Scotia Mortgage Income Fund

Annual Management Report of Fund Performance

For the period ended December 31, 2011

This annual management report of fund performance contains financial highlights, but does not contain the complete annual financial statements of the fund. You can get a copy of the annual financial statements at your request, and at no cost, by calling toll-free 1 800 268-9269, or by asking your mutual fund representative. You can also write to us at Scotia Asset Management, Scotia Plaza, 52nd Floor, 40 King Street West, Toronto, Ontario M5H 1H1, or download from www.scotiafunds.com or www.sedar.com.

You may also contact us using one of these methods to request a copy of the fund's proxy voting policies and procedures, proxy voting disclosure record, or quarterly portfolio disclosure.

In this document, we, us, our and the Manager refers to Scotia Asset Management L.P. ("SAM") and fund refers to the Scotia Mortgage Income Fund.

This report may contain forward-looking statements about the fund. Such statements are predictive in nature and depend upon or refer to future events or conditions and may include such words as "expects", "plans", "anticipates", "believes", "estimates" or other similar expressions. In addition, any statement regarding future performance, strategies, prospects, action or plans is also a forward-looking statement. Forward-looking statements are subject to known and unknown risks and uncertainties and other factors that may cause actual results, performance, events, activity and achievements to differ materially from those expressed or implied by such statements. Such factors include general economic, political and market conditions, interest and foreign exchange rates, regulatory or judicial proceedings, technological change and catastrophic events. You should consider these and other factors carefully before making any investment decisions and before relying forward-looking statements. We have no specific intention of updating any forward-looking statements whether as a result of new information, future events or otherwise.

Management Discussion of Fund Performance

Investment Objectives and Strategies

The fund's objective is to provide regular interest income. It invests primarily in high quality mortgages on residential properties in Canada. The mortgages purchased by the fund are generally either:

- insured or guaranteed by Canadian federal or provincial governments or their agencies.
- conventional first mortgages with loan-to-value ratios of no more than 80%, unless the excess is insured by an insurance company registered or licensed under federal or provincial legislation.

The portfolio advisor uses interest rate and yield curve analysis to select individual investments and manage the fund's average term to maturity. The Bank of Nova Scotia will buy any mortgage that is in default if it was purchased from Scotia Mortgage Corporation. It will buy the mortgage at a price equal to the principal value plus any unpaid interest. That means the fund doesn't assume the risk of default on these mortgages. The fund may invest up to 25% of its assets in fixed income securities issued by Canadian federal, provincial and municipal governments, and by corporations. The fund can invest up to 10% of its assets in foreign securities from anywhere in the world.

Risk

The overall risks of investing in the fund remain as discussed in its simplified prospectus. The fund remains suitable for investors who want regular interest income, who can accept low to medium risk, and who are investing for the medium to long term.

Results of Operations

Over the review period, the fund's Series A units returned 0.99% compared to a 4.99% return for the DEX Canada Mortgage Market Index, and a 4.69% return for a blended benchmark consisting of 33.3%, 33.3% and 33.3% of DEX 1-Year, 3-Year and 5-Year Mortgage Index, respectively. In contrast to the indices, the fund's return is after the deduction of fees and expenses. Any difference between the performance of the Series A units and other series of the fund is the result of the different management fees charged to, and operating expenses recovered from, each series. Please see the "Past Performance" section for the performance returns of the fund's other series.

Over the review period, fears increased that the sovereign debt issues plaguing smaller eurozone members were beginning to spread to the region's larger economies like Italy and Spain. The U.S. economy was slow to recover as employment, housing, and consumer confidence data were weak throughout the period. In August, Standard & Poor's downgraded U.S. government bonds from AAA to AA. Additionally, there were fears of an economic slowdown in China, which would have the potential to significantly hinder global economic growth. With these macroeconomic concerns top of mind, investor confidence was weak for the majority of 2011.

Despite the turbulent economies in Europe and the U.S., the Canadian economy held steady. The Bank of Canada (BoC) maintained its key lending rate at 1.00% over the period. Headline inflation finished the year above the BoC's target rate of 2% (although still below 3%). Bond yields in Canada declined over the period, as investors sought what they perceived to be less risky assets amid heightened market volatility.

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Mortgage rates rose in the early part of 2011 on expectations of a strong economic recovery; however, rates started to fall again after economic growth expectations were revised lower. The mortgage yield curve flattened over the year, with four- and five-year mortgage rates dropping more than shorter-term rates.

