

Phillips, Hager & North U.S. Special Equity Fund

Annual Report 1993

Dear Shareholder,

Your Fund showed a marked improvement in the final six months of 1993. The gain for the last six months of the year was 13.8% in Canadian dollars. At year end, the net asset value of the Phillips, Hager & North U.S. Special Equity Fund was \$13.65 before the payment of a 0.36 cents stock dividend. This represents a 15.1% gain during 1993. The strong U.S. dollar contributed 4.4% of the gain. In U.S. dollars, the Fund was up to 10.7% against 10.1% for the Standard & Poor's 500 Index. A worthwhile but certainly not brilliant year.

PERFORMANCE COMPARISONS*

	Dec 31/92 to Jun 30/93	Jun 30/93 to Dec 31/93	Dec 31/92 to Dec 31/93
US Special Equity Fund \$CDN	1.10%	13.80%	15.10%
US Special Equity Fund \$US	0.30%	10.40%	10.70%
S&P 500 \$U.S.	4.90%	5.00%	10.10%
S&P Midcap \$U.S.	5.80%	8.00%	14.30%
Russell 2000 \$U.S.	6.50%	11.20%	18.40%
Wilshire 5000 \$U.S.	4.70%	5.20%	10.10%
NASDAQ Composite \$U.S.	5.00%	10.70%	16.20%

* includes income in all cases.

The 0.36 cents per share stock dividend paid at the end of the year reduced the net asset value per share to \$13.29 ex-dividend.

Throughout this recovery, which began in 1991, there has been a great deal of nervousness about its durability. Unemployment was running at high levels, disposable income was growing slowly and people were worried about their job security. It is not surprising that consumer confidence was low and summer spending restrained. Now, after almost three years of improvement, the strength and breadth of the U.S. economy has become more obvious to both consumers and business people.

In their year end prognostications, strategists and commentators have been quite unanimous about the current economic condition. This can be summarized as steady economic growth with improving corporate earnings, moderate inflation, and interest rates at the lowest levels in 30 years.

Since this seems too good to be true, most of the commentators temper their comments by pointing out that, of course, the economy may grow too strongly, causing higher inflation and interest rates. Rising interest rates have the general effect of lowering price/earnings multiples as well as ultimately choking off the economic expansion. On the other hand, a moderate increase in the rate of growth, with only slight increases in interest rates would be very good for stock prices.

These comments sum up the situation rather well, but do not tell us which scenario is most probable. We believe there are good fundamental reasons why continued, even stronger economic growth will not be immediately translated into higher inflation and rising interest rates.

Despite almost three years of recovery, virtually no inflationary pressures have surfaced yet. In fact, 1993 ended with consumer and producer price indexes rising at the lowest levels in years. Moreover, the price of oil is the new low levels, which has a worldwide deflationary impact on all prices.

The U.S. is currently a very competitive economy. Years of major layoff and other restructuring aimed at boosting productivity have reduced costs. In addition to this, the U.S. currency is generally undervalued relative to other currencies in the world. It is interesting to note that unit labour costs in the U.S. are now significantly lower than both Germany and Japan. Overall, the American economy is now more competitive internationally than it has been for decades.

The U.S. unemployment rate is down to 6.4% and production is now running at 83.5% of capacity. These are levels where further improvement in the U.S. economy could be expected to produce inflationary pressure. However, worldwide over-capacity in most basic industries should mitigate the effect of strength in the U.S. The world's economies are generally experiencing modest rates of monetary growth from levels that have been declining since the mid 1970's. Restrictive fiscal policy is also a common theme amongst major industrialized countries. On a global basis, inflation will be moderate for some time despite the recovery in the U.S.

In conclusion, it appears that the U.S. economy can continue to grow moderately with low inflation and reasonable interest rates for an extended period of time.

Stock Market Outlook

Stock prices in the coming year will be affected by more than just the economic outlook.

Price/earnings ratios are at the high end of their historic range but not unreasonable given the low current interest rate levels. The initial stage of the bull market, as is typical, saw the price/earnings ratio expand based on anticipated recovery in earnings and lower interest rates. Price/earnings levels peaked in 1993 as earnings began to improve strongly and can be expected to continue to decline for the remainder of this cycle. In 1994, the market will be a tug of war between the effect of rising earnings and falling multiples. As in common with against cycles, the market could experience wider short term swings in the year ahead.

This healthy skepticism is contradicted by two important observations. Records levels of equity mutual fund purchases by the public is a caution sign, as it must indicate general enthusiasm for the market. The public's appetite for initial public offerings has also reached record levels. Some of these offerings are companies with little or no track record. All of them compete for the funds going into the stock market. So far, the heavy mutual fund sales have funded the initial public issues. However, since both of these phenomena are signs of public enthusiasm, they are likely to result in a more volatile market.

Although the Fund concentrates on stock selection rather than market selection, cash levels may be raised further in these two developments appear to get out of hand.

Yours truly,

A handwritten signature in black ink that reads "Rudy North". The signature is written in a cursive, flowing style with a large initial 'R' and 'N'.

Rudy E. North