

*Financial Statements of*

**PALOS EQUITY INCOME FUND**

*For the years ended December 31, 2010 and 2009*

**PALOS EQUITY INCOME FUND**  
**TABLE OF CONTENTS**  
*For the years ended December 31, 2010 and 2009*

	<b>Page</b>
Independent Auditor's Report	3
Statements of Net Assets	5
Statements of Operations	6
Statements of Changes in Net Assets	7
Statements of Cash Flows	8
Statement of Investment Portfolio	9
Notes to the Financial Statements	13 - 22

---

## Independent Auditor's Report

---

### To the Unitholders of Palos Equity Income Fund

We have audited the accompanying financial statements of Palos Equity Income Fund (the "Fund") which comprise the statement of investment portfolio as at December 31, 2010 and the statements of net assets as at December 31, 2010 and 2009, and the statements of operations, changes in net assets and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

#### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



---

## Independent Auditor's Report

---

### Opinion

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2010 and 2009, the results of its operations, changes in net assets and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*(s) BDO Canada LLP/ s.r.l./S.E.N.C.R.L.* <sup>1</sup>

Chartered Accountants

Montréal, Québec  
March 30, 2011

---

<sup>1</sup> CA auditor permit No. 16549

**PALOS EQUITY INCOME FUND**  
**STATEMENTS OF NET ASSETS**  
**AS AT DECEMBER 31**

	<b>2010</b>	<b>2009</b>
ASSETS		
Cash	\$ 203,065	\$ 123,868
Investment portfolio, at fair value	10,487,615	6,581,985
Accrued income receivable	45,298	36,509
Subscriptions receivable	2,485	-
Sales tax receivable	34,551	11,466
	<u>10,773,014</u>	<u>6,753,828</u>
LIABILITIES		
Accounts payable and accrued liabilities	10,350	34,172
Redemptions payable	11,265	11,241
Distributions payable	29,714	21,188
	<u>51,329</u>	<u>66,601</u>
NET ASSETS - Representing Unitholders' Equity	<u>10,721,685</u>	<u>6,687,227</u>
UNITS OUTSTANDING (Note 7)	<u>1,238,901</u>	<u>822,383</u>
Net Asset Value per Unit (Note 5)	<u>8.65</u>	<u>8.13</u>

Approved on behalf of the Manager, Palos Management Inc.

(s) Charles Marleau Director of Palos Management Inc.

(s) Robert Boisjoli Director of Palos Management Inc.

**PALOS EQUITY INCOME FUND  
STATEMENTS OF OPERATIONS  
FOR THE YEARS ENDED DECEMBER 31**

	<b>2010</b>	<b>2009</b>
INVESTMENT INCOME	\$	\$
Dividends, net of withholding taxes	199,740	97,752
Interest income	53,561	15,130
Distributions of income from trusts	<u>160,427</u>	<u>222,498</u>
	<u>413,728</u>	<u>335,380</u>
EXPENSES		
Bank charges and interest	312	264
Transaction costs	13,775	4,639
Foreign exchange loss (gain)	2,094	(470)
Management fees (Note 4)	125,090	83,738
Performance fees (Note 4)	106,852	-
Administration fees and other professional fees	36,207	30,624
Audit fees	20,000	18,000
Legal fees	<u>750</u>	<u>1,035</u>
	<u>305,080</u>	<u>137,830</u>
NET INVESTMENT INCOME	<u>108,648</u>	<u>197,550</u>
REALIZED GAIN (LOSS) ON SALE OF INVESTMENTS	874,952	(248,322)
CHANGE IN UNREALIZED APPRECIATION ON INVESTMENTS	<u>405,404</u>	<u>1,596,919</u>
NET GAIN ON INVESTMENTS	<u>1,280,356</u>	<u>1,348,597</u>
INCREASE IN NET ASSETS FROM OPERATIONS	<u>1,389,004</u>	<u>1,546,147</u>
INCREASE IN NET ASSETS FROM OPERATIONS PER UNIT	<u>1.34</u>	<u>1.88</u>

