



Flaherty & Crumrine  
**INVESTMENT GRADE  
FIXED INCOME FUND**



VALUE INTEGRITY PERFORMANCE

INTERIM REPORT 2006

## Management Report of Fund Performance

August 10, 2006

This interim management report of fund performance for Flaherty & Crumrine Investment Grade Fixed Income Fund (the "Fund") contains financial highlights but does not contain the complete interim financial statements. The complete interim 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 ("TSX") under the symbol FFI.UN and is managed by Brompton Funds Management Limited (the "Manager"). Flaherty & Crumrine Incorporated (the "Portfolio Manager") is a leading North American specialist in managing preferred and debt securities and manages the Fund's portfolio. For a more detailed description of Flaherty & Crumrine and its Portfolio Manager's Report on the Fund, please see the "Portfolio Manager" section. The Fund's investment objectives are to provide unitholders with a stable stream of monthly distributions, to mitigate the impact of significant and rapid long-term 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 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 and rapid 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 units of the Fund are currently rated P-2f by Standard & Poor's and the Fund is RRSP, DPSP, RRIF and RESP eligible as Canadian property.

## 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](http://www.bromptongroup.com) or on SEDAR at [www.sedar.com](http://www.sedar.com). Below is a discussion of some of the more significant risks affecting the Fund during the first half of 2006.

### Decline in the Net Asset Value of the Fund

The net asset value and the cash flow available for distribution of the Fund will vary according to, among other things, the value of and the yield provided by the securities held in the Fund's portfolio, which depend, in part, upon the performance of the issuers of such securities, the performance of the preferred securities and debt markets generally, interest rates and 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 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. During the first half of 2006, the 30-year Treasury bond rate increased by 65 basis points to 5.19%, which had a negative impact on the Fund's net asset value. This negative impact was exacerbated by the Fund's use of leverage but was also mitigated by the use of the safety net hedge.

### Interest Rate Exposure and Leverage

The Fund has borrowed amounts on a floating rate basis to invest in additional portfolio investments to increase the overall distributions of the Fund. If short-term interest rates increase during a period when leverage is utilized, increased interest costs will reduce income or cash available to be distributed. During the first half of 2006, short-term US interest rates rose as the US Federal Reserve Bank increased its overnight rate from 4.25% at the beginning of the year to 5.25% by the end of June.

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 and the Fund's ability to make payments to unitholders 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 borrowing in US dollars. During the six months ended June 30, 2006, the Fund's foreign currency hedging generated realized and unrealized net gains of \$9.1 million which largely offset the foreign currency reduction in the value of the Fund's portfolio.

### Call Risk

Call risk is the risk that an issuer of a fixed income security held in the Fund's portfolio will exercise its right to repay the principal of a security prior to its maturity. This may happen when there is a decline in interest rates and the issuer can refinance at a lower interest rate. Under these circumstances, the Fund may be unable to recoup all of its initial investment (if it paid a premium price over the call value) and may have to reinvest the proceeds from such called security in lower yielding investments. Preferred securities frequently have call features that allow the issuer to redeem the security prior to its stated maturity. The Portfolio Manager actively manages the portfolio including call risk and it seeks to identify those preferred and debt securities that provide optimal return characteristics relative to risks. Using proprietary models, the Portfolio Manager evaluates the specific terms of each issue and is generally willing to forgo high income over the short-term to hold securities with more favourable call terms providing more sustainable income.

### Significant Redemptions and Units Trading at a Discount

Units of the Fund are traded on the TSX and, subject to the applicable notice provisions, are also redeemable, at the option of the unitholder, based on their net asset value per unit on the second last business day of November each year. It is not uncommon for closed-end funds to trade at a discount to their net asset value per unit. 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. While the redemption right provides unitholders the option of annual liquidity for their units based on net asset value per unit, the Fund may trade at a 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.

