Flaherty & Crumrine

INVESTMENT GRADE FIXED INCOME FUND

VALUE INTEGRITY PERFORMANCE

2005 ANNUAL REPORT

Management Report of Fund Performance

February 10, 2006

This annual management report of fund performance for Flaherty & Crumrine Investment Grade Fixed Income Fund (the "Fund") contains financial highlights but does not contain the complete audited annual financial statements. The complete audited annual financial statements are appended to this report.

Unitholders may obtain a copy of the Fund's proxy voting policies and procedures, proxy voting disclosure record, or quarterly portfolio disclosure, at no cost by calling 866-642-6001, or by sending a request to Suite 2930, P.O. Box 793, Bay Wellington Tower, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3.

Investment Objectives and Strategies

Flaherty & Crumrine Investment Grade Fixed Income Fund is a closed-end investment trust that is listed on the Toronto Stock Exchange under the symbol FFI.UN and is managed by Brompton FFI Management Limited (the "Manager"). Flaherty & Crumrine Incorporated, which is headquartered in Pasadena, California, manages the Fund's portfolio. The Fund's investment objectives are to provide unitholders with a stable stream of monthly distributions, to mitigate the impact of significant interest rate increases on the value of the portfolio through the use of the safety net hedge and to preserve the net asset value per unit.

The units of the Fund are currently rated P-2f by Standard & Poor's. The Fund invests in a portfolio of fixed income securities consisting primarily of US dollar denominated corporate debt and hybrid preferred securities of North American issuers. All securities purchased by the Fund are rated investment grade at the time of investment. Substantially all of the US dollar foreign exchange exposure of the Fund's portfolio is hedged to the Canadian dollar at all times. Also, under normal market conditions, 100% of the portfolio will be hedged using the safety net hedge strategy, which is intended to mitigate the impact of significant increases in long-term interest rates on the net asset value of the portfolio, while permitting the net asset value to appreciate when long-term interest rates decline. The Fund is RRSP, DPSP, RRIF and RESP eligible.

Risks

There are risks associated with an investment in units of the Fund. The prospectus that was issued in connection with the initial public offering of the Fund's units, as well as the Fund's annual information form, contains a discussion of these risks. These documents are available on the Fund's website at www.bromptongroup.com or on SEDAR at www.sedar.com. Below is a discussion of some of the more significant risks affecting the Fund in 2005.

Decline in the Net Asset Value of the Fund

The net asset value and the funds available for distribution will vary according to, among other things, the value of the securities held in the portfolio, which depend, in part, upon the performance of the issuers of such securities, the performance of the preferred and debt securities markets, generally, and the level of interest rates and any net foreign currency exposure. Fluctuations in the market values of the securities held in the portfolio may occur for a number of reasons beyond the control of the portfolio manager. It is possible that, due to declines in the market values of such securities in the portfolio, the Fund may not be able to achieve its monthly distribution objective or its objective to preserve the net asset value per unit.

The Fund is widely diversified which mitigates the exposure to the performance of any one issuer. The Fund also employs interest rate and foreign currency hedging strategies to reduce the risk of a change in these factors on the net asset value of the Fund. The net asset value of the Fund in 2005 was also affected by the cost of the safety net hedge and by the fact that it paid out more in distributions than it received in distributable income.

Interest Rate Exposure and Leverage

The Fund has borrowed amounts to invest in additional portfolio investments to increase the overall distributions of the Fund. If short-term interest rates increase relative to long-term interest rates during a period when leverage is utilized, increased interest costs may reduce income or cash available to be distributed. In 2005, short-term US interest rates rose as the US Federal Reserve Bank increased its overnight rate from 2.25% in January to 4.25% by the end of the year. The Fund borrows at short-term rates and, as a result, its income has been negatively affected by the rise in short-term rates without a similar rise in long-term rates.

Interest rate risk also includes the risk that debt obligations and preferred securities will decline in value because of increases in long-term interest rates. Net asset value may fluctuate with interest rate changes and the corresponding changes in the value of the securities in the investment portfolio. The Fund uses a "safety net hedge" to mitigate the impact of significant rapid increases in long-term interest rates on the investment portfolio.

