

Palos Equity Income Fund

Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)



March 29, 2016

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 statements of financial position as at December 31, 2015 and 2014 and the statements of comprehensive income, changes in net assets attributable to holders of redeemable units and cash flows for years then ended, and the related notes, which comprise 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 International Financial Reporting Standards, 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 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.

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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, 2015 and 2014 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP¹

¹ CPA auditor, CA, public accountancy permit No. A106777

Palos Equity Income Fund

Statements of Financial Position

As at December 31, 2015 and 2014

(expressed in Canadian dollars)

	2015 \$	2014 \$
Assets		
Current assets		
Investments	20,163,672	20,646,877
Cash	154,653	455,982
Subscriptions receivable	-	112,416
Accrued income receivable	50,936	55,555
	<hr/>	<hr/>
	20,369,261	21,270,830
Liabilities		
Current liabilities		
Redemptions payable	-	13,518
Distributions payable	148,966	155,162
Accrued liabilities	29,983	33,440
Management fees payable	274	-
Performance fees payable	110,290	-
	<hr/>	<hr/>
	289,513	202,120
Net assets attributable to holders of redeemable units	<hr/>	<hr/>
	20,079,748	21,068,710
Net assets attributable to holders of redeemable units per series		
Series A	17,441,588	19,195,000
Series F	2,638,160	1,873,710
Net assets attributable to holders of redeemable units per series per unit		
Series A	5.93	6.73
Series F	6.13	6.92

Approved by the Manager, Palos Management Inc.

(s) Charles Marleau

(s) Peter Malouf

Director

Director

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund
Statements of Comprehensive Income
For the years ended December 31, 2015 and 2014

(expressed in Canadian dollars)

	Note	2015 \$	2014 \$
Income			
Dividend income		468,361	493,536
Interest income for distribution purposes		184,521	138,718
Other income		2,794	-
Other changes in fair value of investments			
Net realized gain on sale of investments		466,432	2,136,848
Net change in unrealized depreciation of investments		(459,584)	(1,055,982)
Total income (net)		<u>662,524</u>	<u>1,713,120</u>
Expenses			
Management fees	8	344,239	350,386
Performance fees	8	110,290	-
Administration and other professional fees		83,472	91,409
Trustee fees		13,759	13,769
Audit fees		35,570	39,680
Legal fees		40,031	41,115
Bank charges and interest		5,242	11,393
Independent review committee fees		11,968	11,999
Transaction cost		37,229	80,012
Withholding tax expense		7,965	13,661
Charges absorbed by the Manager		-	(6,200)
Total expenses (net)		<u>689,765</u>	<u>647,224</u>
Increase (decrease) in net assets attributable to holders of redeemable units		<u>(27,241)</u>	<u>1,065,896</u>
Increase (decrease) in net assets attributable to holders of redeemable units per series			
Series A		(5,157)	1,079,761
Series F		(22,084)	(13,865)
Increase (decrease) in net assets attributable to holders of redeemable units per series per unit			
Series A		0.00	0.40
Series F		(0.06)	(0.09)

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund

Statements of Changes in Net Assets Attributable to Holders of Redeemable Units

For the years ended December 31, 2015 and 2014

(expressed in Canadian dollars)

	Series A		Series F	
	2015 \$	2014 \$	2015 \$	2014 \$
Net assets attributable to holders of redeemable units – Beginning of year	19,195,000	17,642,743	1,873,710	670,669
Increase (decrease) in net assets attributable to holders of redeemable units	(5,157)	1,079,761	(22,084)	(13,865)
Distributions to holders of redeemable units				
From net realized gains on investments and derivatives	-	(1,585,525)	-	(49,646)
Return of capital	(2,297,497)	(576,264)	(314,109)	(102,198)
Total distributions to holders of redeemable units	<u>(2,297,497)</u>	<u>(2,161,789)</u>	<u>(314,109)</u>	<u>(151,844)</u>
Redeemable unit transactions				
Proceeds from redeemable units issued	1,410,816	4,008,660	1,464,974	1,777,981
Reinvestments of distributions to holders of redeemable units	1,711,293	1,566,984	286,176	136,082
Redemption of redeemable units	(2,572,867)	(2,941,359)	(650,507)	(545,313)
Net increase from redeemable unit transactions	<u>549,242</u>	<u>2,634,285</u>	<u>1,100,643</u>	<u>1,368,750</u>
Net increase (decrease) in net assets attributable to holders of redeemable units	<u>(1,753,412)</u>	<u>1,552,257</u>	<u>764,450</u>	<u>1,203,041</u>
Net assets attributable to holders of redeemable units – End of year	<u>17,441,588</u>	<u>19,195,000</u>	<u>2,638,160</u>	<u>1,873,710</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, 2015 and 2014

