

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

1996 Annual Report

1996 MARKET REVIEW

1996 was the second good year for U.S. equity markets, following a pause in 1994. The Fund's relative performance was very acceptable, as it beat all of the indices followed on a regular basis.

For the third straight year, small-cap stocks underperformed larger cap stocks. Basically, it was a case of the larger the better. The strong performance of the NASDAQ, which includes both small and large-cap stocks, reflected the strong performance of some of the largest high technology stocks such as Intel and Microsoft. More on this later.

Another significant characteristic of 1996 was the high degree of performance rotation between stock groups and even between stocks in the same group. Even the smallest shortfall from expected operating results often sent a stock into a significant downtrend. On the other hand, stocks that consistently reported results, even just slightly above expectations, were rewarded by sustained and, in some cases, surprisingly strong uptrends.

The result of these characteristics of 1996 market behaviour is that some stocks seem rather highly priced, while others are attractively priced relative to their historic P/E ranges. Overall, the indices are priced towards the high end of their historical P/E ranges, but not at historic extremes. This background should provide scope for rewarding stock selection during 1997.

1997 ECONOMIC AND MARKET OUTLOOK

The economic backdrop remains monotonously the same. Low inflation rates, low interest rates and moderate growth are all factors that are supportive of high price/earnings multiples. The down side to this happy set of circumstances is the assumption, which seems completely reasonable, that the next significant move in the economic picture is for these factors to deteriorate. The only tangible evidence of this so far is that the labour market in the U.S. is getting quite tight. It is assumed that this will lead to wage inflation. A mitigating factor is that labour markets in most of the industrialized world are still on the soft side.

Remember how surprising rise in interest rates in the U.S. seemed in 1994? It took an amazingly long time for most of us to come to the conclusion that it was probably related to the weakness of the U.S. dollar. Global factors are becoming more significant to the U.S. economy and stock markets than in the past.

Regardless of the soundness of this line of reasoning, whether or not 1997 is another good year for equity investors will likely be determined by when, and how rapidly, the expected rise in interest rates takes place. If it takes longer to unfold than is generally expected, the market will most likely continue to be surprisingly strong and could possibly enter into a speculative blow-off.

There is no doubt that the current economic expansion is very old and that we are one year closer to the end than a year ago. The eerie thing about this is how similar the day-to-day “economic news” is to what it was a year ago. This is not a reason for complacency, but it might if it continues long enough, lead to a general mood of complacency amongst investors. This certainly is not the case at this time. There are still lots of commentators pointing out that equity markets are too high. When their numbers diminish significantly, expect the next bear market. So much for general economic and market commentary. The investment philosophy and strategy to follow should be much more relevant to the performance of the Fund.

SMALL-CAP VS LARGE-CAP STOCK

This probably falls back into the category of market commentary, but it is currently such an important side show that it warrants some special consideration. As mentioned earlier, 1996 was the third straight year when large-cap stocks outperformed small-cap stocks. This phenomenon has continued through the first two months of 1997.

It seems very hard to forecast, or even explain in hindsight, the major relative cyclical strength between small-cap stocks and the rest of the market. On a short-term basis, the market seems to react to a belief that the small-cap stocks are particularly vulnerable to periods of economic weakness. If the rate of economic growth picks up in 1997, therefore, it would not be inconsistent for the relative performance of small-cap stocks to pick up.

INVESTMENT PHILOSOPHY

The world of 1997 currently enjoys instant dissemination of economic statistics and company information. The problem is that every professional money manager has the same set of inputs. Moreover, most professionals are focused, industrious and quite disciplined (although emotions do still seem to get the upper hand from time to time). Relative success or failure will be determined by an intangible and unmeasurable factor that, for want of a better word, must be called judgment. To us, perception and even intuition are as relevant in the process leading to good judgment as the facts considered and the analytical techniques applied. All of these factors are important, and the “skill” involved in their successful application has never been set out in an operating manual.

Just to make the whole situation more interesting, much of what drives equity markets is counter-intuitive compared to conventional experience. The equity manager then has to develop intuition that is counter-intuitive - clear?

Finally, there is the sobering thought that for all stock purchased there has to be an equal amount of stock sold. There has to be willing sellers and willing purchasers at the same price for any transaction to occur. In today’s marketplace most of these buyers and sellers are well-informed professionals.