Leverage can also impact the net asset value of the Fund as it will enhance the net asset value during a period when the Fund's investments have appreciated and will exacerbate the decline of net asset value during a falling market. The greater the amount of leverage, the greater the impact on net asset value of a rise or decline in market prices of the Fund's investments.

Foreign Currency Exposure

The net asset value is measured in Canadian dollars and payments to unitholders are made in Canadian dollars. However, the investments in the portfolio are securities denominated in US dollars. Accordingly, the net asset value may be affected by fluctuations in the value of the Canadian dollar relative to the US dollar. The Fund hedges this exposure using a combination of foreign currency forward contracts and borrowings in US dollars. During 2005, the Fund's foreign currency hedging generated realized and unrealized net gains of $19.4 million, which offset the foreign currency reduction in the value of the Fund's portfolio.

Significant Redemptions and Units Trading at a Discount

Units of the Fund are redeemable, at their net asset value per unit, on the second last business day of November each year. The purpose of the annual redemption right is to reduce the likelihood that units of the Fund trade at a substantial discount to net asset value per unit and to provide unitholders with the right to realize their investment once per year at net asset value per unit less costs associated with the redemption, including brokerage costs. While the redemption right provides unitholders the option of annual liquidity at net asset value, the Fund may trade at a significant discount during the year. In addition, if a significant number of units are redeemed, the trading liquidity of the units could be significantly reduced and expenses of the Fund would be spread over fewer units resulting in a higher management expense ratio ("MER") for the Fund. In 2005, 2,612,986 units were redeemed for proceeds of $58.2 million.

Recent Developments

Reduction in Distribution Rate

On March 24, 2006, the Fund announced that the annual distribution rate would be reduced from $1.625 per unit to $1.50 per unit commencing with the distribution with a record date of April 28, 2006 and payable on May 12, 2006. The distribution rate has been reduced in large part due to the continuous increase in short-term US interest rates without a corresponding increase in long-term interest rates resulting in a decrease in distributable income.

Restatement of Net Asset Values

On January 13, 2006, the Fund announced that its net asset value per unit was not reported accurately as a result of certain foreign currency contracts not being valued in accordance with the Fund's valuation procedures. At that time the most recent net asset value per unit on January 6, 2006 was recalculated by the Fund's valuation service provider and it resulted in a reduction of the net asset value per unit of $0.56 per unit or 2.5%. As a result of the incorrect valuations, the redemption price paid to unitholders who redeemed their units in 2005 was approximately $1.6 million more than if the correct net asset value had been used. The Manager of the Fund will ensure that the Fund is reimbursed for this overpayment and any excess management or advisor fees collected as a result of incorrect valuations.

Results of Operations

Distributions

During the year ended December 31, 2005, the Fund made regular monthly cash distributions which totalled $1.625 per unit.

The Fund has a distribution reinvestment plan which allows participating unitholders to automatically reinvest monthly distributions in additional units of the Fund. For the year ended December 31, 2005, 4,028 units were acquired in the market pursuant to this plan at an average price of $22.46 per unit.