The accompanying notes are an integral part of these financial statements

**PALOS EQUITY INCOME FUND**  
**STATEMENTS OF CHANGES IN NET ASSETS**  
**FOR THE YEARS ENDED DECEMBER 31**

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
NET ASSETS AT BEGINNING OF YEAR	6,687,227	3,553,354
INCREASE IN NET ASSETS FROM OPERATIONS	1,389,004	1,546,147
DISTRIBUTIONS TO UNITHOLDERS		
Net investment income	(122,423)	(187,528)
Realized gain on sale of investments	(457,655)	-
Return of capital	<u>(282,732)</u>	<u>(406,454)</u>
	<u>(862,810)</u>	<u>(593,982)</u>
CAPITAL TRANSACTIONS		
Unit transactions		
Proceeds from units issued	2,863,106	1,738,614
Reinvested distributions	757,681	506,560
Amounts paid on redemption of units	<u>(112,523)</u>	<u>(63,466)</u>
	3,508,264	2,181,708
INCREASE IN NET ASSETS	<u>4,034,458</u>	<u>3,133,873</u>
NET ASSETS END OF YEAR	<u>10,721,685</u>	<u>6,687,227</u>

The accompanying notes are an integral part of these financial statements

**PALOS EQUITY INCOME FUND**  
**STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31**

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
(Increase) in net assets from operations	1,389,004	1,546,147
Changes in non-cash generating assets and liabilities		
(Increase) in accrued income receivable	(8,789)	(10,630)
(Increase) in subscriptions receivable	(2,485)	-
(Increase) in sales tax receivable	(23,085)	(8,474)
(Decrease) increase in accounts payable and accrued liabilities	(23,822)	13,104
Increase in redemptions payable	24	11,241
Increase in distribution payable	8,526	16,128
Proceeds from investments sold	7,765,000	2,429,195
Purchase of investments	(10,390,274)	(4,273,236)
Realized (gain) loss on sale of investments	(874,952)	248,322
Change in unrealized appreciation of investments	<u>(405,404)</u>	<u>(1,596,919)</u>
Cash flows from operating activities	<u>(2,566,257)</u>	<u>(1,625,122)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issue of fund units	2,863,106	1,738,614
Redemption of fund units	(112,523)	(63,466)
Distributions paid to unitholders	<u>(105,129)</u>	<u>(87,422)</u>
Cash flows from financing activities	<u>2,645,454</u>	<u>1,587,726</u>
<b>INCREASE (DECREASE) IN CASH DURING THE YEAR</b>	<b>79,197</b>	<b>(37,396)</b>
<b>CASH AT BEGINNING OF YEAR</b>	<u><b>123,868</b></u>	<u><b>161,264</b></u>
<b>CASH AT END OF YEAR</b>	<u><u><b>203,065</b></u></u>	<u><u><b>123,868</b></u></u>

