Phillips, Hager & North U.S. Special Equity Fund
Semi-Annual Report - June 1997

October 1, 1997

Commentary

Your Manager often feels there are many more interesting issues concerning the Fund than writing semi-annual reports. Part of the problem is also a desire to say something that is worth reading. Recently, as a warm up exercise, he read the semi-annual omnibus report of a Many Billion Dollar Fund Family that has good management and whom, after PH&N, he holds in very high regard. In effect, it said that the first six months had been very good for equity investors in Canada and the U.S. This, it went on to say, was largely because of the favourable environment of moderate economic growth, low inflation rates and low interest rates. Wow, what insight! What can we possibly add to this depth of thinking more than the monthly trivial that we have already published?

Of course, they hit the nail on the head. In order to avoid just complacently enjoying this happy situation, your Fund's management raised up to 26% cash about mid year. At least rationalizing this move should inspire some more creative commentary.

Remember that the Fund's philosophy is to remain close to fully invested and to concentrate on stock selection rather than market timing in its quest to outperform the market!

This is how the decision to raise cash came about. The market in the first half of the year was dominated by large capitalization stocks best reflected in the Dow Jones index and the S&P 500 index. Some of the best performers of this group of stocks were steady growth companies, very well managed and internationally positioned: a combination that many strategists claimed was an unbeatable hand and the only place to be for the foreseeable future. Coca-Cola is a good example of what this type of stock was all about—outperformed the market strongly since the beginning of 1994—owned by the great value investor, Warren Buffett, destined to continue to grow at 15% to 20% per annum and selling at just 45 times trailing 12 month earnings.

Sometimes succumbing to bouts of cynicism, the Fund's management decided that even though a blow off rally in this type of stock might be in the making, the Fund would not be allowed to participate in this final fun since it had not been clever enough to get in on the earlier stages of the advance in these particular stocks. Furthermore, the fact that the market was so narrowly focussed on these market leaders brought back uncomfortable memories of the aftermath of past markets with similar lack of breadth.

Another broad group of stocks that was outperforming the market was high tech stocks. The Fund was quite well represented in this group and had held them for an extended period of time during which the price earnings multiples had expanded considerably. In June, a number of companies in this group warned that earnings for the June quarter would be below earlier expectations. All of the companies that disappointed in this manner sold off sharply and the market action of the entire group appeared to be breaking down. Since the Fund had dodged all of these bullets to that point, it was decided to sell off a significant portion of its high tech stocks. When a group has been going up for an extended period of time, is expensive in terms of a high current price to earnings multiple, and when this multiple is not only high in absolute terms but also relative to the historical multiple range for the group, it is sometimes wise to sell.

As we have said many times over the past few years, stock selection has served us better than attempts at market timing.

Since we are now well into the second half of the year, it is now possible to make some fairly accurate short term observations about our actions at mid year.

First, the blow off in the big stocks did not occur and in fact they have entered into downtrends despite the powerful sponsorship they were receiving from institutional investors and high profile commentators.

Secondly, the June breakdown in the high tech stocks aborted. No sooner had we sold them than the pre-announcement disappointing results dried up and the group resumed a vigorous up trend. The group is now even more expensive relative to earnings and looks like maybe it will be this cycle's candidate for a speculative blow off.

Despite all of this, the Fund has performed well since the end of June. In general, the indices reflecting smaller cap stocks have been catching up to the S&P 500. This trend has benefited the Fund.

CONCLUSION

Low rates of inflation and interest combined with moderate economic growth and, on balance, favourable earnings results make a very good environment for rising equity markets. These conditions also provide some rationale for the higher than average price/earnings ratios in evaluating common stocks.

The question is, how high is too high? The stock market is cyclical and valuations fluctuate widely around any theoretically "proper" or "fair" valuation. Usually a trend towards higher valuations that seems to be reaching extreme levels will carry on until the market is dealt some sort of shock. Suddenly accelerating interest rates would be a good example of the type of development that can turn a market down. However, it could be something entirely different and even completely unexpected at this time.

Some past signs of a vulnerable market that exist today are high levels of purchasing by the public of equity mutual funds (a sign of over enthusiasm) and high levels of insiders' sales of stock in the companies they manage (informed opinion). Unfortunately, these signs do not pinpoint the top of the market. Moreover, there is no guarantee that once a significant market correction is taking place, that the "bottom" of the market will be recognized. Redeploying a cash buying reserve at the right time can be very difficult. Since June 1st of 1997, the Fund has sold $11,300,000 (Cdn) of stocks, most having appreciated significantly as a result of good operating results and expanding price/earnings multiples.

