

FRONT STREET DIVERSIFIED INCOME FUND CLASS

**FINANCIAL STATEMENTS
OCTOBER 31, 2007**

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MANAGEMENT REPORT

Management's Responsibility for Financial Reporting

The accompanying financial statements of Front Street Diversified Income Fund Class of Front Street Mutual Funds Limited have been prepared by the management of Front Street Mutual Funds Limited, the Manager of the Fund, and approved by the Board of Directors of Front Street Mutual Funds Limited. The Manager is responsible for the information and representations contained in these financial statements.

The Manager maintains processes to ensure that relevant and reliable financial information is produced. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include certain amounts that are based on estimates and judgements. The significant accounting policies, which the Manager believes are appropriate for the Fund, are described in note 2 to the financial statements.

The Board of Directors of Front Street Mutual Funds Limited is responsible for reviewing the financial statements, the adequacy of internal controls, the audit process and financial reporting with the Manager and the external auditors. The Board of Directors approves the audited financial statements for publication.

Segal LLP are the external auditors of Front Street Diversified Income Fund Class. They are appointed by the Manager of the Fund. The external auditors have audited the financial statements in accordance with Canadian generally accepted auditing standards to enable them to express to the shareholders their opinion on the financial statements. Their report is set out below.

On behalf of Management of Front Street Mutual Funds Limited,
Manager of the Fund



Gary P. Selke
Chief Executive Officer and Director



Murray Plaskett
Chief Financial Officer

December 28, 2007

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AUDITORS' REPORT

To the Shareholders of Front Street Diversified Income Fund Class (the "Fund") of Front Street Mutual Funds Limited

We have audited the statement of net assets of the Front Street Diversified Income Fund Class, (the "Fund") as at October 31, 2007 and the statements of operations and changes in net assets for the year then ended and the statement of investment portfolio as at October 31, 2007. These financial statements are the responsibility of the Manager of the Fund. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Manager, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Fund as at October 31, 2007 and the results of its operations and changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Licensed Public Accountants

Toronto, Ontario
December 28, 2007

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF NET ASSETS AS AT OCTOBER 31, 2007

	2007	2006
ASSETS		
Investments, at fair value (cost - \$14,240,544; 2006 - \$7,321,250)	\$ 13,824,005	\$ 7,478,553
Cash and cash equivalents	7,744,479	8,004,825
Accounts receivable relating to shares issued	99,159	1,577,286
Accounts receivable relating to portfolio assets sold	2,724,294	170,222
Amounts receivable relating to accrued income	<u>129,033</u>	<u>42,480</u>
	<u>\$ 24,520,970</u>	<u>\$ 17,273,366</u>
LIABILITIES		
Obligations from portfolio assets sold short, at fair value	\$ 706,800	\$ 261,255
Accrued expenses, note 7	111,170	74,591
Income taxes payable	34,848	-
Liabilities for portfolio assets purchased	1,450,255	378,785
Accounts payable on shares redeemed	<u>1,000</u>	<u>10,000</u>
	<u>2,304,073</u>	<u>724,631</u>
Net assets representing shareholders' equity	<u>\$ 22,216,897</u>	<u>\$ 16,548,735</u>
Net assets applicable to outstanding shares allocated as follows:		
Net assets, Series A	\$ 13,838,855	\$ 5,776,755
Shares outstanding, Series A, note 3	1,461,992	581,171
Net assets per share, Series A	<u>9.47</u>	<u>9.94</u>
Net assets, Series B	\$ 7,926,968	\$ 10,511,832
Shares outstanding, Series B, note 3	837,203	1,058,552
Net assets per share, Series B	<u>9.47</u>	<u>9.93</u>
Net assets, Series F	\$ 451,074	\$ 260,148
Shares outstanding, Series F, note 3	47,596	26,080
Net assets per share, Series F	<u>9.48</u>	<u>9.98</u>

On behalf of the Board of Front Street Mutual Funds Limited:



Gary P. Selke
Chief Executive Officer and Director



Murray Plaskett
Chief Financial Officer

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF OPERATIONS FOR THE YEAR ENDED OCTOBER 31, 2007