The accompanying notes are an integral part of these financial statements

**PALOS EQUITY INCOME FUND**  
**STATEMENT OF INVESTMENT PORTFOLIO**  
**AS AT DECEMBER 31, 2010**

Par Value / Quantity	Name	Average Cost	Fair Value
	<b>CONVERTIBLE BONDS</b>	<b>\$</b>	<b>\$</b>
100,000	Aecon Group Inc, 6.25%, 10/31/2015	100,000	102,250
100,000	Aecon Group Inc, 7%, 9/30/2014	100,000	105,100
100,000	Altus Group Income Fund, 5.75%, 12/31/2017	100,000	97,400
50,000	Angle Energy Inc, 5.75%, 1/31/2016	50,000	50,000
70,000	Bellatrix Exploration Ltd, 4.75%, 4/30/2015	70,000	72,107
50,000	Boralex Inc, 6.75%, 30/06/2017	50,000	50,700
39,000	Canam Group Inc, 6.25%, 10/31/2015	39,000	40,053
85,000	Canexus Income Fund, 5.75%, 12/31/2015	85,627	86,360
75,000	CanWel Building Materials Group Ltd, 5.85%, 04/30/2017	73,356	74,250
35,000	Firm Capital Mortgage Investment, 5.75%, 10/31/2017	35,000	34,388
80,000	Gamehost Income Fund, 6.25%, 7/31/2015	77,868	80,400
90,000	Innvest Real Estate Investment Trust, 6%, 09/30/2017	90,861	90,333
100,000	Just Energy Group Inc, 6%, 6/30/2017	100,188	99,000
45,000	NAL Energy Corp, 6.25%, 12/31/2014	45,000	47,273
50,000	Pembina Pipeline Corp, 5.75%, 11/30/2020	50,000	50,525
100,000	Provident Energy Trust, 5.75%, 12/31/2017	100,000	99,690
25,000	Rocky Mountain Dealerships Inc, 7%, 9/30/2017	25,000	26,350
20,000	Superior Plus Corp, 5.75%, 6/30/2017	20,000	18,858
75,000	TransForce Inc, 6%, 11/30/2015	75,000	76,500
30,000	Fort Chicago Energy Partners Ltd., 5.75%, 7/31/2017	30,000	30,900
110,000	Vicwest Income Fund, 6%, 12/31/2015	112,733	113,849
		<b>1,429,633</b>	<b>1,446,286</b>
	<b>CORPORATE BONDS AND OTHER BONDS</b>		
50,000	Fédération des Caisse Desjardins du Quebec, 5.541%, 06/01/2021	50,000	54,094
50,000	Manulife Financial Corp, 7.405%, 12/31/2108	50,000	55,821
100,000	MEGA Brands Inc, 10%, 03/31/2015	104,745	105,000
50,000	Sun Life Capital Trust II, 5.863%, 12/31/2108	50,000	51,533
		<b>254,745</b>	<b>266,448</b>
	<b>PREFERRED SHARES</b>		
850	Bank of Nova Scotia, 5.25%, Series 12	14,459	20,893
2,000	Brookfield Asset Management In, 5.4%, Series 24	50,000	51,820
1,200	Brookfield Properties Corp, 6.15%, Series N	29,972	31,104
1,900	Brookfield Properties Corp, 6.75%, Series L	47,784	50,084
700	Brookfield Renewable Power, 5.25%, Series I	17,645	18,095
1,000	Dundee Corp, 6.75%, Series 2	25,000	26,850

**PALOS EQUITY INCOME FUND**  
**STATEMENT OF INVESTMENT PORTFOLIO**  
**AS AT DECEMBER 31, 2010**

<b>Par Value</b>			
<b>/ Quantity</b>	<b>Name</b>	<b>Average Cost</b>	<b>Fair Value</b>
		<b>\$</b>	<b>\$</b>
1,500	Fairfax Financial Holdings Ltd, 5%, Series I	37,500	37,065
1,000	IGM Financial Inc, 5.9%, Series B	24,884	24,890
3,000	Innergex Renewable Energy Inc, 5%, Series A	75,000	75,450
620	Royal Bank of Canada, 6.1%, Series AX	17,144	17,118
180	Royal Bank of Canada, 6.25%, Series AV	4,500	4,964
600	Toronto-Dominion Bank/The, 6.25%, Series AK	15,000	16,687
2,000	TransAlta Corp, 4.6%, Series A	50,000	50,000
		<b>408,888</b>	<b>425,020</b>
<b>COMMON STOCK</b>			
<b>Consumer Staples</b>			
3,500	Alliance Grain Traders Inc	103,530	98,630
2,853	Coca-Cola Co	161,455	186,685
76	Liquor Stores Income Fund	1,157	1,154
2,892	Philip Morris International Inc	152,954	168,441
		<b>419,096</b>	<b>454,910</b>
<b>Consumer Discretionary</b>			
17,795	Cineplex Galaxy Income Fund	370,046	398,608
3,406	Magna International Inc	148,189	176,805
		<b>518,235</b>	<b>575,413</b>
<b>Energy</b>			
12,877	ARC Energy Trust	255,898	327,205
4,827	Baytex Energy Trust	181,016	224,890
7,625	Bonavista Energy Trust	147,176	219,295
4,982	Canadian Oil Sands Trust	161,611	131,724
10,000	Canyon Services Group Inc	110,738	108,100
3,603	Cenovus Energy Inc	94,272	119,367
1,621	Crescent Point Energy Corp	64,823	71,600
21,542	Daylight Energy Ltd	205,128	221,883
4,103	Enbridge Inc	212,443	230,712
187	Inter Pipeline Fund Class A	2,355	2,788
4,676	Keyera Facilities Income Fund	112,987	164,361
5,583	NAL Oil and Gas Trust	70,466	72,244
3,150	Suncor Energy Inc	114,105	120,267
5,578	Vermilion Energy Inc	221,432	257,591
		<b>1,954,450</b>	<b>2,272,027</b>

