

# Management Report of Fund Performance



## COVINGTON FUND II INC.

For The Year Ended August 31, 2008

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This annual management report of fund performance contains financial highlights but does not contain the complete annual financial statements of the investment Fund. You can get a copy of the annual financial statements at your request, and at no cost, by calling 1-866-244-4714, by writing to us at Covington Capital Corporation, 200 Front St. West, Suite 3003, Toronto, Ontario M5V 3K2 or by visiting our website at [www.covingtonfunds.com](http://www.covingtonfunds.com) or on SEDAR at [www.sedar.com](http://www.sedar.com).

Shareholders may also contact us using one of these methods to request a copy of the Fund's proxy voting policies and procedures or proxy voting disclosure record.

## **COVINGTON FUND II INC.**

### **CLASS A SHARES**

(in \$000's except for per share amounts, number of shares and percentages)

#### **INVESTMENT OBJECTIVE AND STRATEGIES**

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Covington Fund II Inc. (the "Fund") combines the tax benefits of a Labour Sponsored Investment Fund ("LSIF") while giving investors access to the venture capital market.

The investment objective of the Fund is to realize long-term capital appreciation on part of the investment portfolio, and yield a return on the remainder. The strategy to accomplish this is by investing in two different types of situations. The first is in companies which the Fund anticipates will have significant growth potential in early stage or expanding markets. The second is in more established steady growth companies which the Fund anticipates will provide current yield and early return of capital to the Fund..

The Fund is now in its ninth year of operations. As such, some of the portfolio investments have matured from start up to expansion and later stages of their growth cycle. The Fund continues to manage these investments by working with the investee companies to grow profits while moving toward successful exits and building shareholder value.

#### **RISK FACTORS**

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The Fund is suitable for investors with a longer-term investment focus and higher risk tolerance.

Venture capital investing carries the risk of having illiquid investments in the portfolio along with the risk of finding suitable investments meeting the Fund's investment criteria. The process of valuing venture investments for which no published market exists is subject to inherent uncertainties and the resulting values may differ from values which would have been ascribed had a ready market existed for those investments.

Investors who purchase LSIFs are required to hold their investment for eight years in order to retain the tax credit offered by the provincial and federal governments. The Fund was launched in 2000 and therefore the hold period for the Fund's initial investors expired in 2008. If all shareholders were to redeem their shares at the same time, the Fund may need to liquidate investments at lower values than currently ascribed and shareholders may not receive the posted Net Asset Value. In any financial year, the Fund is not obligated to redeem greater than 20% of the net asset value of the Fund.

Liquidity for investors in the Fund is also limited to redemption of the Class A Shares through brokers and planners.

The Ontario LSIF tax credit on purchases of units of the Fund remains at 15% for the 2008 and 2009 RRSP seasons, but will be reduced to 10% for the 2010 taxation year and 5% for the 2011 taxation year. The federal tax credit remains at 15%.

The Fund is regulated by the Income Tax Act (Canada) (the "Act") and the Community Small Business Investment Funds Act (Ontario) (the "Ontario Act") and restricted to making investments in eligible small and medium sized Canadian businesses. The investments of the Fund must follow restrictions that include the size, nature, and timing of the investments. Companies generally of this size are privately owned and are characterized as having less than \$50 million in assets and less than 500 employees. There is no assurance that suitable investments meeting the restrictions will be found and if not met, the Fund could be levied with penalty taxes and ultimately have its LSIF status revoked. As at August 31, 2008, the Fund was in compliance with all of these restrictions as it relates to the Federal and Ontario Tax Acts.

**CLASS A SHARES**

(in \$000's except for per share amounts, number of shares and percentages)

**RISK FACTORS (Continued)**

The Fund is limited to sourcing investments in Canadian companies operating out of Ontario. Therefore, the Fund is highly sensitive to political, economic, and social conditions within the Canadian environment. However, as many of these companies sell products and services into the U.S. market, the investments are also exposed to foreign exchange fluctuations and U.S. economic conditions.