The portfolio advisor maintained the fund's below-benchmark average term over the entire reporting period, and the fund's term was 2.2 years at the end of the period. The fund's overweight positions in two- and three-year bonds added yield, and provided a defensive stance against rising interest rates.

During the period, the portfolio advisor believed rates were likely to remain low and, therefore, focused the fund's investments on longer-term bonds to maximize the fund's yield.

Over the review period, the fund experienced net redemptions of $126,881,970.

Recent Developments

Effective November 24, 2011, the designation of the units of the fund has been changed from 'class' to 'series'; namely, Class A became Series A, Class F became Series F, and Class I became Series I.

Effective January 27, 2012, the sub-advisor to the fund, Goodman & Company, Investment Counsel Ltd., changed its name to GCIC Ltd.

Effective April 30, 2012, PricewaterhouseCoopers LLP will become the auditor of the fund replacing Ernst & Young LLP.

The portfolio advisor believes there are reasons to be optimistic about 2012. In particular, the portfolio advisor believes the risk of an uncontrolled sovereign debt default in Europe has fallen, and expects there to be improvements in the U.S. employment and housing markets. Further, the portfolio advisor believes improving economic fundamentals may lead to increasing mortgage rates.

The portfolio advisor also believes, however, that several downside risks to the global economic outlook remain, and is not likely to make any material changes to the fund's investment strategy in the first quarter of 2012.

Future Accounting Changes

Effective January 1, 2011, International Financial Reporting Standards ("IFRS") replaced Canadian standards and interpretations as Canadian GAAP for publicly accountable enterprises, which include the Fund. On December 12, 2011, the Accounting Standards Board ("AcSB") made the decision to extend the deferral of the mandatory adoption of IFRS by investment companies for an additional year to January 1, 2014. This extends the previous two-year deferral of IFRS to three years as compared to other publicly accountable entities. The deferral is to provide time for the International Accounting Standards Board ("IASB") to finalize its guidance on investment entities and that a final standard could be issued after January 1, 2013, the previously established changeover date for investment companies in Canada. Entities currently applying Accounting Guideline 18, "Investment Companies" can continue to apply existing Canadian standards in Part V of the CICA Handbook – Accounting until fiscal years beginning on or after January 1, 2014. In light of this decision, the Manager will defer the first-time adoption of IFRS until fiscal year beginning on or after January 1, 2014.

The Manager has commenced the development of a changeover plan to meet the implementation date. The key elements of the plan include identifying differences between the Fund's current accounting policies and those the Fund expects to apply under IFRS, as well as any accounting policy and implementation decisions and their resulting impact, if any, on the Net Assets or Net Asset Value of the Fund.

On August 25, 2011, the IASB issued an exposure draft proposing that investment entities will be exempted from consolidating their controlled investments under IFRS 10. The Fund expects to meet the proposed criteria to qualify as investment entities and would measure all controlled investments at fair value with changes in fair value recognized through profit or loss. In light of this exposure draft, the major qualitative impacts noted as of December 31, 2011 would be the addition of a statement of cash flows, the impact of classification of puttable instruments, the impact of reporting future income tax assets or liabilities when applicable, and additional note disclosures.

The Manager has presently determined that there will be no quantitative impact on the Net Asset Value per Unit of each Fund Series resulting from the changeover to IFRS. However, this present determination is subject to change resulting from the issuance of new standards or new interpretations of existing standards.

Related Party Transactions

We are the trustee, manager, registrar and transfer agent of the fund. The fund pays us a management fee, which may vary for each series of units of the fund. The Bank of Nova Scotia ("Scotiabank"), the parent company of the manager, earns fees for of providing custodial services, including safekeeping and administrative services and unitholder record-keeping services to the fund.

Our affiliates may earn fees and spreads in connection with various services provided to, or transactions with, the fund, such as banking, brokerage, securities lending, foreign exchange and derivatives transactions. We, or our affiliates, may earn a foreign exchange spread when unitholders switch between units of funds denominated in different currencies. The fund also maintains bank accounts and over-draft provisions with Scotiabank for which Scotiabank may earn a fee.

For certain series of units of the fund, Scotia Securities Inc., a wholly-owned subsidiary of Scotiabank, is the principal distributor for which it is paid a trailer commission by SAM. Units of the funds are also distributed through brokers and dealers, including Scotia Capital Inc. ("SCI"), DWM Securities Inc.