Fortunately, one of the better characteristics of the current market has been performance rotation of expensively priced groups of stocks into less expensive groups that are showing signs of improving operating results. Since June, $7,400,000 (Cdn) of stocks were purchased. Of these purchases, 65% were of stock that had been held for some time and appeared to be entering a period of better performance. The remaining 35% went into new ideas with, in our opinion, compelling prospects for growth.

With the clarity of vision that a late report fosters, this realignment of holdings appears to be improving the Fund's performance relative to the indices (despite a cash reserve fluctuating around the 20% level).

This is an old stock market and at some point there will be a significant correction. In the meantime, stock selection will continue to be the key to the Fund's performance. Hopefully, the buying reserve will continue to allow the flexibility to seize attractive opportunities when they are identified.

Yours truly,

Rudy North

Rudy North
Fund Manager

RESULTS

NAVPS: June 30, 1997 $ 18.32 (Canadian)

DEAR UNITHOLDER:

The fund did very well during the six months ended June 30, 1997. The net asset value per share on that date was $ 18.32 (Cdn), a 17.3% increase from the beginning of the year. The effect of currency changes contributed 0.9% to the Canadian net asset value for that period.

PERFORMANCE COMPARISONS*

	March Quarter	June Quarter	May 31, 97 to June 30, 97	Six months to June 30, 97
U.S. Special Equity Fund $Cdn	**3.8%**	**13.0%**	**2.1%**	**17.3%**
U.S. Special Equity Fund $U.S.	**2.7%**	**13.3%**	**1.9%**	**16.4%**
S&P 500 $U.S.	2.7%	17.5%	4.5%	20.6%
S&P Midcap $U.S.	-1.5%	14.7%	2.8%	13.0%
Russell 2000 $U.S.	-5.2%	16.2%	4.3%	10.2%
NASDAQ Composite $U.S.	-5.3%	18.2%	3.0%	11.9%

* *Including income in all cases.*

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Portfolio Valuation - June 30, 1997 (as a %)

Columbia/HCA Healthcare (COL)	4.15
CompUSA Inc. (CPU)	3.96
Kellwood Co. (KWD)	3.29
Diamond Offshore Drilling (DO)	3.29
Wendy's International (WEN)	3.28
Precision Castparts (PCP)	2.90
Inacom Corp (INAC)	2.89
Dress Barn Inc. (DBRN)	2.62
Clayton Homes, Inc. (CMH)	2.46
Wellpoint Health Networks(WLP)	2.37
Xerox Corp. (XRX)	2.36
Northwest Pipe Co. (NWPX)	2.23
Sierra Healthcare (SIE)	2.16
Greyhound Lines Inc. (BUS)	2.00
Carnival Corp (CCL)	1.90
Deere & Company (DE)	1.89
Dsg International Ltd (DSGIF)	1.82
Amerilink Corp. (ALNK)	1.80
Owosso Corp. (OWOS)	1.78
Costco Companies. (COST)	1.61
Mississippi Chemical (GRO)	1.43
Biowhittaker Inc. (BWI)	1.28
O'Sullivan Industries (OSU)	1.28
Singer Co NV (SEW)	1.24
Mesa Airlines Inc. (MESA)	1.24
Integrated Health (IHS)	1.20
Orcad Inc. (OCAD)	1.12
Comcast Corp CL A Special(CMCSK)	1.12
Pier 1 Imports Inc. (PIR)	1.09
Greenbrier Cos Inc (GBX)	1.08
Nextel Communications (NXTL)	1.07
Covenant Transportation (CVTI)	1.04
Claire's Stores (CLE)	1.00
AMR Corporation (AMR)	0.99
Digital Equipment Corp (DEC)	0.98
Michaels Stores Inc (MIKE)	0.98
Harnischfeger Inds. (HPH)	0.93
Chesapeake Energy (CHK)	0.90
Maverick Tube Corp. (MAVK)	0.82
BMC West Corp (BMCW)	0.77
APS Holdings (APSI)	0.67
Costilla Energy (COSE)	0.54
Fred Meyer Inc. (FMY)	0.50
Microsoft Corp. (MSFT)	0.39
Harcor Energy (HARC)	0.37
Bay Networks (BAY)	0.34
Intel Corp. Common (INTC)	0.27
Lone Star Steakhouse (STAR)	0.22
3Com (COMS)	0.21
Hewlett Packard(HWP)	0.21
Ceridian(CEN)	0.21
Omnipoint Corp(OMPT)	0.20
Texas Instruments Inc. (TXN)	0.19
Applied Materials (AMAT)	0.14
Intervoice (INTV)	0.11
Jones Apparel Group, Inc. (JNY)	0.09
EMC Corp. (EMC)	0.07
Total Equities	**77.05**
Cash and Short Term Notes	**22.95**
TOTAL ASSETS	100.00%