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CAPITAL MARKETS

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**North American Financials  
Capital Securities Trust**

Annual Report

December 31, 2010

## North American Financials Capital Securities Trust Message to Unitholders

March 29, 2011

### Dear Investor,

We are pleased to provide you with the annual report for the North American Financials Capital Securities Trust (the "Fund") for the year ending December 31, 2010. The Fund commenced operations on October 23, 2009. It is designed to provide investors with exposure to an actively managed portfolio of Innovative Tier 1 Capital Securities. The portfolio consists primarily of the six largest Canadian banks, large Canadian insurance companies and U.S. financial institutions with a minimum issuer rating of "A" by S&P. The portfolio is actively managed by Connor, Clark & Lunn Investment Management Ltd. (the "Investment Manager"). The portfolio composition is approximately 45% Canadian issuers and 55% U.S. issuers.

The Fund's investment objectives are to (i) provide Unitholders with attractive tax-advantaged quarterly cash distributions, and (ii) return to Unitholders the original issue price of the Units upon termination of the Fund on November 30, 2014. Distributions are initially targeted to be \$1.50 per annum per Unit consisting primarily of returns of capital, representing a yield on the Unit issue price of 6.0% per annum.

The net asset value ("NAV") for Class A units at the end of December was \$25.09 and \$25.61 at the time of writing in March. Distributions of \$1.78 have been paid. This compares favourably with the opening NAV of \$23.39 after the deduction of agents' fees and issuance expenses. The Investment Manager was able to do a good job of investing the money at attractive yields and on a timely basis. The increase in net asset value is primarily due to a drop in the benchmark government bond yields. This increase has been partially offset by a small increase in credit spreads for the banking sector. Credit spreads are the additional amount that a company has to pay over and over the cost for government bonds.

The Investment Manager continues to monitor the companies in the portfolio, the macro-economic situation as well as possible regulatory changes as the Basle III Committee proposals concerning bank capital requirements work their way through the various regulatory bodies. The Investment Manager continues to believe that 10 year Government of Canada bonds will be range bound, trading in a range between 2.85% and 3.50%. There is a certain lack of clarity in the current economic situation and the market is waiting for more information to discern the direction moving forward.

Please check our web site for quarterly investment updates and other timely information. We appreciate your investment in the Fund and look forward to continued strong performance by the Fund.

Yours truly,



W. Neil Murdoch  
Chief Executive Officer  
Connor, Clark & Lunn Capital Markets

# Management Report of Fund Performance

This annual management report of fund performance for North American Financials Capital Securities Trust (the “Fund”) contains financial highlights but does not contain the complete annual financial statements of the Fund. **The annual financial statements and accompanying notes are attached to this report.**

You can obtain a copy of the annual financial statements at no cost by writing to the Manager to the following address: Connor, Clark & Lunn Capital Markets Inc. (the “Manager”), Suite 300, 181 University Avenue, Toronto, Ontario M5H 3M7, or calling (416) 862-2020 or visiting the Manager’s website at [www.cclcapitalmarkets.com](http://www.cclcapitalmarkets.com) or by visiting [www.sedar.com](http://www.sedar.com). Securityholders may also contact us using one of these methods to request a copy of the Fund’s proxy voting policies and procedures, proxy voting disclosure record, or quarterly portfolio disclosure.

Note that any reference to “Net Assets” or “Net Assets per Unit” or “GAAP Net Assets” means that the value was determined in accordance with the Canadian Generally Accounting Principles “GAAP” for financial statements purposes. Also any reference to “Net Asset Value” or “Net Asset Value per Unit” or “Transactional NAV” means that the value was determined for valuation and transactional purposes. An explanation of the difference between both values can be found in note 3 to the financial statements.

## Investment Objectives and Strategy

The Fund is an investment fund established under the laws of the Province of Ontario and governed by the Trust Agreement between the Manager of the Fund and RBC Dexia Investor Services Trust (the “Trustee”) dated September 28, 2009. The Fund’s principal office is at 181 University Avenue, Suite 300, Toronto, Ontario M5H 3M7. The fiscal year-end of the Fund is December 31. Beneficial interest in the net assets and net income of the Fund is divided into units of two classes, Class A Units and Class F Units. Class A Units are listed on the Toronto Stock Exchange under the symbol NAF.UN. Class F Units are not listed on a stock exchange but may be converted into Class A Units on a weekly basis. The principal differences between the Class A Units and the Class F Units are that the agents’ fees payable with respect to the original issuance of the units were lower for the Class F Units, and that the service fee and the TSX listing fees are not paid by Class F Units.

The Fund’s investment objectives are to:

- (i) provide Unitholders with attractive tax-advantaged quarterly cash distributions; and
- (ii) return to Unitholders the original issue price of the Units upon termination of the Fund on November 30, 2014.

Distributions are initially targeted to be \$1.50 per annum per Unit consisting primarily of returns of capital, representing a return on the issue price of 6.0% per annum.

In order to achieve the Fund’s investment objectives, the Fund obtained exposure, in a tax-efficient manner, to the performance of a portfolio (the “Portfolio”) held by North American Portfolio Trust (the “NAPT” or the “Trust”). Connor, Clark & Lunn Investment Management Ltd. (the “Investment Manager”), the Trust’s investment manager, actively manages the Portfolio. The Portfolio consisting primarily of Canadian Innovative Tier 1 Capital Securities issued by banks (or entities related to banks) and U.S. Financials Capital Securities. The Investment Manager may also invest up to 15% of the Portfolio (measured at the time of investment) in other bonds with a minimum issuer rating of “A” by S&P.

The Fund does not invest directly in the NAPT, the Fund used the net proceeds of the initial public offering of its Class A and Class F Units to pre-pay its purchase obligations under a forward purchase and sale agreement (the “Forward Agreement”) with The Bank of Montreal (the “Counterparty” or “BMO”). Under the Forward Agreement, the Fund will receive, on or before November 30, 2014, a specified portfolio consisting of securities of Canadian public issuers that are “Canadian securities” for the purposes of the Tax Act (“Canadian Securities”) in an amount equal to the net asset value of the NAPT. Partial settlements under the Forward Agreement are intended to ensure that Unitholders have economic exposure to the distributions effected by NAPT. A fee of 0.35% per annum, calculated with reference to the NAV of NAPT, is payable to BMO under the Forward Agreement.

## **Risk**

Changes in the risk exposure of the Fund occurred in the following areas:

- **Use of leverage**

The Fund is entitled to employ leverage of up to 25% of the total Portfolio held by NAPT. The Fund applied leverage in the range from 19.2% to 21.5%. The leverage factor as of December 31, 2010 was 19.4%.

For full disclosure of risks associated with an investment in the Fund's units, please refer to the Prospectus dated September 28, 2009 and to the Fund's most recent Annual Information Form.

## **Recent Developments**

### ***Future accounting changes***

In February 2008, the Canadian Accounting Standards Board (the "AcSB") confirmed that the International Financial Reporting Standards ("IFRS") will replace current Canadian standards and interpretations as Canadian GAAP for publicly accountable enterprises effective January 1, 2011, which includes investment funds. The Fund will adopt IFRS on January 1, 2011. Management has commenced activities to identify key issues and the likely impacts resulting from the adoption of IFRS and is in the process of developing a changeover plan, which will include identifying differences between the Fund's current accounting policies and those it expects to apply under IFRS, as well as any accounting policy and implementation decisions and their resulting impact, if any, on NAV of the Funds. Management has presently determined that there will be no significant impact to NAV per Unit as a result of the changeover to IFRS but will continue to assess based on any changes to existing IFRS.

At its January 12, 2011 meeting, the AcSB decided to extend the deferral of mandatory adoption of IFRS for Investment Companies and Segregated Accounts of Life Insurance Enterprises. The decision is in response to the International Accounting Standards Board's announcement in late 2010 that its Investment Company project is delayed and will not likely be issued before January 1, 2012, which is the current date of mandatory adoption of IFRS for these entities. As a result, the Fund will delay implementation of IFRS until January 1, 2013.

The Fund's Manager has commenced activities to identify key issues and the likely impacts resulting from the adoption of IFRS and is in the process of developing a changeover plan, which will include identifying differences between the Fund's current accounting policies and those it expects to apply under IFRS, as well as any accounting policy and implementation decisions and their resulting impact, if any, on NAV of the Funds. Management has presently determined that there will be no significant impact to NAV per Unit as a result of the changeover to IFRS but will continue to assess based on any changes to existing IFRS.

## **Results of Operations**

### ***Caution regarding forward-looking statements***

The analysis in the document includes forward looking statements. The use of any of the words anticipate, may, will, expect, estimate, should, believe and similar expressions are intended to identify forward-looking statements. Such statements reflect the opinion of the Investment Manager regarding factors that might be reasonably expected to affect the performance and the distributions on units of the Fund, and are based on information available at the time of writing. The Investment Manager believes that the expectations reflected in these forward-looking statements and in the analysis are reasonable, but no assurance can be given that these expectations or the analysis will prove to be correct and accordingly they should not be unduly relied on. These statements speak only as of the date of this report. Actual events and outcomes may differ materially from those described in these forward-looking statements or analysis.

