

Palos Equity Income Fund

Financial Statements
December 31, 2016 and 2015
(expressed in Canadian dollars)



March 31, 2017

Independent Auditor's Report

To the Unitholders of Palos Equity Income Fund

We have audited the accompanying financial statements of Palos Equity Income Fund (the "Fund"), which comprise the statements of financial position as at December 31, 2016 and 2015 and the statements of comprehensive income (loss), changes in net assets attributable to holders of redeemable units and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Fund as at December 31, 2016 and 2015 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP¹

¹ CPA auditor, CA, public accountancy permit No. A125840

Palos Equity Income Fund

Statements of Financial Position

As at December 31, 2016 and 2015

(expressed in Canadian dollars)

	2016 \$	2015 \$
Assets		
Current assets		
Investments	23,002,565	20,163,672
Cash	1,335,798	154,653
Subscriptions receivable	29,075	-
Accrued income receivable	88,654	50,936
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	24,456,092	20,369,261
Liabilities		
Current liabilities		
Redemptions payable	7,375	-
Distributions payable	71,264	148,966
Accrued liabilities	21,330	29,983
Management fees payable	850	274
Performance fees payable	70	110,290
	<hr/>	<hr/>
	100,889	289,513
Net assets attributable to holders of redeemable units	<hr/>	<hr/>
	24,355,203	20,079,748
Net assets attributable to holders of redeemable units per series		
Series A	18,648,521	17,441,588
Series F	5,706,682	2,638,160
Net assets attributable to holders of redeemable units per series per unit		
Series A	6.38	5.93
Series F	6.67	6.13
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Approved by the Manager, Palos Management Inc.

(s) Charles Marleau

(s) Peter Malouf

Director

Director

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

Palos Equity Income Fund
Statements of Comprehensive Income (Loss)
For the years ended December 31, 2016 and 2015

(expressed in Canadian dollars)

	Note	2016 \$	2015 \$
Income			
Dividend income		459,540	468,361
Interest income for distribution purposes		142,520	184,521
Other income		4,947	2,794
Other changes in fair value of investments			
Net realized gain on sale of investments		1,094,942	466,432
Net change in unrealized appreciation (depreciation) of investments		2,469,312	(459,584)
Total income, net		4,171,261	662,524
Expenses			
Management fees	8	345,151	344,239
Performance fees	8	-	110,290
Administration and other professional fees		77,982	83,472
Trustee fees		14,222	13,759
Audit fees		41,577	35,570
Legal fees		37,970	40,031
Bank charges and interest		6,173	5,242
Independent Review Committee fees		12,001	11,968
Transaction costs		53,559	37,229
Withholding tax expense		2,984	7,965
Total expenses, net		591,619	689,765
Increase (decrease) in net assets attributable to holders of redeemable units		3,579,642	(27,241)
Increase (decrease) in net assets attributable to holders of redeemable units per series			
Series A		2,798,665	(5,157)
Series F		780,977	(22,084)
Increase (decrease) in net assets attributable to holders of redeemable units per series per unit			
Series A	10	0.95	0.00
Series F		1.16	(0.06)

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

Palos Equity Income Fund

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

For the years ended December 31, 2016 and 2015

(expressed in Canadian dollars)

	Series A		Series F	
	2016 \$	2015 \$	2016 \$	2015 \$
Net assets attributable to holders of redeemable units – Beginning of year	17,441,588	19,195,000	2,638,160	1,873,710
Increase (decrease) in net assets attributable to holders of redeemable units	2,798,665	(5,157)	780,977	(22,084)
Distributions to holders of redeemable units				
From net realized gains on investments	(387,567)	-	(218,143)	-
Return of capital	(1,072,524)	(2,297,497)	(125,077)	(314,109)
Total distributions to holders of redeemable units	(1,460,091)	(2,297,497)	(343,220)	(314,109)
Redeemable unit transactions				
Proceeds from redeemable units issued	766,391	1,410,816	2,626,465	1,464,974
Reinvestment of distributions to holders of redeemable units	1,111,061	1,711,293	331,825	286,176
Redemption of redeemable units	(2,009,093)	(2,572,867)	(327,525)	(650,507)
Net increase (decrease) from redeemable unit transactions	(131,641)	549,242	2,630,765	1,100,643
Net increase (decrease) in net assets attributable to holders of redeemable units	1,206,933	(1,753,412)	3,068,522	764,450
Net assets attributable to holders of redeemable units – End of year	18,648,521	17,441,588	5,706,682	2,638,160

