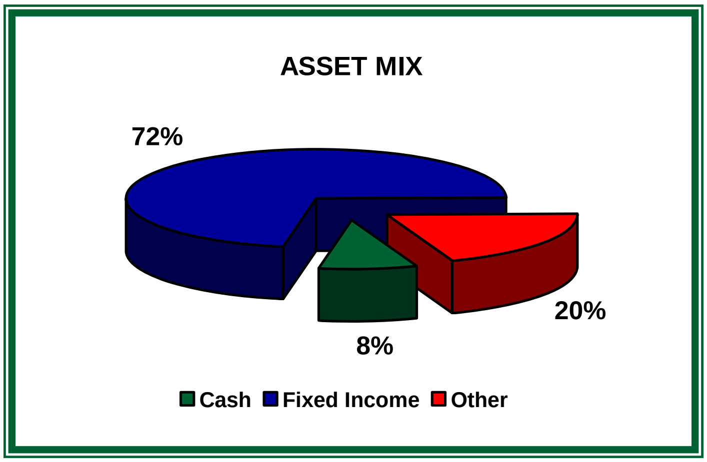
Portfolio Management & Financial Counsel

NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – September 30, 2012

The summer of 2012 turned out to be most rewarding for investors in bond and stock markets alike. While there remain a number of prominent worries that undermine investor confidence, pessimism had perhaps gone a little too far at the end of June. Over the course of this quarter, investor concerns of the direst outcomes receded somewhat, volatility and trading activity in the equity markets subsided, and asset prices rose.



Despite the rebound in returns, the primary sources of investor concern remain unresolved. The tepid economic recovery in the U.S. continues, undermined by ongoing worry about the ability of Americans to put in place policies that will set Washington on the path to fiscal sustainability. While both major parties agree that the deficit must be reined in quickly, until the election is behind us and the balance of power between Republicans and Democrats is understood, it is unlikely that there will be any progress resolving the hard issues of spending reductions and tax increases necessary for a balanced resolution of the issue. For now, consumers and business decision-makers alike labour under a cloud of political and policy uncertainty and so are reluctant to spend or invest.

Europe remains an important focus of investor political worry and economic concern. However, there has been an improvement to the outlook there, based largely on the European Central Bank's (ECB) willingness to put in place policies that remove the risk of a financial meltdown in countries such as Spain and Italy. First floated in August and then explained more fully in September, the ECB has committed to purchasing the short-term securities of EU member countries that are experiencing abnormally high borrowing rates due to investor risk aversion. Europe's structural economic problems are far from resolved. However, as we have said for some time, a slow resolution is our expectation and we are not persuaded by the more negative outcomes espoused by some pundits.

Geo-political tensions continue to worry markets. There is risk of disruption throughout the Middle East – especially between Israel and Iran, but also in Syria and places such as Egypt and Libya. Global energy markets would be particularly affected by a further escalation of tensions in this part of the world. In addition to these longstanding worries, tensions have arisen between China and Japan over the uninhabited and economically insignificant Senkaku Islands. It is tempting to dismiss the risk in this disagreement. However, China and Japan are very tightly integrated by trade and hostility toward Japan in China has already led to the closing of a number of Japanese-owned factories and a steep drop-off in sales of Japanese autos and other goods. A worsening of this situation risks upsetting the global supply chain, so we will continue to pay attention to developments on this issue.

Canada's economic performance remains undermined by the soft economic conditions of our major trading partners and the effect of the strong Canadian dollar on export competitiveness. The Bank of Canada stands apart from every major central bank in the world with its repeated warnings that current easy monetary conditions are unsustainable. This 'hawkish' approach is viewed skeptically by the markets which discount the ability of the Bank of Canada to pursue a tighter monetary policy when every other central bank is re-committing to policies of extraordinary monetary ease[1], and when GDP growth and inflation remain subdued[2]. Nonetheless, this quarter the Canadian dollar rose 3.7%, benefitting from the Bank's rhetoric as well as the relative stability of our economy and financial position that have made Canada an attractive destination for foreign investment.

As we look ahead, we continue to expect a difficult investment environment. Although both economic and profit growth are low, so too is their volatility. However, markets remain concerned about the potential of an extraordinary development such as the dissolution of the EU or a shooting war in the Middle East. As a result, investor unease remains elevated. In the equity markets, risk premia are high (valuations are attractive) and in the bond markets, investor preference for the absolute safety of government bonds has made the extra return available from corporate bonds particularly compelling.

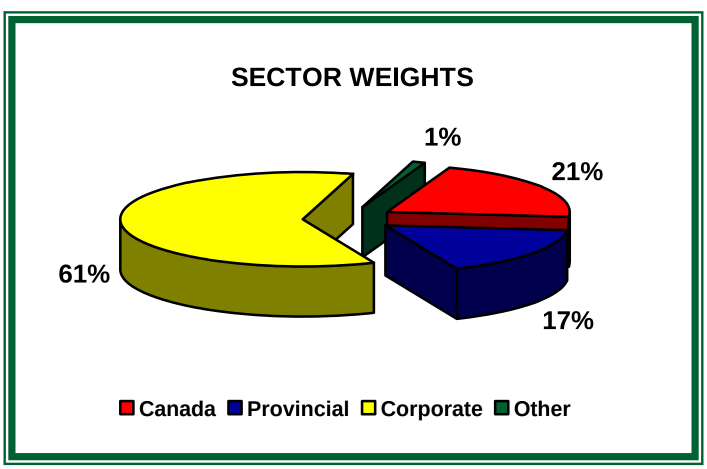
This continues to be a good year for the Fund on both an outright basis as well as when compared to the DEX Universe Bond Index (DUBI). This quarter the return of the Fund was +1.7%[3], a result which led the DUBI return of +1.2%. Not only did our bond holdings produce a higher return than the DUBI, but also our holdings of 'other income producing securities' recovered strongly. In the last 12 months, returns are well ahead of our DUBI benchmark – the Fund returned +7.4% and the DUBI increased 5.5%.