### ***Investment Manager Commentary***

The de-synchronization of the global recovery became more evident throughout the year. Eurozone economic activity was weak but remained positive while emerging markets continued to follow a V-shape recovery pattern with China's growth

strong enough to create fears of inflation. North American economies continued to improve with the US posting positive but slower-than-potential growth. While Canada posted its highest quarterly growth rate in ten years led by consumer spending and housing during the first quarter; its pace decelerated somewhat for the remainder of the year reflecting the impact of a much higher Canadian dollar. The Bank of Canada took the lead among G7 countries by raising interest rates three times during the year starting at its June meeting, bringing its target rate to 1.0% before the end of the third quarter. It opted to stay on the sidelines through year-end as its economic outlook became more muted due to ongoing low inflation pressures. While US administered rates remained unchanged for the entire year, the second round of quantitative easing (QE2) was officially announced towards the end of the year. This bolstered investors' optimism and set off a shift in investment preference from bonds to equities while recent favourable tax legislation also fed this renewed sense of optimism.

The Canadian financial system continued to be the envy of the world in 2010 maintaining its stability amongst volatile capital markets and challenging economic conditions. In fact, the Canadian banking sector performance was relatively impressive posting over \$5.3 billion in operating cash representing a 10% increase over the previous year. As an industry, it was able to continue building on its recognized franchise by further enhancing its already strong reserves.

On the US front, there was a clear improvement in earnings versus previous years. We witnessed large financial institutions such as Citibank posting its first post-financial crisis annual pre-tax profits while others like GE Capital continued to beat expectations.

On the regulatory front, Dodd-Frank Wall Street Reform and Consumer Protection Act was introduced to address a variety of US banking and shadow banking issues to prevent future financial crises and ultimately to protect the taxpayer. 2010 was also a very important year as the Basel Supervision committee (Basel III) provided more clarity on capital adequacy requirements and liquidity standards. On the domestic front, one of the implications will be the treatment of existing hybrid securities, which will gradually be phased out of bank Tier 1 capital starting in 2013. In anticipation of these upcoming requirements, both Generation 1 and 2 hybrid securities performed very well during the year due to their scarcity value. Generation 3 hybrid securities, on the other hand, came under pressure during the third quarter as the possibility of an early redemption at par would be very punitive for debt holders. Fortunately, we had migrated the portfolio away from Generation 3 hybrids in favor of earlier generation hybrids. This not only resulted in favourable performance, but also shortened the average time-to-first-call, which made the fund less exposed to higher interest rates and better aligned with the remaining term of the Fund. While some of the discount associated with Generation 3 hybrids started to decrease in the fourth quarter (based on speculations that the Canadian regulatory authorities might provide favorable ruling on them), we opted to err on the side of caution and maintain exposures to Generation 1 and 2 Tier 1 hybrid securities as they continued to offer the better certainty in the event of an early redemption.

### *Outlook*

The outlook for economic growth improved aided by the implementation of QE2 and further fiscal stimulus in the US. We expect the impact of continued weakness in the housing market to lessen as the positive wealth effect of higher equity markets along with better employment prospects translates into an increase in consumer spending. On the business side, leading indicators in the manufacturing sector continue to show improvement, as does business confidence. While external risks still remain with concerns over the European sovereign debt situation, the impact of rising oil prices and monetary tightening in China, their effect appears contained in the medium term.

The US economy continues to operate with significant excess capacity, and as a result we expect inflation to remain under control, enabling the Fed to remain on the sidelines throughout 2011. The tightening pause initiated by the Bank of Canada should remain in place until the second half of the year and future increases will be dependent upon the state of the overall economy and inflation expectations at that time. Consequently, we expect interest rates will begin to settle into a new, higher trading range (2.85 to 3.45% for the 10 year Canada). The yield curve should continue to flatten slightly as the market start discounting the next move by the Bank of Canada. This combination of somewhat stable interest rates with minimum change in the yield curve should continue to support the performance of overall financials in the upcoming quarters.

### *Capital transactions*

On October 23, 2009, the Fund completed an initial public offering pursuant to the prospectus dated September 28, 2009. \$50,000,000 was raised through the issue of 2,000,000 Class A Units and \$821,500 was raised through the issue of 32,860 Class F Units. The Class A Units were issued at \$25 per unit and incurred agents fees and issue expenses of \$3,215,301 or \$1.61 per unit, for an opening Transactional NAV of \$23.39 per unit. The Class F Units were issued at \$25 per unit and incurred agents fees and issue expenses of \$28,182 or \$0.86 per unit, for an opening Transactional NAV of \$24.14 per unit.

On November 6, 2009, the Agents exercised an over-allotment option in respect of 158,940 Class A Units, raising a further \$3,973,500. Agents' fees were \$208,609 or \$1.31 per unit. During the year ended December 31, 2010 the Fund incurred additional Agents' fees of \$11,731 or \$0.01 per Class A Unit and Class F Unit respectively.

There were no capital transactions during the year ended December 31, 2010.

### ***Net Assets***

The net assets per unit is calculated as the value of the prepaid amount to the counterparty under forward agreement plus any other investments held by the Fund, plus the value of any gain or loss on the Forward Agreement, less any net liabilities of the Fund, divided by the number of units outstanding.

On December 31, 2010, the value of the prepaid amount to counterparty under forward agreement was \$61,035,432. The unrealized gain on forward agreement balance was \$8,255,413. Since the Fund can at any time terminate the Forward Agreement with the Counterparty in exchange for the value of the NAPT, the value of the Forward Agreement to the Fund is equal to the value of the NAPT less the value of the prepaid amount to counterparty under the forward agreement. On December 31, 2010 the value of the unrealized gain on forward agreement balance was \$8,255,413. Other liabilities net of other assets in the Fund totalled \$14,482,084 leaving net assets of \$54,808,761. This amount is assigned to Class A and Class F Unitholders using an allocation percentage that takes into consideration any class level specific expenses. On December 31, 2010 the GAAP Net assets per unit was \$24.99 per Class A Units and \$25.97 per Class F Units.

On December 31, 2009, the value of the prepaid amount to counterparty under forward agreement was \$65,732,908. Since the Fund can at any time terminate the Forward agreement with the Counterparty in exchange for the value of the NAPT, the value of the Forward Agreement to the Fund is equal to the value of the NAPT less the value of the prepaid amount to counterparty under forward agreement. On December 31, 2009 the value of the unrealized gain on forward agreement was \$995,323. Other liabilities net of other assets in the Fund totalled \$15,204,932 leaving net assets of \$51,523,299. On December 31, 2009 the GAAP Net assets per unit was \$23.50 per Class A Units and \$24.26 per Class F Units

### ***Leverage***

The Fund's exposure to the securities in the Portfolio through the Forward Agreement may be increased to 25% of the NAV (being the aggregate value of the assets of the NAPT) (tested daily) for the purposes of adding leverage to the Portfolio and such other short term funding purposes as may be determined by the Investment Manager from time to time and in accordance with the Investment Strategy. The use of leverage has the potential to enhance or reduce returns. At December 31, 2010, the Fund had an outstanding balance of \$13,470,000 under its banking facility (2009- \$14,400,000).

### ***Market repurchases***

The Trust Agreement provides that the Fund may, in its sole discretion, from time to time, purchase (in the open market or by invitation for tenders) Class A Units for cancellation subject to applicable law and stock exchange requirements, based on the Manager's assessment that such purchases are accretive to Unitholders, in all cases at a price per Class A Unit not exceeding the most recently calculated Net Asset Value per Class A Unit immediately prior to the date of any such purchase of Units.

There was no purchase of units for cancellation during the year ended December 31, 2010 or the period from October 23, 2009 (commencement of operation) to December 31, 2009.

### ***Distributions***

The Fund pays quarterly distributions at \$0.375 per Unit, representing a return of 6.0% per annum on the Unit issue price.

The Fund has made all its scheduled distributions since its commencement of operations on October 23, 2009. The Fund paid a total of \$1.50 per Class A and Class F Units during the year ended December 31, 2010 (\$0.28125 during the period from October 23, 2009 (commencement of operation) to December 31, 2009).

## Recommendations or Reports by the Independent Review Committee

The Independent Review Committee of the Board of Advisors tabled no special reports and made no extraordinary material recommendations to management of the Fund during the year ended December 31, 2010.

## Related Party Transactions

### *Management Fees*

The Manager receives a Management Fee from the Fund and NAPT equal in the aggregate to 0.50% per annum of the applicable Net Asset Value, (0.25% from the Fund and 0.25% from the NAPT), calculated daily and payable monthly in arrears, plus applicable taxes.