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

Palos Equity Income Fund
Statements of Cash Flows
For the years ended December 31, 2016 and 2015

(expressed in Canadian dollars)

	2016 \$	2015 \$
Cash flows from operating activities		
Increase (decrease) in net assets attributable to holders of redeemable units	3,579,642	(27,241)
Adjustments for		
Foreign exchange loss (gain)	66,580	(143,777)
Net change in unrealized depreciation (appreciation) of investments	(2,469,312)	459,584
Proceeds from sale and maturity of investments	24,674,152	20,261,098
Purchases of investments	(23,948,791)	(19,771,045)
Net realized gain on sale of investments	(1,094,942)	(466,432)
Accrued income receivable	(37,718)	4,619
Accrued liabilities	(8,653)	(3,457)
Management fees payable	576	274
Performance fees payable	(110,220)	110,290
Net cash from operating activities	<u>651,314</u>	<u>423,913</u>
Cash flows from financing activities		
Distributions paid to holders of redeemable units, net of reinvested distributions	(438,127)	(620,333)
Proceeds from issuance of redeemable units	3,363,781	2,988,206
Amount paid on redemption of redeemable units	(2,329,243)	(3,236,892)
Net cash from (used in) financing activities	<u>596,411</u>	<u>(869,019)</u>
Foreign exchange gain (loss) on cash	<u>(66,580)</u>	<u>143,777</u>
Net change in cash during the year	1,181,145	(301,329)
Cash – Beginning of year	<u>154,653</u>	<u>455,982</u>
Cash – End of year	<u>1,335,798</u>	<u>154,653</u>
Supplementary information on cash flows from operating activities		
Interest received	106,774	189,727
Dividends received, net of withholding taxes	454,584	502,113

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

Palos Equity Income Fund

Schedule of Investment Portfolio

As at December 31, 2016

(expressed in Canadian dollars)

	Maturity date	Coupon or dividend rate	Number of shares or par value	Average cost \$	Fair value \$
Bonds					
Convertible bonds					
Boralex Inc.	June 30, 2020	4.500%	300,000	300,000	343,200
Chemtrade Logistics Inc.	June 30, 2021	5.250%	240,000	240,000	247,200
DH Corp.	Sept. 30, 2020	5.000%	350,000	350,000	345,356
Element Financial Corp.	June 30, 2019	5.125%	250,000	259,525	280,948
Northland Power Inc.	June 30, 2020	4.750%	400,000	426,004	456,000
Total convertible bonds				<u>1,575,529</u>	<u>1,672,704</u>
Corporate bonds					
Canadian Energy Services & Technology Corp.	April 17, 2020	7.375%	250,000	264,375	258,438
DHX Media Ltd.	Dec. 2, 2021	5.875%	500,000	500,000	503,440
Parkland Fuel Corp.	May 28, 2021	5.500%	200,000	200,000	206,500
Total corporate bonds				<u>964,375</u>	<u>968,378</u>
Total bonds				<u>2,539,904</u>	<u>2,641,082</u>
Common stock					
Consumer discretionary					
Cineplex Inc.			4,000	176,999	204,880
DHX Media Ltd.			37,000	301,873	260,850
Dollarama Inc.			3,000	236,004	295,140
EnerCare Inc.			27,000	451,539	481,680
Gildan Activewear Inc.			6,500	230,277	221,585
Imvescor Restaurant Group Inc.			40,000	106,381	140,000
Linamar Corp.			6,000	319,665	346,140
Magna International Inc.			1,600	84,043	93,280
Park Lawn Corp.			4,700	75,200	73,931
Restaurant Brands International Inc.			4,000	198,069	255,800
Spin Master Corp.			9,000	247,515	289,710
Stingray Digital Group Inc.			40,120	306,601	349,445
Total consumer discretionary				<u>2,734,166</u>	<u>3,012,441</u>
Consumer staples					
Alimentation Couche-Tard, Class B			5,500	264,310	334,840
Maple Leaf Foods Inc.			8,000	172,504	224,960
Total consumer staples				<u>436,814</u>	<u>559,800</u>

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

Palos Equity Income Fund
Schedule of Investment Portfolio ... *continued*
As at December 31, 2016

(expressed in Canadian dollars)