## Recent Developments

### Amalgamation of the Managers of Brompton Funds

On June 1, 2006, Brompton FFI Management Limited, the Manager of the Fund at the time, and 12 management companies of other Brompton Funds were amalgamated with Brompton Funds Management Limited. The amalgamation did not impact the operations or management of the Fund and did not change any of the terms of its management agreement.

The board of directors of Brompton Funds Management Limited is comprised largely of the same directors as Brompton FFI Management Limited and includes Peter A. Braaten, Chairman; James W. Davie; P. Michael Nedham; Arthur R.A. Scace; and Ken S. Woolner. The amalgamation did not affect the composition of the independent board members, nor the audit and corporate governance committees, which continue to be represented by Messrs. Davie, Scace and Woolner.

### New Accounting Standard for Fiscal 2007

The Accounting Standards Board of the Canadian Institute of Chartered Accountants ("CICA") has issued CICA Section 3855: Financial Instruments – Recognition and Measurement. The new standards address the accounting and disclosure for financial instruments and were developed to harmonize accounting standards for financial instruments with those previously issued by the International Accounting Standards Board. Starting January 1, 2007, these new standards will impact the manner in which the net asset value of the Fund is determined. The new standards will change the way that fair value is determined for financial instruments; in particular, securities traded in an active market must be valued using a bid price. Currently, the Fund generally values exchange-traded securities at their closing prices and securities that are traded over-the-counter are generally valued at the average of the latest bid and ask prices. In addition, the new accounting standards will require that brokerage commissions be expensed and presented on the Statement of Operations. Currently, brokerage commissions are added to the adjusted cost base when a security is purchased or they are deducted from the proceeds of disposition when a security is sold. The new accounting standards will be applied prospectively and will not require the restatement of prior year financial statements. The change in the fair value of the securities held on January 1, 2007 will be recorded as an adjustment to opening retained earnings. The valuation methodology set out in the Fund's Declaration of Trust will be amended to comply with these new accounting standards.

## Results of Operations

### Distributions

The following table provides, on a per unit basis, an approximate breakdown of the components which affected cash available for distribution over three different periods of investment – for the period from inception of the Fund on December 15, 2004 to December 31, 2005, for the period covering the first six months of 2006 and for the period covering the entire life of the Fund to June 30, 2006. These are approximate figures as the results for each period are affected by different weighted average number of units outstanding.

	From Inception <sup>(1)</sup> to Dec. 31, 2005	For the Six Months Ended June 30, 2006	From Inception <sup>(1)</sup> to June 30, 2006
Income	\$ 2.21	\$ 1.11	\$ 3.32
Expenses			
Management and advisor fees	(0.26)	(0.12)	(0.38)
Interest and bank charges	(0.48)	(0.32)	(0.80)
Other expenses	(0.11)	(0.05)	(0.16)
Total expenses	(0.85)	(0.49)	(1.34)
Net investment income	1.36	0.62	1.98
Add: Management and advisor fees paid in units	0.13	0.12	0.25
Cash flow available for distribution	1.49	0.74	2.23
Distributions to unitholders	(1.62)	(0.78)	(2.40)
Distributions exceeding cash flow available for distribution	(0.13)	(0.04)	(0.17)
Net realized gains (losses)	(0.22)	1.71	1.49
Total distributions exceeding (less than) cash flow available for distribution and net realized gains	\$ (0.35)	\$ 1.67	\$ 1.32

<sup>(1)</sup> The Fund commenced operations on December 15, 2004.

Since the commencement of the Fund, there have been three major factors that have put pressure on the Fund's ability to sustain distributions at its original targeted rate:

- (i) lower long-term interest rates than the original plan during the period of investment. While some margin for reduced spread was factored into the original economics, long-term rates declined beyond the cushion that was built in;
- (ii) timing differences arising from the rapid decline in the US dollar exchange rate relative to the Canadian dollar which reduced US dollar interest income in Canadian dollar terms. Over time, the Fund was able to mitigate a large amount of this impact by investing gains on its foreign currency hedges and redeploying the proceeds therefrom in additional fixed income securities; and
- (iii) while generally long-term interest rates declined during much of the period, short-term interest rates, which affect the cost of the Fund's borrowings, increased by 4.25% since the inception of the Fund (as a result of 17 increases in the Fed Funds rate). While the cost of borrowing is still less than the return earned in the Fund's investment portfolio, and thereby the leverage of the Fund continues to contribute to the amount of cash flow available for distribution, this contribution is less than originally projected.