("DWMI") and Dundee Private Investors Inc. ("DPII") which are wholly-owned subsidiaries of Scotiabank. SCI, DWMI and DPII, like other dealers, are paid a trailer commission by SAM for distributing certain series of units of the fund. Trailer commissions are paid by SAM out of the management fees it receives from the fund and are based on the average value of assets held by each dealer.

SAM has established an independent review committee ("IRC") which acts as an impartial and independent committee to review and provide recommendations or, in certain cases, approvals respecting any conflict of interest matters referred to it by SAM. The IRC prepares, at least annually, a report of its activities to unitholders of the fund. The report is available on the ScotiaFunds website at www.scotiafunds.com or at the unitholder's request at no cost by contacting SAM (see front page).

SAM and the fund relied on standing instructions from the IRC in respect of one or more of the following types of transactions:

- Investing in or holding securities of related issuer, including Scotiabank;
- Trades in securities with SCI or parties related to the manager or the portfolio advisor, where SCI or such related parties act as principal;
- Investing in securities of an issuer during, or for 60 days after, the period in which SCI, or a related entity to the portfolio advisor, acted as an underwriter in the offering of those securities; and
- Purchases or sales of securities from or to another investment fund managed by us (referred to as "Inter fund Trading").

Scotia Mortgage Corporation, a wholly-owned subsidiary of Scotiabank, administers mortgages purchased by the fund. During the period, the fund paid fees of $1,724,394 to Scotia Mortgage Corporation for such administrative services. The fund purchases its mortgages from Scotia Mortgage Corporation and from Scotiabank. SAM and the fund relied on standing instructions from the IRC to purchase mortgages (including mortgages on property in which certain related persons may have an interest) from, and sell mortgages to, Scotia Mortgage Corporation, Scotiabank and their affiliates.

The applicable standing instructions require that investment decisions relating to the above types of transactions (i) are made free from any influence by us or any entity related to us and without taking in account any considerations relevant to us or any entity related to us; (ii) represent the business judgment of the portfolio advisor uninfluenced by any consideration other than the best interests of the funds; (iii) are in compliance with our policies; and (iv) achieve a fair and reasonable result for the fund.

From time to time, the fund may enter into portfolio securities transactions with SCI or other dealers in whom Scotiabank has a significant interest (the "Related Dealers"). These Related Dealers may earn commissions or spreads provided that such trades are made on terms and conditions that are comparable to non-related brokers or dealers.

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 over each of the past five years ended December 31.

The Fund's Net Assets per Unit(1)

Series A Units

		2011	2010	2009	2008	2007
Net Assets, beginning of year	$	10.90	10.98	10.88	10.63	10.77
Increase (decrease) from operations:						
Total revenue	$	0.38	0.39	0.48	0.56	0.57
Total expenses	$	(0.20)	(0.19)	(0.19)	(0.18)	(0.19)
Realized gains (losses) for the period	$	(0.03)	(0.06)	–	(0.01)	–
Unrealized gains (losses) for the period	$	(0.05)	(0.04)	0.06	0.25	(0.15)
Total increase (decrease) from operations(2)	$	0.10	0.10	0.35	0.62	0.23
Distributions:						
From net investment income (excluding dividends)	$	(0.17)	(0.19)	(0.32)	(0.37)	(0.38)
From dividends	$	–	–	–	–	–
From capital gains	$	–	–	–	–	–
Return of capital	$	–	–	–	–	–
Total Annual Distributions(3)	$	(0.17)	(0.19)	(0.32)	(0.37)	(0.38)
Net assets at December 31st of year shown(4)	$	10.84	10.90	10.98	10.88	10.63

Series F Units

		2011	2010	2009	2008	2007*
Net Assets, beginning of year	$	10.86	10.94	10.87	10.62	10.65
Increase (decrease) from operations:						
Total revenue	$	0.37	0.38	0.45	0.56	0.26
Total expenses	$	(0.13)	(0.12)	(0.12)	(0.11)	(0.05)
Realized gains (losses) for the period	$	(0.03)	(0.06)	–	(0.01)	–
Unrealized gains (losses) for the period	$	(0.06)	(0.02)	–	0.25	(0.04)
Total increase (decrease) from operations(2)	$	0.15	0.18	0.33	0.69	0.17
Distributions:						
From net investment income (excluding dividends)	$	(0.23)	(0.27)	(0.40)	(0.45)	(0.20)
From dividends	$	–	–	–	–	–
From capital gains	$	–	–	–	–	–
Return of capital	$	–	–	–	–	–
Total Annual Distributions(3)	$	(0.23)	(0.27)	(0.40)	(0.45)	(0.20)
Net assets at December 31st of year shown(4)	$	10.81	10.86	10.94	10.87	10.62

* The start date for Series F units was July 23.