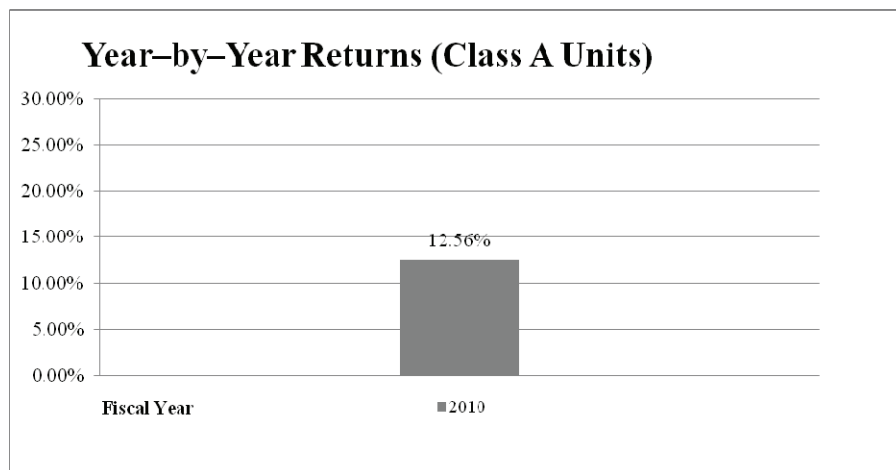
The management fees charged to the Fund and the NAPT on a combined basis during the year ended December 31, 2010 were \$293,331 (\$49,924 during the period from October 23, 2009 (commencement of operation) to December 31, 2009). The Manager is responsible for payment of the investment management fees out of these management fees.

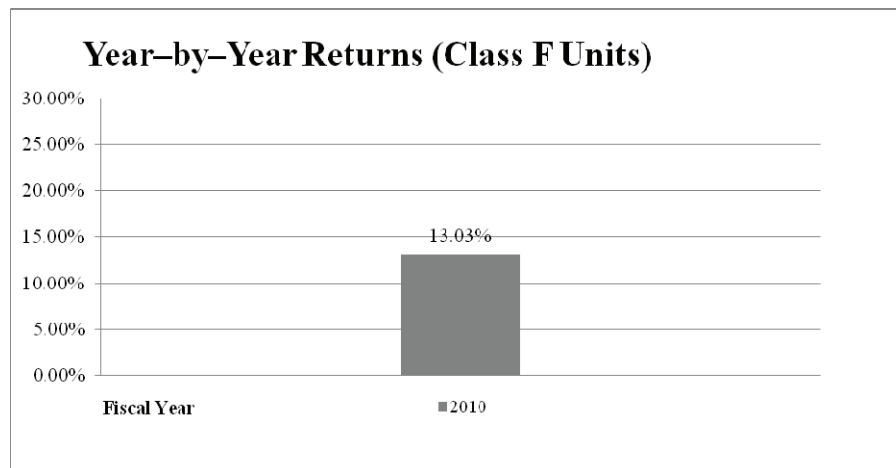
## Past Performance

The following bar chart and table show the Fund's annual performance of the Class A Units and the F Class Units by showing both annual returns by fiscal year and annualized compound returns from inception assuming all the distributions made by the Fund during the periods shown were reinvested. Past performance is not necessarily indicative of future performance.

### *Year – by– Year Returns*

The following bar charts show the Fund's annual performance for the years shown. These bar charts show, in percentage terms, how much an investment made on the first day of the period would have grown or decreased by the last day of the period.





***Annual Compound Returns***

	<b>Past Year</b>	<b>Since Inception <sup>(1)</sup></b>
Based on NAV (Class A Units)	12.56%	12.67%
Based on share price (Class A Units)	13.03%	13.09%
Based on NAV (Class F Units)	10.80%	6.37%
DEX Universe Bond Index	6.74%	6.21%

<sup>(1)</sup> Annualized for the period October 23, 2009 (Commencement of operations) to December 31, 2010.

The Dex index is the broadest and most widely used measure of performance of marketable bonds outstanding in the Canadian market. The fund performed well compared to the index. Tier 1 securities issued by financial companies were some of the best performing bonds during the period as the banking system continued to improve its capitalization and the regulatory environment encouraged risk reducing endeavours.

## Financial Highlights

The following tables show selected key financial information about the Fund and are intended to aid in understanding the Fund's financial performance since inception. This information is derived from the Fund's audited annual financial statements:

### Class A Units:

The Fund's Net Assets per Class A Unit:

	December 31, 2010	December 31, 2009 <sup>(1)</sup>
<b>Net Assets, beginning of period</b>	<b>23.50</b>	25.00
<b>Unit issue expense <sup>(2)</sup></b>	<b>(0.01)</b>	<b>(1.61)</b>
<b>Increase (decrease) from operations:</b>		
Total revenues	–	–
Total expenses	(0.45)	(0.09)
Realized gains (losses) for the period	0.15	–
Unrealized gains (losses) for the period	3.30	0.46
<b>Total increase (decrease) from operations <sup>(3)</sup></b>	<b>3.00</b>	<b>(0.37)</b>
<b>Distributions:</b>		
From income (excluding dividends)	–	–
From dividends	–	–
From capital gains	–	–
Return of capital	(1.50)	(0.28)
<b>Total Distributions <sup>(4)</sup></b>	<b>(1.50)</b>	<b>(0.28)</b>
<b>Net Assets, end of period <sup>(5)</sup></b>	<b>24.99</b>	<b>23.50</b>

<sup>(1)</sup> Results for the period from October 23, 2009 (commencement of operations) to December 31, 2009.

<sup>(2)</sup> Issue expense of \$3,423,910 incurred in connection with the Class A Units issuance. The full amount of issue expenses was deducted from the unit capital for accounting purposes and is amortized over a period of five years for tax purposes. Additional issue expense of \$11,549 incurred in connection with the Class A Units issuance during the year ended December 31, 2010.

<sup>(3)</sup> Net assets and distributions are based on the actual number of units outstanding at the relevant time. The increase / decrease from operations is based on weighted average number of units of 2,158,940 units outstanding as of December 31, 2010 (2009 – 2,128,689).

<sup>(4)</sup> The percentages used to allocate distributions among income, dividends, capital gain and return on capital are based on estimates.

<sup>(5)</sup> This is not reconciliation between the opening and the closing net assets per unit.

Ratios and Supplemental Data (Class A Units):

	December 31, 2010	December 31, 2009 <sup>(1)</sup>
Net asset value (000's)	54,174	51,099
Number of units outstanding	2,158,940	2,158,940
Base Management expense ratio <sup>(2)(3)</sup>	1.36%	1.72%
Issue expenses ratio <sup>(2)(3)</sup>	0.02%	6.90%
Interest expense ratio <sup>(2)(3)</sup>	0.48%	0.37%
Management expense ratio (annualized) <sup>(3)</sup>	1.86%	8.99%
Management expense ratio before waivers or absorptions (annualized) <sup>(3)</sup>	1.86%	8.99%
Portfolio turnover rate <sup>(4)</sup>	0.00%	0.00%
Trading expense ratio <sup>(5)</sup>	0.00%	0.00%
Net asset value per unit	25.09	23.67
Closing market price (TSX)	25.00	24.00

<sup>(1)</sup> Results for the period from October 23, 2009 (commencement of operations) to December 31, 2009.

<sup>(2)</sup> A separate base management expense ratio has been presented to include the normal operating expenses and exclude the Issue expense ratio: representing all agents' fees and unit issue expenses, and Interest expense ratio: representing cost of leverage.

<sup>(3)</sup> Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of daily average net asset value during the period. Unit issue expenses, representing all Agents' fees and other offering expenses, which are one-time expenses, have not been annualized.

<sup>(4)</sup> The Fund's turnover rate indicates how actively the Fund's portfolio adviser manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund's buying and selling all of the securities (including fixed income) in its portfolio once in the course of the year. There is not necessarily a relationship between turnover rate and the performance of the Fund.

<sup>(5)</sup> The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net asset value during the period.

<sup>(6)</sup> The net asset value (Transactional NAV) per unit is based on the last traded price for the day of the underlying portfolio, whereas the net assets per unit (GAAP Net Assets) is based on the closing bid prices of the underlying portfolio; hence the difference between the two amounts.

## Class F Units:

The Fund's Net Assets per Class F Unit:

	December 31, 2010	December 31, 2009 <sup>(1)</sup>
<b>Net Assets, beginning of period</b>	<b>24.26</b>	25.00
<b>Unit issue expense</b> <sup>(2)</sup>	<b>(0.01)</b>	<b>(0.86)</b>
<b>Increase (decrease) from operations:</b>		
Total revenues	–	–
Total expenses	(0.47)	(0.09)
Realized gains (losses) for the period	0.15	–
Unrealized gains (losses) for the period	3.53	0.49
<b>Total increase (decrease) from operations</b> <sup>(3)</sup>	<b>3.21</b>	<b>(0.40)</b>
<b>Distributions:</b>		
From income (excluding dividends)	–	–
From dividends	–	–
From capital gains	–	–
Return of capital	(1.50)	(0.28)
<b>Total Distributions</b> <sup>(4)</sup>	<b>(1.50)</b>	<b>(0.28)</b>
<b>Net Assets, end of period</b> <sup>(5)</sup>	<b>25.97</b>	<b>24.26</b>

(1) Results for the period from October 23, 2009 (commencement of operations) to December 31, 2009.

(2) Issue expense of \$28,182 incurred in connection with the Class F Units issuance. The full amount of issue expenses was deducted from the unit capital for accounting purposes and is amortized over a period of five years for tax purposes. Additional issue expense of \$182 incurred in connection with the Class F Units issuance during the year ended December 31, 2010.