**RESULTS OF OPERATIONS**

The net assets of the Fund for the year ended August 31, 2008 were \$102,851\*. This represents a decline of \$28,331 from \$131,182 at August 31, 2007. The overall decrease in net assets is due primarily to net redemptions of \$18,003 and a loss from operations of \$8,817. The decrease was funded primarily from the sale of marketable securities which declined from \$36,642 in 2007 to \$17,869 in 2008.

The Series realized \$4,177 in losses from the sale of its holdings in ExcelTech Ltd. and Golftown Income Fund during the year.

In addition, the Fund made \$12,341 in new and follow-on investments including an investment of \$8,534 in EGI Financial Holdings Inc. EGI has demonstrated significant growth through expansion via the formation of a US subsidiary and has accelerated its efforts to capitalize on opportunities in the US non-standard auto insurance sector.

Redemptions during for this fiscal year were up by \$17,067 over the same period in 2007 and are due to the large number of Class A shares which became eligible for redemption. Shareholders who initially purchased units in the 1999-2000 RRSP season were eligible to redeem their shares in early 2008. This matured capital explains the increase in redemptions year over year as well as the decrease in marketable securities held by the Fund.

Accounts receivable and prepaid expenses have decreased to \$518 from \$5,913 in 2007 due to receipt of proceeds from the sale of the Fund's investments in Coast Software and Watchfire Corporation in August of 2007.

Overall, Fund expenses have fallen by \$1,174. This represents a decrease of 17% from the prior year which is consistent with a decline in the net assets which have decreased by 21%. The MER for the year-ended August 31, 2008 is 4.86% which has increased slightly by only 0.08% from the prior year. Expenses which have increased nominally include audit fees and the costs related to the implementation and ongoing operations of the Independent Review Committee as required under National Instrument 81-107.

\* On August 1, 2007, the Series adopted CICA section 3855 on a retrospective basis with out restatement of prior periods –see "Recent Developments". As such, the opening balances of net assets may not equal the August 31, 2007 closing net assets.

## COVINGTON FUND II INC.

### CLASS A SHARES

(in \$000's except for per share amounts, number of shares and percentages)

#### Investment Performance

A significant percentage of the Fund's performance was driven by the changes in Canada's economic environment which have resulted in a significant increase in the volatility of the public markets. As a result, a number of the Fund's public holdings decreased in value from fiscal 2007 to 2008. SXC Health solutions Inc. ("SXC") (SXC:TSX, SXCI:NASDAQ) posted a decline of 31% and EGI Financial Holdings Inc. ("EGI") (EFH:TSX) posted decline of 11% over a one year period. Despite the decline in the public value of these stocks, both enterprises continued to post positive growth results in core business segments.

Consequently, fundamental operating and market pressures have resulted in an 8% decrease in the Fund's NAVPS from fiscal 2007. The Fund continued to support existing portfolio investments through follow-on investments in Adventus Bioremediation, Linea Marketing, Fidelity Stainless, and EGI Financial. These follow-on financings are a reflection of the maturity of the overall portfolio and the focus on growing the Fund's current holdings toward future exit events.

Covington Fund II Inc. is registered as a labour-sponsored investment fund corporation ("LSIF") under the Community Small Business Investment Funds Act (Ontario) (the "Ontario Act") and is a prescribed labour-sponsored venture capital corporation under the Income Tax Act (Canada) (the "Tax Act"). These acts set levels of qualifying venture investments required to be made by the Fund as a whole. If the required minimum level of qualifying venture investments is not met under each statute, the Fund will be subject to defined taxes and penalties. As at August 31, 2008, the Fund is in compliance with these requirements.

#### RECENT DEVELOPMENTS

##### Amalgamation of Investment Advisor and Affiliated Company

On January 1, 2007, the Investment Advisor of the Fund, Covington Capital Corporation, amalgamated with its affiliated company, Covington Group of Funds Inc., to be continued as Covington Capital Corporation. As a result, Covington Capital assumed both investment advisory and fund advisory roles for the Fund.