**PALOS EQUITY INCOME FUND**  
**STATEMENT OF INVESTMENT PORTFOLIO**  
**AS AT DECEMBER 31, 2010**

Par Value /

Quantity	Name	Average Cost	Fair Value
	<b>Financials</b>	\$	\$
11,990	Altus Group Income Fund	156,259	155,630
6,352	Bank of Nova Scotia	338,276	362,255
5,500	Boardwalk Real Estate Investment Trust	221,375	226,435
7,078	Calloway Real Estate Investment Trust	171,897	165,413
3	Canadian Imperial Bank of Commerce	227	235
5,700	Horizons BetaPro US Dollar Bear Plus ETF	86,297	102,714
3,183	National Bank of Canada	165,466	217,717
10,539	RioCan Real Estate Investment Trust	194,886	231,331
5,665	Royal Bank of Canada	263,397	295,713
4,383	Toronto-Dominion Bank	323,085	324,780
8,898	Transglobe Apartment Real Estate Investment Trust	85,475	92,361
		<b>2,006,640</b>	<b>2,174,584</b>
	<b>Health Care</b>		
1,145	Bristol-Myers Squibb Co	26,846	30,179
		<b>26,846</b>	<b>30,179</b>
	<b>Industrials</b>		
14,579	IESI-BFC Ltd	335,377	351,500
3,212	Emerson Electric Co	144,248	182,702
35	General Electric Co	580	637
9,723	Morneau Sobeco Income Fund	90,930	100,439
7,474	SNC-Lavalin Group Inc	363,304	446,721
660	Vicwest Income Fund	10,299	9,985
		<b>944,738</b>	<b>1,091,984</b>
	<b>Materials</b>		
3,383	Agnico-Eagle Mines Ltd	203,456	258,630
16,015	Kinross Gold Corp	305,636	302,043
5,816	Teck Resources Ltd	228,020	358,382
		<b>737,112</b>	<b>919,055</b>
	<b>Telecommunication Services</b>		
6,486	Rogers Communications Inc Class B	229,172	223,832
7,480	TELUS Corp Class B	348,035	340,116
336	TELUS Corp Class A	12,084	14,531
		<b>589,291</b>	<b>578,479</b>
	<b>Utilities</b>		
15,879	Northland Power Income Fund	247,007	248,666
		<b>247,007</b>	<b>248,666</b>

**PALOS EQUITY INCOME FUND**  
**STATEMENT OF INVESTMENT PORTFOLIO**  
**AS AT DECEMBER 31, 2010**

<b>Par Value / Quantity</b>	<b>Name</b>	<b>Average Cost</b>	<b>Fair Value</b>
	<b>WARRANTS</b>	<b>\$</b>	<b>\$</b>
990	Kinross Gold Corp expires September 2014	-	4,564
		<u>-</u>	<u>4,564</u>
	<b>Total Portfolio</b>	<u><b>9,536,681</b></u>	<u><b>10,487,615</b></u>

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**1) STATUS AND NATURE OF OPERATIONS**

Palos Equity Income Fund (the "Fund") was formed on January 3, 2008, under the laws of Quebec pursuant to a trust agreement (the "Agreement") made between Hubert Marleau (the "Trustee") and Charles Marleau (the "Settlor"). Effective November 24, 2010 following the receipt of the necessary approvals from the Unitholders of the Fund, the Trust Agreement was amended and restated (the "Amended and Restated Trust Agreement"). Effective January 7, 2011, the Trustee was changed to BNY Trust Company of Canada. The Fund is an open-ended mutual fund qualified as a unit trust and is registered as a registered investment under section 204.4 of the Income Tax Act.

The Fund shall act as an investment holding unit trust for the benefit of the Unitholders by acquiring, investing in, holding, transferring, disposing of, or otherwise dealing with such investments as the Trustee and the investment fund manager may, in their discretion, determine in accordance with the investment objectives of the Fund.

The investment fund manager and portfolio advisor is Palos Management Inc. (the "Manager"). The Fund shall continue its activities until its dissolution in accordance with terms of the Amended and Restated Trust Agreement.

**2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**(a) Valuation of Investments**

In accordance with Accounting Guideline 18 - Investment Companies, the Fund's investments are deemed to be categorized as held for trading, and are required to be recorded at fair value as defined by CICA Handbook Section 3855, "Financial Instruments - Recognition and Measurement" ("Section 3855"). The net assets of the Fund for financial reporting purposes ("Net Assets") are calculated in accordance with Section 3855.