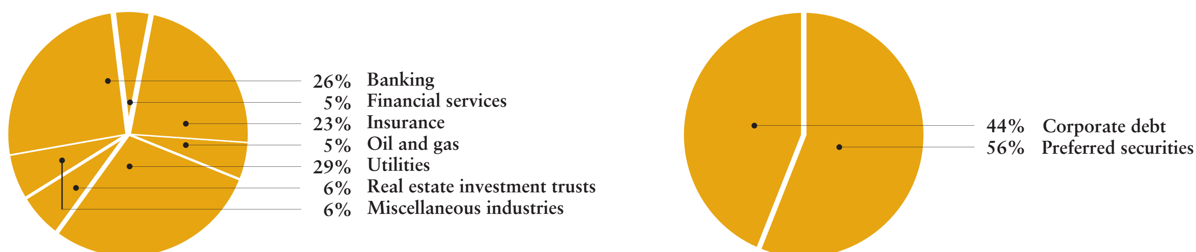
Net Asset Value

The net asset value per unit of the Fund decreased by $0.88 per unit or 3.8% from $23.23 to $22.35 over the year. The Fund's aggregate net assets declined from $346 million at December 31, 2004 to $268 million at December 31, 2005, due in large part to redemptions and repurchases under the issuer bid program. The decline in the net asset value per unit was primarily attributable to the cost of the safety net hedge and the fact that distributions exceeded cash available for distribution. These declines were partially offset by gains on the January 2015 foreign currency forward contracts resulting from changes in the US and Canadian long-term interest rate differential. The foreign currency forward contracts are discussed further below under "Currency Hedge."

Investment Portfolio

As of December 31, 2005, the Fund's investments included a total of 57 hybrid preferred securities and 27 debt securities which are diversified by issuer and industry. All of the securities of the Fund were rated investment grade by at least one rating agency at the time of purchase. Approximately 83% of the portfolio is invested in the banking, finance, insurance and utilities sectors, which are industries that are subject to regulatory oversight. The breakdown of the portfolio is shown in the pie charts below.

Portfolio Sectors



Net Investment Income

During the year, the Fund earned net investment income of $19.3 million and generated cash available for distribution in the amount of $21.7 million. The cash that was available for distribution was higher than net investment income primarily as a result of fees paid by the Fund in the form of units and to a lesser extent from undistributed cash from 2004. In 2005, the Fund paid the Manager all of its fees in the amount of $1.2 million by issuing units and, in addition, a portion of the advisor fees in the amount of $0.5 million were paid by issuing units.

The Fund declared monthly distributions totalling $1.625 per unit or $23.4 million in 2005. The total monthly distributions in excess of cash available for distribution in the amount of $1.7 million are primarily attributable to the lower yield on the US Treasuries that were held during the initial invest up period when the Fund was investing in corporate and preferred securities, and the increase in borrowing costs due to rising short-term US interest rates.

Currency Hedge

The Fund's portfolio is comprised of securities denominated in US dollars. The Fund hedges its foreign currency exposure by borrowing in US dollars and by entering into foreign currency forward contracts. Borrowing in US dollars creates a natural hedge as movement in the spot foreign exchange rate and its impact on the value of the portfolio are offset by opposite changes in the value of the loan when it is calculated in Canadian dollars. When using foreign currency forward contracts, the Fund agrees to sell to a counterparty a certain amount of US dollars and receive a set amount of Canadian dollars at a specified future date. Over the term of the forward contract, its value will fluctuate as the spot foreign exchange rate and interest rate differentials change. At December 31, 2005, approximately 65% of the portfolio's US dollar exposure was hedged using forward contracts, and the remaining 35% was hedged by the Fund's US dollar borrowings. On a regular basis, the total notional amount of these forwards is adjusted to match the Fund's net US dollar exposure.

As of December 31, 2005, the Fund had entered into two forward contracts, one with a maturity date in January 2015 and a notional value of US$190.1 million and one with a maturity date in January 2006 and a notional value of US$23.8 million. During 2005, the longer dated contract comprised approximately two-thirds of the total notional value of the forward contracts with the remaining one-third being in a one-month contract. At the end of the year, the January 2015 contract comprised nearly 90% of the notional value of all forward contracts. This higher weighting resulted when a portion of the Fund's US dollar portfolio was liquidated to fund the annual redemption in November. The Fund reduced the size of the short-dated contract to offset the smaller portfolio size.

Due to its longer duration, the value of the January 2015 forward contract is more sensitive to changes in the differential between US and Canadian long-term interest rates than short dated contracts such as a one-month contract. This sensitivity of the contract contributed to fluctuations in the net asset value of the Fund over the year.