The above is not meant as an argument for indexed funds. It is just an attempt to be objective about the process of managing a portfolio of equities. It is what makes being an equity manager so interesting and we believe that we can be winners in this serious game which always will have an equal number of winners and losers. The record will tell whether or not we succeed in the long term. So far, the results have been quite encouraging.

The nice thing about equity investing is that over the long term even some of the losers are going to do well in absolute terms, and better than non-equity investors in relative terms - or so we believe.

Well, this has turned into a nice preamble to a discussion on the Philosophy of Investment. Obviously a difficult subject to fit into an annual report. Look for the next installment in the semi-annual report.

LIKELY STRATEGY

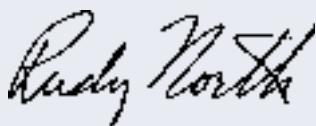
So much for investment philosophy. Our strategy will be to try to win.

The plan at this time is to remain nervously bullish. There are some good stocks in the portfolio that are getting expensive relative to their normal price/earnings range. These companies are still getting good earnings results and are in strong uptrends. As mentioned in the "review of 1996", any stocks that fell even slightly short of expectations suffered serious corrections. Many of these companies are working through their operation problems and their stocks appear in some cases to be establishing new uptrends. These stocks are priced attractively relative to the average price/earnings ratio of the market on normalized earnings. The Fund has been buying such stocks.

Any acceleration in the growth of the economy, especially if it results in increasing inflation rates and higher interest rates, will be interpreted very negatively. Under these circumstances, the Fund would attempt to switch its emphasis to stocks with defensive characteristics. At such a time, it might not be possible to find enough interesting equity investments to prevent a cash buying reserve from building. It is not clear at this time when these conditions will arise. It might be some time later in 1997; it might be in a later year.

Stock selection will remain the focus of the Fund. Any apparent market timing will be a de-facto result of the stock selection process. 1997 is going to be an interesting year and it has got off to a good start. It might even be another very profitable year. However the rest of the year unfolds, we will strive for the best investment results that we are capable of providing.

Yours truly,

A handwritten signature in black ink that reads "Rudy North". The signature is written in a cursive, flowing style.

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

PERFORMANCE RESULTS

March 10, 1997

On December 31, 1996 the net asset value of the Phillips, Hager & North Special Equity Fund was \$17.79 Canadian per unit, before the payment of a stock dividend. This represents a 29.6% gain during 1996.

The annual stock dividend paid at the end of the year was \$2.16 per unit. This payout reflects the income and realized capital gains that will be allocated to each unitholder by way of their 1996 T3 tax form from the Fund.

PERFORMANCE COMPARISONS*

| | <i>Annual Results</i> | | | |
|---------------------------------|-----------------------|-------------|-------------|-------------|
| | <i>1993</i> | <i>1994</i> | <i>1995</i> | <i>1996</i> |
| U.S. Special Equity Fund \$Cdn | 15.1% | 0.4% | 25.0% | 29.6% |
| U.S. Special Equity Fund \$U.S. | 10.7% | 3.5% | 28.4% | 28.9% |
| S&P 500 \$U.S. | 10.1% | 1.3% | 37.6% | 23.0% |
| S&P Midcap \$U.S. | 14.3% | -3.5% | 30.9% | 19.3% |
| Russell 2000 \$U.S. | 18.4% | -1.9% | 27.8% | 16.2% |
| NASDAQ Composite \$U.S. | 16.2% | -1.9% | 41.0% | 23.7% |

* Including income in all cases.

Average Annual Compound Rate of Returns as of Dec 31/96

| | <i>1 Year</i> | <i>2 Years</i> | <i>3 Years</i> | <i>4 Years</i> |
|--------------------------------|---------------|----------------|----------------|----------------|
| U.S. Special Equity Fund \$Cdn | 29.5% | 27.3% | 17.6% | 17.0% |

PORTFOLIO FUND VALUATION - December 31, 1996 (as a %)

Basic Industries

| | |
|----------------------------|-------------|
| Maverick Tube Corp. (MAVK) | 0.64 |
| Mississippi Chemical (GRO) | 1.97 |
| Northwest Pipe Co. (NWPX) | 0.96 |
| Nucor Corp. (NUE) | 0.35 |
| Pope & Talbot (POP) | 1.27 |
| Praxair Inc. (PX) | 4.21 |
| Total | 9.40 |