To mitigate these pressures on distributable cash flow, the Fund took additional steps, including migrating the Fund's portfolio towards higher yielding preferred securities as corporate spreads widened, and the Manager and the Portfolio Manager agreed to take all of their fees in units of the Fund. Notwithstanding these steps, the Fund had to reduce its monthly distribution rate in April 2006 from \$0.1354 per unit to \$0.125 per unit. At this new distribution level, the yield on the Fund units based on its July 31, 2006 closing price was 7.4%. The Manager estimates that based on current borrowing costs and the level of management and advisor fees taken in units, the current level of distribution is sustainable.

Under the terms of the Fund's constating documents and in order to maintain its tax exempt status, the Fund must payout all of its taxable income including realized gains on its investments. As a result, as the above table indicates since the inception of the Fund, it has paid out in regular monthly cash distributions, amounts greater than the Fund has generated strictly from cash flow available for distribution.

During the first half of 2006, the Fund realized significant gains from its foreign exchange hedging program and from the safety net hedge. To the extent possible, the Fund will try to realize losses to offset a portion of these gains. Gains that the Fund is not able to shelter with losses or other deductions such as issue costs will be distributed to unitholders by the end of the year using a combination of cash and unit distributions. The additional cash distribution should approximately cover the income tax that would be payable on the additional cash and unit distributions.

The Fund has a distribution reinvestment plan which allows participating unitholders to automatically reinvest monthly distributions in additional units of the Fund. For the six months ended June 30, 2006, 3,154 units were acquired in the market pursuant to this plan at an average price of \$21.17 per unit.

## Changes in Net Asset Value

Investors who purchased units of the Fund at the time of the initial public offering paid a price of \$25.00 per unit. On closing, a total of \$1.37 per unit was paid for issue costs resulting in an initial opening net asset value of \$23.63 per unit. Issue costs included with itemed such items as agency fees, legal costs and printing costs.

From December 15, 2004 (commencement of operations) to June 30, 2006, the net asset value has decreased from \$23.63 per unit to \$20.87 per unit, which is a decline of 11.7%. The table below provides an approximate breakdown of the various factors which have contributed to the decline in net asset value per unit over this period. These are approximate figures as the results for each period are affected by different weighted average numbers of units outstanding.

## Changes in Net Asset Value on a Per Unit Basis

	From Inception <sup>(1)</sup> to Dec. 31, 2005	For the Six Months Ended June 30, 2006	From Inception <sup>(1)</sup> to June 30, 2006
Opening net asset value per unit	\$ 23.63	\$ 22.35	\$ 23.63
Gains (losses) on portfolio investments <sup>(2)</sup>	(0.49)	(2.32)	(2.81)
Gain from cost of the safety net hedge	(0.98)	1.24	0.26
Distributions exceeding cash flow available for distribution	(0.13)	(0.04)	(0.17)
Foreign exchange hedge	0.40	(0.27)	0.13
Reduction from management and advisor fees paid in units	(0.13)	(0.12)	(0.23)
Rounding and timing adjustments	0.08	0.03	0.06
Total change	(1.28)	(1.48)	(2.76)
Ending net asset value per unit	\$ 22.35	\$ 20.87	\$ 20.87

<sup>(1)</sup> The Fund commenced operations on December 15, 2004.

<sup>(2)</sup> Excludes the impact of foreign exchange which is included in the foreign exchange hedge.

