

## Management's Responsibility Statement

The financial statements of Flaherty & Crumrine Investment Grade Fixed Income Fund (the "Fund") have been prepared by Brompton FFI Management Limited (the "Manager" of the Fund) and approved by the Board of Directors of the Manager. The Manager is responsible for the information and representations contained in these financial statements and the other sections of the Annual Report.

The Manager maintains appropriate procedures to ensure that relevant and reliable financial information is produced. Statements have been prepared in accordance with accounting principles generally accepted in Canada and include certain amounts that are based on estimates and judgements. The significant accounting policies applicable to the Fund are described in Note 2 to the financial statements.

The Board of Directors of the Manager is responsible for ensuring that management fulfills its responsibilities for financial reporting and has reviewed and approved these financial statements. The Board carries out this responsibility through the Audit Committee, which is comprised of unrelated directors of the Board.

The Manager, with the approval of its Board of Directors, has appointed the external firm of PricewaterhouseCoopers LLP as the auditor of the Fund. They have audited the financial statements of the Fund in accordance with Canadian generally accepted auditing standards to enable them to express to unitholders their opinion on the financial statements. The auditors have full and unrestricted access to the Audit Committee to discuss their findings.

(Signed)

**Raymond R. Pether**  
*Chief Executive Officer*  
*Brompton FFI Management Limited*  
February 1, 2005

(Signed)

**Mark A. Caranci**  
*Chief Financial Officer*  
*Brompton FFI Management Limited*

## Auditors' Report

### To the Unitholders of Flaherty & Crumrine Investment Grade Fixed Income Fund:

We have audited the statement of investments of Flaherty & Crumrine Investment Grade Fixed Income Fund (the "Fund") as at December 31, 2004 and the statement of net assets as at December 31, 2004 and the statements of operations, changes in net assets and cash flows for the period from December 15, 2004 (date of commencement of operations) to December 31, 2004. These financial statements are the responsibility of management of the Fund's Manager. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2004 and the results of its operations, the changes in its net assets and its cash flows for the period from December 15, 2004 (date of commencement of operations) to December 31, 2004 in accordance with Canadian generally accepted accounting principles.

(Signed)

**PricewaterhouseCoopers LLP**  
*Chartered Accountants*  
Toronto, Ontario  
February 1, 2005

## Statement of Net Assets

As at December 31	2004
<b>Assets</b>	
Investments, at market value (cost – \$528,622,454)	\$ 511,614,710
Cash and short-term investments	25,957
Dividends and interest receivable	9,524,609
Unrealized gain on forward contracts (note 7)	8,192,087
Deferred financing costs (note 8)	33,365
<b>Total assets</b>	<b>529,390,728</b>
<b>Liabilities</b>	
Accounts payable and accrued liabilities	1,222,277
Loans payable (note 8)	182,442,309
<b>Total liabilities</b>	<b>183,664,586</b>
<b>Net assets representing unitholders' equity</b>	<b>\$ 345,726,142</b>
<b>Units outstanding (note 3)</b>	<b>14,882,310</b>
<b>Net asset value per unit</b>	<b>\$ 23.23</b>

Approved on behalf of Flaherty & Crumrine Investment Grade Fixed Income Fund, by the Board of Directors of Brompton FFI Management Limited, its Manager.

(Signed)

**Peter A. Braaten**  
Director

(Signed)

**James W. Davie**  
Director

## Statement of Operations

For the period from December 15 (commencement of operations) to December 31	2004
<b>Income</b>	
Interest income	\$ 993,055
	993,055
<b>Expenses</b>	
Advisor fee (note 5)	108,670
Management fee (note 5)	57,192
Service fee (note 5)	47,437
General and administrative	185,032
Interest and bank charges (note 8)	243,746
	642,077
<b>Net investment income</b>	<b>350,978</b>
Net realized loss on investments, options, and foreign currency transactions (notes 6 & 8)	(1,626,319)
Net change in unrealized loss on investments, options, and foreign currency transactions (note 8)	(12,764,055)
Net change in unrealized gain on forward contracts (note 7)	8,192,087
<b>Results of operations</b>	<b>\$ (5,847,309)</b>
<b>Results of operations per unit <sup>(1)</sup></b>	<b>\$ (0.40)</b>

<sup>(1)</sup> Based on the weighted average number of units outstanding for the period (note 3).