	Number of shares or par value	Average cost \$	Fair value \$
Energy			
ARC Resources Ltd.	19,000	334,446	439,090
Canadian Energy Services & Technology Corp.	68,000	398,748	520,880
Canyon Services Group Inc.	36,000	177,373	253,080
Crescent Point Energy Corp.	17,000	338,785	310,250
Keyera Corp.	15,200	518,285	614,992
Parkland Fuel Corp. SUB REC	3,000	72,366	72,366
Pembina Pipeline Corp.	9,000	280,267	377,640
Secure Energy Services Inc.	33,900	367,722	396,969
Tamarack Valley Energy Ltd.	130,000	407,223	449,800
Tidewater Midstream and Infrastructure Ltd.	200,000	271,250	318,000
Veresen Inc.	16,000	199,920	209,760
Vermilion Energy Inc.	8,300	370,325	468,867
Whitecap Resources Inc.	39,000	474,352	474,240
Total energy		<u>4,211,062</u>	<u>4,905,934</u>
Financials			
Bank of Montreal	4,000	345,492	386,280
ECN Capital Corp.	28,000	93,800	92,400
Element Fleet Management Corp.	20,000	265,000	249,200
Intact Financial Corp.	4,200	385,243	403,620
Royal Bank of Canada	10,000	755,462	908,700
Sun Life Financial Inc.	17,000	662,103	876,350
The Bank of Nova Scotia	10,000	648,316	747,600
The Toronto-Dominion Bank	13,514	534,390	894,897
The Goldman Sachs Group Inc.	1,400	277,036	450,113
Total financials		<u>3,966,842</u>	<u>5,009,160</u>
Health care			
Knight Therapeutics Inc.	32,700	287,600	351,198
Sienna Senior Living Inc.	10,000	172,600	163,000
Total health care		<u>460,200</u>	<u>514,198</u>
Industrials			
Badger Daylighting Ltd.	11,000	290,294	353,100
Heroux-Devtek Inc.	12,000	152,317	176,400
Morneau Shepell Inc.	11,635	121,452	223,275
New Flyer Industries Inc.	4,000	161,940	163,360
People Corp.	30,000	114,441	132,000
Savaria Corp.	8,000	90,720	86,960
Waste Connections Inc.	3,500	294,544	368,690
WSP Global Inc.	8,000	320,910	357,520
Total industrials		<u>1,546,618</u>	<u>1,861,305</u>

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

Palos Equity Income Fund
Schedule of Investment Portfolio ... *continued*
As at December 31, 2016

(expressed in Canadian dollars)

	Number of shares or par value	Average cost \$	Fair value \$
Information technology			
CGI Group Inc.	5,500	322,842	354,420
Kinaxis Inc.	3,750	240,560	234,375
Shopify Inc.	4,000	153,180	230,800
Total information technology		<u>716,582</u>	<u>819,595</u>
Materials			
Agnico Eagle Mines Ltd.	6,000	242,274	338,700
Agrium Inc.	2,000	215,047	269,920
B2Gold Corp.	70,000	260,853	223,300
CCL Industries Inc.	1,700	249,695	448,460
Franco-Nevada Corp.	5,000	360,363	401,400
Lundin Mining Corp.	84,000	390,731	537,600
Nevsun Resources Ltd	57,000	229,349	236,550
Total materials		<u>1,948,312</u>	<u>2,455,930</u>
Real estate			
American Hotel Income Properties REIT	25,500	241,414	266,730
InterRent Real Estate Investment Trust	25,100	181,963	187,246
Total real estate		<u>423,377</u>	<u>453,976</u>
Utilities			
Algonquin Power & Utilities Corp.	35,000	376,076	398,650
Crius Energy Trust	25,800	210,218	217,494
Superior Plus Corp.	12,000	136,760	153,000
Total utilities		<u>723,054</u>	<u>769,144</u>
Total common stock		<u>17,167,027</u>	<u>20,361,483</u>
Total investments		<u>19,706,931</u>	<u>23,002,565</u>
Other assets, less liabilities			<u>1,352,638</u>
Net assets attributable to holders of redeemable units			<u>24,355,203</u>

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

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

1 General information

Palos Equity Income Fund (the “Fund”) was formed in January 3, 2008 under the laws of the Province of Quebec pursuant to a trust agreement (the agreement), as amended for the last time on August 26, 2013, between Computershare Trust Company of Canada (the trustee) and Charles Marleau (the settlor). The address of the Fund’s registered office is 1 Place Ville-Marie, Suite 1670, Montréal, Quebec, H3B 2B6, Canada. The Fund is an open-ended mutual fund, is qualified as a unit trust and is a registered investment fund under Section 204.4 of the Income Tax Act (Canada).