Asset Mix

With an allocation of more than 19%, we continue to be at our maximum allowable allocation to 'other income-oriented securities'. Our cash position is 8%, which is high as compared to history. Given our view that there is risk of capital erosion in the bond market should yields increase, and that we earn 1% on our cash invested in the money market, we think that it is best to have a larger balance and wait for interest rates to rise and then put our cash to work at more attractive levels.

Fixed Income (72% of Assets)

There was little change in interest rates over the course of the third quarter. Rates for two-year bonds rose 0.02% (2 basis points) and rates for thirty-year bonds fell by the same amount. This remarkable stability, at very low nominal rates, is a perfect environment for corporate and provincial treasurers to raise funds. Unsurprisingly, it was a very busy quarter of new issuance in both the provincial and corporate bond markets. So far this year, over $57 billion has been raised in the Canadian corporate debt markets, and hardly a day goes by without at least one new issue in the bond market[4]. There remains a well-documented flow of capital into bond and balanced mutual funds and portfolio managers appear to have an urgency to put this cash to work. Demand is such that there is even easy access to credit for companies in cyclical industries with sub-investment grade credit ratings (< BBB) that heretofore would have found raising new debt financing difficult.

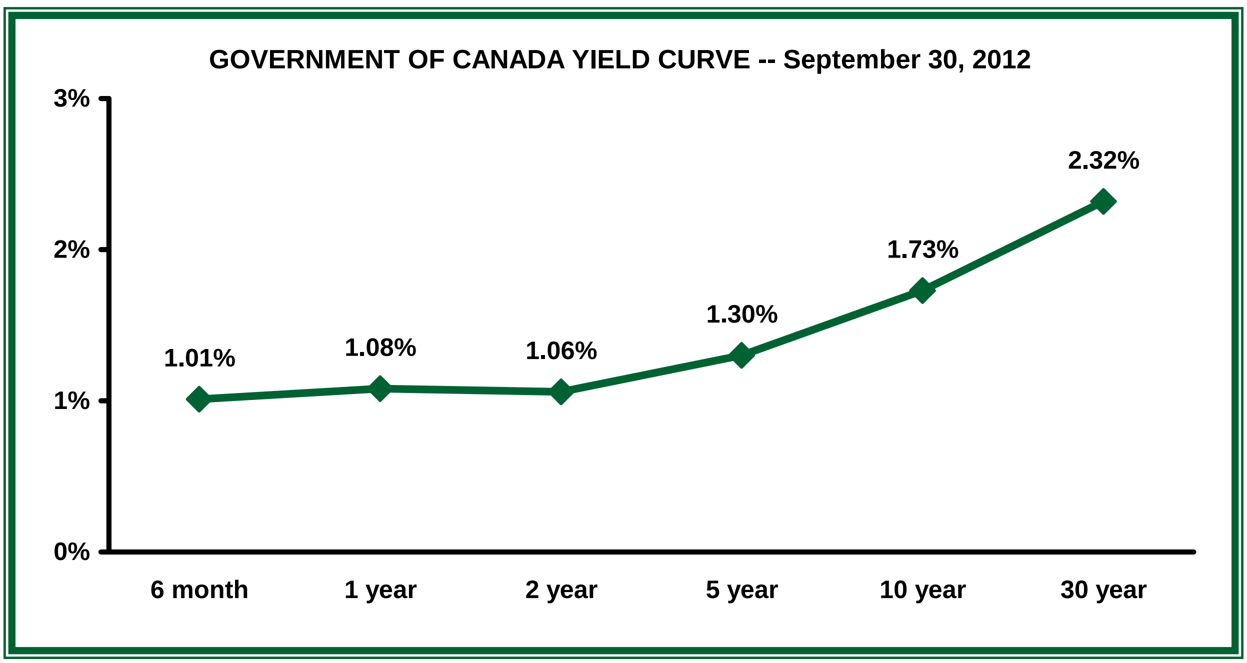


Our strategy continues to feature a significant over-weighting of the corporate sector but we have emphasized higher quality issuers. In fact, many of our corporates are asset-backed structures with AAA ratings which yield more than Provincial bonds of similar maturity. With respect to our exposure to changes in the general level of interest rates, our maturity profile remains substantially shorter than the DEX Universe Bond Index (DUBI), due to our belief that prospective returns in the bond market could well be significantly negative should interest rates rise. Rates at today's levels represent an historic opportunity for borrowers to raise capital and, conversely, a particularly inopportune time for investors to tie up their capital.

Although the general level of interest rates was close to unchanged last quarter, our holdings benefitted from a compression in the spread between corporate bonds and government bonds. Last quarter, our bond portfolio generated a positive return of +1.4%, while the DEX Universe Bond Index (DUBI) increased 1.2%. In the last 12 months, our bonds generated a return of +5.0% while the DUBI was up 5.5%.

Other Income-Oriented Securities (20% of Assets)

There was a significant recovery in the value of our holdings of 'other Income-oriented' securities this quarter. Returns from this area were +4.4% and are up 11.3% in the year-to-date. We have 14 positions diversified across seven different industrial sectors. 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.



1Over the course of the second quarter, the Bank of Japan, the U.S. Federal Reserve, the People's Bank of China, the Bank of England and the European Central Bank all re-committed to monetary ease or increased the level of monetary stimulus in their respective countries.
2 Canadian Headline CPI for August 2012 was 1.2% and the GDP YoY growth rate for Q2 was 2.5%.
3 Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.
4 'Weekly Corporate Comment", National Bank Financial, October 1,2012.