Since the Fund's inception to December 31, 2005, long-term US Treasury rates remained relatively flat decreasing from approximately 4.71% to 4.55%. The values of the Fund's portfolio investments (including net realized and unrealized gains) decreased during the period by approximately \$0.49 per unit. From December 31, 2005 to June 30, 2006, US long-term Treasury rates increased to approximately 5.19% and these rising rates resulted in the Fund's net asset value per unit decreasing by approximately \$2.32 per unit. Since inception to June 30, 2006, the net asset value of the Fund's units declined by approximately \$2.51 per unit as a result of increasing long-term interest rates.

While long-term interest rates remained relatively flat from the inception of the Fund to December 31, 2005, there were no benefits to be realized from the safety net hedge. The costs of implementing the hedging strategy during the period totalled approximately \$0.98 per unit. During the first six months of 2006, long-term interest rates rose quickly and the safety net hedge provided some positive returns for the Fund which totalled approximately \$1.24 per unit after all costs. Since inception of the Fund until June 30, 2006, the safety net hedge has had a small profit of approximately \$0.26 per unit.

Since the commencement of operations, the Fund has distributed approximately \$0.17 per unit more than its cash flow available for distribution. Of this, only \$0.04 relates to the six-month period to June 30, 2006, which included three months at the previous higher distribution rate. Please refer to the discussion in the section "Distributions" above.

The currency hedge has had only a minor (\$0.13 per unit) impact on the Fund's net asset value since inception. The currency hedge has done its job considering the 9.7% increase in the Canadian dollar, relative to the US dollar, since the Fund's inception. The significant gains that have been realized in 2006 partially offset unrealized losses due to the appreciation of the Canadian dollar that were inherent in the portfolio investments.

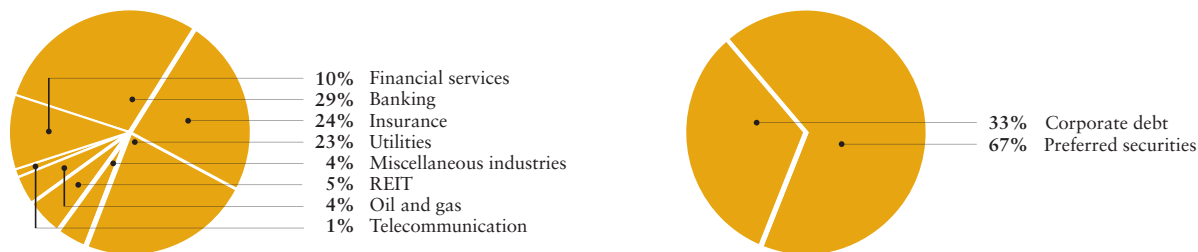
When the Manager and Portfolio Manager agree to take their fees in units of the Fund, additional cash is available for distributions. The Manager has been taking its fee in units since the inception of the Fund. At the end of 2005, the Manager and Portfolio Manager agreed to take all of their fees in units (1.05% of net asset value per annum) to help offset the decline in cash flow available for distribution discussed above. The disadvantage of taking the management and advisor fees in Fund units is that the net asset value per unit declines over time due to the additional units outstanding. If the Manager and Portfolio Manager continue to take all of their fees in units for the next year, the net asset value per unit will decline from what it otherwise would be by about \$0.22 per unit (1.05% of net asset value per annum). However, unitholders will receive an equivalent benefit of \$0.22 per unit of additional distributable income.

Although the net asset value per unit has declined by about \$2.76 since inception, it is important for unitholders to remember that they have received \$2.40 per unit in cash distributions over this period.

## Investment Portfolio

All securities purchased by the Fund are rated investment grade at the time of investment. The portfolio is well diversified with 122 issues. Approximately 86% 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 accompanying pie charts. The Fund's credit quality remains investment grade and its units are currently rated P-2f by Standard and Poor's.

## Portfolio Sectors



## Hedging Strategies

### Foreign Exchange Hedge

Units of the Fund are purchased and valued in Canadian dollars, but the Fund invests in US corporate debt and US preferred securities. Substantially all of the US dollar foreign exchange exposure of the Fund's portfolio is hedged by the Manager to the Canadian dollar at all times. Since the Fund's inception and for the six months ended June 30, 2006, the Canadian dollar has appreciated by 9.7% and 4.3%, respectively.