Section 14.2 of National Instrument 81-106 ("NI 81 - 106") issued by the Canadian Securities Administrators requires the Trust to calculate its net asset value for the purchase and redemption of units based on the fair value of the Trust's assets and liabilities. The Trust has not changed their methodology in this respect. In accordance with NI 81 - 106, the net asset value is compared to the transactional net asset value and the explanation of the differences between such amounts are required in the notes to the financial statements. Refer to Note 5 for such comparison.

The Fund records its investments at fair value. The difference between the fair value and the cost of the investments held is shown as change in unrealized appreciation in value of investments.

The fair value of investments is determined as follows:

- (i) Securities listed on a recognized public stock exchange are valued at their closing bid price on valuation date.
- (ii) Bonds are valued at the closing bid price as reported by a recognized investment dealer.
- (iii) Warrants on public traded companies are valued at their intrinsic value.

**(b) Financial Instruments**

The Fund's financial instruments consist of cash, investments, accrued income receivable, subscriptions receivable, accounts payable, redemptions payable and distributions payable.

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

The Fund classifies its financial instruments into one of the following categories based on the purpose for which the asset was acquired. The Fund's accounting policy for each category is as follows:

*Held-for-trading*

Financial instruments classified as held-for-trading are carried in the statement of net assets at fair value with changes in fair value recognized in the statement of operations. Transaction costs related to instruments classified as held-for-trading are expensed as incurred. Investments and cash are classified as held-for-trading.

*Loans and Receivables*

These assets are non-derivative financial assets resulting from the delivery of cash or other assets by a lender to a borrower in return for a promise to repay on a specified date or dates, or on demand. They arise principally through the investment in income bearing investments, but also incorporate other types of contractual monetary assets. They are initially recognized at fair value and subsequently carried at amortized cost, using the effective interest rate method, less any provision for impairment. Transaction costs related to loans and receivables are expensed as incurred. Accrued income receivable and subscriptions receivable are classified as loans and receivables.

*Other Financial Liabilities*

Other financial liabilities include all financial liabilities other than those classified as held-for-trading, and comprise trade payables and other short-term monetary liabilities. These liabilities are initially recognized at fair value and subsequently carried at amortized cost using the effective interest rate method. Transaction costs related to other financial liabilities are expensed as incurred. Accounts payable, redemptions payable and distributions payable are classified as other financial liabilities.

**(c) Investment Transactions and Income Recognition**

Investment transactions are accounted for on a trade-date basis. Dividends are recorded on the ex-dividend date. Interest is recorded on an accrual basis. Gains or losses arising from the sale of investments and unrealized appreciation or depreciation in value of investments are determined on an average-cost basis.

Distributions received from income trust units are recorded as income, dividends, capital gains or return of capital, based on the best information available to management. Due to the nature of these investments, actual allocations could vary from this information. Distributions which represent return of capital reduce the cost base of the investment.

**(d) Net Asset Value per Unit**

Net asset value per unit is calculated as the value of the Fund's assets less its liabilities divided by the number of units outstanding at the end of the year.

**(e) Increase in Net Assets From Operations per Unit**

Increase in net assets from operations per unit is based upon the increase in net assets from operations for the year divided by the weighted average number of units outstanding for the year.

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**(f) Use of Estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the period reported. Actual results could differ from those estimates.

**(g) Foreign Currency Translation**

The fair value of investments and other assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing at the end of the year.

Purchases and sales of investments and investment income denominated in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing on the respective dates of the transactions. Realized and unrealized foreign exchange losses (gains) are included in the statements of operations.

**(h) New Accounting Pronouncements**

Recent accounting pronouncements that have been issued but are not yet effective, and have a potential implication for the Fund, are as follows:

*Section 3855, Financial Instruments - Recognition and Measurement*

In June 2009, the CICA amended Section 3855, Financial Instruments - Recognition and Measurement, to clarify application of the effective interest rate method after a debt instrument has been impaired. The amendment also clarifies when an embedded prepayment option is separated from its host debt instrument for accounting purposes. This amendment is effective January 1, 2011. Early adoption is permitted. At this point, the Fund does not intend to adopt this amendment early. The Fund is currently evaluating the impact of the adoption of this amendment.