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

## Statement of Cash Flows

For the period from December 15 (commencement of operations) to December 31	2004
<b>Cash flows from operating activities:</b>	
Results of operations	\$ (5,847,309)
Adjustments to reconcile net cash provided by (used in) operations:	
Net realized loss on sale of investments, options and foreign currency transactions	632,163
Net change in unrealized loss on investments, options and foreign currency transactions	12,763,892
Net change in unrealized gain on foreign currency forward contracts	(8,192,087)
Amortization of deferred financing costs	1,635
Increase in dividends and interest receivable	(9,524,609)
Increase in accounts payable and accrued liabilities	1,222,277
Purchase of investments (note 6)	(593,219,810)
Proceeds from sale of investments (note 6)	63,965,193
<b>Cash used in operating activities</b>	<b>(538,198,655)</b>
<b>Cash flows from financing activities:</b>	
Proceeds from issuance of units, net (note 3)	351,573,451
Increase in loans payable	186,686,161
Deferred financing costs paid	(35,000)
<b>Cash provided by financing activities</b>	<b>538,224,612</b>
Net increase in cash and short-term investments	25,957
Cash and short-term investments, beginning of period	—
<b>Cash and short-term investments, end of period</b>	<b>\$ 25,957</b>
<b>Supplemental information:</b>	
Interest paid	\$ —

## Statement of Changes in Net Assets

For the period from December 15 (commencement of operations) to December 31	2004
Net assets – beginning of period	\$ —
<b>Operations:</b>	
Results of operations	(5,847,309)
<b>Unitholder transactions:</b>	
Proceeds from issuance of units, net (note 3)	351,573,451
Net increase in net assets	345,726,142
<b>Net assets – end of period</b>	<b>\$ 345,726,142</b>
<b>Distributions per unit</b>	<b>\$ —</b>