(expressed in Canadian dollars)

	2015	2014
	\$	\$
Cash flows from operating activities		
Increase (decrease) in net assets attributable to holders of redeemable units	(27,241)	1,065,896
Adjustments for		
Foreign exchange loss (gain) on cash	(143,777)	17,638
Net change in unrealized depreciation (appreciation) of investments	459,584	1,055,982
Proceeds from sale and maturity of investments	20,261,098	35,591,505
Purchases of investments	(19,771,045)	(37,044,774)
Net realized gain on sale of investments	(466,432)	(2,136,848)
Accrued income receivable	4,619	4,094
Accrued liabilities	(3,457)	3,614
Management fees payable	274	-
Performance fees payable	110,290	-
Net cash from (used in) operating activities	423,913	(1,442,893)
Cash flows from financing activities		
Distributions paid to holders of redeemable units, net of reinvested distributions	(620,333)	(593,436)
Proceeds from issuance of redeemable units	2,988,206	5,714,725
Amount paid on redemption of redeemable units	(3,236,892)	(3,474,677)
Net cash from (used in) financing activities	(869,019)	1,646,612
Foreign exchange gain (loss) on cash	143,777	(17,638)
Net change in cash during the year	(301,329)	186,081
Cash – Beginning of year	455,982	269,901
Cash – End of year	154,653	455,982
Supplementary information on cash flows from operating activities		
Interest received	189,727	143,959
Dividends received, net of withholding taxes	502,113	478,776

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund

Schedule of Investment Portfolio

As at December 31, 2015

(expressed in Canadian dollars)

	Maturity date	Coupon or dividend rate	Number of shares or par value	Average cost \$	Fair value \$
Bonds					
Convertible bonds					
Boralex Inc.	June 30, 2020	4.500%	300,000	300,000	304,500
Chemtrade Logistics Inc.	June 30, 2021	5.250%	240,000	240,000	239,400
DH Corp.	Sept. 30, 2030	5.000%	350,000	350,000	358,750
Element Financial Corp.	June 30, 2019	5.125%	250,000	259,525	297,500
Emera Inc.	Sept 29, 2025	4.000%	350,000	116,550	120,575
Northland Power Inc.	June 30, 2020	4.750%	250,000	250,000	258,750
Total convertible bonds				<u>1,516,075</u>	<u>1,579,475</u>
Corporate bonds					
Canadian Energy Services & Technology Corp.	April 17, 2020	7.375%	250,000	264,375	230,000
DHX Media Ltd.	Dec. 2, 2021	5.875%	500,000	500,000	487,500
Parkland Fuel Corp.	May 28, 2021	5.500%	200,000	200,000	200,000
Total corporate bonds				<u>964,375</u>	<u>917,500</u>
Total bonds				<u>2,480,450</u>	<u>2,496,975</u>
Common stocks					
Consumer discretionary					
Cineplex Inc.			5,000	221,249	237,750
DHX Media Ltd.			37,000	301,873	313,390
Dollarama Inc.			4,500	354,006	359,730
Enercare Inc.			16,000	208,000	255,360
Gildan Activewear Inc.			7,000	277,750	275,380
Goeasy Ltd.			6,000	126,399	113,700
Magna International Inc.			6,000	144,323	336,720
Restaurant Brands International			8,000	396,139	414,000
Sleep Country Canada Holding			32,500	534,954	560,300
Stingray Digital			57,000	435,600	351,690
Total consumer discretionary				<u>3,000,293</u>	<u>3,218,020</u>
Consumer staples					
Alimentation Couche-Tard – Class B			6,000	241,285	365,460
Maple Leaf Foods Inc.			14,000	301,883	332,640
Total consumer staples				<u>543,168</u>	<u>698,100</u>

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund
Schedule of Investment Portfolio ... *continued*
As at December 31, 2015

(expressed in Canadian dollars)