*International Financial Reporting Standards*

In September 2010, the Canadian Accounting Standards Board approved a one year deferral of the effective date for the changeover to IFRS for investment funds from January 1, 2011 to January 1, 2012. In January 2011, an additional one year extension to the option deferral was approved. Investment funds will now be required to mandatorily adopt IFRS for interim and annual financial statements relating to annual periods beginning on or after January 1, 2013.

Based on the Manager's current evaluation of the differences between Canadian GAAP and IFRS, the Manager does not expect that net assets attributable to unitholders or net asset value per security will be impacted by the changeover to IFRS. Currently, the Manager expects that the impact of IFRS on the Fund's financial statements will result in additional disclosures and potentially different presentation of unitholder interests and certain other items.

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**3. CHANGE IN ACCOUNTING POLICIES**

On January 1, 2010, the Fund has adopted the following new Handbook section issued by the CICA: Handbook Section 1506, Accounting Changes, has been amended to exclude from its scope changes in accounting policies upon the complete replacement of an entity's primary basis of accounting. The adoption of this new standard did not have any material impact on the financial statements.

**4. MANAGEMENT FEES AND EXPENSES**

Palos Management Inc., the Manager, provides management and advisory services to the Fund in accordance with the Trust Agreement. In return for these services, Palos Management Inc. is paid a management fee and a performance fee. The management fee is calculated as 1/12 of 1.5% of the net asset value of the Fund, payable monthly.

Until November 23, 2010 the performance fee was calculated as 1/12 of 20% of the monthly realized rate minus the hurdle rate multiplied by the book value of the Fund at the end of the previous month. The monthly realized rate and the hurdle rate are terms that are defined in subsections 1.01 (t) and 1.01 (o) of the Trust Agreement dated January 31, 2008 governing the Fund. Based on the amended and restated Trust agreement dated November 24, 2010, the performance fee is 20% of the amount by which the Fund outperforms its benchmark, the S&P/TSX Composite Index. Any performance fees will be calculated and accrued daily, and paid quarterly.

The management fee for the year ended December 31, 2010 was \$125,090 (2009 - \$83,738). The performance fee for the year ended December 31, 2010 was \$106,852 (2009 - \$Nil). These transactions are in the normal course of operations and are measured at the exchange value which is the amount of consideration established and agreed to by the related parties

As at December 31, 2010, the accounts payable and accrued liabilities include \$Nil (2009 - \$8,172) payable to Palos Management Inc.

In addition to management and performance fees, the Fund is responsible for payment of all expenses relating to the operations and the carrying on of its business.

**5. RECONCILIATION OF TRANSACTIONAL NET ASSET VALUE TO NET ASSET VALUE PER GAAP**

The following table reconciles the GAAP NAV to the Transactional NAV

	GAAP NAV \$	Section 3855 Adjustment \$	Transactional NAV \$	GAAP NAV per unit \$	Transactional NAV per unit \$
<b>As at December 31, 2010</b>	<b>10,721,685</b>	<b>18,605</b>	<b>10,740,290</b>	<b>8.65</b>	<b>8.67</b>
As at December 31, 2009	6,687,227	0	6,687,227	8.13	8.13

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**6. FINANCIAL INSTRUMENTS**

*Fair Value*

Accrued income receivable, subscriptions receivable, accounts payable, redemptions payable, and distributions payable carrying amounts approximate fair values due to their short-term nature.

The following table provides an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into Levels 1 to 3 based on the degree to which the fair value is observable:

Level 1: fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

Level 3: fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Investments at fair value as at December 31, 2010:

	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities	8,774,881	-	-	8,774,881
Fixed-Income	-	1,712,734	-	1,712,734
	<u>8,774,881</u>	<u>1,712,734</u>	<u>-</u>	<u>10,487,615</u>

Investments at fair value as at December 31, 2009:

	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities	5,795,556	-	-	5,795,556
Fixed-Income	-	786,429	-	786,429
	<u>5,795,556</u>	<u>786,429</u>	<u>-</u>	<u>6,581,985</u>

During the year, there were no transfers of financial instruments between the levels.

*Management of Financial Risk*

The Fund's investment activities expose it to a variety of financial risks: credit risk, liquidity risk, market risk including interest rate risk. The Fund endeavors to mitigate the specific risks through the policies and analysis tools as described below.