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

## Statement of Investments

As at December 31, 2004		Cost (USD)	Cost (CDN)	Market Value (USD)	Market Value (CDN)	% of Portfolio
<b>Par Value (\$US)</b>	<b>Bonds</b>					
175,675,000	US Treasury Bond, 6.25% August 15, 2023	\$ 208,723,859	\$ 256,021,219	\$ 205,716,725	\$ 246,479,510	
86,100,000	US Treasury Bond, 6.625% February 15, 2027	107,472,281	131,543,567	106,218,083	127,265,205	
		<b>\$ 316,196,140</b>	<b>\$ 387,564,786</b>	<b>\$ 311,934,808</b>	<b>\$ 373,744,715</b>	<b>73.1%</b>
<b>Shares/ Par Value (\$US)</b>	<b>Preferred Securities</b>					
	<b>Banking</b>					
850,000	First Midwest Capital Trust I, 6.95% December 1, 2033 Capital Security	\$ 932,161	\$ 1,152,994	\$ 928,813	\$ 1,112,857	
5,000,000	GreenPoint Capital Trust I, 9.10% June 1, 2027 Capital Security	5,712,500	7,032,674	5,769,576	6,912,817	
5,000,000	US Bancorp Capital I, 8.27% December 15, 2026 Capital Security	5,525,950	6,828,652	5,548,572	6,648,021	
		<b>12,170,611</b>	<b>15,014,320</b>	<b>12,246,961</b>	<b>14,673,695</b>	<b>2.9%</b>
	<b>Financial Services</b>					
82,450	Corporate Backed Trust Certificates, 6.3% Series GS	2,081,862	2,553,618	2,116,492	2,535,874	0.5%
	<b>Insurance</b>					
8,000,000	ACE Capital Trust II, 9.70% April 1, 2030 Capital Security	10,628,860	13,078,244	10,656,898	12,768,562	
2,000,000	AON Capital Trust A, 8.205% January 1, 2027 Capital Security	2,124,560	2,605,991	2,116,856	2,536,311	
		<b>12,753,420</b>	<b>15,684,235</b>	<b>12,773,754</b>	<b>15,304,873</b>	<b>3.0%</b>
	<b>Utilities</b>					
868,000	Dominion Resources Cap Trust I, 7.83%, December 1, 2027	946,415	1,151,735	965,324	1,156,603	
80,000	DTE Energy Trust II, 7.50% Pfd.	2,096,000	2,595,151	2,133,600	2,556,373	
		<b>3,042,415</b>	<b>3,746,886</b>	<b>3,098,924</b>	<b>3,712,976</b>	<b>0.7%</b>
	<b>Miscellaneous Industries</b>					
52,100	Cabco – Goldman Sachs, 6%	1,276,450	1,565,697	1,276,971	1,530,003	0.3%
	<b>Total Preferred Securities</b>	<b>\$ 31,324,758</b>	<b>\$ 38,564,756</b>	<b>\$ 31,513,102</b>	<b>\$ 37,757,421</b>	<b>7.4%</b>
<b>Par Value (\$US)</b>	<b>Corporate Debt Securities</b>					
	<b>Agency</b>					
16,000,000	Fannie Mac, 6.625% November 15, 2030	\$ 19,349,600	\$ 23,734,269	\$ 19,041,923	\$ 22,815,082	
17,000,000	Freddie Mac, 6.25% July 15, 2032	19,823,360	24,315,384	19,495,308	23,358,303	
		<b>39,172,960</b>	<b>48,049,653</b>	<b>38,537,231</b>	<b>46,173,385</b>	<b>9.0%</b>
	<b>Insurance</b>					
9,000,000	Assurant Inc., 6.75% February 15, 2034 Senior Notes	9,763,020	12,019,279	9,762,773	11,697,268	
2,600,000	OneAmerica Financial Partners, 7% October 15, 2033	2,830,672	3,472,109	2,802,873	3,358,262	
5,000,000	Prudential Holdings LLC, 8.695% December 18, 2023	6,434,750	7,959,170	6,435,736	7,710,977	
		<b>19,028,442</b>	<b>23,450,558</b>	<b>19,001,382</b>	<b>22,766,507</b>	<b>4.4%</b>
	<b>Utilities</b>					
5,000,000	Duke Energy Corporation, 6.45% October 15, 2032, Senior Notes	5,437,550	6,669,712	5,389,331	6,457,227	
2,500,000	Progress Energy Inc., 7% October 30, 2031, Senior Notes	2,777,700	3,435,749	2,767,603	3,316,003	
5,000,000	TXU Corp., 6.55% November 15, 2034, Senior Notes	4,982,250	6,162,566	4,962,486	5,945,803	
		<b>13,197,500</b>	<b>16,268,027</b>	<b>13,119,420</b>	<b>15,719,033</b>	<b>3.1%</b>
	<b>Miscellaneous Industries</b>					
8,000,000	Disney Enterprises Inc., 7.55% July 15, 2093, Senior Notes	9,402,320	11,629,770	9,502,612	11,385,555	2.2%
	<b>Total Corporate Debt Securities</b>	<b>\$ 80,801,222</b>	<b>\$ 99,398,008</b>	<b>\$ 80,160,645</b>	<b>\$ 96,044,480</b>	<b>18.7%</b>
<b>Contracts</b>	<b>Options</b>					
2,100	March Put on March 2005 CBT Futures@110	\$ 1,002,172	\$ 1,236,909	\$ 1,345,313	\$ 1,611,886	
1,600	March Put on March 2005 CBT Futures@112	1,502,133	1,857,995	2,050,000	2,456,208	
		<b>\$ 2,504,305</b>	<b>\$ 3,094,904</b>	<b>\$ 3,395,313</b>	<b>\$ 4,068,094</b>	<b>0.8%</b>
	<b>Total</b>	<b>\$ 430,826,425</b>	<b>\$ 528,622,454</b>	<b>\$ 427,003,868</b>	<b>\$ 511,614,710</b>	<b>100.0%</b>

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

# Notes to the Financial Statements

December 31, 2004

## 1. OPERATIONS

Flaherty & Crumrine Investment Grade Fixed Income Fund (the "Fund") is a closed-end investment trust created under the laws of the Province of Alberta on November 25, 2004, pursuant to an amended and restated declaration of trust. Computershare Trust Company of Canada is the Trustee and Brompton FFI Management Limited is the Manager and is responsible for managing the affairs of the Fund. Flaherty & Crumrine Incorporated manages the Fund's portfolio. The Fund commenced operations on December 15, 2004.