	Number of shares or par value	Average cost \$	Fair value \$
Energy			
Altagas Ltd.	11,000	479,414	339,900
ARC Resources Ltd.	19,000	334,446	317,900
Canadian Energy Services & Technology	30,000	274,046	116,400
Enbridge Inc.	6,250	340,184	287,500
Keyera Corp.	18,084	596,656	728,062
Lonestar West Inc.	50,000	142,200	35,000
Secure Energy Services Inc.	51,100	659,542	427,196
Tamarack Valley Energy Ltd.	75,000	199,500	224,250
Tidewater Midstream and Infrastructure	200,000	264,250	288,000
Vermilion Energy Inc.	5,112	268,252	192,262
Whitecap Resources Inc.	48,000	583,817	435,360
Total energy		<u>4,142,307</u>	<u>3,391,230</u>
Financials			
American Hotel Income Properties REIT	25,500	243,542	271,575
Boardwalk Real Estate Investment	6,100	283,751	289,445
Goldman Sachs Group Inc.	1,600	316,613	398,755
Intact Financial Corp.	4,200	385,243	372,456
Interrent REIT	50,000	309,840	328,000
Manulife Financial Corp.	13,000	279,500	269,620
Onex Corp.	3,000	188,235	254,460
Royal Bank of Canada	10,000	755,462	741,500
Sun Life Financial Inc.	12,000	453,658	517,800
Toronto-Dominion Bank Corp.	13,514	534,390	732,999
Units-Granite REIT – Staple	12,030	435,406	456,659
SunTrust Banks Inc.	3,780	108,081	223,924
Wells Fargo & Co	6,260	221,533	470,558
Wintrust Financial Corp.	2,200	144,969	147,606
Total financials		<u>4,660,223</u>	<u>5,475,357</u>
Health care			
Concordia Healthcare Corp.	8,000	207,643	452,320
Industrials			
Badger Daylighting Ltd.	8,700	237,795	212,454
Canadian Pacific Railway Ltd.	1,250	247,309	220,913
Dirtt Environmental Solutions	25,000	184,937	173,500
GDI Integrated Facility Services Inc.	20,000	383,000	276,800
Heroux-Devtek Inc.	12,000	141,000	154,200
Morneau Shepell Inc.	13,635	142,329	197,435
WSP Global Inc.	9,000	339,002	382,590
Total industrials		<u>1,675,372</u>	<u>1,617,892</u>

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund
Schedule of Investment Portfolio ... *continued*
As at December 31, 2015

(expressed in Canadian dollars)

	Number of shares or par value	Average cost \$	Fair value \$
Information technology			
CGI Group Inc. – Class A	4,000	227,998	221,600
DH Corp.	6,000	236,194	189,720
Total information technology		<u>464,192</u>	<u>411,320</u>
Materials			
Agrium Inc.	2,684	288,594	331,930
CCL Industries Inc. – Class B	2,400	308,475	538,488
Detour Gold Corp.	25,000	332,843	360,250
Lundin Mining Corp.	75,000	403,675	285,000
Nevsun Resources Ltd.	35,000	140,018	131,250
Silver Wheaton Corp.	10,000	178,033	172,000
Total materials		<u>1,651,638</u>	<u>1,818,918</u>
Utilities			
Crius Energy Trust	10,000	80,500	88,000
Hydro One Ltd.	8,000	164,000	178,320
Northland Power Inc.	17,000	267,564	317,220
Total utilities		<u>512,064</u>	<u>583,540</u>
Total common stock		<u>16,856,900</u>	<u>17,666,697</u>
Total investments		<u>19,337,350</u>	<u>20,163,672</u>

The accompanying notes are an integral part of these financial statements.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

1 General information

Palos Equity Income Fund (the Fund) was formed in January 3, 2008 under the laws of the Province of Quebec pursuant to a trust agreement (the agreement), as amended for the last time on August 26, 2013, and between Computershare Trust Company of Canada (the trustee) and Charles Marleau (the settlor). The address of the Fund's registered office is 1 Place Ville-Marie, Suite 1670, Montréal, Quebec. The Fund is an open-ended mutual fund, is qualified as a unit trust and is a registered investment under Section 204.4 of the Income Tax Act (Canada).

Series A opened on January 3, 2008 and series F on February 24, 2012.

The Fund acts as an investment holding unit trust for the benefit of unitholders by acquiring, investing in, holding, transferring, disposing of, or otherwise dealing with such investments as the trustee and the investment fund manager determine, at their discretion, in accordance with the investment objectives of the Fund which are to preserve capital, to provide an attractive and steady stream of income and to deliver trading-enhanced returns.

The investment fund manager and portfolio advisor is Palos Management Inc. (the Manager).