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

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

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

These financial statements have been authorized for issue by the Board of Directors of the Manager on March 30, 2017.

2 Basis of presentation

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

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

3 Summary of significant accounting policies

Financial instruments

Recognition

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

Income recognition

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

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

Fair value measurement

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

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

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

Classification of redeemable units

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

Foreign currency translation

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

Offsetting financial assets and financial liabilities

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

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

Cash

Cash comprises deposits with financial institutions and bank overdraft.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

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

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

Taxation

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

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

Accounting standard issued but not yet adopted relevant to the Fund

IFRS 9, Financial Instruments

In July 2014, the IASB issued the complete and final version of IFRS 9, which will replace IAS 39, Financial Instruments: Recognition and Measurement. IFRS 9 includes, among others, the requirements for the classification and measurement of financial assets and financial liabilities.

IFRS 9 sets out a new classification and measurement model for financial assets to determine whether a financial asset should be classified at amortized cost, at FVTPL or at fair value through other comprehensive income. This model is based on the contractual cash flow characteristics of the financial asset and the business model under which the financial asset is held. The valuation basis of financial assets, namely amortized cost or fair value, may need to be changed, as well as the recognition of unrealized gains and losses arising from changes in fair value. For the classification and measurement of financial liabilities, the new standard essentially carries forward the current requirements under IAS 39.

The Fund will have to adopt IFRS 9 retrospectively for annual periods beginning on or after January 1, 2018. However, the restatement of comparative periods is not mandatory, as an exemption from applying the standard allows comparative periods to be presented in accordance with the previous GAAP under certain conditions. The Manager continues to assess the impact of adopting IFRS 9.

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

4 Critical accounting estimates and judgments

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

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

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

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

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

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

Palos Equity Income Fund

Notes to Financial Statements

December 31, 2016 and 2015

(expressed in Canadian dollars)

5 Risks associated with financial instruments

Risk factors

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

Credit risk

The Fund is exposed to credit risk, which is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. The majority of the credit risk to which the Fund is exposed arises from its investments in debt securities. In selecting fixed income securities for the Fund, the Manager considers factors such as the debt security's yield, risk of interest rate fluctuation, credit risk, the issuer's capital structure, credit spread and duration. The analysis below summarizes the credit quality of the Fund's debt portfolio as at December 31, 2016 and 2015.

Credit rating	2016	2015
	Total fixed income %	Total fixed income %
BB	-	27.5
BB -	26.9	-
B	-	9.2
B -	9.8	-
Non-rated	63.3	63.3
	100.0	100.0

Source: Standard & Poor's

All portfolio transactions in securities are settled or paid for upon delivery using approved brokers. The risk of default is considered minimal as delivery of securities sold is only made once the broker has received payment. Payment is made on a purchase once the securities are received by the broker. The trade will not settle if either party fails to meet its obligation. In addition, the Fund lodges its cash with quality institutions which have credit ratings of A- or above. Credit risk with respect to accrued income receivable is limited as the receivables are derived from a portfolio of diversified investments.

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

Palos Equity Income Fund

Notes to Financial Statements

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(expressed in Canadian dollars)

Liquidity risk

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

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

	2016		
Financial liabilities	On demand	< 3 months	Total
	\$	\$	\$
Redemptions payable	-	7,375	7,375
Distributions payable	-	71,264	71,264
Accrued liabilities	-	21,330	21,330
Management fees payable	-	850	850
Performance fees payable	-	70	70
Redeemable units	24,355,203	-	24,355,203

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

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

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Market risk

The Fund's investments are subject to market risk which is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. To monitor the risk, the Fund's Manager uses stress testing to examine the impact that abnormally large swings in market factors and periods of prolonged inactivity might have on trading portfolios. The stress testing is designed to identify key risks and ensure that the losses from abnormal events are not above the Fund's risk tolerance.

