

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

Annual Report 1994

Dear Shareholder,

On December 31, 1994 the net asset value of the Phillips, Hager & North Special Equity Fund was \$13.34 per share before the payment of a stock dividend. This represented a 0.4% gain during 1994. The strength of the U.S. dollar against the Canadian dollar contributed 5.0% to the performance of the Fund during the year. The annual stock dividend paid at the end of the year was \$0.87 per share, reducing the net asset value per share to 12.47 ex-dividend on December 31st, 1994.

PERFORMANCE COMPARISONS*

	Dec 31/92 to Dec 31/93	Dec 31/93 to June 30/94	June 30/94 to Dec 31/94	Dec 31/93 to Dec 31/94
US Special Equity Fund \$CDN	15.10%	-5.10%	5.80%	0.40%
US Special Equity Fund \$US	10.70%	-9.30%	4.40%	-5.40%
S&P 500 \$US	10.10%	-3.40%	4.90%	1.30%
S&P MidCap \$US	14.30%	-7.00%	4.10%	-3.10%
Russell 2000 \$U.S.	18.40%	-6.40%	4.80%	-1.90%
Wilshire 5000 \$U.S.	10.10%	-4.90%	4.00%	-1.10%
NASDAQ Composite \$U.S.	16.20%	-8.40%	7.20%	-1.90%

* includes income in all cases.

1994 U.S. Equity Market

1994 turned out to be a year of correction and consolidation for U.S. equity markets. The first phase of the correction started on February 4, 1994 when the Federal Reserve Board raised interest rates for the first time in this business cycle. This precipitated a sharp sell-off in the stock market followed by a period of general decline which reached a low in July. By that time just about every group of stocks had been hit and the market had become very oversold. Small-cap stocks fared worse than the general market.

Since July, 1994 the market has recovered erratically. Leadership switched from group to group. There were brief period when small-cap stocks responded well as the market rose but, on balance, it was a large-cap market. Both small and medium-cap stocks lagged the overall market during the second half rally. Even within the NASDAQ Composite (O.T.C. Market), it was the large-cap stocks that performed best; smaller O.T.C. stocks were much weaker.

1994 Interest Rates and the Market

Rising interest rates were the main problem for the U.S. equity markets during 1994. Early in the 1994, fears of mounting inflationary pressure began to appear. Whether or not these fears were justified is now of minor consequence. Our view is that they were overdone and indeed, inflation has continued to be well behaved despite the accelerating growth patter during the year. What matter is that inflation fears prompted the Federal Reserve Board to raise short-term interest rates at a much earlier point in the inflationary cycle than has typically been the case.

Interest rates, as measured by the Fed. Funds Rate, nearly double last year, from 3% in early February to 5.5% by mid-November. The rise in short-term interest rates was accompanied by a substantial flatterng of the yield curve. We believe that the economic growth in the United States will decelerate in 1995 as higher rates take the customary bite out of economic activity. It seems likely that growth will slow to around 2% by the second half of this year. This slowing, and commensurate easing of interest rate pressures, will provide the basis for a continuation of the current economic cycle into 1996 and possibly longer.

Intermediate Term Outlook for Small-Cap Stocks

Although the secondary or small-cap sector of the market did not do well in 1994, we do not believe that this performance marks an end to its longer term relative improvement which began in late 1990. Prior to November, 1990 small-cap stocks has lagged the larger-cap sector since mid 1983. These longer term or secular performance plays have tended to be recurring and last about six to seven years.

The present recovery cycle has been taking place for four years. The history of these six to seven year periods of leadership for the small-cap area has shown a tendency for the last couple of years to be the most dynamic and rewarding.

The small-cap sector still appears to be undervalued relative to larger-cap areas. A good proxy for small-cap growth companies is the large T. Rowe Price New Horizons Fund. Since 1961, the average P/E ratio of the holdings of this fund have peaked at two times the P/E multiple of the S&P index. Conversely, the beginning of major advances for small-cap growth stocks as represented by this portfolio has been equal to the P/E multiple of the S&P index.

The relative P/E ratio of small-cap growth stocks has been slow to expand during the current cycle. On November 30, 1994, based on the study mentioned above, it stood at just 1.29 times the S&P multiple. This is well below the danger level of two times and suggests the secular recovery cycle from small-cap stocks is far from over.

