Q2

# Palos Income Trust Fund, L.P.

*Quarterly Portfolio Commentary*

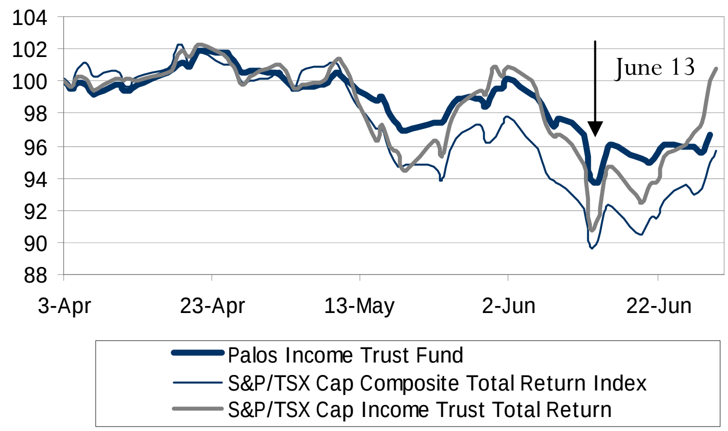
2006

## PERSONAL & CONFIDENTIAL

Dear Investor,

**Montreal, July 4, 2006** – Palos Income Trust Fund, L.P. For the quarter ending June 30, 2006, the Palos Income Trust Fund generated a net return of negative 2.4%. Although we are never happy with a negative return, we would note that we fared very well in light of the current market environment. Specifically, fears of rising inflation and higher interest rates, a slowing Chinese economy and a falling housing market across Canada and the U.S. caused significant market volatility during the past quarter. Nevertheless, we managed to navigate through these markets by minimizing volatility and adhering to our principal of preserving capital first and foremost. As shown in the graph below, the volatility of the Palos Income Trust Fund was significantly less than that of the TSX Index and the TSX Income Trust Index. Specifically, the Palos Income Trust Fund consistently outperformed both indices for most of the quarter with the difference in returns most apparent on June 13, when the Palos Income Trust Fund was down 6.3% for the quarter-to-date versus down 10.3% and 9.2% for the TSX Index and TSX Income Trust Index, respectively.

**Volatility Analysis**




Source: Palos, Bloomberg.

### Business Trusts

Reviewing our Business Trust book, our exposure to small cap undervalued names helped us outperform larger cap more expensive names. Specifically, our Business Trust book produced a net negative return of approximately 8.0% during the second quarter while larger cap business names, which are included in the TSX Income Trust Index, declined roughly 10.0%.

### REITs

Reviewing our REIT book, our decision to significantly reduce our exposure to that sector at the beginning of the second quarter proved to be timely. Specifically, the TSX REIT Index declined 8.0% during the second quarter. We started slowly rebuilding our positions in this sector near the end of the quarter, as several REITs looked much more attractive from a risk/return standpoint. We started by buying Legacy Hotels REIT, Canadian Apartment REIT, H&R REIT and Primaris REIT, as all four were trading at reasonable valuations.

**Utilities**

In light of fears of rising inflation and higher interest rates, the utility sector was more volatile than normal this quarter and consequently our Utility Trust book produced a net negative return of 2.0%. Nevertheless, we took advantage of this volatility and became net buyers of utilities throughout the quarter. Specifically, our Utility book as a percent of the portfolio increased from 25% at the beginning of the quarter to approximately 30% at the end of the quarter.

**Energy**

Our Energy Trust book produced a net negative return of 5.0%. Although oil price increased from $69.09 per barrel to $73.80 per barrel as a result of strong supply/demand fundamentals and rising geopolitical tensions during the second quarter, our exposure to more conservative energy service companies dampened our results. Nevertheless, we continue to view our net exposure to the energy services sector as a conservative way to participate in global economic growth.

The fund has generated the following monthly net returns since inception:

**Monthly Performance Net of All Fees (Since Inception)**

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sept | Oct | Nov | Dec | Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2006** | 5.09% | -0.27% | 1.04% | 0.76% | -1.18% | -1.98% | | | | | | | 3.35%(1) |
| **2005** | 4.68% | 1.97% | 1.18% | -5.07% | 2.22% | 2.93% | 5.01% | 1.51% | 0.72% | -9.52 | 7.41% | 2.72% | 15.62% |
| **2004** | 2.99% | 4.95% | 0.59% | -6.66% | 0.24% | 3.12% | 2.58% | 1.83% | 3.57% | 1.04% | 3.86% | 2.83% | 22.48% |
| **2003** | 3.04% | 0.90% | -0.98% | 4.16% | 1.32% | 3.08% | 2.82% | 4.80% | -1.37% | 2.45% | 3.35% | 4.97% | 32.29% |
| **2002** | 2.07% | 5.40% | 3.39% | -3.97% | 3.63% | 3.48% | -2.47% | 1.51% | 3.37% | -0.37% | -4.12% | 4.28% | 16.76% |
| **2001** | | | | | | | | | 0.24% | 0.21% | 2.31% | 5.50% | 8.43%(1) |

(1) Does not include full year.

Best regards,

**Phil Marleau, CFA**
*Portfolio Manager*

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