## 2. SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles and they include estimates and assumptions made by management that affect the reported amounts of assets and liabilities at the date of these financial statements and the reported amounts of income and expenses during the period. Actual results could differ from these estimates.

### a) Valuation of Investments

The Fund's investments are presented at market value. Investments that are publicly traded are valued at their closing price. If a closing price is not available, these investments are valued using an average of the latest bid and ask prices. Short-term investments are valued at cost which, when taken together with accrued interest income thereon, is an approximation of their market value. Listed options are valued at market values as reported on recognized exchanges. The value of any security which is traded over-the-counter will be priced at the average of the last bid and ask prices quoted by a major dealer in such securities.

### b) Investment Transactions and Income Recognition

Investment transactions are recorded on trade date and any realized gains or losses are recognized using the average cost of the investments. Interest income is recognized on an accrual basis. Dividend income is recognized on the ex-dividend date. Net realized gains (losses) on investments and options include net realized gains or losses from foreign currency changes.

Option premiums paid or received by the Fund are, so long as the options are outstanding, reflected as an asset or liability, respectively, in the Statement of Investments and are valued at an amount equal to the current market value of an option that would have the effect of closing the position.

### c) Foreign Currency Forward Contracts

The Fund may enter into foreign currency forward contracts, which are agreements between two parties to buy and sell currencies at a set price on a future date. The market value of the contract will fluctuate with changes in currency exchange rates. The contract is marked-to-market and the change in market value is recorded as an unrealized gain or loss. When the contract is closed, the Fund records a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed.

### d) Income Taxes

The Fund qualifies as a mutual fund trust under the Income Tax Act (Canada). Provided the Fund makes distributions in each year of its net income and net realized capital gains, the Fund will not generally be liable for income tax. It is the intention of the Fund to distribute all of its net income and net realized capital gains on an annual basis. Accordingly, no income tax provision has been recorded.

### e) Foreign Exchange

The market value of investments and other assets and liabilities that are denominated in foreign currencies are translated into Canadian dollars at the noon rate of exchange on each valuation date. Purchases and sales of investments and income derived from investments are translated at the rate of exchange prevailing at the time of such transactions.

### f) Fair Value of Financial Instruments

The fair value of the Fund's financial instruments, which are composed of cash and short-term investments, dividends and interest receivable, accounts payable and accrued liabilities and loans payable, approximates their carrying value.

## 3. UNITS OF THE FUND

### Authorized

The Fund is authorized to issue an unlimited number of transferable, redeemable units of beneficial interest, each of which represents an equal, undivided interest in the net assets of the Fund. Each unit entitles the holder to one vote and to participate equally with respect to any and all distributions made by the Fund.

Units may be redeemed during November of any year, between twenty and forty-five business days prior to the second last business day in November. Unitholders whose units are redeemed will receive a redemption price equal to the net asset value per unit on the redemption date.

Units may also be redeemed at least ten business days prior to the second last business day of each month, except for the month of November. Unitholders whose units are redeemed will receive a redemption price per unit equal to the lesser of (i) 96% of the weighted average trading price of the units for the ten trading days preceding the redemption date and (ii) 100% of the closing market price of the units.

### Issued

For the period from December 15 (commencement of operations) to December 31

	2004	
	Number of Units	Amount
Units – beginning of period	—	\$ —
Initial public offering, net	14,400,000	340,150,000
Exercise of over-allotment option, net	480,000	11,370,000
Units issued under the distribution reinvestment plan (note 4)	—	—
Issued for services (note 5)	2,310	53,451
Units – end of period	14,882,310	\$ 351,573,451

On December 15, 2004, the Fund completed its initial public offering of 14,400,000 units at a price of \$25.00 for proceeds, net of agents' fees and issuance costs, of \$340,150,000.

On December 30, 2004, the Fund completed the issuance of an additional 480,000 units at a price of \$25.00 for proceeds, net of agents' fees, of \$11,370,000. The issuance of these additional units was pursuant to the exercise of the over-allotment option granted to the agents in connection with the initial public offering.

During the period the Fund issued 2,310 units to the Manager in respect of its management fee.