Presently, about two-thirds of the portfolio is hedged using a combination forward contracts with maturity dates of July 2006, January 2007, January 2008 and January 2009, at approximately 17% each and one-third of the portfolio is hedged naturally through the Fund's US dollars borrowings.

### Safety Net Hedge

Due to the negative effect that a long-term interest rate increase can have on a long-duration portfolio, the Portfolio Manager employs a safety net hedge strategy. The safety net hedge has two purposes. The first is to offset, in part, the decline in the value of the Fund's securities portfolio caused by a significant and rapid rise in long-term US interest rates. The Fund purchases out-of-the-money put options on US treasury futures whose price movements are correlated (albeit not perfectly) with those of the Fund's investments. During a period of rising long-term interest rates, the Fund will initially experience a reduction in net asset value as the hedge tightens and only partially offsets the decline in the value of the securities portfolio. However, as interest rates continue to increase, the hedge will offset an increasing proportion of the decline in the value of the Fund's investments. The safety net hedge has worked well so far in 2006 as it has helped insulate the Fund from a more significant decline in net asset value resulting from the rapid rise in long-term rates which has occurred during the six months ended June 30, 2006.

The second purpose of the safety net hedge is to generate additional income following a rapid increase in long-term interest rates. This can be achieved by investing realized gains from the put options in additional income producing securities. The additional income to be earned as a result of the Fund's gains realized in 2006 will provide support for the Fund's current distribution rate with any excess income being retained by the Fund to increase the net asset value.

### Liquidity and Capital Resources

As of June 30, 2006, the Fund had total borrowings of \$143.8 million (US\$129.3 million), which represented 36.3% of total assets. The rate paid on these borrowings is adjusted monthly based on the London-Inter bank Offered Rate ("LIBOR"). The borrowings have been used to invest in additional portfolio investments to enhance the distributions paid by the Fund. During the six months ended June 30, 2006, the minimum and maximum amounts of borrowings of the Fund were US\$148.0 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 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 308,200 units were purchased in the six months ended June 30, 2006 under this program at an average price of \$20.56 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 are issued at the net asset value per unit. During the six months ended June 30, 2006, the entire management fee was paid in units resulting in the issuance of 17,007 units. Flaherty & Crumrine Incorporated, the Portfolio Manager for the Fund, and Brompton Capital Advisors Inc. are entitled to receive an additional fee equal to 0.70% per annum of the net asset value, plus applicable taxes. During the six months ended June 30, 2006, another 40,971 units were for the payment of their 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. For the six months ended June 30, 2006, management, advisor and service fees amounted to \$0.5 million, \$0.9 million and \$0.4 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 and unaudited interim 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

	For the	For the Years Ended December 31	
	Six Months Ended June 30, 2006	2005	2004 <sup>(1)</sup>
Net asset value, beginning of period <sup>(2)</sup>	\$ 22.35	\$ 23.23	\$ 23.63
Increase (decrease) from operations: <sup>(3)</sup>			
Total revenue	1.11	2.14	0.07
Total expenses	(0.49)	(0.81)	(0.04)
Realized gain (loss) for the period	1.71	(0.11)	(0.11)
Unrealized gain (loss) for the period	(3.06)	(0.55)	(0.32)
<b>Total increase (decrease) in net assets from operations</b>	<b>(0.73)</b>	<b>0.67</b>	<b>(0.40)</b>
Distributions to unitholders: <sup>(2)</sup>			
From net investment income	\$ N/A	\$ 0.22	\$ —
From net realized gain on investments	N/A	0.82	—
Return of capital	N/A	0.59	—
<b>Total distributions to unitholders</b>	<b>\$ 0.78</b>	<b>\$ 1.63</b>	<b>\$ —</b>
<b>Net asset value, end of period</b>	<b>\$ 20.87</b>	<b>\$ 22.35</b>	<b>\$ 23.23</b>

<sup>(1)</sup> Period from December 15, 2004 (commencement of operations) to December 31, 2004.