	2007 (12 months)	2006 (4 1/3 months)
Investment income		
Interest	\$ 901,737	\$ 44,319
Dividend	38,849	1,905
Less: foreign withholding taxes	<u>(362)</u>	<u>-</u>
	<u>940,224</u>	<u>46,224</u>
Expenses		
Management fees, note 4	470,702	20,401
Performance fees, note 4	101,721	-
Legal fees	80,052	27,411
Capital tax	54,324	-
Administration fees	49,741	16,253
Audit fees	33,973	9,664
Securityholder reporting costs	33,906	22,404
Custodial fees	14,012	3,710
Other expenses	<u>5,126</u>	<u>1,914</u>
	<u>843,557</u>	<u>101,757</u>
Net investment income (loss) for the year	<u>96,667</u>	<u>(55,533)</u>
Net realized and unrealized gains on investments		
Net realized gain on the sale of investments	835,116	12,755
Transaction costs, note 6	(95,049)	-
Change in the unrealized appreciation (depreciation) of the value of investments	<u>(523,589)</u>	<u>217,737</u>
Net gain on investments for the year	<u>216,478</u>	<u>230,492</u>
Net increase (decrease) in net assets from operations for the year	<u>\$ 313,145</u>	<u>\$ 174,959</u>
Increase (decrease) in net assets from operations applicable to outstanding shares allocated as follows:		
Increase in net assets from operations, Series A	\$ 182,622	\$ 68,986
Increase in net assets from operations per share, Series A	<u>\$ 0.17</u>	<u>\$ 0.56</u>
Increase in net assets from operations, Series B	\$ 141,879	\$ 102,825
Increase in net assets from operations per share, Series B	<u>\$ 0.13</u>	<u>\$ 0.68</u>
Increase (decrease) in net assets from operations, Series F	\$ (11,356)	\$ 3,148
Increase (decrease) in net assets from operations per share, Series F	<u>\$ (0.39)</u>	<u>\$ 0.13</u>

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED OCTOBER 31, 2007

	2007 (12 months)	2006 (4 1/3 months)
Series A		
Net assets, beginning of year	\$ 5,776,755	\$ -
Adoption of new accounting policy, notes 2 and 8	<u>(10,544)</u>	<u>-</u>
Adjusted net assets, beginning of year	<u>5,766,211</u>	<u>-</u>
Net increase in net assets from operations	<u>182,622</u>	<u>68,986</u>
Distributions to shareholders		
Return of capital	<u>(655,505)</u>	<u>(85,892)</u>
Shareholder transactions		
Proceeds from the issuance of shares	9,204,056	5,717,769
Aggregate amounts paid on the redemption of shares	(154,659)	(10,000)
Net transfer to shares of other funds	(941,727)	-
Shares issued on reinvestment of distributions	<u>437,857</u>	<u>85,892</u>
	<u>8,545,527</u>	<u>5,793,661</u>
Net increase in net assets for the year	<u>8,072,644</u>	<u>5,776,755</u>
Net assets, end of year	<u>\$ 13,838,855</u>	<u>\$ 5,776,755</u>
Series B		
Net assets, beginning of year	\$ 10,511,832	\$ -
Adoption of new accounting policy, notes 2 and 8	<u>(19,178)</u>	<u>-</u>
Adjusted net assets, beginning of year	<u>10,492,654</u>	<u>-</u>
Net increase in net assets from operations	<u>141,879</u>	<u>102,825</u>
Distributions to shareholders		
Return of capital	<u>(566,472)</u>	<u>(156,444)</u>
Shareholder transactions		
Proceeds from the issuance of shares	3,277,827	10,667,360
Aggregate amounts paid on the redemption of shares	(6,006,824)	(198,544)
Net transfer from (to) shares of other funds	115,136	(59,809)
Shares issued on reinvestment of distributions	<u>472,768</u>	<u>156,444</u>
	<u>(2,141,093)</u>	<u>10,565,451</u>
Net increase (decrease) in net assets for the year	<u>(2,565,686)</u>	<u>10,511,832</u>
Net assets, end of year	<u>\$ 7,926,968</u>	<u>\$ 10,511,832</u>