In January 2006, the Fund closed-out the January 2015 forward contract and reinvested the proceeds in the portfolio. On the close-out, the Fund realized a gain of Cdn$17.3 million or US$15.0 million. The long-term contract resulted in approximately an additional Cdn$3.6 million of gains to the Fund as compared to a strategy of rolling one-month forward contracts. The new forward contract component of the foreign currency hedge is composed of four contracts with approximately 25% exposure in 3-years, 2-years, 1-year and 3 month terms.

Safety Net Hedge

The Fund uses the safety net hedge to mitigate the impact of significant increases in long-term interest rates. When long-term interest rates decline or increase only slightly, the Fund expects to lose money on the safety net hedge. Since the hedge is constructed primarily by purchasing put options on US Treasury bond futures, the Fund's loss on the hedge is limited to the cost of the put options. When long-term interest rates increase significantly, the Fund expects to make money on the safety net hedge.

The safety net hedge will not perfectly protect the Fund against increases in long-term interest rates. To reduce the ongoing cost of hedging, the hedge is typically structured so that the Fund bears some initial risk to the net asset value as interest rates increase. In addition, the Fund's portfolio investments may not track perfectly with the hedge instrument as interest rates change. However, even if the hedge results are less than perfect, if long-term interest rates rise significantly, any gains realized on the hedge may increase the Fund's income because the gains can be invested in additional income producing securities. Typically, long-term interest rates move higher with an increase in short-term rates; however, in 2005 the yield curve flattened as the yield on the 30-year US Treasury bond declined from 4.8% to 4.6% while the US Federal Reserve Bank increased its overnight rate from 2.25% to 4.25% over the year. In 2005 the Fund had net realized and unrealized losses on option contracts in the amount of approximately $15.7 million which is approximately 3% of the average value of the portfolio. The Fund intends to continue to use the safety net hedge to mitigate the impact of significant increases in long-term interest rates.

Liquidity and Capital Resources

As of December 31, 2005, the Fund had borrowings of $151 million (US$129.3 million) under its revolving credit facility, which represented 35.3% of total assets. The rate paid on these borrowings is adjusted monthly based on the London Interbank Offered Rate ("LIBOR"). The borrowings have been used to invest in additional portfolio investments to enhance the distributions paid by the Fund. During the year, the minimum and maximum amounts of borrowings of the Fund were US$129.3 million and US$154.8 million, respectively.

To provide liquidity, units of the Fund are listed on the TSX under the symbol FFI.UN. The Fund's normal course issuer bid program allows it to purchase its units on the TSX when they trade below net asset value per unit. As a result, purchases under the issuer bid are accretive to the net asset value per unit of the Fund. A total of 332,500 units were purchased in 2005 under this program at an average price of $21.92 per unit.

In addition to the annual redemption described earlier, on a monthly basis, unitholders may redeem units on the second last business day of each month at a price 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 on the redemption date. Unitholders must tender their units for redemption at least ten business days prior to the second last business day of the relevant month. On December 29, 2005, 19,473 units were redeemed on this basis at $20.24 per unit.

Related Party Transactions

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. In addition, 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 2005, the entire management fee was paid in units resulting in the issuance of 51,342 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. During 2005, another 21,769 units were issued for the payment of these fees. 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. In 2005, management, advisor and service fees amounted to $1.3 million, $2.4 million and $1.0 million, respectively.

Financial Highlights

The following tables show selected key financial information about the Fund and are intended to help readers understand the Fund's financial performance for the fiscal periods indicated. This information is derived from the Fund's audited annual financial statements. The information in the following tables is presented in accordance with National Instrument ("NI") 81-106 and as a result, does not act as a continuity of opening and closing net asset value per unit. The increase (decrease) in net assets from operations is based on average units outstanding during the period and all other numbers are based on actual units outstanding at the relevant point in time.

