

**PERSONAL & CONFIDENTIAL**

Dear Investor,

**Montreal, January 12, 2007** – Palos Income Trust Fund, L.P. For the year ended December 31, 2006, the Palos Income Trust Fund generated a return of positive 0.42% while the TSX Income Trust Index declined 2.8%. We would note that our results were significantly pressured by a government proposal to internally tax Canadian income trusts. Specifically, on October 31, the Canadian Minister of Finance, Jim Flaherty, issued a paper proposing to change the tax laws pertaining to income trusts in an effort to level the tax treatment between corporations and income trusts. He basically proposed to internally tax trusts at the statutory rate of 31.5% starting in 2011. Consequently, during the following days, the income trust market gave back all of its gains for the year and then some. At these new price levels, however, we believe that the market has discounted much of the new proposed tax and that trusts still offer competitive yields for investors. Moreover, any amendments to the proposal would prove positive for the overall market and for your Fund. Looking ahead, we plan to continue to manage the fund in an effort to preserve capital and seek high levels of income by investing in high yielding equities.

**Real Estate Investment Trusts (REITs)**

The Canadian REIT market was the only sector of the Canadian Income Trust market that was exempt from the new tax proposal on Canadian income trusts and accordingly the Canadian REIT index appreciated 6.6% during the fourth quarter as money flowed out of other potentially 'taxable' income trusts and into REITs. Near the end of the quarter, however, we decided to take some money off the table and sold most of our REIT portfolio as REITs no longer looked attractive from a risk/return standpoint.

**Energy Trusts**

Primarily as a result of the income trust tax proposal, the Canadian Energy Trust Index was very volatile during the quarter and declined approximately 6.8%. Moreover, since the beginning of January, the price of oil declined from \$62.38 to \$52.84 or roughly 18.0% and, accordingly, over the same period the Canadian Energy Trust index declined an additional 8.5%. From a risk/return point of view we believe Canadian Energy Trusts are now very attractive and as such we recently increased our exposure to Canadian Energy Trusts. Specifically, we started buying some large cap and high quality trusts such as Enerplus, PennWest and Baytex.

**Utility Trusts**

We recently decided to increase our exposure to Utility trusts as yields on these trusts are very competitive at 8.97%. The S&P U.S. Utility Index yields 3.28% while the S&P Canadian Utility Index yields 4.53%

**Business Trusts**

Given the high level of uncertainty surrounding the Canadian income trust market as a result of the income trust tax proposal, immediately following the announcement we sold many of our smaller business trusts and bought larger, higher quality business trusts such as Yellow Pages and Terranet.

# Q4

## Palos Income Trust Fund, L.P.

Quarterly Portfolio Commentary

# 2006

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%	2.52%	-11.46%	3.36%	0.42%
2005	4.68%	1.97%	1.18%	-5.07%	2.22%	2.93%	5.01%	1.51%	0.74%	-9.52%	7.41%	2.72%	15.65%
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% <sup>(1)</sup>

(1) Does not include full year.

Best regards,



**Phil Marleau, cFA**  
Portfolio Manager