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED OCTOBER 31, 2007

	2007 (12 months)	2006 (4 1/3 months)
Series F		
Net assets, beginning of year	\$ 260,148	\$ -
Adoption of new accounting policy, notes 2 and 8	<u>(477)</u>	<u>-</u>
Adjusted net assets, beginning of year	<u>259,671</u>	<u>-</u>
Net increase (decrease) in net assets from operations	<u>(11,356)</u>	<u>3,148</u>
Distributions to shareholders		
Return of capital	<u>(17,495)</u>	<u>(3,855)</u>
Shareholder transactions		
Proceeds from the issuance of shares	454,300	507,000
Aggregate amounts paid on the redemption of shares	(6,845)	-
Net transfer to shares of other funds	(244,182)	(250,000)
Shares issued on reinvestment of distributions	<u>16,981</u>	<u>3,855</u>
	<u>220,254</u>	<u>260,855</u>
Net increase in net assets for the year	<u>191,403</u>	<u>260,148</u>
Net assets, end of year	<u>\$ 451,074</u>	<u>\$ 260,148</u>
Total		
Net assets, beginning of year	\$ 16,548,735	\$ -
Adoption of new accounting policy, notes 2 and 8	<u>(30,199)</u>	<u>-</u>
Adjusted net assets, beginning of year	<u>16,518,536</u>	<u>-</u>
Net increase in net assets from operations	<u>313,145</u>	<u>174,959</u>
Distributions to shareholders		
Return of capital	<u>(1,239,472)</u>	<u>(246,191)</u>
Shareholder transactions		
Proceeds from the issuance of shares	12,936,183	16,892,129
Aggregate amounts paid on the redemption of shares	(6,168,328)	(208,544)
Net transfer to shares of other funds	(1,070,773)	(309,809)
Shares issued on reinvestment of distributions	<u>927,606</u>	<u>246,191</u>
	<u>6,624,688</u>	<u>16,619,967</u>
Net increase in net assets for the year	<u>5,698,361</u>	<u>16,548,735</u>
Net assets, end of year	<u>\$ 22,216,897</u>	<u>\$ 16,548,735</u>
See accompanying notes to the financial statements		

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF INVESTMENT PORTFOLIO AS AT OCTOBER 31, 2007

	Number of Shares / Units	Cost \$	Fair Value \$
Long Positions (62.2%)			
Financial (13.0%)			
Allied Properties Real Estate Investment Trust	10,460	\$ 202,020	\$ 221,752
Artis Real Estate Investment Trust	12,050	169,356	200,632
Canadian Apartment Properties Real Estate Investment Trust	12,860	242,174	233,409
Canadian Imperial Bank of Commerce	5,190	508,268	529,380
* Carlyle Capital Corporation Limited	11,250	261,966	106,954
Chesswood Income Fund	15,620	108,404	76,538
H & R Real Estate Investment Trust	5,610	132,000	125,945
InnVest Real Estate Investment	17,250	217,241	204,240
InStorage Real Estate Investment Trust	122,200	180,184	119,756
InterRent Real Estate Investment Trust	49,250	244,275	211,775
Laurentian Bank of Canada	3,500	152,894	152,775
Power Corporation of Canada	11,950	472,771	483,617
Primaris Retail Real Estate Investment Trust	12,505	<u>219,505</u>	<u>219,338</u>
		<u>\$ 3,111,058</u>	<u>\$ 2,886,111</u>
Energy (10.6%)			
Baytex Energy Trust	22,630	455,590	457,126
Big Eagle Energy Services Trust	16,000	48,000	38,400
Major Drilling Group International Inc.	4,415	202,760	274,613
NAL Oil & Gas Trust	31,080	373,721	394,405
Pembina Pipeline Income Fund	20,040	344,018	357,313
ShawCor Limited 'A'	3,820	149,367	149,438
Vermilion Energy Trust	12,090	439,196	475,258
Zargon Energy Trust	8,025	<u>240,310</u>	<u>216,675</u>
		<u>\$ 2,252,962</u>	<u>\$ 2,363,228</u>
Consumer Discretionary (3.3%)			
Centurion Apartment Properties Limited Partnership	11,110	\$ 229,966	\$ 236,751
Linamar Corporation	12,080	302,027	277,840
Magna International Inc. 'A'	2,320	<u>209,665</u>	<u>207,710</u>
		<u>\$ 741,658</u>	<u>\$ 722,301</u>

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF INVESTMENT PORTFOLIO AS AT OCTOBER 31, 2007

	Number of Shares / Units	Cost \$	Fair Value \$
Industrials (2.4%)			
AG Growth Income Fund	8,770	\$ 245,182	\$ 217,496
MacQuarie Power & Infrastructure Income Fund	14,339	132,081	137,081
SuiteWorks Inc. 'A'	5,143	<u>180,005</u>	<u>180,005</u>
		<u>\$ 557,268</u>	<u>\$ 534,582</u>
Materials (2.0%)			
Anvil Mining Limited	4,500	\$ 79,496	\$ 85,860
Canexus Income Fund	13,600	77,207	67,864
TimberWest Forest Corporation	19,510	<u>300,179</u>	<u>291,675</u>
		<u>\$ 456,882</u>	<u>\$ 445,399</u>
Utilities (2.0%)			
ATCO Limited	5,175	\$ 251,930	\$ 328,509
Primary Energy Recycling Corporation	19,745	<u>184,808</u>	<u>118,667</u>
		<u>\$ 436,738</u>	<u>\$ 447,176</u>
Consumer Staples (1.8%)			
Saputo Inc.	2,018	\$ 84,391	\$ 115,995
Saskatchewan Wheat Pool Inc.	21,875	<u>235,977</u>	<u>278,469</u>
		<u>\$ 320,368</u>	<u>\$ 394,464</u>
Telecommunication Services (1.7%)			
BCE Inc.	4,658	\$ 169,938	\$ 192,096
* Reuters Group PLC	13,730	<u>191,478</u>	<u>178,651</u>
		<u>\$ 361,416</u>	<u>\$ 370,747</u>
Health Care (1.3%)			
Extendicare Real Estate Investment Trust	20,160	<u>\$ 295,719</u>	<u>\$ 288,691</u>
Information Technology (0.3%)			
Hemisphere GPS Inc.	25,715	<u>\$ 72,381</u>	<u>\$ 79,459</u>