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

<sup>(3)</sup> 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

	For the	For the Years Ended December 31	
	Six Months Ended June 30, 2006	2005	2004
Net assets (in 000s)	\$ 244,928	\$ 268,420	\$ 345,726
Number of units outstanding (in 000s)	11,737	12,011	14,882
Management expense ratio ("MER") <sup>(1)(2)</sup>	4.47%	3.45%	9.21%
MER excluding interest expense and issuance costs <sup>(1)(3)</sup>	1.53%	1.48%	1.52%
Portfolio turnover rate <sup>(4)</sup>	37.79%	131.75%	N/A
Trading expense ratio <sup>(5)</sup>	0.09%	0.12%	N/A
Closing market price	\$ 19.91	\$ 21.40	\$ 24.95

<sup>(1)</sup> Annualized for the period from December 15, 2004 (commencement of operations) to December 31, 2004 and for the six months ended June 30, 2006.

<sup>(2)</sup> Management expense ratio is based on the requirements of NI 81-106 and includes 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.

<sup>(3)</sup> MER excluding interest expense and issuance costs has been presented separately as it expresses only the ongoing management and administrative expenses of the Fund as a percentage of average net assets. Issuance costs are one-time costs incurred at inception, and the inclusion of interest expense does not consider the additional revenues that have been generated from the investment of the leverage in income-generating assets.

<sup>(4)</sup> 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.

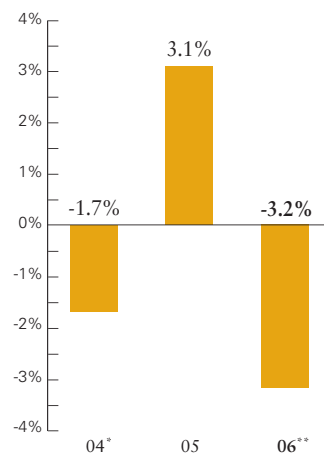
<sup>(5)</sup> The trading expense ratio represents total commissions expressed as an annualized percentage of daily average net assets of the Fund during the period. This disclosure was a new requirement in 2005 under NI 81-106 and was not applied retroactively.

## Past Performance

The following chart and table show 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 chart shows the Fund's return (based on net asset value per unit) and includes distributions made in each year since inception to June 30, 2006. The chart shows, in percentage terms, how an investment held on the first day of each fiscal period would have increased or decreased by the last day of the fiscal period.



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

\*\* For the period from January 1, 2006 to June 30, 2006.

### Annual Compound Returns

The following table shows the Fund's compound return for the six months ended June 30, 2006 and the annual compound return since inception, 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 fund benchmark for the Fund although, generally, the investment grade bond funds in the Lipper Benchmark do not hedge long-term interest rate exposure.

	Six Months Ended June 30, 2006	Since Inception <sup>(1)</sup>
Flaherty & Crumrine Investment Grade Fixed Income Fund	(3.2)%	(1.2)%
Lipper Domestic (US) Investment Grade Bond Funds	0.0%	2.7%

<sup>(1)</sup> For the period from December 15, 2004 (commencement of operations) to June 30, 2006.

## Summary of Investment Portfolio

As at June 30, 2006

Total net asset value	\$ 244,928,230
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Portfolio Composition	% of NAV
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<b>Preferred securities:</b>	
Banking	43.4%
Insurance	30.0%
Utilities	12.1%
Financial services	9.5%
Oil and gas	5.7%
Telecommunication	1.6%
Miscellaneous industries	0.2%
	102.5%
<b>Corporate debt:</b>	
Utilities	22.8%
Real estate investment trusts	8.2%
Insurance	7.3%
Miscellaneous industries	5.5%
Financial services	5.5%
Telecommunication	0.3%
Oil and gas	0.2%
	49.8%
Currency forward contracts	3.0%
Options	1.7%
Cash and short-term investments	2.3%
Total investment portfolio	159.3%
Other net liabilities	(59.3%)
Total net asset value	100.0%