##### Adoption of new accounting standards

The Canadian Institute of Chartered Accountants ("CICA") has issued section 3855, "Financial Instruments – Recognition and Measurement" effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2006. This section sets out standards for the fair valuation of investments and the way transaction costs are recorded for financial reporting purposes. Specifically, it stipulates 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 securities sold short.

**CLASS A SHARES**

(in \$000's except for per share amounts, number of shares and percentages)

**RECENT DEVELOPMENTS (Continued)**

National Instrument 81-106 ("NI 81-106"), which governs continuous disclosure requirements for investment funds, requires the Fund's financial statements to be prepared in accordance with Canadian GAAP. While Section 3855 defines specific measurement parameters for fair valuation of financial instruments which are traded in active markets, NI 81-106 allows daily net asset values of investment funds to be calculated using the fair value of the fund's assets and liabilities. The valuation rules and techniques used by the Fund are in accordance with the Fund's prospectus but are not necessarily in accordance with Section 3855. NI 81-106 has been amended to allow the daily Net Asset Value ("NAV") of an investment fund to be calculated in a manner that is not in accordance with Canadian GAAP for other than financial statement purposes. The adoption of Section 3855 therefore, results in a different valuation method for determining the Fund's net assets as described in the Fund's valuation methodologies in Note 2 to the financial statements. Consequently, the Fund has applied section 3855 for financial statement reporting purposes only.

A reconciliation between the net asset value calculated in accordance with GAAP (referred to as "Net Assets" or "net assets for GAAP purposes") and the price used for subscriptions and redemptions (referred to as "Net Asset Value" or "net assets for pricing purposes") is provided in the supplementary schedules to the financial statements.

**Independent Review Committee**

National Instrument 81-107 Independent Review Committee for Investment Funds ("NI 81-107"), came into force on November 1, 2006. NI 81-107 requires all publicly offered investment funds, such as the Fund, to establish an independent review committee (the "IRC" or the "Independent Review Committee"). The manager must refer certain conflict of interest matters between the Fund and its manager for review or approval to the IRC. NI 81-107 also imposes obligations upon the manager to establish written policies and procedures for dealing with conflict of interest matters, to maintain records, in respect of these matters and to provide the IRC with guidance and assistance in carrying out its functions and duties. According to NI 81-107, the IRC must be comprised of a minimum of three independent members, and is required to conduct regular assessments of its members and to provide reports, at least annually, to the Fund and to its shareholders in respect of those functions. The Fund's IRC commenced operations October 11, 2007 and the report prepared by the Fund will be available, in November 2008, on the Fund's website [www.covingtonfunds.com](http://www.covingtonfunds.com), or at a shareholders' request at no cost, by contacting the Fund at 200 Front Street W., Suite 3003, P.O. Box 10, Toronto, Ontario M5V 3K2 or at [info@covingtonfunds.com](mailto:info@covingtonfunds.com).

**RELATED PARTY TRANSACTIONS**

The Fund Manager and Advisor, the Sponsor, and the Transfer Agent and Registrar are deemed to be related parties. Please refer to the section titled "Management Fees" which outlines the fees paid to these related parties.

## COVINGTON FUND II INC.

### CLASS A SHARES

(in \$000's except for per share amounts, number of shares and percentages)

#### FINANCIAL HIGHLIGHTS

The following tables show selected key financial information about the Fund and are intended to help you understand the Fund's financial performance.

All references to "net assets" or "net assets per share" are determined in accordance with Canadian GAAP as presented in the audited financial statements of the Series. All references to "net asset value" or "net asset value per share" are determined in accordance with the net asset value calculated for pricing purposes.