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF INVESTMENT PORTFOLIO AS AT OCTOBER 31, 2007

	Number of Shares / Units	Cost \$	Fair Value \$
Government Bonds (15.6%)			
British Columbia Municipal Financial Authority 5.50% March 24, 2008	442,000	\$ 448,413	\$ 444,179
Canada Mortgage & Housing Corporation 5.30% December 3, 2007	1,300,000	1,301,168	1,300,948
Province of Manitoba 5.25% March 2, 2009	433,000	442,695	437,611
Province of New Brunswick 4.25% December 2, 2008	210,000	210,214	209,538
Province of Quebec Real Return 3.30% December 1, 2013	916,000	<u>1,084,530</u>	<u>1,074,807</u>
		<u>\$ 3,487,020</u>	<u>\$ 3,467,083</u>
Corporate Bonds (8.2%)			
Artis Real Estate Investment Trust Convertible Debentures 7.50% November 21, 2010	14,000	\$ 13,885	\$ 15,401
Citigroup/Starling/Botticelli CDO Notes September 22, 2014	400,000	400,000	260,000
* Duke Funding Limited 2003-5A 4A Floating Rate August 7, 2033	400,000	414,786	227,940
Fairborne Energy Limited 6.50% Convertible Subordinated Debentures December 31, 2011	150,864	143,813	143,321
Holloway Lodging Real Estate Investment Trust 8.00% August 1, 2011	460,000	461,638	462,346
Huntingdon Real Estate Investment Trust 8.00% June 30, 2010	114,000	114,025	114,000
Paramount Energy Trust 6.25% Convertible Subordinated Debentures June 30, 2010	222,300	218,085	208,962
Royal Host Real Estate Investment Trust Debentures 6.00% October 31, 2015	384,000	<u>380,842</u>	<u>392,794</u>
		<u>\$ 2,147,074</u>	<u>\$ 1,824,764</u>
Total Long Positions		<u>\$ 14,240,544</u>	<u>\$ 13,824,005</u>
Short Positions (-3.2%)			
Energy (-1.1%)			
Canetic Resources Trust	(8,860)	\$ (134,416)	\$ (136,355)
Paramount Energy Trust	(1,720)	(13,632)	(12,814)
Pengrowth Energy Trust	(5,650)	<u>(102,563)</u>	<u>(101,700)</u>
		<u>\$ (250,611)</u>	<u>\$ (250,869)</u>

See accompanying notes to the financial statements

FRONT STREET DIVERSIFIED INCOME FUND CLASS

STATEMENT OF INVESTMENT PORTFOLIO AS AT OCTOBER 31, 2007

	Number of Shares / Units	Cost \$	Fair Value \$
Consumer Discretionary (-0.5%)			
The Thomson Corporation	(2,195)	\$ (99,083)	\$ (98,095)
Industrials (-0.4%)			
Mullen Group Income Fund	(4,630)	\$ (83,664)	\$ (83,757)
Index Fund (-1.2%)			
iShares S&P/TSX 60 Index Fund ETF	(3,215)	\$ (251,188)	\$ (274,079)
Total Short Positions		<u>\$ (684,546)</u>	<u>\$ (706,800)</u>
Transaction costs, note 2		<u>\$ (44,650)</u>	-
Total Investments (59.0%)		<u>\$ 13,511,348</u>	13,117,205
Cash and cash equivalents (34.9%)			7,744,479
Other assets less other liabilities (6.1%)			<u>1,355,213</u>
Net assets (100.0%)			<u>\$ 22,216,897</u>

* Non Canadian Holdings

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

1. THE FUND

Front Street Diversified Income Fund Class (the "Fund") is a class of shares of Front Street Mutual Funds Limited (the "Corporation"), a mutual fund corporation incorporated under the Canada Business Corporations Act on April 11, 2006, and is authorized to issue an unlimited number of classes of shares in multiple series. Reference is made to the Fund's simplified Prospectus for additional information on the Fund's structure. Series A commenced operations on June 22, 2006. Series B commenced operations on June 22, 2006. Series F commenced operations on August 11, 2006.