Net Asset Value per Unit

		2005		2004[1]
Net asset value, beginning of year[2]	$	**23.23**	$	23.63
Increase (decrease) from operations:[3]				
Total revenue		**2.14**		0.07
Total expenses		**(0.81)**		(0.04)
Realized gain (loss) for the year		**(0.11)**		(0.11)
Unrealized gain (loss) for the year		**(0.55)**		(0.32)
Total increase (decrease) in net assets from operations	$	**0.67**	$	(0.40)
Distributions to unitholders:[2]				
From net investment income	$	**0.22**	$	—
From net realized gain on investments		**0.82**		—
Return of capital		**0.59**		—
Total distributions to unitholders	$	**1.63**	$	—
Net asset value, end of year[2]	$	**22.35**	$	**23.23**

(1) Period from December 15, 2004 (commencement of operations) to December 31, 2004.

(2) Net asset value per unit and distributions per unit are based on the actual number of units outstanding at the relevant time.

(3) The increase (decrease) in net assets from operations is based on the weighted average number of units outstanding over the fiscal period.

Ratios and Supplemental Data

		2005		2004
Net assets (in 000s)	$	**268,420**	$	345,726
Number of units outstanding (in 000s)		**12,011**		14,882
Management expense ratio ("MER")[1][2]		**3.45%**		9.21%
MER excluding interest expense and issuance costs[1]		**1.48%**		1.52%
Portfolio turnover rate[3]		**131.75%**		N/A
Trading expense ratio[4]		**0.12%**		N/A
Closing market price	$	**21.40**	$	24.95

(1) Annualized for the period from December 15, 2004 (commencement of operations) to December 31, 2004.

(2) Management expense ratio is based on the total expenses of the Fund for the stated period including interest expense and issuance costs and is expressed as an annualized percentage of the average net assets of the period.

(3) The Fund's portfolio turnover rate indicates how actively the Fund's portfolio advisor manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund buying and selling all of the securities in its portfolio once in the course of the year. The higher the Fund's portfolio turnover rate in a year, the greater the trading costs payable by the Fund in the year, and the greater the chance of an investor receiving taxable capital gains in the year. There is not necessarily a relationship between a high turnover rate and the performance of the Fund. The portfolio turnover rate is not provided when a fund is less than one year old. Portfolio turnover rate is calculated by dividing the lesser of the cost of purchases and the proceeds of sales of portfolio securities for the period, excluding cash and short-term investments maturing in less than one year, by the average market value of investments during the period.

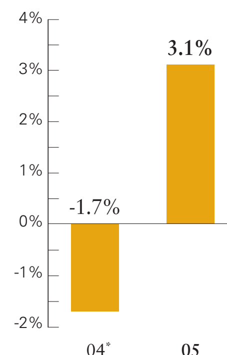
(4) The trading expense ratio represents total commissions expressed as an annualized percentage of daily average net assets of the Fund during the period. This disclosure is a new requirement under NI 81-106 and is not applied retroactively.

Past Performance

The following chart and table shows the past performance of the Fund and will not necessarily indicate how the Fund will perform in the future. The information shown is based on net asset value per unit and assumes that distributions made by the Fund in the periods shown were reinvested (at net asset value per unit) in additional units of the Fund.

Year-by-Year Returns

The bar chart shows the Fund's return (based on net asset value per unit) in each year since inception to December 31, 2005. The chart shows, in percentage terms, how an investment held on the first day of each fiscal year would have increased or decreased by the last day of the fiscal year.



* For the period from December 15, 2004 (commencement of operations) to December 31, 2004.

Annual Compound Returns

The following table shows the Fund's annual compound return for each period indicated, compared with the return for the Lipper Domestic (US) Investment Grade Bond Funds ("Lipper Benchmark"). The Lipper Benchmark includes all US government bond, mortgage bond and term trust and investment grade bond funds in Lipper's closed-end fund database at each point in time and provides a fixed income security benchmark for the Fund, although, generally the investment grade bond funds in the Lipper Benchmark do not hedge long-term interest rate exposure.

	1 year	Since Inception[1]
Flaherty & Crumrine Investment Grade Fixed Income Fund	3.1%	1.4%
Lipper Domestic (US) Investment Grade Bond Funds	3.5%	4.0%

[1] For the period from December 15, 2004 (commencement of operations) to December 31, 2005.

