



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

The Fund

Flaherty & Crumrine Investment Grade Fixed Income Fund commenced operations on December 15, 2004 when it was listed on the Toronto Stock Exchange under the symbol FFI.UN and issued 14.4 million units at \$25 per unit for gross proceeds of \$360 million. An additional 480,000 units were issued on December 30, 2004 pursuant to the over-allotment option, bringing total gross proceeds from the offering to \$372 million.

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. At the time of investment, all of the fixed income securities held in the portfolio are rated investment grade. Initially, the majority of the portfolio consists of debt securities. The portfolio will be actively managed to allocate assets between preferred securities and debt securities in order to enhance the total return by taking advantage of pricing anomalies and market inefficiencies. 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 interest rate increases on the net asset value of the portfolio, while permitting it to benefit from declines in interest rate.

The units of the Fund have received a rating of P-2f by Standard & Poor's. The Fund is managed by Brompton FFI Management Limited and the portfolio is managed by Flaherty & Crumrine Incorporated, which is headquartered in Pasadena, California.

The Fund's investment objectives are to provide unitholders with a stable stream of monthly distributions equal to \$1.625 per annum; 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.

Management's Discussion and Analysis

The following information provides an analysis of the operations and financial position of the Fund and it should be read in conjunction with the financial statements and accompanying notes.

Distributions

The Fund commenced distributions as scheduled in January 2005 at the targeted rate of \$0.1354 per unit. As a result, tax reporting for unitholders of the Fund will not be required for 2004.

The Fund also has a distribution reinvestment plan, which allows participating unitholders to automatically reinvest monthly distributions in additional units of the Fund.

Investment Portfolio

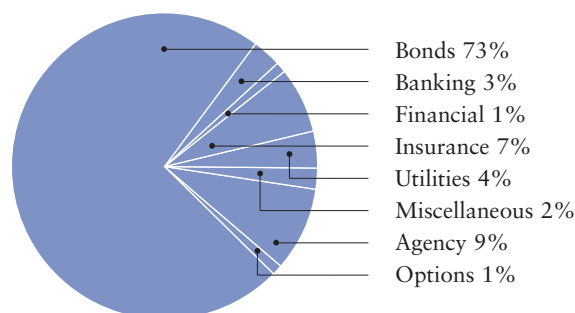
Upon closing, the portfolio manager invested the net proceeds of the offering together with drawings under the loan facilities in long-term US government bonds in order to "lock in" the level of yield earned by the Fund. Currency hedges and the "safety net hedge" were also put in place at this time.

By locking in the level of yield, the portfolio manager is able to be very selective about the corporate debt and preferred securities it acquires without having to worry about interest rate movements prior to making these investments.

During the two week period following the initial public offering to December 31, 2004, a total of nine hybrid preferred securities and nine corporate debt securities were acquired representing about 7.4% and 18.7% of the Fund respectively. At the date of writing, approximately 77.5% of the Fund had been invested in corporate debt and preferred securities.

The breakdown of the portfolio is shown in the accompanying pie chart, and a detailed listing of the Fund's security holdings is provided in the financial statements.

Portfolio Mix



Net Asset Value

During the year ended December 31, 2004, the net asset value per unit of the Fund decreased by \$0.39 or 1.65% to \$23.23 per unit, broken down as follows:

	Per Unit
Net investment income	\$ 0.02
Net realized loss on investments, options and foreign currency transactions	(0.11)
Net change in unrealized loss on investments, options and foreign currency transactions	(0.88)
Net change in unrealized gain on forward contracts	0.57
Results of operations	(0.40)
Capital transactions	0.01
Decrease in net asset value	\$ (0.39)

Hedging

The Fund's portfolio is comprised of securities denominated in US dollars. As a result, the Fund hedges its foreign currency exposure in two ways: by borrowing in US dollars and by entering into foreign currency forward contracts. Following the initial public offering, the Fund entered into three forward contracts hedging approximately 83% of the portfolio's US dollar exposure. The remaining 17% of the Fund's portfolio is hedged by its 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. During the period from December 15, 2004 to December 31, 2004 the Canadian dollar appreciated by 6.7% versus the US dollar, resulting in significant unrealized and realized gains on the Fund's forward contracts. These gains offset foreign exchange losses on the Fund's US dollar assets. In addition, the Fund has entered into currency forwards which represent approximately the Fund's foreign exchange exposure for 12 months of distributions.

During the period ended December 31, 2004, the Fund implemented the safety net hedge using various put options on US Treasury bond futures. The Fund had unrealized gains of \$1 million on the put options.

When long-term interest rates decline, we expect to lose money on the Fund's safety net hedge, while earning extra returns on the preferred securities in the portfolio. 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 puts. Typically, it takes only a 10-15 basis point rally in preferred yields to overcome the cost of hedging.

It is important to remember that the safety net hedge will not perfectly protect the Fund against increases in interest rates. To reduce the ongoing cost of hedging, the hedge is typically structured so that unitholders bear some initial risk to the net asset value as interest rates increase. In addition, the Fund's preferred securities may not track perfectly with the hedge instrument as interest rates change. However, even if the hedge results are less than perfect, any gains realized on the hedge may permit the Fund to increase its distribution rate if interest rates rise significantly.

Liquidity and Capital Resources

As of December 31, 2004, the Fund had borrowings of \$182.4 million (US\$152.3 million) under its revolving credit facility, which represented 34.5% of total assets. These borrowings are on a floating rate basis priced against LIBOR. The borrowings have been used to invest in additional portfolio investments to enhance the distributions paid by the Fund.

To provide liquidity, the Fund's units 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 the net asset value. As a result, purchases under the issuer bid are accretive to the net asset value of the Fund. No units were purchased during the period.

Unitholders may also redeem units of the Fund on the second last business day of November of each year at the then current net asset value, commencing in 2005.

Management Expense Ratio

The Fund has a low management fee for an actively managed fund of 1.05% of net asset value per annum. Combined with the 0.30% service fee that is paid to investment dealers and the general and administrative expenses of the Fund, the management expense ratio for 2004 was 1.52% based on net assets and 0.96% based on total assets.

Risk Analysis

The Fund is subject to a number of risks and uncertainties which are discussed briefly on page 95 of this report. Unitholders are encouraged to review these risks.

Outlook

While we believe in the long-term fundamentals of the investment strategy and the skill of our portfolio manager, investors are cautioned that net asset values will fluctuate over time, particularly with movements in long-term interest rates.