The foregoing financial statements and accompanying notes to the financial statements presented herein are for the Fund. Separate financial statements of each of the other classes of shares of the Corporation have also been prepared as at October 31, 2007.

Management of Front Street Mutual Funds Limited is the manager of the Fund (the "Manager"). Front Street Investment Management Inc. (the "Investment Advisor") has been retained by the Manager, on behalf of the Fund, to provide investment advisory and portfolio management services to the Fund. NBCN Inc. is the custodian and Felcom Data Services Inc. provides fund accounting and shareholder recordkeeping services.

The Fund's investment objective is to provide Fund security holders with capital appreciation through investment in a diversified portfolio of income trusts, preferred shares and corporate and government debt. The Fund's portfolio (the "Portfolio") will include securities the Fund's Investment Advisor believes are undervalued and may include short positions in securities the Investment Advisor believes are overvalued.

The Investment Advisor will manage the relative weightings of the Fund's long and short positions to achieve the Fund's investment objective. The Fund will also engage in pairs trading, special warrant arbitrage, merger arbitrage, convertible arbitrage and trading in securities of issuers that may be involved in restructurings or business unit dispositions. The Portfolio will consist primarily of investments which generate capital gains, but will also include investments, which generate income.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

2. SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The following is a summary of the significant accounting policies followed by the Fund:

a) Adoption of new accounting standards - Financial instruments

In April 2005, the Canadian Institute of Chartered Accountants ("CICA") issued Section 3855, Financial Instruments - Recognition and Measurement, effective for financial statements relating to fiscal years beginning on or after October 1, 2006. This section establishes standards for the valuation of financial instruments, including the Fund's investments, and the accounting for transaction costs. Section 3855 requires that the fair value of financial instruments which are traded in active markets be measured based on the bid price for long securities and the ask price for short securities. Prior to the implementation of this new standard, the fair value was based on the last traded price for the day, when available. Section 3855 also requires that transaction costs, such as brokerage commissions, incurred in the purchase and sale of securities be charged to net income in the period. Prior to this new standard, these costs were added to the cost of the securities purchased or deducted from the proceeds of sale. Section 3855 has been applied retrospectively without restatement of prior periods effective November 1, 2006. The cost of individual investments in the Statement of Investment Portfolio are recorded at total cost including transaction costs. Accordingly, the opening net assets in the Statement of Changes in Net Assets for the year ended October 31, 2007 has been adjusted to reflect these changes in valuation.

National Instrument 81-106 ("NI 81-106") issued by the Canadian Securities Administrators ("CSA") in 2005, requires the daily net asset value ("NAV") of an investment fund to be calculated in accordance with Canadian generally accepted accounting principles ("GAAP"). The CSA had granted temporary relief to investment funds from complying with Section 3855, for the purpose of calculating and reporting NAV (other than for financial reporting purposes) until September 30, 2008. This temporary relief was to permit review of the suitability of these financial reporting requirements for purposes other than the financial statements, such as the purchase and redemption price of units in an investment fund. The CSA has completed this review and has proposed amendments to NI 81-106 that will permit funds to have two different net asset values: one for financial statements, which will be prepared in accordance with Canadian GAAP (referred to as "net assets"); and another for all the other purposes including unit pricing (referred to as "net asset value"). These financial statements have been prepared on a basis consistent with the proposed amendments including a reconciliation between net assets and net asset value (see note 8).

b) Valuation of investments

i) Investments listed on an exchange are valued at the last bid price reported by the principal securities exchange on which the issue is traded on the financial statement date. The difference between this amount and cost is shown as the change in the unrealized appreciation (depreciation) of the value of investments. Securities for which reliable quotations are not readily available are valued at fair value, as determined in good faith and pursuant to procedures established by the Manager.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

2. SIGNIFICANT ACCOUNTING POLICIES (Continued..)

b) Valuation of investments (continued..)

- ii) Any investment for which a market quotation is not readily available (“private companies”) shall be valued at cost, in the absence of any subsequent financing, or shall be valued at its fair value as determined by the Manager.
- iii) Investments which are restricted as to transferability are valued at the fair value of the unrestricted investment as provided in paragraphs (i) and (ii) above less a discount of 2% per month up to four months.

The process of valuing investments for which no published market exists is inevitably based on inherent uncertainties and the resulting values may differ from values that would have been established had a ready market existed for these investments.