These financial statements have been authorized for issue by the Board of Directors of the Manager on March 29, 2016.

2 Basis of presentation and adoption of IFRS

These financial statements have been prepared in compliance with International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board (IASB).

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

3 Summary of significant accounting policies

Financial instruments

Recognition

Regular way purchases and sales of financial assets are recognized at their trade date. The Fund's investment assets and liabilities are measured at fair value through profit or loss (FVTPL), including certain investments in debt securities which have been designated at FVTPL. The Fund's non-derivative investments are designated at FVTPL upon initial recognition and all derivatives are classified in this category as held for trading. The Fund's obligation for net assets attributable to holders of redeemable units is classified as a financial liability and is measured at amortized cost which corresponds to the redemption amount. The redemption amount is determined as the net difference between total assets and all other liabilities for which accounting policies are described herein. All other financial assets and financial liabilities are classified as loans and receivables and other financial liabilities respectively and are measured at amortized cost. Under this method, financial assets and financial liabilities reflect the amount required to be received or paid, discounted, when appropriate, at the contract's effective interest rate. The Fund's accounting policies for measuring the fair value of its investments and derivatives are identical to those used in measuring its net asset value (NAV) for transactions with unitholders.

Income recognition

The interest income for distribution purposes shown on the statements of comprehensive income represents the contractual interest accounted for on an accrual basis. The Fund does not amortize premiums paid or discounts received on the purchase of fixed income securities except for zero coupon bonds and loans which would be amortized on a straight-line basis.

Realized gain/loss on sale of investments and unrealized appreciation/depreciation in investments are determined on an average cost basis. Average cost does not include amortization of premiums or discounts on fixed income securities with the exception of zero coupon bonds.

Fair value measurement

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of financial assets and financial liabilities traded in active markets (such as publicly traded derivatives and marketable securities) are based on quoted market prices at the close of trading on the reporting date. The Fund uses the last traded market price for both financial assets and financial liabilities where the last traded price falls within that day's bid-ask spread. In circumstances where the last traded price is not within the bid-ask spread, the Manager determines the point within the bid-ask spread that is most representative of fair value based on the specific facts and circumstances.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

The fair value of financial assets and financial liabilities that are not traded in an active market, including over-the-counter derivatives, is determined using valuation techniques. The Fund uses a variety of methods and makes assumptions that are based on market conditions existing at each reporting date. Valuation techniques include the use of comparable recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, option pricing models and others commonly used by market participants and which make the maximum use of observable inputs.

Classification of redeemable units

The Fund's outstanding redeemable units are in different series which do not have identical features. Consequently, the Fund's outstanding redeemable units are classified as financial liabilities in accordance with the requirements of International Accounting Standard (IAS) 32, Financial Instruments: Presentation.

Foreign currency translation

The Fund's subscriptions and redemptions are denominated in Canadian dollars, which is also its functional and presentation currency. Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates that transactions occur. Foreign currency assets and liabilities denominated in a foreign currency are translated into the functional currency using the exchange rate prevailing at the measurement date. Foreign exchange gains and losses relating to cash and to other financial assets and financial liabilities are presented as "Net realized gain on sale of investments" and "Net change in unrealized appreciation (depreciation) of investments" in the statement of comprehensive income.

Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset in the Fund's statement of financial position when and only when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the asset and settle the liability simultaneously. The Fund has a legally enforceable right to offset a financial asset and financial liability when such right is enforceable in the normal course of business and in the event of default, insolvency or bankruptcy.

Over-the-counter derivatives, securities lending, repurchase agreements and receivable for investments sold and payable for investments purchased are subject to master netting or similar agreements that do not meet the criteria for offsetting in the statement of financial position as they give a right to set-off that is enforceable only in the event of default, insolvency or bankruptcy.

Cash

Cash comprises deposits with financial institutions and bank overdraft.

Increase (decrease) in net assets attributable to holders of redeemable units per unit

The increase (decrease) in net assets attributable to holders of redeemable units per unit is calculated by dividing the increase (decrease) in net assets attributable to holders of redeemable units by the weighted average number of units outstanding during the year.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

Taxation

The Fund qualifies as a mutual fund trust under the Income Tax Act (Canada). All of the Fund's net income for tax purposes and sufficient net capital gains realized in any year are required to be distributed to unitholders such that no income tax is payable by the Fund. As a result, the Fund does not record income taxes. Since the Fund does not record income taxes, the tax benefit of capital and non-capital losses has not been reflected in the statement of financial position as a deferred income tax asset.