Series I Units

		2011	2010	2009	2008	2007
Net Assets, beginning of year	$	10.83	10.91	10.85	10.61	10.75
Increase (decrease) from operations:						
Total revenue	$	0.38	0.38	0.49	0.56	0.57
Total expenses	$	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
Realized gains (losses) for the period	$	(0.03)	(0.06)	–	(0.01)	–
Unrealized gains (losses) for the period	$	(0.05)	(0.02)	0.08	0.23	(0.14)
Total increase (decrease) from operations[(2)]	$	0.26	0.26	0.53	0.74	0.39
Distributions:						
From net investment income (excluding dividends)	$	(0.33)	(0.34)	(0.46)	(0.52)	(0.53)
From dividends	$	–	–	–	–	–
From capital gains	$	–	–	–	–	–
Return of capital	$	–	–	–	–	–
Total Annual Distributions[(3)]	$	(0.33)	(0.34)	(0.46)	(0.52)	(0.53)
Net assets at December 31st of year shown[(4)]	$	10.77	10.83	10.91	10.85	10.61

(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. This difference is due to the requirements of generally accepted accounting principles ("GAAP"), including CICA Handbook Section 3855, and may result in a different valuation of securities held by the fund in accordance with GAAP than the market value used to determine net asset value of the fund for the purchase, switch and redemption of the fund's units ("Pricing NAV"). The Pricing NAV per unit at the end of the period is disclosed in Ratios and Supplemental Data.
(2) Net assets and distributions are based on the actual number of units outstanding at the relevant time. The increase/decrease from operations is based on the weighted average number of units outstanding over the financial period.
(3) Distributions were paid in cash/reinvested in additional units of the fund, or both.
(4) The net assets per unit at period end is not a cumulative amount but, rather, the value of the fund's units, in accordance with GAAP, as at the fund's period end.

Ratios and Supplemental Data

Series A Units

		2011	2010	2009	2008	2007
Total net asset value (000's)[(1)]	$	234,381	296,057	316,398	161,210	171,570
Number of units outstanding (000's)[(1)]		21,621	27,162	28,814	14,819	16,138
Management expense ratio[(2)]	%	1.86	1.79	1.74	1.72	1.75
Management expense ratio before waivers or absorptions[(2)]	%	1.86	1.79	1.74	1.81	1.83
Trading expense ratio[(3)]	%	–	–	–	–	–
Portfolio turnover rate[(4)]	%	36.18	86.54	78.20	48.96	54.72
Net asset value per unit	$	10.84	10.90	10.98	10.88	10.63

Series F Units

		2011	2010	2009	2008	2007
Total net asset value (000's)[(1)]	$	2,353	20,059	17,266	3	4
Number of units outstanding (000's)[(1)]		218	1,847	1,578	–	–
Management expense ratio[(2)]	%	1.16	1.07	1.07	1.01	0.44
Management expense ratio before waivers or absorptions[(2)]	%	1.16	1.07	1.09	60.66	68.19
Trading expense ratio[(3)]	%	–	–	–	–	–
Portfolio turnover rate[(4)]	%	36.18	86.54	78.20	48.96	54.72
Net asset value per unit	$	10.81	10.86	10.94	10.87	10.62

Series I Units

		2011	2010	2009	2008	2007
Total net asset value (000's)[(1)]	$	221,444	272,190	243,531	265,836	234,235
Number of units outstanding (000's)[(1)]		20,565	25,131	22,318	24,491	22,079
Management expense ratio[(2)]	%	0.39	0.37	0.34	0.35	0.34
Management expense ratio before waivers or absorptions[(2)]	%	0.39	0.37	0.34	0.37	0.36
Trading expense ratio[(3)]	%	–	–	–	–	–
Portfolio turnover rate[(4)]	%	36.18	86.54	78.20	48.96	54.72
Net asset value per unit	$	10.77	10.83	10.91	10.85	10.61

(1) This information is provided as at December 31st end of the year shown.
(2) Management expense ratio is based on total expenses (excluding commissions and other portfolio transaction costs) for the stated period and is expressed as an annualized percentage of the daily average net asset value during the period.
(3) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of the daily average net asset value during the period.
(4) The fund's portfolio turnover rate indicates how actively 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 year. The higher a fund's portfolio turnover rate in a year, the greater the trading costs payable by the fund in the year, and the greater the chance of an investor receiving taxable capital gains in the year. There is not necessarily a relationship between a high turnover rate and the performance of a fund.