- iv) Short-term investments are valued at amortized cost, which approximates fair value.
- v) Trust units are valued at the last bid price reported by the principal securities exchange on which the issue is traded on the financial statement date. The cost of the trust units is reduced on an annual basis by distributions from the trust and increased by the annual income allocated to the units by the trust.
- vi) The Fund values its investments in limited partnerships at fair value as determined by the Manager. The Fund calculates the cost value of its investment in limited partnerships using the equity method. Under this method, the limited partnership investments are recorded at cost plus the Fund's pro rata share in undistributed earnings since acquisition.
- vii) The Fund may make short sales whereby a security that it does not own is sold in anticipation of a decline in the fair value of the security. Securities which are sold short are valued at the last ask price reported by the principal securities exchange on which the issue is traded on the financial statement date. To enter a short sale, the Fund may need to borrow the security for delivery to the buyer.

While the transaction is open, the Fund will also incur a liability for any paid dividends or interest which are due to the lender of the security.

- viii) The fair value of other financial assets and liabilities approximate their carrying values due to the short-term nature of these instruments.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

2. SIGNIFICANT ACCOUNTING POLICIES (Continued..)

c) Transaction costs

In accordance with Section 3855, portfolio transaction costs are expensed and are included in "Transaction costs" in the Statement of Operations. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of an investment, which include fees and commissions paid to agents, advisors, brokers and dealers, levies by regulatory agencies and securities exchanges. The individual security's cost shown on the Statement of Investment Portfolio includes only those transaction costs incurred on the acquisition of portfolio investments. Prior to the adoption of Section 3855, transaction costs were capitalized and included in the cost of purchase or proceeds from sale of investments. The impact on the net assets of the investment fund is the same regardless of which accounting method is utilized.

d) Cash and cash equivalents

Cash and cash equivalents consist of cash balances with banks and highly liquid short-term investments with original terms to maturity of less than three months.

e) Investment transactions and income recognition

Investment transactions are accounted for on a trade date basis. Gains and losses from such transactions are calculated using the average cost of the securities on disposition.

Interest income is recorded on an accrual basis. Dividend income is recorded on the ex dividend date.

f) Foreign currency translation

Income, expenses and investment transactions in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing on the dates of such transactions. Assets and liabilities in foreign currencies are translated into Canadian dollars at the closing exchange rates on each valuation day.

g) Earnings (loss) per share

Earnings (loss) per share are based on the increase (decrease) in net assets from operations attributable to each series of shares divided by the weighted average number of shares outstanding of that series during the year.

h) Net assets per share

The net assets per share is calculated by dividing the net assets of a series of shares by the total number of shares of the series outstanding at the end of the year.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

2. SIGNIFICANT ACCOUNTING POLICIES (Continued.)

i) Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires the Manager to make estimates and assumptions that affect the reported amount of assets and liabilities, the disclosure of contingent assets and liabilities at the date of financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

3. SHARES ISSUED AND OUTSTANDING

The authorized capital of the Fund consists of an unlimited number of mutual fund shares, available in three series. Redemption and commission fees vary according to each series of shares as follows:

Series A shares

Redemption fees payable to the Manager may be applicable upon the sale of shares of this series based on the original cost amount and the time to disposition. A redemption fee of 3% applies to shares of this series sold within the first 18 months following acquisition. A redemption fee of 2% applies to shares of this series sold after the first 18 months and prior to 36 months following acquisition. No redemption fee applies to shares of this series sold after the first 36 months following acquisition.

Series B shares

Commission fees payable to brokers, dealers or advisors may be applicable upon the purchase of shares of this series up to 3% of the gross purchase amount, at the discretion of the broker, dealer or advisor.

Series F shares

No redemption or commission fees are applicable to shares of this series.

The Fund allocates income and expenses, and realized and unrealized capital gains and losses to each class of shares outstanding based on the average class allocation for the year.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

3. SHARES ISSUED AND OUTSTANDING (Continued..)

The following share transactions took place during the year:

	2007	2006
Shares outstanding, beginning of the year:		
Series A	581,171	-
Series B	1,058,552	-
Series F	26,080	-
Shares issued during the year:		
Series A	1,071,703	573,609
Series B	403,340	1,066,924
Series F	47,045	25,697
Shares distributions reinvested during the year:		
Series A	45,815	8,554
Series B	49,299	15,594
Series F	1,771	383
Shares redeemed during the year:		
Series A	236,697	992
Series B	673,988	23,966
Series F	27,300	-
Shares outstanding, end of the year:		
Series A	1,461,992	581,171
Series B	837,203	1,058,552
Series F	47,596	26,080

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

4. MANAGEMENT AND PERFORMANCE FEES

The Fund pays the Investment Advisor a monthly management fee equal to 1/12 of 2% of the net asset value of the Fund calculated and paid at the end of each month in arrears from each Fund series.

