Canso Credit Income Fund

Quarterly Report
December 31, 2011

2011 was the year, it was unanimously agreed, when interest rates would finally start to rise. Bond media personalities lectured and hectored the world on the low level of yields and the obvious investment insanity of owning bonds. The problem was, bond yields fell dramatically in 2011 and proved the investment talking heads wrong once again. As always, the consensus for higher interest rates existed to give investors a place of psychological comfort to share with the investment herd. As is quite often the case, this investment place of comfort proved very uncomfortable as things turned out far differently than the shared expectation. With the yield on 30-year bonds declining from 3.6% to 2.5% during the year, 2011 turned out to be one of the best years for Canadian bonds in quite some time. The DEX Universe closed the year with a total return of 9.7% which is the best year since 2000.

Credit was not a place to be in 2011 as investment dealers and banks reduced inventories. Credit spreads widened on average by about 40 bps in 2011 from their already elevated level at the end of 2010. Risk assets sold off as the European debt crisis flared up anew in August as a result of the Greek debt restructuring negotiations. The German insistence that private creditors take a loss on their Greek government bonds as part of the restructuring of Greece's debt unleashed a wave of worry over the solvency of Europe's banks and some sovereigns. European banks hold large amounts of sovereign debt. Once the possibility of losses on these holdings arose, investors began to worry about the state of European bank balance sheets. The regulators added to the uncertainty. In a vain attempt to restore confidence in Europe's banks, the European Banking Authority (EBA) conducted stress tests which involved markdowns on troubled European sovereign debt. This only added fuel to the fire as many banks were declared to lack sufficient capital. Finally, in December, the euro zone leaders announced that no other sovereign debt restructurings would force private creditors to take losses. This was too late to make much of a difference. Concerns with European sovereigns led to rising government yields and wider spreads for European financials, which had a spill-over effect into spreads of U.S. financials.

Canso continues to believe that corporate bond spreads are at very attractive levels, with the average spread of all corporate bonds at about 1.8% above Government of Canada bonds, which is well above an historical average of 0.9%. Canso has positioned the Fund to isolate and take advantage of wide credit spreads, by shorting government of Canada bonds against our long corporate bond positions. The net effect of these long/short positions is to insulate the Fund against an increase in interest rates, which we expect over the medium term, and to exploit attractive credit spreads of the long corporate bond positions. In terms of inflation, Canadian government bonds have seldom been more expensive. Either yields have to rise 1% or inflation has to fall 1% to give investors at least a positive real yield on their Canada holdings.

Credit spreads began to stabilize in the fourth quarter following several months of spread widening. Corporate bonds returned 1.6% in the quarter, roughly in-line with the return of Canadian government bonds. Maple and telecommunication bonds underperformed during the quarter, two areas where the fund has higher exposure. Based on the change in the net asset value per unit and assuming the monthly distributions were reinvested, the return of the Class A units of the Fund was -0.23% during the fourth quarter compared to a return of 2.5% for the DEX Corporate High Yield Index and 1.6% for the DEX Corporate Bond Index. Performance for 2011, CCIF Class A: -6.35%, DEX HY: -2.29%, DEX Corp: 8.24%

A portfolio of government bonds would currently be yielding an average of under 2%, -below the current level of inflation in Canada of 2.9%. Current yields on government bonds, barely cover expenses for many bond portfolios. As interest rates move off their current lows, which we believe is inevitable, government bonds will underperform. We believe that corporate bonds remain very attractive with average spreads at 1.8% over governments. We remain committed to our overall strategy, which is to remain long corporate credit spreads, while protecting the portfolio against an increase in interest rates.