(3) Net assets and distributions are based on the actual number of units outstanding at the relevant time. The increase / decrease from operations is based on weighted average number of units of 32,860 units outstanding as of December 31, 2010 (2009 – 32,860).

(4) The percentages used to allocate distributions among income, dividends, capital gain and return on capital are based on estimates.

(5) This is not reconciliation between the opening and the closing net assets per unit.

Ratios and Supplemental Data (Class F Units):

	December 31, 2010	December 31, 2009 <sup>(1)</sup>
Net asset value (000's)	857	803
Number of units outstanding	32,860	32,860
Base Management expense ratio <sup>(2)(3)</sup>	0.94%	1.25%
Issue expenses ratio <sup>(2)(3)</sup>	0.02%	3.56%
Interest expense ratio <sup>(2)(3)</sup>	0.48%	0.37%
Management expense ratio (annualized) <sup>(3)</sup>	1.44%	5.18%
Management expense ratio before waivers or absorptions (annualized) <sup>(3)</sup>	1.44%	5.18%
Portfolio turnover rate <sup>(4)</sup>	0.00%	0.00%
Trading expense ratio <sup>(5)</sup>	0.00%	0.00%
Net asset value per unit	26.08	24.44

(1) Results for the period from October 23, 2009 (commencement of operations) to December 31, 2009.

(2) A separate base management expense ratio has been presented to include the normal operating expenses and exclude the Issue expense ratio: representing all agents' fees and unit issue expenses, and Interest expense ratio: representing cost of leverage.

(3) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of daily average net asset value during the period. Unit issue expenses, representing all Agents' fees and other offering expenses, which are one-time expenses, have not been annualized.

(4) The Fund's turnover rate indicates how actively the Fund's portfolio adviser manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund's buying and selling all of the securities (including fixed income) in its portfolio once in the course of the year. There is not necessarily a relationship between turnover rate and the performance of the Fund.

(5) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net asset value during the period.

(6) The net asset value (Transactional NAV) per unit is based on the last traded price for the day of the underlying portfolio, whereas the net assets per unit (GAAP Net Assets) is based on the closing bid prices of the underlying portfolio; hence the difference between the two amounts.

## Summary of Investment Portfolio as of December 31, 2010

The summary of investment portfolio may change due to ongoing portfolio transactions of the Fund. A quarterly update is available at [www.cclcapitalmarkets.com](http://www.cclcapitalmarkets.com) and at [www.sedar.com](http://www.sedar.com).

<i>Investment portfolio of the Fund</i>			
		Fair value \$	% of NAV
<b>Portfolio by Category</b>			
Equity Derivatives		69,512,984	126.3%
Materials		8,685	0.0%
<b>Top 25 Holdings</b>			
Equity Derivatives		69,512,984	126.3%
Celestica Inc.		8,685	0.0%
<b>Net asset value</b>		<b>53,030,900</b>	

<i>Investment portfolio of the North American Portfolio Trust</i>				
	Coupon Rate %	Maturity date	Fair value \$	% of NAV
<b>Portfolio by Category</b>				
Foreign Corporate Bonds (US\$)			30,804,328	44.2%
Domestic Corporate Bonds			29,860,660	43.1%
Foreign Preferred Stock (US\$) / Financials			5,744,836	8.3%
Cash and Short term investments			2,346,828	3.5%
Foreign currency forward contracts			379,077	0.5%
<b>Top 25 Holdings</b>				
TD Capital Trust III	7.24%	12/31/2018	7,058,739	10.2%
Manulife Financial Capital Trust II	7.41%	12/31/2019	6,935,685	10.0%
GE Capital Trust I (U.S. Dollars)	6.38%	11/15/2017	6,215,073	8.9%
Wachovia Capital Trust III (U.S. Dollars)	5.80%	3/15/2049	6,060,026	8.7%
Citigroup Capital XIII			5,347,827	7.7%
JPMorgan Chase & Co. (U.S. Dollars)	7.90%	4/30/2018	5,299,064	7.6%
NBC Asset Trust	7.24%	6/30/2018	4,971,333	7.2%
Northgroup Preferred Capital Corp. (U.S. Dollars)	6.38%	10/15/2017	4,665,905	6.7%
The Toronto-Dominion Bank	5.76%	12/18/2017	4,645,961	6.7%
Morgan Stanley	4.90%	2/23/2017	3,467,183	5.0%
Great-West Life & Annuity Insurance Co. (U.S. Dollars)	7.15%	5/16/2016	3,010,761	4.3%
RBC Capital Trust	6.82%	6/30/2018	2,719,602	3.9%
NBC Asset Trust	7.45%	6/30/2020	2,559,364	3.7%
Cash and Short term investments			2,346,828	3.5%
Merrill Lynch & Co., Inc.	5.29%	5/30/2017	1,239,229	1.8%
Great-West Lifeco Finance Delaware LP II	7.13%	6/26/2018	969,976	1.4%
Goldman Sachs Capital II (U.S. Dollars)	5.79%	6/1/2012	847,087	1.2%
Citigroup Capital XII			397,009	0.6%
Foreign currency forward contracts			379,077	0.5%
<b>Net asset value</b>			<b>69,512,984</b>	

## Management's Responsibility for Financial Reporting

The accompanying financial statements of **North American Financials Capital Securities Trust** (the "Fund") and all of the information have been prepared by Connor, Clark & Lunn Capital Markets in its capacity as Manager of the Fund and has been approved by the Board of Directors of the Manager. The Fund's Manager is responsible for all of the information and representations contained in these financial statements and other sections of the Annual Report.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Financial statements are not precise since they include certain amounts based on estimates and judgements. The Manager has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. Management has ensured that the other financial information presented in this annual report is consistent with the financial statements.

The financial statements have been audited by PricewaterhouseCoopers LLP on behalf of the unitholders. They have audited the financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the unitholders their opinion on the financial statements.



W. Neil Murdoch  
President and Chief Executive Officer  
Connor, Clark & Lunn Capital Markets Inc.



Michael W. Freund  
Director  
Connor, Clark & Lunn Capital Markets Inc.

Toronto, Canada  
March 29, 2011

March 29, 2011

## Independent Auditor's Report

To the Unitholders of  
North American Financials Capital Securities Trust

We have audited the accompanying financial statements of North American Financials Capital Securities Trust (the Fund), which comprise the statement of investment portfolio as at December 31, 2010, the statements of net assets as at December 31, 2010 and 2009 and the statements of operations, changes in net assets and surplus (deficit) and cash flow for the year ended December 31, 2010 and the period from October 23, 2009 (commencement of operations) to December 31, 2009, and the related notes including a summary of significant accounting policies.

### 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 the 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 an audit 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 in our audits is sufficient and appropriate to provide a basis for our audit opinion.



**Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2010 and 2009 and the results of its operations, the changes in its net assets and surplus (deficit) and its cash flow for the year ended December 31, 2010 and the period from October 23, 2009 (commencement of operations) to December 31, 2010 in accordance with Canadian generally accepted accounting principles.

*Price Waterhouse Coopers LLP*

**Chartered Accountants, Licensed Public Accountants**

# North American Financials Capital Securities Trust

Statements of Net Assets

As at December 31, 2010 and 2009

	2010	2009
	\$	\$
<b>Assets</b>		
Cash	61,789	69,280
Short-term investments	-	299,821
Investments at fair value (cost - \$10,035)	8,685	-
Prepaid Forward Agreement (note 8)	69,290,845	66,728,231
Prepaid expenses and other receivables	6,931	-
	<u>69,368,250</u>	<u>67,097,332</u>
<b>Liabilities</b>		
Bank indebtedness (note 5)	13,470,000	14,400,000
Interest payable	80,413	35,064
Distributions payable	821,925	616,444
Accounts payable and accrued liabilities	174,377	511,247
Management fees payable	12,774	11,278
	<u>14,559,489</u>	<u>15,574,033</u>
<b>Net assets and unitholders' equity</b>	<u>54,808,761</u>	<u>51,523,299</u>
<b>Net Assets</b>		
<b>Class A Units</b>	53,955,331	50,725,982
<b>Class F Units</b>	<u>853,430</u>	<u>797,317</u>
	<u>54,808,761</u>	<u>51,523,299</u>
<b>Units issued and outstanding (note 6)</b>		
<b>Class A Units</b>	2,158,940	2,158,940
<b>Class F Units</b>	32,860	32,860
<b>Net assets per unit</b>		
<b>Class A Units</b>	24.99	23.50
<b>Class F Units</b>	25.97	24.26
<b>Unitholders' equity</b>		
Unit Capital (note 6)	47,427,033	50,726,464
Surplus	<u>7,381,728</u>	<u>796,835</u>
<b>Unitholders' equity - end of period</b>	<u>54,808,761</u>	<u>51,523,299</u>

Approved on behalf of the Manager,  
Connor, Clark & Lunn Capital Markets Inc.