The Fund currently incurs withholding taxes imposed by certain countries on investment income and capital gains. Such income and gains are recorded on a gross basis and the related withholding taxes are shown as a separate expense in the statement of comprehensive income.

Accounting standards issued but not yet adopted

IFRS 9 – Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9, Financial Instruments, which replaces IAS 39, Financial Instruments: Recognition and Measurement. IFRS 9 covers requirements related to the classification and measurement of financial assets and financial liabilities, the impairment of financial assets, and hedge accounting.

IFRS 9 establishes a new classification and measurement model for financial assets to determine whether a financial asset must be classified as measured at amortized cost, at fair value through profit or loss or at fair value through other comprehensive income. This model is based on the characteristics of the contractual cash flows of the financial asset and on the business model under which it is held. For the classification and measurement of financial liabilities, the new standard essentially follows the current requirements under IAS 39.

The standard also introduces a single impairment model for financial assets that requires recognizing expected credit losses instead of incurred losses, which is the requirement under the current impairment model. The model provides for a multi-phase approach based on changes in credit quality since initial recognition.

Lastly, IFRS 9 includes a new hedge accounting model to align hedge accounting more closely with risk management activities.

The effective date of IFRS 9 was set for annual years beginning on or after January 1, 2018. The Fund is currently assessing the impact of adopting this standard and has not yet determined if it will early adopt the new standard.

IFRS 7 – Financial Instruments Disclosures

IFRS 7 is effective for annual periods beginning on or after January 1, 2018. Amendments to IFRS 7 consist of additional disclosures required for the transition from IAS 39 to IFRS 9.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

4 Critical accounting estimates and judgments

The preparation of financial statements requires management to use judgment in applying its accounting policies and to make estimates and assumptions about the future. The following discusses the most significant accounting judgments and estimates that the Fund has made in preparing the financial statements:

a) Fair value measurement of derivatives and securities not quoted in an active market

The Fund may hold financial instruments that are not quoted in active markets, including derivatives. Fair values of such instruments are determined using valuation techniques and may be determined using reputable pricing sources or indicative prices from market makers. Broker quotes as obtained from the pricing sources may be indicative and not executable or binding. Where no market data is available, the Fund may value positions using its own models, which are usually based on valuation methods and techniques generally recognized as standard within the industry. The models used to determine fair values are validated and periodically reviewed by experienced personnel of the Manager. The models used for private equity securities are based mainly on earnings multiples adjusted for a lack of marketability as appropriate.

Models use observable data, to the extent practicable. However, areas such as credit risk (both own and counterparty), volatilities and correlations require the Manager to make estimates. Changes in assumptions about these factors could affect the reported fair values of financial instruments. The Fund considers observable data to be market data that is readily available, regularly distributed and updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

b) Classification and measurement of investment and application of the fair value option

In classifying and measuring financial instruments held by the Fund, the Manager is required to make significant judgments about whether or not the business of the Fund is to invest on a total return basis for the purpose of applying the fair value option for financial assets under IAS 39. The most significant judgments made include the determination that the fair value option can be applied to all investments as the Fund is managed on a fair value basis.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

5 Risks associated with financial instruments

Risk factors

The Fund's activities expose it to a variety of risks associated with financial instruments, as follows: credit risk, liquidity risk, market risk (including currency risk, interest rate risk and price risk) and concentration risk. The Fund's overall risk management program seeks to maximize the returns derived for the level of risk to which the Fund is exposed and seeks to minimize potential adverse effects on the Fund's financial performance. All investments result in a risk of loss of capital. These risks are moderated through careful selection of securities and other financial instruments within the Fund's investment guidelines. The risks are measured using a method that reflects the expected impact on the results and net assets attributable to unitholders of the Fund from reasonably possible changes in the relevant risk variables.

Credit risk

The Fund is exposed to credit risk, which is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. The majority of the credit risk to which the Fund is exposed arises from its investments in debt securities. In selecting fixed income securities for the Fund, the Manager considers factors such as the debt security's yield, risk of interest rate fluctuation, credit risk, the issuer's capital structure, credit spread and duration. The analysis below summarizes the credit quality of the Fund's debt portfolio as at December 31, 2015 and 2014.