Top 25 Holdings	% of NAV
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Southern Union Company, 8.25% <i>November 15, 2029</i>	5.1%
Morgan Stanley Capital Trust VI, 6.6% <i>Pfd.</i>	4.9%
Liberty Mutual Insurance Co., 7.697% <i>October 15, 2097</i>	4.8%
KN Capital Trust III, 7.63% <i>April 15, 2028 Capital Security</i>	4.8%
EOP Operating L.P., 7.5% <i>April 19, 2029, Senior Unsecured Notes</i>	4.3%
Barclays Bank PLC, 6.278% <i>December 15, 2034</i>	4.2%
Duquesne Light Holdings, Inc., 6.25% <i>August 15, 2035, Senior Notes</i>	4.1%
Westar Energy Inc., 5.95% <i>January 1, 2035</i>	4.1%
TXU Corp., 6.5% <i>November 15, 2024, Senior Notes</i>	4.0%
PECO Energy Capital Trust IV, 5.75% <i>June 15, 2033 Capital Security</i>	3.9%
Great-West Life & Annuity Insurance Capital LP II	3.3%
Citigroup Capital VIII, 6.95% <i>Pfd.</i>	3.3%
Commonwealth Edison Co., 6.35% <i>March 15, 2033</i>	3.1%
Washington Mutual Preferred Funding (Cayman) I Ltd., 6.534% <i>March 15, 2011</i>	3.0%
Cash and short-term investments	2.9%
Webster Capital Trust I, 9.36% <i>January 29, 2027 Capital Security</i>	2.9%
Aegon NV, 6.375% <i>Pfd.</i>	2.8%
Axis Capital Holdings Limited, 7.5% <i>Pfd.</i>	2.8%
General Motors Acceptance Corporation, 8% <i>November 1, 2031, Senior Bonds</i>	2.8%
Lehman Capital Trust VI, 6.24% <i>Pfd.</i>	2.6%
HBOS Capital Funding, 6.85% <i>March 23, 2049</i>	2.4%
GreenPoint Capital Trust I, 9.1% <i>June 1, 2027 Capital Security</i>	2.4%
First Empire Capital Trust II, 8.277% <i>June 1, 2027 Capital Security</i>	2.4%
Wachovia Capital Trust V, 7.965% <i>June 1, 2027 Capital Security</i>	2.3%
Royal Bank of Scotland PLC, 6.35% <i>Pfd.</i>	2.3%

*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.*

## 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 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

The investment environment has been challenging over the past year. In June 2005, 30-year US Treasury bond yields reached their lowest level since we began keeping this data series in 1978<sup>(1)</sup>. While long-term interest rates have been on the rise since last summer, the trend accelerated this year. At the beginning of 2006, yields on 30-year US Treasuries were just above 4.5%; by the end of June, these yields equalled 5.25%. When an interest rate move is of this magnitude and begins at such a low level, the impact on bond valuations is dramatic – long-term US Treasury bonds declined in price by almost 10% during the six months ending June 30, 2006.

It is precisely for times like these that the Fund employs its "safety net" hedging strategy. Rising long-term interest rates cause the value of most fixed income investments including the Fund's to decline, but the interest rate hedge helps moderate the impact, limiting the decline in the Fund's net asset value (NAV).

Recall that our hedge positions are analogous to an insurance policy. We make regular "premium" payments to buy protection against rising long-term interest rates. In order to keep the cost of these payments down, we typically structure the hedge with a "deductible," meaning some portion of the loss must be absorbed by the Fund before we can collect on the policy. If long-term interest rates increase significantly, the hedge position will help offset the decline in the value of the portfolio. This was the experience during both the Second Quarter and calendar year-to-date.