The Fund underperformed the Lipper Benchmark largely due to the cost of the safety net hedge and distributions exceeding cash available for distribution.

Summary of Investment Portfolio

As at December 31, 2005

Total net asset value	$ 268,420,032

Portfolio Composition	**% of NAV**
Preferred securities:	
Banking	36.7%
Insurance	26.3%
Utilities	10.4%
Oil and gas	5.9%
Financial services	4.3%
	83.6%
Corporate debt:	
Utilities	32.0%
Miscellaneous industries	9.2%
Real estate investment trust	8.6%
Insurance	7.3%
Financial services	3.8%
Banking	2.3%
Oil and gas	1.7%
	64.9%
Currency forward contracts	6.3%
Options	(0.5%)
Cash and short-term investments	0.6%
Total investment portfolio	154.9%
Other net liabilities	(54.9%)
Total net asset value	100.0%

Top 25 Holdings	**% of NAV**
Constellation Energy Group, *7.6% April 1, 2032, Senior Notes*	7.5%
KN Capital Trust III, *7.63% April 15, 2028 Capital Security*	5.9%
Southern Union Company, *8.25% November 15, 2029*	5.3%
EOP Operating L.P., *7.5% April 19, 2029, Senior Unsecured Notes*	4.5%
Pulte Homes Inc., *6.375% May 15, 2033*	4.4%
Assurant Inc., *6.75% February 15, 2034 Senior Notes*	4.3%
Duquesne Light Holdings, Inc., *6.25% August 15, 2035, Senior Notes*	4.3%
Westar Energy Inc., *5.95% January 1, 2035*	4.3%
PECO Energy Capital Trust IV, *5.75% June 15, 2033 Capital Security*	4.2%
Aegon NV, *6.375% Pfd.*	4.2%
TXU Corp., *6.5% November 15, 2024, Senior Notes*	4.2%
Barclays Bank PLC, *6.278% December 15, 2034*	4.0%
Disney Enterprises Inc., *7.55% July 15, 2093, Senior Notes*	3.9%
ACE Capital Trust II, *9.7% April 1, 2030*	3.6%
Lehman Capital Trust VI, *6.24% Pfd.*	3.2%
Fleet Capital Trust II, *7.92% December 11, 2026*	3.2%
Commonwealth Edison Co., *6.35% March 15, 2033*	3.1%
Axis Capital Holdings Limited, *7.5% Pfd.*	3.0%
Webster Capital Trust I, *9.36% January 29, 2027 Capital Security*	2.8%
General Motors Acceptance Corporation, *8% November 1, 2031, Senior Bonds*	2.8%
Progress Energy Inc., *7% October 30, 2031, Senior Notes*	2.7%
HBOS Capital Funding, *6.85% March 23, 2049*	2.5%
Royal Bank of Scotland PLC, *6.35% Pfd.*	2.5%
GreenPoint Capital Trust I, *9.1% June 1, 2027 Capital Security*	2.4%
First Empire Capital Trust II, *8.277% June 1, 2027 Capital Security*	2.4%

The investment portfolio may change due to ongoing portfolio transactions of the investment fund. Quarterly updates are available within 60 days of each quarter end.

2005 Tax Information

The following information is applicable to holders who, for the purpose of the Income Tax Act (Canada), are resident in Canada and hold Fund units as capital property outside of an RRSP, RRIF or DPSP. Unitholders should receive a T3 slip from their investment dealer providing this information.

T3 supplementary slips for holdings of the Fund will indicate Foreign Non-Business Income in Box 25, Other Taxable Income in Box 26, Capital Gains in Box 21 and Dividend Income in Box 23. Dividend income is subject to the standard gross-up and federal dividend tax credit rules.

The return of capital component is a non-taxable amount that serves to reduce the adjusted cost base of Fund units and is reported on the T3 supplementary slips Box 42.

The following table outlines the breakdown of the Fund's distributions declared in 2005 on a per unit basis.