	<u>December 31, 2015</u>	<u>December 31, 2014</u>
Credit rating	Total fixed income %	Total fixed income %
BBB	-	3.7
BB	27.5	25.4
B	9.2	15.8
Non-rated	63.3	55.1
	<hr/> 100.0	<hr/> 100.0

Source: Standard & Poor's

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. In addition, the Fund lodges its cash with quality institutions which have credit ratings of A- or above. Credit risk with respect to accrued income receivable is limited as the receivables are derived from a portfolio of diversified investments.

The Fund's maximum exposure to credit risk is equal to the carrying value of the assets presented on the statement of financial position. The Fund does not anticipate any significant losses from the non-performances of counterparties.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2015 and 2014

(expressed in Canadian dollars)

Liquidity risk

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations associated with financial liabilities. The Fund is exposed to daily cash redemptions. Financial liabilities that potentially subject the Fund to liquidity risk consist of accrued liabilities, management and performance fees payable, redemptions payable and distributions payable. The Fund's investment approach focuses on investing in highly liquid securities and moderately liquid securities, which are therefore readily saleable to meet liquidity needs.

The Fund may invest in debt securities and unlisted equity investments that are not traded in an active market. As a result, the Fund may not be able to quickly liquidate its investments in these instruments at amounts which approximate their fair values, or be able to respond to specific events such as deterioration in the creditworthiness of any particular issuer. In accordance with the Fund's policy, the Manager monitors the Fund's liquidity position on a daily basis. The tables below analyze the Fund's financial liabilities into relevant maturity groupings based on the remaining period to the contractual maturity date. The amounts in the tables are the contractual undiscounted cash flows.

Financial liabilities	December 31, 2015		
	On demand \$	< 3 months \$	Total \$
Distributions payable	-	148,966	148,966
Accrued liabilities	-	29,983	29,983
Management fees payable	-	274	274
Performance fees payable	-	110,290	110,290
Redeemable units	20,079,748	-	20,079,748

Financial liabilities	December 31, 2014		
	On demand \$	< 3 months \$	Total \$
Redemptions payable	-	13,518	13,518
Distributions payable	-	155,162	155,162
Accrued liabilities	-	33,440	33,440
Redeemable units	21,068,710	-	21,068,710

Redeemable units are redeemable on demand at the holder's option. However, the Manager does not expect that the contractual maturity disclosed above will be representative of the actual cash outflows, as holders of these instruments typically retain them for a longer period.

Market risk

The Fund's investments are subject to market risk which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. To monitor the risk, the Fund's Manager 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 losses from abnormal events are not above the Fund's risk tolerance.

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The following include sensitivity analyses that show how the net assets attributable to holders of redeemable units would have been affected by a reasonably possible change in the relevant risk variable at each reporting date. In practice, the actual results may differ and the difference could be material.

a) Currency risk

The Fund invests in monetary assets denominated in currencies other than the Canadian dollar. These investments result in currency risk, which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The table below indicates the foreign currencies to which the Fund had significant exposure as at December 31, 2015 and 2014, in Canadian dollars. The table also illustrates the potential impact on the net assets attributable to holders of redeemable units if the Canadian dollar had strengthened or weakened by 5% in relation to each of the other currencies, with all other variables held constant. The monetary exposure presents the impact on cash and the non-monetary exposure presents the impact on investments. Non-monetary items are investments in equity securities and are classified based on the currency in which they were purchased.

December 31, 2015						
Currency	Exposure			Impact on net assets attributable to holders of redeemable units and the increase (decrease) thereof		
	Monetary \$	Non- monetary \$	Total \$	Monetary \$	Non- monetary \$	Total \$
United States dollar	895,965	1,240,843	2,136,808	44,798	62,042	106,840
% of net assets attributable to holders of redeemable units	4.5%	6.2%	10.7%	0.2%	0.3%	0.5%
December 31, 2014						
Currency	Exposure			Impact on net assets attributable to holders of redeemable units and the increase (decrease) thereof		
	Monetary \$	Non- monetary \$	Total \$	Monetary \$	Non- monetary \$	Total \$
United States dollar	(175,329)	2,133,996	1,958,667	(8,766)	106,700	97,934
% of net assets attributable to holders of redeemable units	(0.8%)	10.1%	9.3%	0.0%	0.5%	0.5%

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b) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Fund holds securities with fixed interest rates that expose the Fund to fair value interest rate risk. The Fund also holds a limited amount of cash subject to variable interest rates which exposes the Fund to cash flow interest rate risk.