Director



Director

# North American Financials Capital Securities Trust

## Statements of Operations

For the year ended December 31, 2010 and the period from October 23, 2009 (commencement of operations) to December 31, 2009

	2010	2009
	\$	\$
<b>Income</b>		
Interest income	170	234
<b>Expenses</b>		
Interest expense (note 5)	261,723	35,064
Forward fees (note 8)	238,502	42,359
Service fees (note 11)	217,570	39,780
Management fees (note 10)	145,788	24,962
Custodial and other unitholder fees	27,372	3,483
Administration fees	26,263	4,330
Audit fees	23,725	25,000
Transfer agent fees	14,907	2,765
Sustaining fees	11,001	3,020
Filing fees	10,165	13,000
Other	7,350	569
Legal fees	5,248	1,007
Printing and mailing fees	4,859	3,000
IRC fees	2,336	383
	996,809	198,722
<b>Investment income (loss)</b>	(996,639)	(198,488)
<b>Realized and unrealized gain (loss) on investments</b>		
Net realized gain (loss) on forward agreement (note 3 and 8)	322,524	-
Change in unrealized gain (loss) on investments	(1,350)	-
Change in unrealized gain (loss) on forward agreement (note 8)	7,260,358	995,323
	7,581,532	995,323
<b>Increase (decrease) in net assets from operations</b>	6,584,893	796,835
<b>Increase (decrease) in net assets from operations</b>		
Class A Units	6,479,308	783,594
Class F Units	105,585	13,241.00
<b>Increase (decrease) in net assets from operations per unit</b>		
Class A Units	3.00	0.37
Class F Unit	3.21	0.40

## North American Financials Capital Securities Trust

Statements of Changes in Net Assets and Surplus (Deficit)

For the year ended December 31, 2010 and the period from October 23, 2009 (commencement of operations) to December 31, 2009

	Class A		Class F		Total	
	2010	2009	2010	2009	2010	2009
	\$	\$	\$	\$	\$	\$
<b>Increase (decrease) in net assets from operations</b>	<u>6,479,308</u>	<u>783,594</u>	<u>105,585</u>	<u>13,241</u>	<u>6,584,893</u>	<u>796,835</u>
<b>Distributions to unitholders from:</b>						
Return of capital	<u>(3,238,410)</u>	<u>(607,202)</u>	<u>(49,290)</u>	<u>(9,242)</u>	<u>(3,287,700)</u>	<u>(616,444)</u>
<b>Unitholders' transactions (note 6)</b>						
Proceeds from issue of units	-	53,973,500	-	821,500	-	54,795,000
Agents' fees and issue expenses	<u>(11,549)</u>	<u>(3,423,910)</u>	<u>(182)</u>	<u>(28,182)</u>	<u>(11,731)</u>	<u>(3,452,092)</u>
	<u>(11,549)</u>	<u>50,549,590</u>	<u>(182)</u>	<u>793,318</u>	<u>(11,731)</u>	<u>51,342,908</u>
<b>Change in net assets during the year</b>	3,229,349	50,725,982	56,113	797,317	3,285,462	51,523,299
<b>Net assets - Beginning of year</b>	<u>50,725,982</u>	-	<u>797,317</u>	-	<u>51,523,299</u>	-
<b>Net assets - End of year</b>	<u>53,955,331</u>	<u>50,725,982</u>	<u>853,430</u>	<u>797,317</u>	<u>54,808,761</u>	<u>51,523,299</u>
<b>Surplus (deficit), beginning of year</b>	783,594	-	13,241	-	796,835	-
Increase (decrease) in net assets from operations	<u>6,479,308</u>	<u>783,594</u>	<u>105,585</u>	<u>13,241</u>	<u>6,584,893</u>	<u>796,835</u>
<b>Surplus (deficit), end of year</b>	<u>7,262,902</u>	<u>783,594</u>	<u>118,826</u>	<u>13,241</u>	<u>7,381,728</u>	<u>796,835</u>

# North American Financials Capital Securities Trust

## Statements of Cash Flow

For the year ended December 31, 2010 and the period from October 23, 2009 (commencement of operations) to December 31, 2009

	2010	2009
	\$	\$
<b>Operating Activities</b>		
Increase (decrease) in net assets from operations	6,584,893	796,835
Items not affecting cash:		
Change in unrealized (gain) loss on investments	1,350	-
Change in unrealized (gain) loss on forward agreement (note 8)	(7,260,358)	(995,323)
Net realized gain (loss) on forward agreement	(322,524)	-
Changes in non-cash working capital:		
(Increase) decrease in prepaid expenses	(6,931)	-
Increase (decrease) in interest payable	45,349	35,064
Increase (decrease) in accounts payable and accrued liabilities	(336,870)	511,247
Increase (decrease) in management fees payable	1,496	11,278
Forward Agreement	930,000	(65,732,908)
Fair value of Canadian Securities delivered by Counterparty under the forward agreement through partial pre-settlement	4,090,268	-
Purchase of investment portfolio	(10,035)	-
<b>Net cash flow provided by (used in) operating activities</b>	<u>3,716,638</u>	<u>(65,373,807)</u>
<b>Financing Activities</b>		
Proceeds from issuance of units	-	54,795,000
Unit issue costs	(11,731)	(3,452,092)
Distributions paid to unitholders	(3,082,219)	-
Proceeds from bank indebtedness	-	14,400,000
Principal payments on bank indebtedness	(930,000)	-
<b>Net cash flow provided by (used in) financing activities</b>	<u>(4,023,950)</u>	<u>65,742,908</u>
<b>Net increase (decrease) in cash</b>	(307,312)	369,101
<b>Cash and short-term notes - beginning of period</b>	<u>369,101</u>	<u>                    </u>
<b>Cash and short-term notes - end of period</b>	<u>61,789</u>	<u>369,101</u>
<b>Supplementary Information</b>		
Interest paid	216,374	-

## North American Financials Capital Securities Trust

Statement of Investments

As at December 31, 2010

	% Rate	Maturity date	Number of shares / Par value	Average cost \$	Fair value \$	% of net assets
<b>Investments</b>						
<b>Canadian common stocks</b>						
<b>Information Technology</b>						
Celestica Inc.			900	10,035	8,685	0.0%
<b>Total Canadian common stocks</b>				10,035	8,685	0.0%
<b>Forward agreement:</b>						
<b>Investments held in North American Portfolio Trust under the Forward Agreement with Bank of Montreal (note 8) <sup>(c)</sup></b>						
<b>Short-term investments</b>						
<b>Bankers Acceptance</b>						
Canadian Imperial Bank of Commerce		1/28/2011	250,000	249,320	249,320	0.5%
Bank of Nova Scotia		1/4/2011	300,000	299,571	299,571	0.5%
Canadian Imperial Bank of Commerce		2/22/2011	800,000	798,704	798,704	1.5%
<b>Bearer Deposit Notes</b>						
Bank of Nova Scotia		3/25/2011	950,000	947,093	947,093	1.7%
				2,294,688	2,294,688	4.2%
<b>Investments</b>						
<b>Fixed Income</b>						
<b>Domestic Corporate Bonds</b>						
Great-West Lifeco Finance Delaware LP II	7.13%	6/26/2018	865,000	974,593	967,813	1.8%
NBC Asset Trust	7.45%	6/30/2020	2,168,000	2,579,506	2,551,234	4.7%
RBC Capital Trust	6.82%	6/30/2018	2,355,000	2,748,423	2,712,832	4.9%
The Toronto-Dominion Bank	5.76%	12/18/2017	4,258,000	4,670,431	4,635,316	8.5%
NBC Asset Trust	7.24%	6/30/2018	4,300,000	4,925,848	4,957,895	9.0%
Manulife Financial Capital Trust II	7.41%	12/31/2019	6,326,000	7,066,037	6,911,962	12.6%
TD Capital Trust III	7.24%	12/31/2018	6,005,000	7,056,069	7,039,973	12.8%
				30,020,907	29,777,025	54.3%
<b>Foreign Corporate Bonds</b>						
Goldman Sachs Capital II (U.S. Dollars)	5.79%	6/1/2012	1,000,000	805,522	842,119	1.5%
Merrill Lynch & Co., Inc.	5.29%	5/30/2017	1,305,000	1,224,795	1,235,967	2.3%
Great-West Life & Annuity Insurance Co. (U.S. Dollars)	7.15%	5/16/2016	3,000,000	2,797,535	2,980,952	5.4%
Morgan Stanley	4.90%	2/23/2017	3,500,000	3,362,800	3,456,245	6.3%
Northgroup Preferred Capital Corp. (U.S. Dollars)	6.38%	10/15/2017	5,075,000	4,754,313	4,650,096	8.5%
JPMorgan Chase & Co. (U.S. Dollars)	7.90%	4/30/2018	5,000,000	5,436,052	5,281,203	9.6%
Wachovia Capital Trust III (U.S. Dollars)	5.80%	3/15/2049	7,000,000	5,470,471	6,033,943	11.0%
GE Capital Trust I (U.S. Dollars)	6.38%	11/15/2017	6,310,000	5,852,168	6,191,561	11.3%
				29,703,656	30,672,086	55.9%
<b>Total Fixed Income</b>				59,724,563	60,449,111	110.2%
<b>Foreign Preferred Stock (U.S. Dollars)</b>						
<b>Financials</b>						
Citigroup Capital XII			15,100	410,767	396,709	0.7%
Citigroup Capital XIII			200,000	5,251,206	5,341,865	9.7%
<b>Total Foreign Preferred Stock</b>				5,661,973	5,738,574	10.4%
<b>Total investments</b>				65,386,536	66,187,685	120.6%