The Fund is responsible for payment of all operating and administrative expenses of the Fund. The main components of these expenses are legal and accounting fees, printing expenses, reporting issuer filing and sustaining fees, custodial fees, fees payable to and expenses incurred by the Independent Review Committee and expenses of making distributions to shareholders. As the Fund has more than one series of shares, the shareholders of each series, bear their pro rata share of those expenses which are common to the operation of all series as well as those expenses which are attributable solely to that series.

The Fund pays the Investment Advisor a performance fee if the percentage gain in the net asset value of a series of the Fund (as adjusted for any prior return deficiencies) over the preceding fiscal quarter or quarters since a performance fee was last payable exceeds the percentage gain or loss of the benchmark (the "Benchmark") over the same period. The Benchmark for the Fund is calculated as follows: 50% of the percentage gain or loss in the S&P/TSX Income Trust Index and 50% of the percentage gain or loss in the ScotiaMcLeod Bond Index over the same period. The fee will be equal to this excess return per share multiplied by the number of shares outstanding at the end of the quarter multiplied by 20%, provided that the net asset value per share of the Fund (including distributions) is greater than all previous values at the end of each previous fiscal quarter, in which a performance fee was paid. The starting reference point for the next fiscal quarter's calculation will be based on the higher of either the Benchmark performance adjusted net asset value per share or the adjusted actual net asset value per share, both with respect to the previous quarter in which a performance fee was payable.

5. INCOME TAX AND DISTRIBUTION

The Fund qualifies as a mutual fund corporation under the Income Tax Act (Canada). The Corporation will earn three types of income being Canadian dividends, taxable capital gains and other net taxable income. The income of the Fund, including taxable capital gains, will be subject to tax at applicable corporate tax rates, after claiming allowable deductions for expenses and applicable credits for foreign taxes paid on foreign source income. Tax on capital gains is refundable to the Fund to the extent that such gains are distributed to shareholders as capital gains dividends or the Fund's share are redeemed. Gains and losses realized by the Fund in relation to certain derivative transactions and short sale transactions may be taxed on account of income as opposed to on account of capital. Other income is subject to tax at normal corporate rates and is not subject to refundable tax treatment.

The Fund may elect in the prescribed manner and form in order to have the dividends it distributes treated as capital gains dividends to the extent that the dividends do not exceed the Fund's capital gains dividend account. The capital gains dividend account will be represented by the amount by which capital gains realized by the Fund while it was a mutual fund corporation exceed the aggregate of:

- (a) capital losses realized by the Fund while it was a mutual fund corporation;
- (b) certain capital gains dividends previously paid by it; and
- (c) amounts in respect of which the Fund received capital gains tax refunds.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

5. **INCOME TAX AND DISTRIBUTION** (Continued..)

The Fund anticipates that gains and losses realized on the disposition of investments will normally give rise to capital gains not ordinary income. The Fund intends to declare sufficient capital gains dividends so that it is entitled to a refund of the full amount of tax paid or payable on their capital gains. The suspended loss rules in the Income Tax Act (Canada) may prevent the Fund from recognizing capital losses on the disposition of securities in certain circumstances, which may increase the amount of capital gains dividends that the Fund must pay to Fund shareholders.

If allowable capital losses exceed taxable capital gains of the Fund in any taxation year, the excess cannot be allocated to shareholders, but may be carried back three years and carried forward indefinitely and be applied against taxable capital gains in such previous or subsequent years.

The Fund will allocate taxes payable and recoverable of the Fund to each of the classes. The Fund can pay ordinary taxable dividends or capital gains dividends to shareholders of any class in order to receive a refund of taxes on Canadian dividends or capital gains taxes. The Fund intends to pay out such dividends so as to maximize tax refunds and minimize taxes payable at the corporate level.

The Fund may be subject to provincial capital taxes. The Fund may also be subject to large corporations' capital tax under Part 1.3 of the Income Tax Act (Canada) although it is proposed that such tax be reduced and then eliminated by 2008.

The corporation's shares are qualified investments for registered plans.

6. **TRANSACTION COSTS**

The total brokerage commissions paid by the Fund with respect to securities transactions for the year ended October 31, 2007 was \$95,049 (2006 - \$14,986).

7. **RELATED PARTY TRANSACTIONS**

Management fees of \$470,702 (2006 - \$20,401) were paid to the Investment Advisor, a company under common control to the Manager, during the year (see note 4). Performance fees of \$101,721 (2006 - Nil) were also paid to the Investment Advisor during the year (see note 4). Included in accrued expenses are \$39,918 (2006 - \$12,626) of management fees payable to the Investment Advisor.