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 at fair value, categorized by the earlier of contractual interest rate reset dates or maturity dates. The table also illustrates the potential impact on the net assets attributable to holders of redeemable units if the prevailing levels of market interest rates changed by 1%, assuming a parallel shift in the yield curve with all other variable held constant.

Terms to maturity	Total exposure	
	December 31, 2015 \$	December 31, 2014 \$
1-5 years	1,449,500	1,287,357
5-10 years	1,047,475	1,464,075
Total	2,496,975	2,751,432
Impact on net assets attributable to holders of redeemable units	47,717	147,988
Impact on net assets attributable to holders of redeemable units (%)	0.2%	0.7%

c) Price risk

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 price risk through its equity investment portfolio, which includes a variety of common shares in a wide range of industries. Other assets and liabilities are monetary items that are short term in nature, and as such are not subject to price risk.

As at December 31, 2015, the expected increase or decrease in net assets attributable to holders of redeemable units of the Fund if the S&P/TSX composite index had increased or decreased by 5%, with all other variables held constant would be \$943,748 and would represent 4.7% of the net assets attributable to holders of redeemable units of the Fund (December 31, 2014 – \$531,679 and represent 2.52% of the net assets attributable to holders of redeemable units of the Fund).

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Concentration risk

Concentration risk arises as a result of the concentration of exposure within the same category, whether it is geographical location, product type, industry sector or counterparty type. The following is a summary of the Fund's concentration risk of the market segment over the total investments market value:

Market segment	December 31, 2015 %	December 31, 2014 %
Consumer discretionary	18.4	12.0
Consumer staples	3.5	2.5
Energy	19.0	21.2
Financials	28.6	31.4
Health care	2.2	1.5
Industrials	8.0	10.9
Information technology	3.8	4.7
Materials	10.2	14.8
Utilities	6.3	1.0

Asset class weighting	December 31, 2015 %	December 31, 2014 %
Convertible bonds	7.9	6.9
Corporate bonds	4.6	6.2
Common stocks	88.0	84.9
Other net assets	(0.5)	2.0

Fair value measurement

The carrying amounts of accrued income receivable, accrued liabilities, redemptions payable, distributions payable and management and performance fees payable approximate their fair values due to the short-term nature of these financial instruments.

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: unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date;
- Level 2: 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: valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

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	As at December 31, 2015			
	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities, long	17,666,697	-	-	17,666,697
Fixed income, long	1,579,475	917,500	-	2,496,975

	As at December 31, 2014			
	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities, long	17,895,445	-	-	17,895,445
Fixed income, long	1,449,300	1,302,132	-	2,751,432

All fair value measurements above are recurring. 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, the 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.

a) Equities and convertible bonds

The Fund's equity and convertible bond positions are classified as Level 1 when the security is actively traded and a reliable price is observable. All equities and convertible bonds are classified as Level 1 investments.

b) Bonds and short-term investments

Corporate bonds are valued using models with inputs including interest rate curves, credit spreads and volatilities. The inputs that are significant to valuation are generally observable and therefore the Fund's bonds and short-term investments have been classified as Level 2.

There was no transfer between levels during the years.

6 Gains and losses on financial instruments by category

All of the Fund's non-derivative financial assets were designated, at inception, as financial assets at fair value through profit and loss (FVTPL). As at December 31, 2015, the total value of the non-derivative assets and liabilities was \$20,163,672 (2014 – \$20,646,877). All of the Fund's derivative liabilities are classified as held for trading (HFT). As at December 31, 2015, the total value of the derivative liabilities was nil (2014 – nil). Furthermore, all of the Fund's financial assets and financial liabilities other than its non-derivative financial assets and financial liabilities and its derivative liabilities were carried at amortized cost.

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The following table presents the net gains (losses) on financial instruments at FVTPL by category for the years ended December 31, 2015 and 2014:

Category	Net gain (loss)	
	2015 \$	2014 \$
Financial assets at FVTPL designated at inception		
Unrealized loss	(459,584)	(1,059,182)
Realized gain	434,037	2,079,318
Total financial assets at FVTPL designated at inception	(25,547)	1,020,136
Financial liabilities at FVTPL held for trading		
Unrealized gain	-	3,200
Realized gain	32,395	57,530
Total financial liabilities at FVTPL held for trading	32,395	60,730
Total	6,848	1,080,866

7 Redeemable units

During the years ended December 31, 2015 and 2014, the number of units issued, redeemed and outstanding were as follows:

	2015		2014	
	Series A	Series F	Series A	Series F
Units outstanding – Beginning of year	2,851,909	270,625	2,489,066	93,017
Redeemable units issued	210,056	213,093	546,807	235,577
Redeemable units issued on reinvestments	270,639	43,927	218,278	18,690
Redeemable units redeemed	(391,467)	(97,391)	(402,242)	(76,659)
Units outstanding – End of year	2,941,137	430,254	2,851,909	270,625

Capital structure

Units issued and outstanding are considered to be the capital of the Fund. The Fund does not have any specific capital requirements.