## North American Financials Capital Securities Trust

Statement of Investments .... Continued

As at December 31, 2010

	<b>Maturity date</b>	<b>Contract price / rate \$</b>	<b>Fair value \$</b>	<b>Unrealized gain (loss) \$</b>	<b>% of Net Assets</b>
<b>Foreign currency forward contracts</b>					
Bought CAD 32,143,882, sold USD 31,914,100	03/21/11	1.0072	31,769,115	374,767	0.7%
Bought CAD 168,270, sold USD 164,700	03/21/11	1.0217	163,960	4,310	0.0%
				<u>379,077</u>	<u>0.7%</u>
<b>Other liabilities net of other assets of the North American Portfolio Trust</b>				<u>429,395</u>	<u>0.8%</u>
<b>Net assets of the North American Portfolio Trust</b>				<u>69,290,845</u>	<u>126.3%</u>
<b>Prepaid forward agreement</b>				<u>69,290,845</u>	<u>126.3%</u>
<b>Other liabilities net of other assets of the Fund</b>				<u>(14,490,769)</u>	<u>-26.3%</u>
<b>Net assets of the Fund</b>				<u>54,808,761</u>	<u>100.0%</u>

<sup>(1)</sup> North American Financials Capital Securities Trust (the "Fund") obtained exposure to the performance of the portfolio held by North American Portfolio Trust ("NAPT") through the Forward Agreement (see note 8), thus the portfolio of NAPT is presented as part of this statement.

(See accompanying notes to financial statements)

# North American Financials Capital Securities Trust

## Notes to Financial Statements

December 31, 2010 and 2009

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### 1 Corporate activities

North American Financials Capital Securities Trust (the "Fund") is an investment fund established under the laws of the Province of Ontario and governed by the Trust Agreement between Connor, Clark & Lunn Capital Markets Inc. (the "Manager") the Manager of the Fund and RBC Dexia Investor Services Trust (the "Trustee") dated September 28, 2009. The Fund's principal office is at 181 University Avenue, Suite 300, Toronto, Ontario M5H 3M7. The fiscal year-end of the Fund is December 31. The Fund is divided into units of two classes, Class A Units and Class F Units. Class A Units are listed on the Toronto Stock Exchange under the symbol NAF.UN. Class F Units are not listed on a stock exchange but may be converted into Class A Units on a weekly basis.

### 2 Investment objectives

The Fund's investment objectives as set out in the Prospectus dated September 28, 2009 are to:

- (i) provide Unitholders with attractive tax-advantaged quarterly cash distributions; and
- (ii) return to Unitholders the original issue price of the Units upon termination of the Fund on November 30, 2014.

Distributions are initially targeted to be \$1.50 per annum per Unit consisting primarily of returns of capital, representing a yield on the issue price of 6.0% per annum.

In order to achieve the Fund's investment objectives, the Fund obtained exposure, in a tax-efficient manner, to the performance of a portfolio (the "Portfolio") held by North American Portfolio Trust (the "NAPT" or the "Trust"). Connor, Clark & Lunn Investment Management Ltd. (the "Investment Manager"), the Trust's investment manager, actively manages the Portfolio. The Portfolio consisting primarily of in Canadian Innovative Tier 1 Capital Securities issued by banks (or entities related to banks) and U.S. Financials Capital Securities. The Investment Manager may also invest up to 15% of the Portfolio (measured at the time of investment) in other bonds with a minimum issuer rating of "A" by S&P.

### 3 Summary of significant accounting policies

#### Basis of presentation

These financial statements, prepared in accordance with Canadian generally accepted accounting principles, include estimates and assumptions by management that affect the reported amounts of assets, liabilities, income and expenses during the reporting period. Actual results could differ from these estimates. The following is a summary of the significant accounting policies of the Fund.

#### Future accounting changes

In February 2008, the Canadian Accounting Standards Board (the "AcSB") confirmed that the International Financial Reporting Standards ("IFRS") will replace current Canadian standards and interpretations as Canadian GAAP for publicly accountable enterprises effective January 1, 2011, which includes investment funds. The Fund will adopt IFRS on January 1, 2011. Management has commenced activities to identify key issues and the likely impacts resulting from the adoption of IFRS and is in the process of developing a changeover plan, which will include identifying differences between the Fund's current accounting policies and those it expects to apply under IFRS, as well as any accounting policy and implementation decisions and their resulting impact, if any, on NAV of the Funds. Management has presently determined that there will be no significant impact to NAV per Unit as a result of the changeover to IFRS but will continue to assess based on any changes to existing IFRS.

At its January 12, 2011 meeting, the AcSB decided to extend the deferral of mandatory adoption of IFRS for Investment Companies and Segregated Accounts of Life Insurance Enterprises. The decision is in response to the International Accounting Standards Board's announcement in late 2010 that its Investment Company project is delayed and will not likely be issued before January 1, 2012, which is the current date of mandatory adoption of IFRS for these entities. As a result, the Fund will delay implementation of IFRS until January 1, 2013.

The Fund's Manager has commenced activities to identify key issues and the likely impacts resulting from the adoption of IFRS and is in the process of developing a changeover plan, which will include identifying differences between the Fund's current accounting policies and those it expects to apply under IFRS, as well as any accounting policy and implementation decisions and their resulting impact, if any, on NAV of the Funds. Management has presently determined that there will be no significant impact to NAV per Unit as a result of the changeover to IFRS but will continue to assess based on any changes to existing IFRS.

#### Valuation of investments

Investments are deemed to be categorized as "held for trading" in accordance with CICA 3855, Financial Instruments – Recognition and Measurement ("Section 3855") and therefore are recorded at fair value, established by the closing bid price for a security on the recognized exchange on which it is principally traded ("GAAP Net Assets"). Should the quoted value for a security, in the opinion of the Manager, be inaccurate, unreliable or not readily available, the fair value of the security is estimated based on valuation techniques. Fair value is determined by the Manager on the basis of the most recently reported information for the security, similar securities and the markets in which the security is active. Investment purchase and sale transactions are recorded as of the trade date and realized and unrealized gains and losses on investments are determined using average cost. Brokers' commissions and other transaction charges are immediately charged to net income in the period incurred. The Canadian Securities Administrators allow investment funds to calculate the daily net asset value for the purpose of processing unitholder transactions using the last traded price for the day as fair value of financial instruments traded in an active market, which is referred to as a "Transactional NAV". The fund processes unitholder transactions using Transactional NAV.

The reconciliation between the Transactional NAV and the GAAP Net Assets as a result of the adoption of Section 3855 is as follows:

# North American Financials Capital Securities Trust

## Notes to Financial Statements

December 31, 2010 and 2009

	Transactional NAV	Section 3855 Adjustment	GAAP Net Assets
<b>Per Class A Unit</b>			
December 31, 2009	23.67	(0.17)	23.50
December 31, 2010	25.09	(0.10)	24.99
<b>Per Class F Unit</b>			
December 31, 2009	24.44	(0.18)	24.26
December 31, 2010	26.08	(0.11)	25.97

### Cash and short term investments

Cash and short term investments include cash and cash equivalents with maturities of less than 90 days from the date of acquisition.

### Income recognition

Income from investments is recognized on an accrual basis. Dividend income is recognized at the time a security trades on an ex-dividend basis. Interest income is based on the number of days the investment is held during the period. All income, realized and unrealized net gains (losses) and transaction costs (apart from an insignificant amount of income arising from cash) are attributable to investments and derivatives which are deemed held for trading.

### Foreign currency translation

Assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate prevailing at the end of the year. Purchases and sales of investments and income and expenses are translated into Canadian dollars at the exchange rate prevailing on the transaction dates.

### Increase (decrease) in net assets from operation per unit

This calculation is based on the increase (decrease) in net assets from operations attributable to each class divided by the weighted average number of units of that class outstanding during the period.

### Valuation of series

A separate net assets per unit is calculated for each class. The net assets of a class are computed by calculating the class' proportionate share of the assets and liabilities to all classes, less the liabilities attributable only to that class. Expenses directly attributable to a class are charged to that class. Other expenses, income, realized and unrealized gains and losses are allocated proportionately to each class based upon the relative net assets of each class.

## 4 Custodian

Pursuant to the Trust Agreement RBC Dexia Investor Services Trust ("the Custodian") acts as custodian of the assets of the Fund. The Custodian is also responsible for certain aspects of the Fund's day-to-day operations, including calculating the Net Asset Value ("NAV"), net income and net realized capital gains of the Fund and maintaining the books and records of the Fund. In consideration for these services, the Fund pays a fee to the Custodian.