The Fund received approval from the Toronto Stock Exchange for a normal course issuer bid for the period from December 22, 2004 through to December 21, 2005. Pursuant to the issuer bid, the Fund may purchase up to 1,436,000 units for cancellation. The Fund may only repurchase units when the net asset value per unit exceeds its trading price. For the period from December 15, 2004 to December 31, 2004, no units were purchased.

The weighted average number of units outstanding from the date of commencement of operations on December 15, 2004 to December 31, 2004 was 14,456,606.

#### 4. DISTRIBUTIONS TO UNITHOLDERS

Distributions, as declared by the Manager, are made on a monthly basis to unitholders of record on the last business day of each month. The distributions are payable by the tenth business day of the following month. For the period from December 15, 2004 to December 31, 2004, no distributions were declared. Under the Fund's distribution reinvestment plan, unitholders may elect to reinvest monthly distributions in additional units of the Fund which may be issued from treasury or purchased on the open market. For the period from December 15, 2004 to December 31, 2004, no units were issued by the Fund pursuant to the reinvestment plan.

#### 5. MANAGEMENT, ADVISOR AND SERVICE FEES

Pursuant to a management agreement, the Manager provides management and administrative services to the Fund, for which it is paid a management fee equal to 0.35% per annum of the net asset value of the Fund, plus applicable taxes. The management fee may be paid in cash or units at the option of the Manager. To the extent that units are issued from treasury for this purpose, they will be issued at the net asset value per unit. During 2004, the entire management fee was paid in units. Flaherty & Crumrine Incorporated, the portfolio manager for the Fund, and Brompton Capital Advisors Inc. are entitled to receive an aggregate fee equal to 0.70% per annum of the net asset value, plus applicable taxes. Both fees are calculated and payable monthly. The Fund also pays to the Manager a service fee equal to 0.30% per annum of the net asset value of the Fund. The service fee is in turn paid by the Manager to the investment dealers in proportion to the number of units held by clients of each dealer at the end of each calendar quarter.

#### 6. INVESTMENT TRANSACTIONS

Investment transactions for the period from December 15 to December 31 were as follows:

	2004
Proceeds from sale of investments and options	\$ 63,965,193
Less cost of investments and options sold:	
Investments at cost – beginning of period	—
Investments purchased during the period	593,219,810
Investments at cost – end of period	(528,622,454)
Cost of investments and options sold during the period	64,597,356
Net realized loss on sale of investments and options	\$ (632,163)

Brokerage commissions on investments purchased and sold during the period ended December 31, 2004 amounted to \$21,724.

#### 7. FOREIGN CURRENCY FORWARD CONTRACTS

The Fund uses foreign currency forward contracts to hedge foreign exchange risks associated with its US dollar investment portfolio. At December 31, 2004, the Fund had entered into the following foreign currency forward contracts with a Canadian chartered bank:

Canadian Dollars Purchased	US Dollars Sold	Delivery Date	Unrealized Gain
\$ 70,446,262	\$ 57,250,000	January 18, 2005	\$ 1,843,944
2,030,595	1,650,000	February 18, 2005	53,140
72,483,815	58,900,000	March 18, 2005	1,893,427
2,030,222	1,650,000	April 18, 2005	53,026
215,514,960	171,750,000	January 15, 2015	4,348,550
\$ 362,505,854	\$ 291,200,000		\$ 8,192,087

#### 8. LOANS PAYABLE

Pursuant to an agreement with a Canadian chartered bank, the Fund maintains a 364-day revolving credit facility. The revolving credit facility provides for maximum borrowings of \$13.9 million for working capital purposes under one tranche and US\$153.8 million under the second tranche for investment purposes. Both tranches can be availed at either the prime rate of interest, the bankers' acceptance rate plus a fixed percentage, at the LIBOR rate plus a fixed percentage or by US base rate borrowings. At December 31, 2004, the Fund had a US dollar loan equivalent to \$182.4 million (US\$152.3 million) outstanding under this facility. At December 31, 2004, borrowings in US dollars had an unrealized foreign exchange gain of \$4,243,852. The credit facility is secured by a first-ranking and exclusive charge on all of the Fund's assets.

Costs incurred to establish the credit facility are deferred and amortized over its term. For the period from December 15, 2004 to December 31, 2004, the Fund has recorded amortization of these costs in the amount of \$1,635.

The credit facility is used by the Fund for the purchase of additional investments and for general Fund purposes.