In addition to helping protect the value of the portfolio in weak fixed-income markets, a second purpose of the safety-net hedge is to generate additional income following a significant increase in long-term interest rates. This can be achieved by investing realized gains from the interest rate hedge in additional income producing securities. If long-term interest rates increase sufficiently, the additional income received helps support and possibly increase the Fund's monthly dividend rate.

One method to better understand the performance of the Fund's NAV this year is to begin with the total return on the Fund's US dollar denominated securities portfolio, and progressively adjust for the impact of interest rate hedging, expenses, currency hedging and leverage to arrive at the total return based on NAV (which includes all of these factors). While the securities in the portfolio performed much better than long-term US Treasury bonds this year, the Fund's securities portfolio still produced a negative total return of (2.3)% during the second Quarter, and (3.5)% over the calendar year-to-date prior to factoring in the interest rate hedge.

The bright spot so far this year has been the degree to which the interest rate hedge helped insulate the Fund's portfolio from a more significant decline due to the recent rise in long-term interest rates. During the Second Quarter, the hedge improved results by 1.1%, and over the year-to-date, by 3.5%.

Since the inception of the Fund, the currency hedge has been effective in fully protecting the Fund's Canadian dollar denominated NAV from the substantial decline in the value of the US dollar. However, during the Second Quarter and year-to-date periods, the currency hedge offset most of, but did not compensate fully for, the weakening US dollar. In addition, the leveraged portion of the portfolio tends to generate sufficient incremental income to offset the expenses of the Fund. Since the Fund's borrowing costs are based on short-term interest rates, which increased significantly in 2006, the Fund earned less incremental income from leverage and it was insufficient to fully offset the Fund's expenses. As a result, the Fund's total returns on NAV, including the impact of the currency hedge, leverage and expenses, was slightly lower than the return on the investment portfolio (including the favourable contribution of the safety net hedge) at (3.2)% for the quarter and (3.2)% for the year-to-date.

Some investors have wondered if it's prudent to continue to leverage the Fund in view of how flat the US Treasury yield curve has become. While the use of borrowed funds to improve the Fund's return (with a corresponding increase in risk) clearly made sense when short-term interest rates were lower, does it still make sense to do so now?

The answer is yes. Provided that short-term US Treasury interest rates are not dramatically above long-term rates, the Fund continues to benefit from the use of leverage. Generally, the rate paid on the Fund's bank borrowing is well below the rate the Fund can earn on the investment portfolio, and the additional cash flow generated by leverage enhances the income available for distribution to unitholders.

Even in the case of a flat or an inverted yield curve (short-term rates are higher than long-term rates) the Fund should continue to benefit from the use of leverage. An inverted yield curve typically describes the relationship between short-term and long-term US Treasury interest rates. Preferred securities trade at yields higher than Treasuries, the difference commonly referred to as the “credit spread.” So, although the Treasury curve may be inverted, the preferred securities in the portfolio will ordinarily continue to have a higher return than the short-term rates the Fund pays for its leverage.

As we have discussed previously, the preferred market in the United States has been in flux following the various rating agency attempts over the past year to clarify their equity capital treatment of preferred securities. Neither fish nor fowl, with characteristics of both debt and equity, preferred securities can serve a wide range of financing needs. At the same time, these mixed characteristics leave room for differing opinions on how to view preferreds.

Whether investor or issuer, credit agency or regulator, accountant or the IRS – all have different approaches for treating preferred securities. While the rating agency attempts at clarification have prompted significant growth in the market, confusion still reigns as reflected in the volatility of preferred securities’ prices.

However, in confusion lies opportunity as the turmoil contributes to the preferred market’s inefficiency. We attempt to add value by exploiting these opportunities, and will continue to try and take advantage of future market inefficiencies.

Further information on the specific holdings in the Fund can be found by visiting a website maintained by Flaherty & Crumrine – [www.preferredstockguide.com](http://www.preferredstockguide.com) – using the “search” function.



<sup>(1)</sup> Actually, June 30, 2005 wasn't quite the lowest level. On June 13, 2003, 30-year US Treasury yields were 2 basis points lower.

## 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.*