#### THE FUND'S NET ASSETS PER SHARE

Year ended August 31,	2008	2007	2006	2005	2004
<b>Net assets, beginning of period (1)</b>	\$ <b>7.73</b>	\$ 8.10	\$ 8.24	\$ 7.75	\$ 8.60
Increase (decrease) from operations:					
Total revenue	<b>0.14</b>	0.14	0.14	0.24	0.22
Total expenses	<b>(0.36)</b>	(0.41)	(0.41)	(0.37)	(0.40)
Write off of deferred charges	-	-	(0.08)	(0.33)	-
Realized and unrealized gain (loss) on investments	<b>(0.34)</b>	-	0.13	0.98	(0.57)
Total increase (decrease) from operations (2)	<b>(0.56)</b>	(0.27)	(0.22)	0.52	(0.75)
<b>Net asset value, end of period (1)</b>	\$ <b>7.17</b>	\$ 7.82	\$ 8.10	\$ 8.24	\$ 7.75

(1) This information is derived from the Fund's audited annual financial statements. The net assets per security presented in the financial statements differs from the net asset value calculated for fund pricing purposes. On September 1, 2007, the Fund adopted CICA Section 3855 on a retrospective basis without restatement of price periods. As such, the beginning balance of net assets per share for the year ended August 31, 2008 may not equal the closing balance on August 31, 2007.

(2) The increase/(decrease) from operations is based on the weighted average number of shares outstanding over the financial period whereas net assets are based on the actual number of shares outstanding as at the stated year end.

## COVINGTON FUND II INC.

### CLASS A SHARES

(in \$000's except for per share amounts, number of shares and percentages)

#### FINANCIAL HIGHLIGHTS *(Continued)*

#### RATIOS AND SUPPLEMENTAL DATA <sup>(1)</sup>

Year ended August 31,	2008	2007	2006	2005	2004
Net assets <sup>(1)</sup>	\$ 103,199	\$ 132,561	\$ 138,928	\$ 137,705	\$ 127,424
Number of shares outstanding <sup>(1)</sup>	14,341,035	16,777,760	16,821,808	16,715,457	16,444,695
Management expense ratio <sup>(2)</sup>	4.86%	4.78%	4.97%	4.99%	4.94%
Portfolio turnover rate <sup>(3)</sup>	12.01%	12.07%	7.95%	13.95%	0.55%
Trading expense ratio <sup>(4)</sup>	-	-	0.04%	0.06%	-
Closing market price or pricing NAV <sup>(1)</sup>	\$ 7.20	\$ 7.90	\$ 8.26	\$ 8.49	\$ 7.75

<sup>(1)</sup> This information is provided as at the dates shown.

<sup>(2)</sup> Management expense ratio includes all fees, expenses, capital taxes, and Goods and Services Tax and is expressed as an annualized percentage of the average net assets administered during the period.

<sup>(3)</sup> The Fund's portfolio turnover rate indicates how active the Fund's portfolio advisor manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund buying and selling all of the securities in its portfolio once in the course of the period. The higher a fund's portfolio turnover rate in a period, the greater the trading costs payable by the fund in the period, and the greater the chance of an investors receiving taxable capital gains in the period. There is not necessarily a relationship between a high turnover rate and the performance of a fund.

<sup>(4)</sup> The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net assets during the period.

## COVINGTON FUND II INC.

### CLASS A SHARES

(in \$000's except for per share amounts, number of shares and percentages)

#### Management Fees

The Fund's management expense ratio ("MER") consist of all of its operating expenses, including sales commissions, certain ongoing marketing costs of the Fund, audit and legal expenses, fees paid to any independent valuator, certain consultancy costs. The major components of the MER are fees that are calculated as a percentage of the NAV of the Fund and these fees are the Investment Advisor, Fund Advisor, Fund Administrator, and Sponsor fees.