## 5 Bank indebtedness

The Fund's exposure to the securities in the Portfolio through the Forward Agreement may be increased to 25% of the NAV (being the aggregate value of the assets of the NAPT) (computed daily) for the purposes of adding leverage to the Portfolio and such other short term funding purposes as may be determined by the Investment Manager from time to time and in accordance with the Investment Strategy. The use of leverage has the potential to enhance or reduce returns. Initially, the Fund is expected to employ leverage of 25% of the NAV of NAPT.

The Fund entered into a letter of agreement (the "Credit Agreement") dated October 23, 2009, between the Manager and the Bank of Montreal (the "Counterparty" or "BMO"), to borrow amounts up to 25% of the NAV of the NAPT as being part of the Forward Agreement (see note 8). This agreement will be terminated on the earlier of (i) November 21, 2014, and (ii) the date on which this Transaction is pre-settled in full pursuant to the terms of the Credit Agreement.

During the year ended December 31, 2010, the Fund had bank indebtedness balances between \$13.5 million and \$14.4 million or 19.2% to 21.5% of the NAV of NAPT. The related interest expense during the same period was \$261,723. At December 31, 2010, the borrowed balance was \$13,470,000 (during the period from October 23, 2009 (commencement of operation) to December 31, 2009, the Fund had bank indebtedness balances between \$0 and \$14,400,000 or 0.00% to 23.0% of the NAV of NAPT. The related interest expense during the same period was \$35,064. At December 31, 2009, the borrowed balance is \$14,400,000).

## 6 Unitholders' equity

The Fund is authorized to issue an unlimited number of redeemable, transferable units of Class A and Class F Units, each of which represents an equal, undivided interest in the net assets of the Fund, subject to the terms and conditions of the Trust Agreement.

A holder of Class F Units may convert Class F Units into Class A Units on a weekly basis.

# North American Financials Capital Securities Trust

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On October 23, 2009, the Fund completed an initial public offering pursuant to the prospectus dated September 28, 2009. \$50,000,000 was raised through the issue of 2,000,000 Class A Units and \$821,500 was raised through the issue of 32,860 Class F Units. The Class A Units were issued at \$25 per unit and incurred agents fees and issue expenses of \$3,215,301 or \$1.61 per unit, for an opening Transactional NAV of \$23.39 per unit. The Class F Units were issued at \$25 per unit and incurred agents fees and issue expenses of \$28,182 or \$0.86 per unit, for an opening Transactional NAV of \$24.14 per unit.

On November 6, 2009, the Agents exercised an over-allotment option in respect of 158,940 Class A Units, raising a further \$3,973,500. Agents' fees were \$208,609 or \$1.31 per unit. There were no capital transactions during the year ended December 31, 2010.

Class A Units and Class F Units may be redeemed on an Annual Redemption Date, subject to certain conditions and, in order to effect such a redemption, the Units must be surrendered by no later than 5:00 p.m. (Toronto time) on the last Business Day of March in the year of redemption. Unitholders whose Units are redeemed on an Annual Redemption Date will receive a redemption price in an amount equal to 100% of the Net Asset Value per Unit of the relevant class less any costs associated with the redemption, including brokerage costs, and less any net realized capital gains to the Fund that are distributed to a Unitholder concurrently with the proceeds of disposition on redemption.

In addition to the annual redemption right, Class A Units and Class F Units may also be redeemed on a Monthly Redemption Date, subject to certain conditions and, in order to effect such a redemption, the Units must be surrendered by no later than 5:00 p.m. (Toronto time) on the date which is the last Business Day of the month preceding the Monthly Redemption Date. Payment of the redemption price will be made on or before the Redemption Payment Date, subject to the Manager's right to suspend redemptions in certain circumstances. Concurrently with the payment of the proceeds of redemption, the Fund may pay to the redeeming Unitholder a cash distribution in the amount of the net realized capital gains of the Fund incurred by it to fund the payment of the redemption price. Unitholders surrendering a Class A Unit for redemption will receive a redemption price equal to the lesser of (i) 95% of the Market Price of a Class A Unit, and (ii) 100% of the Closing Market Price of a Class A Unit on the applicable Monthly Redemption Date less, in each case, any costs associated with the redemption, including brokerage costs, being the Monthly Redemption Amount. Unitholders surrendering a Class F Unit for redemption will receive an amount equal to the product of (i) the Monthly Redemption Amount and (ii) a fraction, the numerator of which is the most recently calculated Net Asset Value per Class F Unit and the denominator of which is the most recently calculated Net Asset Value per Class A Unit.

Changes in outstanding units during the year ended December 31, 2010 and during the period from October 23, 2009 (commencement of operation) to December 31, 2009 are summarized as follows:

	Class A Units		Class F Units	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
Balance – beginning of period/year	2,158,940	–	32,860	–
Units issued	–	2,158,940	–	32,860
Units redeemed	–	–	–	–
Units cancelled (note 7)	–	–	–	–
Balance – end of period/year	<u>2,158,940</u>	<u>2,158,940</u>	<u>32,860</u>	<u>32,860</u>

The Fund considers capital to include all units issued and outstanding. The Fund manages its capital in accordance with the objectives outlined in Note (2).

### 7 Market Purchase Program

The Trust Agreement provides that the Fund may, in its sole discretion, from time to time, purchase (in the open market or by invitation for tenders) Class A Units for cancellation subject to applicable law and stock exchange requirements, based on the Manager's assessment that such purchases are accretive to Unitholders, in all cases at a price per Class A Unit not exceeding the most recently calculated Net Asset Value per Class A Unit immediately prior to the date of any such purchase of Units.

During the year ended December 31, 2010 and during the period from October 23, 2009 (commencement of operation) to December 31, 2009, the Fund did not purchase any units for cancellation.

### 8 Forward Agreement

The Fund does not invest directly in the NAPT, the Fund used the net proceeds of the initial public offering of its Class A and Class F Units to pre-pay its purchase obligations under a forward purchase and sale agreement (the "Forward Agreement") with The Bank of Montreal (the "Counterparty" or "BMO") whose S&P credit rating was A+ as of December 31, 2010. Under the Forward Agreement, the Fund will receive, on or before June 30, 2014, a specified portfolio consisting of securities of Canadian public issuers that are "Canadian securities" for the purposes of the Tax Act ("Canadian Securities") in an amount equal to the value of the NAPT. Partial settlements under the Forward Agreement are intended to ensure that Unitholders have economic exposure to the distributions effected by NAPT. A fee of 0.35% per annum, calculated with reference to the net asset value of the NAPT, is payable to BMO under the Forward Agreement.

On December 31, 2010, the value of the prepaid amount to counterparty under forward agreement was \$61,035,432 (2009 - \$65,732,908). Since the Fund can at any time terminate the Forward Agreement with the Counterparty in exchange for the value of the NAPT, the value of the Forward Agreement to the Fund is equal to the value of the NAPT less the value of the prepaid amount to counterparty under the forward agreement. On December 31, 2010 the value of the unrealized gain on forward agreement balance was \$8,255,413 (2009 - \$995,323). Other liabilities net of other assets in the Fund totalled \$14,482,084 (2009 - \$15,204,932) leaving net assets of \$54,808,761 (2009 - \$51,523,299). This amount is assigned to Class A and Class F Unitholders using an allocation percentage that takes into consideration any class level specific expenses.

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### 9 Distributions

The Fund pays quarterly distributions at \$0.375 per Unit, representing a return of 6.0% per annum on the Unit issue price.

The Fund has made all its scheduled distributions since its commencement of operations on October 23, 2009. The Fund paid a total of \$1.50 per Class A and Class F Units during the year ended December 31, 2010 (\$0.28125 during the period from October 23, 2009 (commencement of operation) to December 31, 2009).

### 10 Management Fees

The Manager receives a Management Fee from the Fund and NAPT equal in the aggregate to 0.50% per annum of the applicable Net Asset Value, (0.25% from the Fund and 0.25% from the NAPT), calculated daily and payable monthly in arrears, plus applicable taxes.

The management fees charged to the Fund and the NAPT on a combined basis during the year ended December 31, 2010 were \$284,271 (\$49,924 during the period from October 23, 2009 (commencement of operation) to December 31, 2009). The Manager is responsible for payment of the investment management fees out of these management fees.

### 11 Service Fee

The Fund pays to the Manager a Service Fee (calculated quarterly and paid as soon as practicable after the end of each calendar quarter); solely with respect to the Class A Units, equal to 0.40% per annum of the Net Asset Value attributable to the Class A Units, plus applicable taxes. The Service Fee is applied by the Manager to pay a service fee in an equivalent aggregate amount, plus applicable taxes, to brokers based on the number of Class A Units held by clients of such brokers at the end of the relevant quarter. No Service Fee is payable in respect of the Class F Units.

The service fees charged to the Fund during the year ended December 31, 2010 were \$217,570 (\$39,780 during the period from October 23, 2009 (commencement of operation) to December 31, 2009).

### 12 Income taxes

The Fund qualifies as a mutual fund trust under the provisions of the Income Tax Act (Canada) and, accordingly, is subject to tax on its investment income, including net realized capital gains, for any calendar year in which its net investment income or sufficient net realized capital gains are not paid or payable to its unitholders as at the end of the calendar year. It is the intention of the Manager that all annual net investment income and sufficient net taxable capital gains will be distributed to unitholders on a calendar year basis such that Canadian income taxes payable by the Fund under present legislation will be eliminated. As a result thereof, and of the deduction of expenses in computing its taxable income, no provisions for income taxes are made in the financial statements.