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**6. FINANCIAL INSTRUMENTS (Continued)**

*Credit Risk*

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation or meet contractual commitments that it has entered into with the Fund.

The Fund's main credit risk concentration is spread among fixed-income securities. To maximize the credit quality of its investments, the Fund's Manager performs ongoing credit evaluations based on factors relating to the credit risk of investments, historical trends and other information.

Generally, the greater the credit rating of a security, the lower the probability of it defaulting on its obligations. Ratings for securities that subject the portfolio to credit risk at December 31, 2010 are noted below:

<b>Credit Risk Rating</b>	<b>% of total fixed income</b>
A	9.4%
N/R	<u>90.6%</u>
<b>Total</b>	<u>100.0%</u>

At December 31, 2009.

<b>Credit Risk Rating</b>	<b>% of total fixed income</b>
AA	6.8%
A	13.5%
BBB	13.0%
N/R	<u>66.7%</u>
<b>Total</b>	<u>100.0%</u>

All portfolio transactions in securities are settled or paid for upon delivery using approved brokers. The risk of default is considered minimal as delivery of securities sold is only made once the broker has received payment. Payment is made on a purchase once the securities are received by the broker. The trade will not settle if either party fails to meet its obligation.

There have been no significant changes in the way the Fund manages its exposure to credit risk since the previous year.

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**6. FINANCIAL INSTRUMENTS (Continued)**

*Liquidity Risk*

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations associated with financial liabilities. Financial liabilities that potentially subject the Fund to liquidity risk consist of accounts payable, redemptions payable and distributions payable. The Fund holds primarily fixed income and equity investments with high volume, liquid trading and therefore are readily saleable to meet liquidity needs.

The contractual terms to maturity of the financial liabilities of the Fund at December 31, 2010 are all under 6 months (2009 - all less than 6 months).

The Fund has a quarter-end redemption policy in order to plan ahead for liquidity needs. In addition, the amount of quarter-end distributions payable to Unitholders is determined by the Manager, and is based in part on the Fund's working capital for that quarter.

There have been no significant changes to the way the Fund manages its exposure to liquidity risk since the previous year.

*Market Risk*

Market risk arises from changes in market prices and rates (including equity prices, interest rates, and foreign exchange rates), the correlations among them, and their level of volatility.

The Fund monitors the portfolio market risk exposure for all securities on a regular basis using a rolling 12-month Value-at-Risk (VaR) test, which determines the amount of the portfolio at risk as at a given date based on historical performance of the investments held. VaR is a statistical measure that estimates the potential loss in value of the Fund's equity positions due to adverse market movements over a defined time horizon with a specified confidence level.

To complement VaR, the Fund also uses stress testing to examine the impact that abnormally large swings in market factors and periods of prolonged inactivity might have on trading portfolios. The stress testing is designed to identify key risks and ensure that the Fund's capital can absorb potential losses from abnormal events.

*Other Price Risk (Market risk)*

Other price risk is the risk that the value of an investment will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual investment or its issuer or by factors affecting all securities traded in the market. The Fund is exposed to other price risk through its equity investment portfolio, which includes a variety of common and preferred shares in a wide range of industries.

In addition to measuring VaR, the Fund mitigates the risk of individual investments by diversifying its portfolio to include investments that have low correlations with other investments.

As at December 31, 2010, the one-day VaR of the portfolio due to other price risk, using a 95% confidence level and other specific inputs, was \$87,000 (2009 - \$110,000).

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**6. FINANCIAL INSTRUMENTS (Continued)**

*Foreign Currency Risk (Market Risk)*

The Fund is exposed to foreign currency translation risk due to investments and cash denominated in U.S. dollars. The Fund may choose to be temporarily exposed or hedged against foreign currency.

In addition to measuring VaR, the Fund mitigates foreign currency risk by investing in foreign currency exchange traded funds. The Fund also regularly monitors the volatility of the foreign currency to which it is exposed.

As at December 31, 2010, the one-day VaR of the portfolio due to foreign currency risk, using a 95% confidence level and other specific inputs, was \$5,000 (2009 - \$Nil).

*Interest Rate Risk (Market Risk)*

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or fair values of financial instruments. Interest rate risk arises when the Fund invests in interest-bearing financial instruments. The Fund is exposed to the risk that the value of such financial instruments will fluctuate because of changes in the prevailing levels of market interest rates.