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

a) Currency risk

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

The table below indicates the foreign currencies to which the Fund had significant exposure as at December 31, 2016 and 2015, in Canadian dollars. The table also illustrates the potential impact on the net assets attributable to holders of redeemable units if the Canadian dollar had strengthened or weakened by 5% in relation to each of the other currencies, with all other variables held constant. The monetary exposure presents the impact on cash and the non-monetary exposure presents the impact on investments. Non-monetary items are investments in equity securities and are classified based on the currency in which they were purchased.

Currency	2016					
	Exposure			Impact on net assets attributable to holders of redeemable units and the increase (decrease) thereof		
	Monetary \$	Non- monetary \$	Total \$	Monetary \$	Non- monetary \$	Total \$
United States dollar	593,966	450,113	1,044,079	29,698	22,506	52,204
% of net assets attributable to holders of redeemable units	2.4%	1.8%	4.2%	0.1%	0.1%	0.2%

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Currency	2015					
	Exposure			Impact on net assets attributable to holders of redeemable units and the increase (decrease) thereof		
	Monetary \$	Non-monetary \$	Total \$	Monetary \$	Non-monetary \$	Total \$
United States dollar	895,965	1,240,843	2,136,808	44,798	62,042	106,840
% of net assets attributable to holders of redeemable units	4.5%	6.2%	10.7%	0.2%	0.3%	0.5%

b) Interest rate risk

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

The Fund mitigates interest rate risk by monitoring interest rates and the maturities of its portfolio of interest-bearing financial instruments. The following table summarizes the Fund's exposure to interest rate risk. It includes the Fund's interest-bearing financial assets at fair value, categorized by the earlier of contractual interest rate reset dates or maturity dates. The table also illustrates the potential impact on the net assets attributable to holders of redeemable units if the prevailing levels of market interest rates changed by 1%, assuming a parallel shift in the yield curve with all other variables held constant.

Terms to maturity	Total exposure	
	2016 \$	2015 \$
1-5 years	2,641,082	1,449,500
5-10 years	-	1,047,475
Total	2,641,082	2,496,975
Impact on net assets attributable to holders of redeemable units	67,109	47,717
Impact on net assets attributable to holders of redeemable units (%)	0.3%	0.2%

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c) Price risk

Price risk is the risk that the value of an investment will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual investment or its issuer, or by factors affecting all securities traded in the market. The Fund is exposed to price risk through its equity investment portfolio, which includes a variety of common shares in a wide range of industries. Other assets and liabilities are monetary items that are short-term in nature, and as such are not subject to price risk.

As at December 31, 2016, the expected increase or decrease in net assets attributable to holders of redeemable units of the Fund if the S&P/TSX composite index had increased or decreased by 5%, with all other variables held constant, would amount to \$1,193,405 and would represent 4.9% of the net assets attributable to holders of redeemable units of the Fund (2015 – \$943,748 representing 4.7% of the net assets attributable to holders of redeemable units of the Fund).

Concentration risk

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

Market segment	2016 %	2015 %
Consumer discretionary	15.3	18.4
Consumer staples	2.4	3.5
Energy	23.3	19.0
Financials	23.0	28.6
Health care	2.2	2.2
Industrials	8.1	8.0
Information technology	5.1	3.8
Materials	11.8	10.2
Real estate	2.0	-
Utilities	6.8	6.3
Asset class weighting	2016 %	2015 %
Convertible bonds	6.9	7.9
Corporate bonds	4.0	4.6
Common stock	83.6	88.0
Other net assets	5.5	(0.5)

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Fair value measurement

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

The following table provides an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into Levels 1 to 3 based on the degree to which the fair value is observable:

- Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date;
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3: Valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

				2016
	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities, long	20,361,483	-	-	20,361,483
Fixed income, long	1,672,704	968,378	-	2,641,082
	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Equities, long	17,666,697	-	-	17,666,697
Fixed income, long	1,579,475	917,500	-	2,496,975

All fair value measurements above are recurring. Fair values are classified as Level 1 when the related security or derivative is actively traded and a quoted price is available. If an instrument classified as Level 1 subsequently ceases to be actively traded, it is transferred out of Level 1. In such cases, the instruments are reclassified into Level 2, unless the measurement of its fair value requires the use of significant unobservable inputs, in which case it is classified as Level 3.

a) Equities and convertible bonds

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

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b) Bonds and short-term investments

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

There was no transfer between levels during the years ended December 31, 2016 or 2015.

