

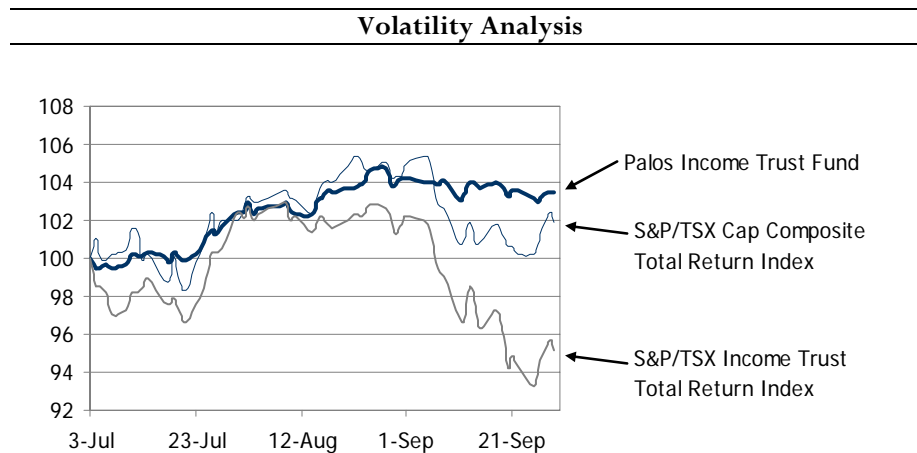


PERSONAL & CONFIDENTIAL

Dear Investor,

Montreal, October 12, 2006 – Palos Income Trust Fund, L.P. For the quarter ended September 30, 2006, the Palos Income Trust Fund generated a net positive return of 3.5%. We are very pleased with these results especially considering that during the same quarter, the TSX Income Trust Index declined 5.0%. Just as importantly, we not only outperformed the TSX Income Trust Index by a considerable margin, but we did it with significantly less volatility. The latter is exemplified by the graph shown below.

We attribute our solid performance during the third quarter primarily to the defensive stance we took at the end of the second quarter as well as our decision to significantly reduce our exposure to Energy Trusts. One may recall from our last *Quarterly Portfolio Commentary* that we increased our allocation to Utility Trusts, shifted our Business Trust exposure to more defensive names, and reduced our exposure to Energy Trusts. Moreover, given the serious correction that the Income Trust market experienced during the third quarter, several opportunities presented themselves that allowed us to significantly build upon our current positions. Specifically, we steadily increased our positions in Yellow Pages, Terranet, and Crescent Point, throughout the third quarter.



Source: Palos, Bloomberg.

Business Trusts

Reviewing our Business Trust book, our exposure to more defensive names helped us outperform most Business Trusts which are included in the TSX Income Trust Index. Specifically, our Business Trust book produced a positive net return of approximately 5.0% during the third quarter while the names which are included in the TSX Income Trust Index produced a return of just over 3.0%. Moreover, throughout the quarter we took advantage of the volatility in the income trust market to build considerable positions in quality defensive trusts such as Yellow Pages and Terranet.





Palos Income Trust Fund, L.P.

Quarterly Portfolio Commentary

2006

REITs

As we mentioned in our last *Quarterly Portfolio Commentary*, we slowly rebuilt our positions in the REIT sector toward the end of the second quarter, as several REITs looked much more attractive from a risk/return standpoint. Specifically, we bought Legacy Hotels REIT, Canadian Apartment REIT, H&R REIT and Primaris REIT, as all four were trading at reasonable valuations. Since then, our REIT book produced a net return of about 11.0% which was roughly in line with the TSX REIT Index.

Utilities

Reviewing our Utility Trust book, our decision to increase our exposure to that sector throughout the second quarter proved to be timely. Specifically, our Utility Trust book produced a net positive return of 4.0% while the Utility Trusts which are included in the TSX Income Trust Index produced a return of about 2.5%.

Energy

Due to significant increases in oil prices during the second quarter primarily as a result of very high geopolitical tensions as opposed to fundamental supply/demand conditions we decided to take some money off the table. Specifically, our Energy Trust book as a percent of the portfolio decreased from 25% at the beginning of the quarter to approximately 15% at the end of the quarter. Our decision was well rewarded as the TSX Energy Trust Index declined well over 9.0% during the third quarter. Now, however, given the recent poor performance of the overall sector, we have started buying some large cap blue chip energy names such as Crescent Point, as their valuations have started to look particularly attractive.

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% | -1.90% | 2.43% | 1.78% | -0.73% | | | | 7.04% ⁽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