357,861.017 (2006 - Nil) of series B shares outstanding at year end representing 42.74% (2006 - Nil) of the total series B shares of the Fund are held by the Partners of Front Street Capital 2004, a partnership under common control to the Manager.

The Fund may place a portion of its portfolio transactions with brokerage firms which are affiliates of the Manager provided it determines that these affiliates' trade execution abilities and costs are comparable to those non affiliated, qualified brokerage firms, on an execution only basis. During the year ended October 31, 2007, Tuscarora Capital Inc, a company under common control to the Manager, received \$11,897 (2006 - \$321) in commissions on portfolio transactions for the Fund.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

7. RELATED PARTY TRANSACTIONS (Continued..)

Management fees and performance fees are measured at the exchange amount of consideration prescribed by the offering documents of the Fund. When related parties enter shareholder transactions with the Company, the exchange amount of consideration is the transactional NAV available to all other shareholders on the trade date. In the case of brokerage commissions, the exchange amount of consideration is that which is negotiated by the related parties.

8. RECONCILIATION OF NET ASSET VALUE - ADOPTION OF NEW ACCOUNTING POLICY - FINANCIAL INSTRUMENTS

In accordance with the decision made by the Canadian securities regulatory authorities, a reconciliation between the transactional net asset value ("NAV") and net assets calculated using generally accepted accounting principles ("GAAP NA") of an investment fund is required for financial reporting periods commencing October 31, 2007. For investments that are traded in an active market where quoted prices are readily and regularly available, Section 3855 requires bid prices (for investments held) and ask prices (for investments sold) to be used in the fair valuation of investments, rather than the use of closing sale prices currently used for the purpose of determining transactional NAV. For investments that are not traded in an active market, Section 3855 requires the use of specific valuation techniques (see note 2), rather than the use of valuation techniques by virtue of general practice in the investment funds industry.

These changes account for the difference between transactional NAV and GAAP NA. The impact of the adoption of Section 3855 on the net asset value of the Fund is as follows:

As at October 31, 2007

	<u>Net Asset Value</u>			<u>Net Assets per Share</u>		Opening NAV
	Transactional NAV	Section 3855 Adjustment	GAAP NA	Transactional NAV	GAAP NA	Section 3855 Adjustment
Series A	13,877,748	(38,893)	13,838,855	9.49	9.47	(10,544)
Series B	7,949,342	(22,374)	7,926,968	9.50	9.47	(19,178)
Series F	452,342	(1,268)	451,074	9.50	9.48	(477)
Total Net Asset Value	22,279,432	(62,535)	22,216,897			(30,199)

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

9. FINANCIAL INSTRUMENTS

The Fund's financial instruments consist of investments at fair value, cash and cash equivalents, accounts receivable relating to shares issued, accounts receivable relating to portfolio assets sold, amounts receivable relating to accrued income, obligations from portfolio assets sold short at fair value, accrued expenses, income taxes payable, liabilities for portfolio assets purchased and accounts payable relating to shares redeemed. It is management's opinion that the Fund is not exposed to significant market, currency, interest rate, liquidity and cash flow risks arising from these financial instruments except as described below. The fair value of these financial instruments approximate their carrying values, unless otherwise noted.

The Fund's investment activities expose it to various types of risk that are associated with the financial instruments and markets in which it invests.

i) Market risk

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual security of its issuer or factors affecting all securities in the market. All trading instruments are recognized at fair value and all changes in market conditions directly affect net assets from operations.

ii) Currency risk

The Fund may invest in financial instruments denominated in currencies other than its measurement currency. Consequently, the Fund is exposed to risks that the exchange rate of its currency relative to other currencies may change in a manner that has an adverse effect on the fair value of the portion of the Fund's assets or liabilities denominated in currencies other than Canadian dollars.

iii) Interest rate risk

The Fund is exposed to interest rate risk related to short-term deposits and borrowings as well as investments in government and corporate debt instruments. Consequently, the cash flows related to interest income and expense and the valuation of debt instruments could vary significantly from current value.

iv) Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with its financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

v) Cash flow risk

Cash flow risk is the risk that future cash flows associated with a monetary financial instrument will fluctuate in amount. In the case of a floating rate debt instrument, for example, such fluctuations could result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

FRONT STREET DIVERSIFIED INCOME FUND CLASS

NOTES TO THE FINANCIAL STATEMENTS OCTOBER 31, 2007

10. CREDIT RISK

The Fund is exposed to credit risk arising from its transactions with its counterparties and brokers, related to securities purchases and sales. Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

11. COMPARATIVE AMOUNTS

Certain of the prior year figures have been reclassified to conform with the current year's presentation.