The key components of the MER are as follows:

Description - % of NAV	Year ended	Year ended
	August 31, 2008	August 31, 2007
	\$	\$
Investment Advisor - annual rate of 2.0%	2,351	2,898
Fund Advisor - annual rate of 0.75%	885	1,087
Fund Administration - annual rate of 0.6%	704	867
Sponsor - blended rate of 0.3% and 0.1% (1)	369	476
Service Fee - annual rate of 0.5%	621	682
Sales commissions - 6% of new sales	39	75
<b>Total fees</b>	<b>4,969</b>	<b>6,085</b>

(1) The Sponsor is paid a fee of 0.3% on the net asset value of the Fund with respect to the Fund's share of the first \$200 million of combined assets of the Fund, and Covington Strategic Capital Fund Inc., another LSIF sponsored by the Sponsor, and a rate of 0.1% of the net asset value of the Fund thereafter.

The Fund Advisor is responsible for directing the business, operations and affairs of the Fund while the Investment Advisor is responsible for implementing the investment strategy, monitoring the Fund's investments and providing management assistance to portfolio companies. Because the portfolio companies of the Fund are generally small in size and in an earlier stage of development relative to conventional mutual funds, the Fund requires a greater level of advisor involvement in the analysis, monitoring support and development activities. The Fund Advisor and Investment Advisor uses the management fees it receives to finance its general and administrative expenses.

## COVINGTON FUND II INC.

### CLASS A SHARES

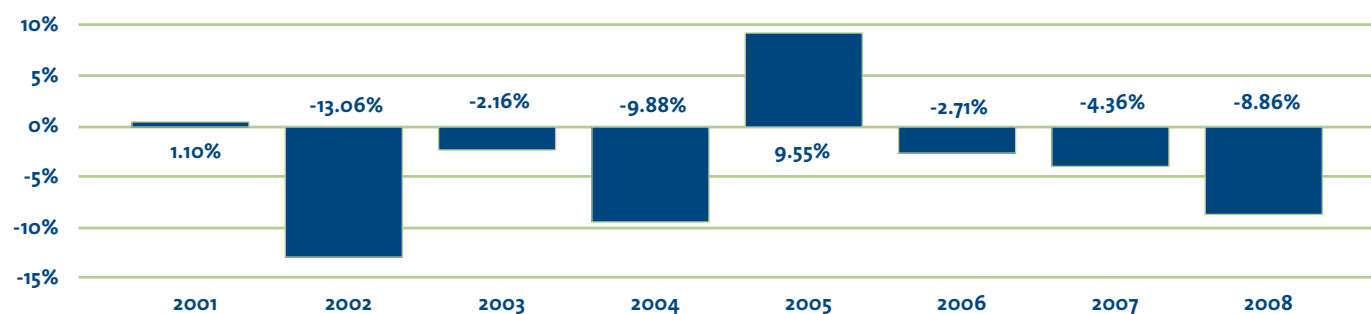
(in \$000's except for per share amounts, number of shares and percentages)

#### PAST PERFORMANCE

The performance information shown does not take into account sales, redemption, distribution or other optional charges that would have reduced returns on performance. The Fund's past performance is no guarantee of how it will perform in the future.

#### Year by Year Non-Cumulative Returns

The graph below indicates the Fund's annual performance for each of the years shown and how the Fund's performance has changed from year to year. It also shows, in percentage terms, how an investment made on the first day of each financial year would have increased or decreased by the last day of each financial year.



#### ANNUAL COMPOUND RETURNS

The table below summarizes the Fund's past performance for the five, three and one year periods ended August 31 of the periods indicated. As a basis of comparison, we have provided the Retail Venture Capital Index as posted on [www.globefund.com](http://www.globefund.com) and the BMO Nesbitt Burns Cdn Small Cap index as at August 31, 2008.

The Retail Venture Capital Index is the most representative broad-based securities market index as it accumulates all the Ontario based LSIF's.