The Fund mitigates interest rate risk by monitoring interest rates and the maturities of its portfolio of interest bearing financial instruments.

The following table summarizes the Fund's exposure to interest rate risk. It includes the Fund's interest bearing financial assets and liabilities at fair value, categorized by the earlier of contractual interest rate reset dates or maturity dates as at December 31, 2010.

	1 to 5 Years	5 to 10 Years	Greater Than 10 Years	Total
	\$	\$	\$	\$
Financial assets held-for-trading	828,892	671,869	211,973	1,712,734

At December 31, 2009.

	1 to 5 Years	5 to 10 Years	Greater Than 10 Years	Total
	\$	\$	\$	\$
Financial assets held-for-trading	349,167	277,585	159,677	786,429

As at December 31, 2010, had prevailing interest rates increased or decreased by 1%, assuming a parallel shift in the yield curve, with all other variables held constant, Net Assets would have decreased or increased by \$73,000 (2009 - \$42,000). In practice, actual results may differ from this sensitivity analysis and the difference could be material.

There have been no significant changes in the way the Fund manages its exposure to market risks

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

since the previous year.

**7. UNITHOLDERS' EQUITY**

The Fund considers its capital to consist of the net assets attributable to Unitholders.

The Manager manages the capital of the Fund in accordance with the Fund's investment objectives, policies and restrictions, as outlined in the Fund's Agreement, while maintaining sufficient liquidity to meet distributions to Unitholders and Unitholders' redemptions. The Fund's primary objectives are to preserve capital, to provide an attractive and steady stream of income, and to deliver trade-enhanced returns.

The Fund employs qualitative, quantitative and comparative research to manage a portfolio of select high-grade and undervalued dividend-paying and income-paying securities. The Fund takes long positions and employs market and statistical arbitrage techniques to maximize returns

Effective November 24, 2010, all of the issued and outstanding units of the Fund were automatically reclassified, on a one-for-one basis, as Series A Units of the Fund. The Amended and Restated Trust Agreement provides for, among other things, redemption of units on any business day, with two certain exceptions: 1) during any period when normal trading is suspended on any exchange on which securities or derivatives that make up more than 50% of the Fund's value or its underlying market exposure are traded, provided those securities or derivatives are not traded on any other exchange that is a reasonable alternative for the Fund, or 2) with the approval of securities regulators.

The Fund is permitted to issue an unlimited number of units issuable in one or more Series as determined by the Trustee. Each Series has a proportionate share in the assets and property of the Fund less that Series' proportionate share of the Fund's common liabilities and less any specific liabilities of that Series. As at December 31, 2010, only Series A units have been issued by the Fund.

There has been no change during the year in the description of what the Fund manages as capital, nor in its objectives, policies and processes for managing its capital.

The numbers of units issued, redeemed and outstanding for the years ended December 31 are summarized as follows:

	<b>2010</b>	<b>2009</b>
Units, beginning of year	822,383	508,355
Units issued	339,233	255,353
Units issued from distribution reinvestment	90,840	67,700
Units redeemed	<u>(13,555)</u>	<u>(9,025)</u>
Units, end of year	<u><u>1,238,901</u></u>	<u><u>822,383</u></u>

**PALOS EQUITY INCOME FUND**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**DECEMBER 31, 2010**

**8 INCOME TAXES**

The Fund qualifies as a quasi-mutual fund trust under the Income Tax Act (Canada).

All or substantially all of the net income for tax purposes and net taxable capital gains realized, after utilization of loss carryforwards, in any year are distributed to unitholders such that no income taxes are payable by the Fund.

**9 SUBSEQUENT EVENTS**

Effective January 7, 2011, the Fund's Trustee was changed to BNY Trust Company of Canada.

On February 18, 2011, the Manager prepared and filed a simplified prospectus and annual information form with provincial securities regulators establishing the Fund as a reporting issuer and qualifying the distribution of the units of the Fund on an ongoing basis. On February 23, 2011, the Fund has received regulatory approval to deviate from National Instrument 81-102 by selling securities short, by providing a security interest over Fund assets in connection with the short sales and by depositing Fund assets with Dealers as security in connection with such transactions. The Fund will engage in short selling only within certain controls and limitations.

**10. COMPARATIVE FIGURES**

Certain comparative figures have been reclassified to conform to the current year's presentation.