The Fund did not have any net taxable capital losses carry forward balances as at December 31, 2010 and 2009, and had non-capital losses of \$1,790,826 (2009 – \$309,908), which will expire within the next twenty years as shown in the following table:

Year of the realized non-capital tax loss	Amount of tax loss	Expiry date
2009	309,908	2029
2010	1,480,918	2030
<b>Total</b>	<b>1,790,826</b>	

### 13 Broker commission charges and soft dollar services

There were \$nil of broker commissions paid during the year ended December 31, 2010 (\$nil during the period from October 23, 2009 (commencement of operation) to December 31, 2009) in connection with portfolio transactions. No contractual arrangements for soft dollar services exist in the broker commission charges.

### 14 Financial instruments

	December 31, 2010	December 31, 2009
<b>Assets</b>	\$	\$
Cash	61,789	69,280
Held for trading	69,299,530	67,028,052
Loans and receivables	6,931	–
<b>Total assets</b>	<b>69,368,250</b>	<b>67,097,332</b>
<b>Liabilities</b>		
Held for trading	–	–
Financial liabilities at amortized cost	14,559,489	15,574,033
<b>Total liabilities</b>	<b>14,559,489</b>	<b>15,574,033</b>

For the purposes of categorization in accordance with CICA Section 3862, Financial Instruments - Disclosures, bank indebtedness, interest payable, distributions payable, management fees payable and accounts payable and accrued liabilities are deemed to be financial liabilities and reported at amortized cost.

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The Fund obtained exposure to the performance of the portfolio held by NAPT through the Forward Agreement (see note 8), and therefore the following table illustrates the classification of the Fund's and the NAPT's financial instruments within the fair value hierarchy as at December 31, 2010 and 2009:

Assets at fair value as at December 31, 2010	Level 1	Level 2	Level 3	Total
Equities	5,738,574	–	–	5,738,574
Bonds	–	60,449,111	–	60,449,111
Short-term investments	–	2,294,688	–	2,294,688
Foreign currency forward contracts	–	379,077	–	379,077
<b>Total</b>	<b>5,738,574</b>	<b>63,122,876</b>	<b>–</b>	<b>68,861,450</b>

Assets at fair value as at December 31, 2009	Level 1	Level 2	Level 3	Total
Bonds	–	64,402,065	–	64,402,065
Short-term investments	–	1,898,949	–	1,898,949
Foreign currency forward contracts	–	300,638	–	300,638
<b>Total</b>	<b>–</b>	<b>66,601,652</b>	<b>–</b>	<b>66,601,652</b>

Fair values are classified as Level 1 when the related security or derivative is actively traded and a quoted price is available. If an instrument classified as Level 1 subsequently ceases to be actively traded, it is transferred out of Level 1. In such cases, instruments are reclassified into Level 2, unless the measurement of its fair value requires the use of significant unobservable inputs, in which case it is classified as Level 3.

*Equities:* The Fund's long equity positions are classified as Level 1 as the security held is actively traded and a reliable quote is observable.

*Bonds and short-term investments:* Bonds and Short-term investments are classified as Level 2 as they are valued using observable inputs, including interest rate curves, credit spreads and volatilities.

*Foreign currency forward contracts:* Foreign currency forward contracts for which inputs, including interest rates, forward market rates and credit spreads are observable and reliable, or for which unobservable inputs are determined not to be significant to fair value, are classified as Level 2.

There were no transfers among the three levels during the year ended December 31, 2010 or during the period from October 23, 2009 (commencement of operation) to December 31, 2009.

## 15 Financial instrument risk

The Fund obtained exposure to the performance of the portfolio held by NAPT through the Forward Agreement (see note 8) and therefore the risks associated with an investment in the Fund's units are best defined in conjunction with financial risks associated with an investment in the NAPT's portfolio.

### Interest rate risk

Interest rate risk arises on interest-bearing financial instruments held in the investment portfolio such as bonds and short term notes. The Fund is exposed to the risk that the value of interest-sensitive financial instruments will fluctuate due to changes in the prevailing levels of market interest rates. The table below summarizes the exposure of the Fund and NAPT interest rate risks. It includes the assets and liabilities of the Fund and NAPT at fair value.

#### December 31, 2010:

	Less than 1 year	1 - 3 years	3 - 5 years	> 5 years	Non-interest bearing	Total
Investments	–	842,119	59,606,992	–	6,126,336	66,575,447
Cash and cash equivalents	2,408,617	–	–	–	–	2,408,617
Other assets	–	–	–	–	415,474	415,474
Liabilities	(13,470,000)	–	–	–	(1,120,777)	(14,590,777)
<b>Net assets</b>						<b>54,808,761</b>

#### December 31, 2009:

	Less than 1 year	1 - 3 years	3 - 5 years	> 5 years	Non-interest bearing	Total
Investments	1,898,949	812,470	63,589,595	–	300,638	66,601,652
Cash and cash equivalents	97,858	–	–	–	–	97,858
Other assets	–	–	–	–	426,288	426,288
Liabilities	(14,400,000)	–	–	–	(1,202,499)	(15,602,499)
<b>Net assets</b>						<b>51,523,299</b>

As at December 31, 2010, had prevailing interest rates raised or lowered by 1.0%, with all other variables held constant, net assets would have decreased or increased, respectively, by approximately \$3,786,000 (2009 - \$4,220,000). In practise, actual results may differ from this sensitivity analysis and the difference could be material.

### Currency risk

Currency risk arises from financial instruments that are denominated in a currency other than the Canadian dollar, which is the Fund's functional currency. The Fund is exposed to the risk that the value of securities denominated in other currencies will fluctuate due to changes in exchange rates. The Statement of Investments identifies all securities denominated in foreign currencies.

The table below summarizes the Fund's combined exposure to foreign currencies held by the fund and NAPT. Amounts shown are based on the carrying values of monetary and non-monetary assets as well as the underlying principal amounts of foreign currency derivatives such as forward contracts. Other financial assets and liabilities such denominated in foreign currencies do not expose the Fund to significant currency risk. The table below summarizes the NAPT's significant exposure to foreign currencies and

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the approximate impact on net assets had the Canadian Dollar ("CAD") weakened by 5% in relation to these currencies. If the Canadian dollar were to strengthen relative to these currencies, the opposite would occur. In practice, actual results may differ from this sensitivity analysis and the difference could be material.

### December 31, 2010:

	Monetary instruments \$	Non-monetary instruments \$	Derivative instruments \$	Net Exposure \$	% of Net Assets	Sensitivity (based on devaluation of CAD) \$
US Dollar	25,986,691	5,738,574	(31,875,118)	(149,853)	(0.3%)	(7,000)

### December 31, 2009:

	Monetary instruments \$	Non-monetary instruments \$	Derivative instruments \$	Net Exposure \$	% of Net Assets	Sensitivity (based on devaluation of CAD) \$
US Dollar	24,990,185	–	(25,322,158)	(331,973)	(0.6%)	(17,000)

### Credit risk

The Fund is exposed to the risk that a security issuer or counterparty will be unable to pay amounts in full when due. The fair value of debt securities includes consideration of the credit worthiness of the debt issuer. The carrying amount of debt investments and unrealized gain on derivative instruments outstanding with counterparties represents the maximum credit risk exposure as at December 31, 2010 and 2009.

The tables below summarize the Fund's exposure to credit risk through its investment in NAPF as of December 31, 2010 and 2009. Amounts shown are based on the carrying value of debt investments and the unrealized gain on derivative instruments outstanding with counterparties.

	December 31, 2010 (% of Net Assets)
Rating <sup>(1)</sup>	
AAA	0.7%
A+	11.3%
A	53.6%
A-	20.5%
BBB+	23.3%
BBB-	1.5%
BB+	10.4%
A-1+	2.3%
A-1	1.4%
<b>Total</b>	<b>125.5%</b>

	December 31, 2009 (% of Net Assets)
Rating <sup>(1)</sup>	
AA-	13.7%
A+	11.7%
A	37.5%
A-	60.9%
BBB	1.6%
A-1+	2.3%
A-1	1.4%
<b>Total</b>	<b>129.1%</b>

As at December 31, 2010 and 2009, no debt securities were contractually past due and no longer meeting interest payment obligations.

All transactions in listed 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 have been received by the broker. The trade will fail if either party fails to meet its obligation.

### Liquidity risk

Liquidity risk is the risk of not being able to meet the Fund's cash requirements in a timely manner and includes the risk of not being able to liquidate assets at reasonable prices. This risk arises mainly from the Fund's exposure to daily cash redemptions from to its market purchase program which is limited to certain conditions (see note 7). The Fund is also exposed to unlimited annual anniversary redemptions on March 31 of every year (see note 6). Therefore, the Fund invests the majority of its assets in investments that can be readily disposed. In addition, the Fund retains sufficient cash and cash equivalent positions to meet its daily cash requirements. All liabilities (other than bank indebtedness) are due within three months.