Compound Returns	Covington II	Retail Venture Capital Index	BMO Nesbitt Burns Cdn Small Cap Index*
1 Year	-8.86%	-5.05%	-10.80%
3 Years	-5.35%	-1.63%	5.74%
5 Years	-3.49%	-0.85%	11.77%
Since Inception	-4.02%	**	**

\* The inclusion of the BMO Nesbitt Burns Cdn Small Cap Index is only intended to give perspective to general market activity. (Source: [globefund.com](http://globefund.com))

\*\* This has not been included because there is no comparable index quotation for the same period.

## COVINGTON FUND II INC.

### CLASS A SHARES

(in \$000's except for per share amounts, number of shares and percentages)

#### SUMMARY OF INVESTMENT PORTFOLIO

Below is a summary of the Fund's venture investment portfolio as at August 31, 2008. This is a summary only and may change due to on-going portfolio activity in the Fund. Updated portfolio information is available on Covington's website at [www.covingtonfunds.com](http://www.covingtonfunds.com).

	Debt, at cost	Shares, at cost	Total, at cost
Adventus Remediation Technologies Inc.	225	7,007	7,232
BTE Technologies Inc.	520	2,128	2,648
Business Propulsion Systems Inc.	2,997	1,520	4,517
Coast Software Inc	150	-	150
Cyence International Inc.	7,107	7,974	15,081
EGI Financial Holdings Inc. (formerly Canadian Insurance Marketing Inc.)	-	12,133	12,133
Exco Technologies Limited	-	1,524	1,524
Fidelity Stainless Inc.	286	2,060	2,346
Ivey-Robarts CSBIF I Inc.	-	2,500	2,500
Ivey-Robarts CSBIF II Inc.	-	2,500	2,500
Linea Marketing Inc.	2,900	2,000	4,900
Marketrend Inc.	2,249	6,910	9,159
Mist Mobility Integrated Systems Technology Inc.	6,400	2,250	8,650
Mo Products Inc.	375	-	375
PowerBand Canada Inc.	-	150	150
Soliton Inc.	-	-	-
Statpro Plc.	-	284	284
Systems Xcellence Inc.	-	3,728	3,728
Tough N Ready Doors Inc.	271	250	521
	<b>23,479</b>	<b>54,918</b>	<b>78,398</b>

**COVINGTON FUND II INC.**

**CLASS A SHARES**

(in \$000's except for per share amounts, number of shares and percentages)

**SUMMARY OF INVESTMENT PORTFOLIO (Continued)**

	Number of companies	Cost of investments \$	% Total venture investments at cost %	Fair value of investments \$	% Total venture investments at fair value %
<b>Stage of Development</b>					
Start-Up / Early	2	525	0.7	525	0.6
Expansion	14	74,003	94.4	80,527	96.0
Later	3	3,870	4.9	2,796	3.4
	19	78,398	100.0	83,848	100.0
<b>Industry class</b>					
Entertainment/Retail	1	375	0.5	375	0.4
Health Sciences	1	2,648	3.4	1,568	1.9
Financial Services	7	36,881	47.0	43,511	51.9
Technology	5	20,553	26.2	29,193	34.8
Manufacturing	5	17,941	22.9	9,201	11.0
	19	78,398	100.0	83,848	100.0

	Fair Value of Investments \$	% of Net Asset Value %
<b>Composition of net assets</b>		
Marketable securities, at fair value	17,869	17.4
Venture investments, at fair value	83,848	81.5
Other assets, net of liabilities	1,134	1.1
<b>Net assets, at market value</b>	<b>102,851</b>	<b>100.0</b>

**NOTES**

**NOTES**

**CORPORATE INFORMATION**

**Fund Symbols**

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CIG912

**Investment and Fund Advisor**

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**Covington Capital Corporation**

200 Front Street West, Suite 3003  
Toronto, ON M5V 3K2

**Fund Administrator**

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**Sponsor**

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**Canadian Police Association**

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**Auditor**

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**Ernst & Young LLP**

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**Transfer Agent and Registrar**

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**Legal Counsel**

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