Record Date	Payment Date	Return of Capital	Foreign Non-Business Income	Other Taxable Income	Dividend Income	Capital Gains	Total Distribution
Jan. 31, 2005	Feb. 14, 2005	$ 0.04904	$ 0.01785	$ 0.00011	$ —	$ 0.06840	$ 0.13540
Feb. 28, 2005	Mar. 14, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Mar. 31, 2005	Apr. 14, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Apr. 29, 2005	May 13, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
May 31, 2005	June 14, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
June 30, 2005	July 15, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
July 29, 2005	Aug. 15, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Aug. 31, 2005	Sep. 15, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Sep. 30, 2005	Oct. 17, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Oct. 31, 2005	Nov. 14, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Nov. 30, 2005	Dec. 14, 2005	0.04904	0.01785	0.00011	—	0.06840	0.13540
Dec. 30, 2005	Jan. 16, 2006	0.04904	0.01785	0.00011	—	0.06840	0.13540
Total distributions		**$ 0.58848**	**$ 0.21420**	**$ 0.00132**	**$ —**	**$ 0.82080**	**$ 1.62480**

Portfolio Manager

Flaherty & Crumrine Incorporated

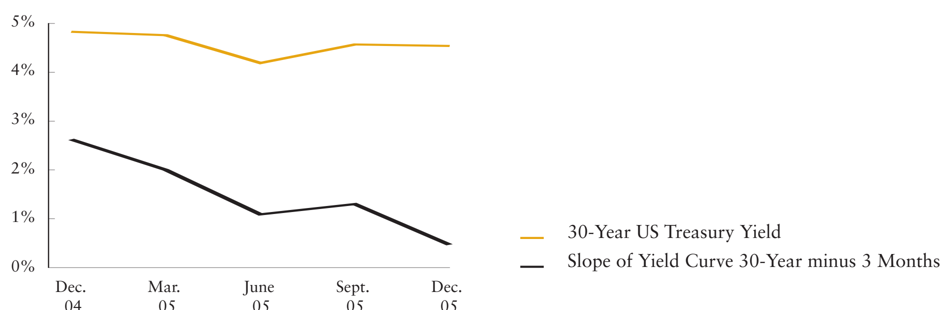
Flaherty & Crumrine Incorporated is the oldest and most experienced firm specializing in preferred securities with extensive additional experience in corporate debt instruments. Flaherty & Crumrine acts as portfolio manager for two Brompton funds – Flaherty & Crumrine Investment Grade Preferred Fund and Flaherty & Crumrine Investment Grade Fixed Income Fund, both of which invest in investment-grade corporate debt and preferred securities, primarily of US issuers. The firm uses intensive credit analysis and thorough analysis of securities' terms and structure and active portfolio management, exploiting pricing inefficiencies in the fixed income markets to provide attractive rates of return on its funds.

Flaherty & Crumrine's two oldest funds (NYSE: PFD and NYSE: PFO) have received Morningstar 4 and 5 star overall ratings, respectively, and have outperformed an index of Lipper Domestic US Investment Grade Bond Funds, while providing low levels of volatility. To achieve this, Flaherty & Crumrine employs a "safety-net" hedging strategy in the management of all its funds, mitigating the risk of significant rapid increases in long-term interest rates, but allowing the net asset value of the funds to increase if interest rates decline. As a result, the hedge permits distributions paid by the funds to increase if long-term interest rates increase significantly, while being relatively resistant to declining interest rates.

Portfolio Manager's Report

During 2005, the Fund continued to be impacted by several developments, including a flattening yield curve, as long-term interest rates remained relatively stable but short-term rates increased. Fueled by eight separate 1/4% increases in the US Fed funds rate during 2005 (following five in 2004 and one subsequent to year-end), the yield on 3-month US Treasury bills increased from 2.2% to 4.1% during the year. However, the yield on the 30-year US Treasury bond actually declined in yield during this period from 4.8% to 4.6%! As can be seen in the chart below, with little change in long-term interest rates (as shown by the line), the slope of the yield curve declined precipitously throughout the year (the bars) as short-term rates increased significantly.