The Fund is authorized to issue an unlimited number of redeemable unit series, as well as an unlimited number of redeemable units within each series. Each series unit enables its bearer to participate equally in the allocations the Fund completes for the given series. Unit fractions may also be issued.

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The Fund is composed of more than one redeemable unit series; each redeemable unit series may feature different structures regarding management fees, performance fees and brokerage. As a result, each redeemable unit entitles its holder to one vote and to participate equally in the allocations the Fund completes and, in the case of Fund liquidation, in the allocation of the redeemable unit series' net assets attributable to holders of redeemable units after all current liabilities have been paid.

8 Related party transactions

a) Management fees and performance fees

The Manager provides management and advisory services to the Fund in accordance with the agreement. In return for these services, the Manager is paid a management fee and a performance fee. The Series A units of the Fund are subject to a monthly management fee equal to 1/12 of 1.5% of the net asset value of the Series A units. The Manager will pay a trailer fee of 0.75% out of the management fees collected from the Fund with respect to Series A units.

Series F is similar to Series A, but no trailer fee is included in the management fee. Series F charges a monthly management fee of 1/12 of 0.75% of the net asset value of series F.

Based on the agreement amended and restated on August 26, 2013, the performance fee is 20% of the amount by which the Fund outperforms its benchmark, the S&P/TSX Composite Index. Performance fees are calculated and accrued daily, and paid annually.

The total management fees and performance fees for the year ended December 31, 2015 were \$344,239 and \$110,290 respectively (2014 – \$350,386 and nil respectively), with \$110,564 in outstanding fees due to the Manager as at December 31, 2015 (2014 – nil).

The Manager may waive or absorb the operation of management fees of the Fund. The decision to do so is reviewed regularly and is determined at the sole discretion of the Manager. During the year, the Manager did not waive any fees (2014 – \$5,610 for series A and \$590 for series F).

The Manager holds 59,353 units of the Fund as at December 31, 2015 (2014 – 52,405).

b) Independent Review Committee fees

The total remuneration paid to members of the Independent Review Committee during the year ended December 31, 2015 was \$11,968 (2014 – \$11,999) and consisted only of fixed fees.

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9 Brokerage commissions and soft dollars

The total commissions paid by the Fund to brokers in connection with portfolio transactions for the years ended December 31, 2015 and 2014, together with other transaction charges, are disclosed in the statement of comprehensive income of the Fund. Brokerage business is allocated to brokers based on the best net result for the Fund. Subject to this criteria, preference may be given to brokerage firms which provide (or pay for) certain services (arrangements referred to as soft dollar), which may include investment research, analysis and reports, and data bases or software in support of these services. The ascertainable soft dollar value received as a percentage of total brokerage commissions paid during the years ended December 31, 2015 and 2014 is disclosed below.

	2015	2014
Soft dollars	\$9,099	\$6,120
Percentage of total transaction costs (%)	24%	8%

10 Increase (decrease) in net assets attributable to holders of redeemable units per series per unit

The increase (decrease) in net assets attributable to holders of redeemable units per series per unit for the years ended December 31, 2015 and 2014 is calculated as follows:

	2015		2014	
	Series A \$	Series F \$	Series A \$	Series F \$
Increase (decrease) in net assets attributable to holders of redeemable units per series	(5,157)	(22,084)	1,079,761	(13,865)
Weighted average units outstanding during the year	2,902,281	373,355	2,696,507	162,364
Increase (decrease) in net assets attributable to holders of redeemable units per series per unit	0.00	(0.06)	0.40	(0.09)

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11 Taxes

The Fund qualifies as a 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 in any year, after use of loss carryforwards, are distributed to unitholders such that no income taxes are payable by the Fund.

Capital and non-capital losses determined for tax purposes as at December 31, 2015 are as follows:

<u>Capital losses</u>		<u>Non-capital losses</u>	
Amount	Expires	Amount	Expires
\$		\$	
-	-	35,685	2031
-	-	11,873	2032
-	-	165,912	2033