1999 Outlook

1995 will likely go down as a mid-cycle lull for the North American economies. We expect a slow-down in the U.S. growth rate to alleviate some of the concerns over inflationary pressures and set the stage for a continuation of the economic cycle into 1996.

Past mid-cycle slowdowns have been good news for the stock market. We expect this will prove to true once more in 1995. The expansions of the 1960s and 1980s exhibited significant mid-cycle slowdowns in 1967 and 1986. The Standard and Poor's Index experienced returns of roughly 15% during these periods. We expect this tendency will be repeated once more in 1995.

The fundamentals of the U.S. equity market have improved dramatically over the past year as corporate earnings have surged ahead. The Standard and Poor's 500 Index is currently at approximately 16 times 1994 earnings and 14 times estimated earnings for this year. These levels make the stock market good value by past standards. Moderate earnings growth in 1995 should be translated into higher stock market prices in an environment of stable to declining interest rates.

In summary, 1994 was a poor year for financial markets. It was one of the works ever for bonds and lackluster for equities, especially mid and small-cap stocks. We expect that 1995 will prove to be a rewarding year for holder of both equities and fixed income investments. The PH&N U.S. Special Equity Fund will continue to be invested in high potential growth stocks including a major commitment to small-cap stocks.

Yours truly,

A handwritten signature in cursive script that reads "Rudy North". The signature is written in black ink and is positioned below the "Yours truly," text.

Rudy E. North

PORTFOLIO HOLDINGS — December 31, 1994

	(%)
Adaptec (ADPT)	0.91
Airborne Freight Corporation (ABF)	1.98
Allied Healthcare (AHPI)	0.64
Amerilink (ALNK)	0.39
Applied Materials Inc. (AMAT)	0.98
Astec Inds. Inc. (ASTE)	1.48
Aviall Inc. (AVL)	1.18
Barrett Business Services (BBSI)	1.08
Bay Networks (BNET)	2.28
Bic Corp Common (BIC)	1.02
BMC West Corp (BMCW)	0.43
Chesapeake Energy (CSPK)	7.29
Clayton Homes, Inc. (CMH)	3.18
CML Group Inc. (CML)	0.39
Columbia Healthcare (COL)	2.82
CompUSA Inc. (CPU)	0.12
Covenant Transportation (CVTI)	0.75
Designs Inc. (DESI)	0.81
Destec Energy (ENG)	0.41
Dress Barn Inc. (DBRN)	2.07
DSC Communications (DIGI)	0.69
DSG International (DSGIF)	1.64
EMC Corp. (EMC)	2.50
Falcon Building Prod. (FB)	0.43
Fleet Financial Group, Inc. (FLT)	2.51
Fred Meyer Inc. (FMY)	1.19
Hamischfeger Inds. (HPH)	0.49
Health Trust Inc. (HTI)	4.16
Intel Corp Common (INTC)	1.97
Jones Apparel Group, Inc. (JNY)	3.48
Kellwood Co. (KWD)	1.21
Limited Inc. (LTD)	2.80
Linear Technology (LLTC)	0.76
Magma Copper Co. Class B (MCU)	1.55
Mascotech Inc. (MSX)	1.92
Maverick Tube Corp. (MAV)	0.36
Merrill Lynch & Co. (MER)	3.59
Mesa Airlines Inc. (MESA)	1.41
Microsoft Corp (MSFT)	4.72
Mississippi Chemical (MISSS)	0.40
Mohawk Industries (MOHK)	0.79
Nike, Inc. (NKE)	2.88
Nine West Group (NIN)	2.19
Owosso Corp. (OWOS)	0.39
Physician Corp. America (PCAM)	2.37
Pier 1 Imports Inc. (PIR)	1.23
Praxair Inc. (PX)	3.16
Price/Costco Inc. (PCCW)	3.03
Pyxis Corp. Common (PYXS)	0.73
Seitel Inc. (SEI)	2.49
Sensormatic Electronics (SRM)	1.39
Singer Co. (SEW)	3.46
Texas Instruments Inc. (TXN)	2.60
Top Source Tech (TPS)	0.26
TRC Companies Inc. (TRR)	0.59
Wellpoint Health Networks (WLP)	<u>4.49</u>
Total Equities	<u>99.99%</u>
Cash and Short Term Notes	<u>0.01%</u>
TOTAL ASSETS	100.00%