6 Gains and losses on financial instruments by category

All of the Fund's non-derivative financial assets were designated, at inception, as financial assets at FVTPL. As at December 31, 2016, the total value of the non-derivative assets and liabilities was \$23,002,565 (2015 – \$20,163,672). All of the Fund's derivative liabilities are classified as held for trading (HFT). As at December 31, 2016, the total value of the derivative liabilities was nil (2015 – nil). Furthermore, all of the Fund's financial assets and financial liabilities other than its non-derivative financial assets and financial liabilities and its derivative liabilities were carried at amortized cost.

The following table presents the net gains (losses) on financial instruments at FVTPL by category for the years ended December 31, 2016 and 2015:

Category	Net gain (loss)	
	2016 \$	2015 \$
Financial assets at FVTPL designated at inception		
Unrealized gain (loss)	2,384,661	(459,584)
Realized gain	1,062,654	434,037
Total gain (loss) in financial assets at FVTPL designated at inception	3,447,315	(25,547)
Financial liabilities at FVTPL held for trading		
Unrealized gain	84,651	-
Realized gain	32,288	32,395
Total gain in financial liabilities at FVTPL held for trading	116,939	32,395
Total	3,564,254	6,848

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7 Redeemable units

During the years ended December 31, 2016 and 2015 the number of units issued, redeemed and outstanding were as follows:

	2016		2015	
	Series A	Series F	Series A	Series F
Units outstanding – Beginning of year	2,941,137	430,254	2,851,909	270,625
Redeemable units issued	130,572	424,409	210,056	213,093
Redeemable units issued on reinvestments	185,119	52,796	270,639	43,927
Redeemable units redeemed	(332,730)	(52,236)	(391,467)	(97,391)
Units outstanding – End of year	2,924,098	855,223	2,941,137	430,254

Capital structure

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

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

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

8 Related party transactions

a) Management fees and performance fees

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

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

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

The total management fees and performance fees for the year ended December 31, 2016 amounted to \$345,151 and nil, respectively (2015 – \$344,239 and \$110,290, respectively), with \$920 in outstanding fees due to the Manager as at December 31, 2016 (2015 – 110,564).

The Manager may waive or absorb the operation of management fees of the Fund. The decision to do so is reviewed regularly and is determined at the sole discretion of the Manager. During the year, the Manager did not waive any fees (2015 – did not waive any fees).

The Manager holds 30,654 units of the Fund as at December 31, 2016 (2015 – 59,353 units).

b) Independent Review Committee fees

The total remuneration paid to members of the Independent Review Committee during the year ended December 31, 2016 amounted to \$12,001 (2015 – \$11,968) and consisted only of fixed fees.

9 Brokerage commissions and soft dollars

The total commissions paid by the Fund to brokers in connection with portfolio transactions for the years ended December 31, 2016 and 2015, together with other transaction charges, are disclosed in the statements of comprehensive income (loss) of the Fund. Brokerage business is allocated to brokers based on the best net result for the Fund. Subject to this criteria, preference may be given to brokerage firms which provide (or pay for) certain services (arrangements referred to as soft dollar), which may include investment research, analysis and reports, and databases or software in support of these services. The ascertainable soft dollar value received as a percentage of total brokerage commissions paid during the years ended December 31, 2016 and 2015 is disclosed below.

	2016	2015
Soft dollars	\$9,798	\$9,099
Percentage of total transaction costs	18%	24%

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

The increase (decrease) in net assets attributable to holders of redeemable units per series per unit for the years ended December 31, 2016 and 2015 is calculated as follows:

	2016		2015	
	Series A \$	Series F \$	Series A \$	Series F \$
Increase (decrease) in net assets attributable to holders of redeemable units per series	2,798,665	780,977	(5,157)	(22,084)
Weighted average units outstanding during the year	2,947,585	672,386	2,902,281	373,355
Increase (decrease) in net assets attributable to holders of redeemable units per series per unit	0.95	1.16	0.00	(0.06)

11 Taxes

The Fund qualifies as a mutual fund trust under the Income Tax Act (Canada).

All or substantially all of the net income for tax purposes and net taxable capital gains realized in any year, after use of loss carryforwards, are distributed to unitholders such that no income taxes are payable by the Fund.

Capital and non-capital losses determined for tax purposes as at December 31, 2016 are as follows:

Capital losses		Non-capital losses	
Amount \$	Expires	Amount \$	Expires
-	-	-	-
-	-	-	-
-	-	-	-