Yield on 30-Yr US Treasury Bond vs. Slope of US Treasury Yield Curve



The stability of long-term interest rates in the face of a flattening yield curve impacted the Fund in several ways. First, maintaining the Fund's "safety-net" interest rate hedge proved an unproductive expense. To use an insurance analogy, we paid a premium for insurance against a significant increase in long-term interest rates, but the house didn't burn down. Long-term interest rates remained range bound, and the hedge produced positive results during only a couple of months in 2005. However, we have no intention of eliminating the "safety net" hedge going forward. At some point, it will earn its keep; in the meantime, we'll continue to attempt to minimize its cost.

The Fund has also been impacted as rising short-term interest rates have increased the cost of the Fund's leverage. Thus far, the Fund has coped reasonably well with higher short-term interest rates. We anticipate that significant further increases in short-term rates will at some point result in long-term rates also increasing, benefiting the hedge. While we have been puzzled by the relative stability of long-term interest rates in the face of strength in the economy and the US Federal Reserve's efforts to raise short-term interest rates, history has taught us there is little likelihood of current market conditions persisting for long. The good news is that while the flattening of the yield curve increases the cost of the Fund's leverage, it significantly reduces the cost of hedging going forward. Although these two factors offset each other to some degree, they do so only at total return.

A second major development in 2005 was the continuing evolution of the preferred market in the United States. Stimulated by Moody's Investors Services formalizing their equity treatment of preferreds early last year, both preferred issuance and the creation of new preferred structures has accelerated. Recently, an innovative twist on an old preferred structure has produced a new type of preferred security appropriate for the Fund. In classic Wall Street tradition, the bankers can't agree on what to call them; for now, we'll use the first coined acronym "ECAPS℠," which stands for "Enhanced Capital Advantage Preferred Security."

This new structure combines a variety of terms and covenants to create a security that captures some important characteristics of both debt and equity. As a result, these issues are considered "equity-like" by the rating agencies, yet the interest paid on the issue is deductible by the issuer as interest expense for tax purposes (both critical factors in a company's cost of capital). To date, corporations have sold twelve "enhanced" issues totaling almost US$7.5 billion. The winds of change continue to blow through the preferred market, presenting the opportunity to take advantage of mispricings due either to supply pressures or market unfamiliarity with new structures. For instance, late in 2005, a number of insurance companies issued new preferred securities to replenish capital after one of the worst hurricane seasons for the US on record. While many of these new issues didn't meet our credit standards, we identified several attractive issues and made meaningful additions to the portfolio.

We have avoided the temptation to boost the income from the Fund's investment portfolio by purchasing lower quality securities or those with high coupons but little call protection. While the Fund restricts itself to investment grade securities at the time of purchase, we have some flexibility within the investment grade universe. Balancing the tradeoff between credit quality and income is never easy, but we believe foregoing some current income in favour of higher long-term results is advantageous for Unitholders with a long-term investment horizon. A similar tradeoff exists in the coupon level of securities purchased. Reaching for yield by buying the higher coupon issues of an issuer may produce higher income in the short run, but doing so increases the portfolio's exposure to issuer call and compromises the sustainability of the income generated by the Fund.

Further information on the specific holdings in the Fund can be found by visiting a website maintained by Flaherty & Crumrine, www.preferredstockguide.com and using the "search" function.

Forward-looking Statements

Some of the statements contained herein including, without limitation, financial and business prospects and financial outlook may be forward-looking statements which reflect management's expectations regarding future plans and intentions, growth, results of operations, performance and business prospects and opportunities. Words such as "may," "will," "should," "could," "anticipate," "believe," "expect," "intend," "plan," "potential," "continue" and similar expressions have been used to identify these forward-looking statements. These statements reflect management's current beliefs and are based on information currently available to management. Forward-looking statements involve significant risks and uncertainties. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, changes in general economic and market conditions and other risk factors. Although the forward-looking statements contained herein are based upon what management believes to be reasonable assumptions, we cannot assure that actual results will be consistent with these forward-looking statements. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof and we assume no obligation to update or revise them to reflect new events or circumstances.