Consumer Cyclical

| | |
|---------------------------------|-------------|
| Jones Apparel Group, Inc. (JNY) | 2.56 |
| Kellwood Co. (KWD) | 2.97 |
| Nike, Inc. (NKE) | 2.18 |
| Total | 7.71 |

Consumer Durables

| | |
|-----------------------------|-------------|
| Falcon Building Prod. (FB) | 1.68 |
| Mohawk Industries (MOHK) | 0.05 |
| O'Sullivan Industries (OSU) | 1.60 |
| Singer Co NV (SEW) | 1.74 |
| Total | 5.07 |

Capital Goods

| | |
|---------------------------|--------------|
| BHA Group (BHAG) | 0.15 |
| Boeing Co. (BA) | 4.08 |
| Deere & Company (DE) | 3.71 |
| General Electric (GE) | 1.80 |
| Harnischfeger Inds. (HPH) | 2.03 |
| Owosso Corp. (OWOS) | 1.18 |
| Precision Castparts (PCP) | |
| Xerox Corp. (XRX) | 2.07 |
| Total | 15.25 |

Credit Cyclical

| | |
|---------------------------|-------------|
| BMC West Corp (BMCW) | 0.84 |
| Clayton Homes, Inc. (CMH) | 2.52 |
| Total | 3.36 |

Consumer Growth Staple

| | |
|-------------------------------|-------------|
| Dsg International Ltd (DSGIF) | 1.82 |
| Total | 1.82 |

Technology

| | |
|-------------------------------|--------------|
| Amerilink Corp. (ALNK) | 0.58 |
| Applied Materials Inc. (AMAT) | 0.16 |
| Bay Networks (BAY) | 1.50 |
| Digital Equipment Corp (DEC) | 1.24 |
| EMC Corp. (EMC) | 1.36 |
| Intel Corp. Common (INTC) | 1.79 |
| Intervoice (INTV) | 0.17 |
| Kemet Corporation (KMET) | 0.80 |
| Linear Technology (LLTC) | 0.20 |
| Microsoft Corp. (MSFT) | 0.38 |
| Orcad Inc. (OCAD) | 0.58 |
| Texas Instruments Inc. (TXN) | 3.20 |
| Total | 11.96 |

Energy

| | |
|--------------------------------|-------------|
| Chesapeake Energy (CHK) | 1.90 |
| Destec Energy (ENG) | 1.28 |
| Diamond Offshore Drilling (DO) | 2.60 |
| Harcor Energy (HARC) | 0.44 |
| Total | 6.22 |

PORTFOLIO FUND VALUATION - December 31, 1996 (as a %)

Financial

| | |
|-----------------------------------|-------------|
| Fleet Financial Group, Inc. (FLT) | 3.41 |
| Total | 3.41 |

Healthcare

| | |
|-------------------------------|-------------|
| Allied Healthcare Inc (AHPI) | 0.57 |
| Biowhittaker Inc. (BWI) | 0.55 |
| Columbia/HCA Healthcare (COL) | 5.85 |
| Healthsource (HS) | 1.20 |
| Integrated Health (IHS) | 1.11 |
| Total | 9.28 |

Media/Entertainment

| | |
|---------------------|-------------|
| Carnival Corp (CCL) | 1.81 |
| Total | 1.81 |

Retail

| | |
|----------------------------|--------------|
| APS Holdings (APSI) | 0.71 |
| CompUSA Inc. (CPU) | 0.94 |
| Dress Barn Inc. (DBRN) | 2.67 |
| Fred Meyer Inc. (FMY) | 0.81 |
| Gap, Inc. (GPS) | 3.44 |
| Michaels Stores Inc (MIKE) | 0.82 |
| Nine West Group (NIN) | 1.06 |
| Pier 1 Imports Inc. (PIR) | 1.44 |
| Price/Costco Inc. (PCCW) | 3.50 |
| Total | 15.39 |

Transportation

| | |
|--------------------------------|-------------|
| AMR Corporation (AMR) | 4.42 |
| Covenant Transportation (CVTI) | 0.98 |
| Greyhound Lines Inc. (BUS) | 1.66 |
| Mesa Airlines Inc. (MESA) | 1.85 |
| Total | 8.91 |

| | |
|----------------------------------|--------------|
| Total Equities | 99.59 |
| Cash and Short Term Notes | 0.41 |

| | |
|--------------------|----------------|
| TOTALASSETS | 100.00% |
|--------------------|----------------|