Management Fees

The management fee for each series is calculated as a percentage of its daily net asset value and is accrued daily. The management fees cover the costs of managing the fund, allow us to arrange to provide investment analysis, recommendations and investment decision making for the fund, allow us to make brokerage arrangements for the purchase and sale of the fund's portfolio securities and to provide or arrange to provide other services. The breakdown of the services received in consideration of the management fees for each series, as a percentage of the management fees, are as follows:

	Maximum Management Fees (%)	Breakdown of Services	
		Dealer Compensation (%)	Other* (%)
Series A	1.25	5.70	94.30
Series F	0.625	–	100

* Includes all costs related to management, trustee, investment advisory services, general administration and profit.

Past Performance

The performance shown assumes that all distributions made by the fund in the periods shown were reinvested in additional units of the fund. If you hold the fund outside of a registered plan, you will be taxed on these distributions.

The performance information does not take into account sales, redemption, distribution or other optional charges that would have reduced returns.

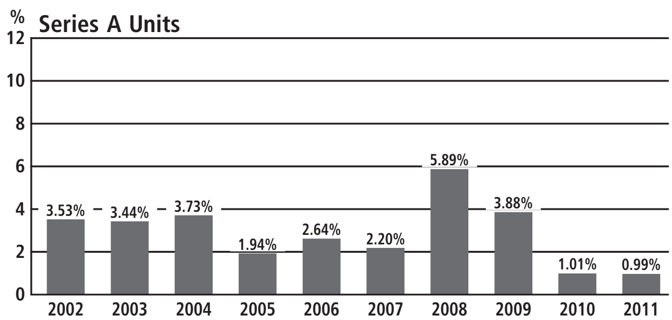
How the fund has performed in the past does not necessarily indicate how it will perform in the future.

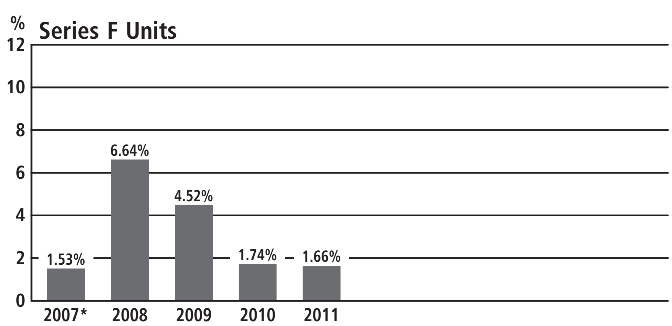
On April 1, 2011, the Manager appointed Goodman & Company, Investment Counsel Ltd. as sub-advisor to the fund. This change could have materially affected the performance of the fund during the performance measurement periods.

All rates of return are calculated based on Pricing NAV and are in Canadian dollars unless stated otherwise.

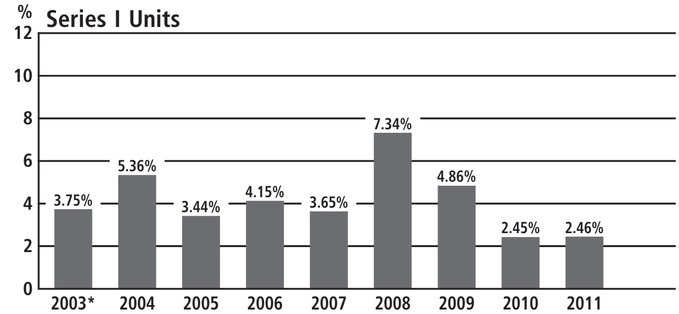
Year-by-Year Returns

This chart shows the fund's performance, which changes from year to year. It shows in percentage terms how much an investment held on January 1, or held commencing from start of series in each year, would have increased or decreased by December 31 of that year.





* Jul. 23 – Dec. 31



* Apr. 28 – Dec. 31

Annual Compound Returns

This table shows the fund's annual compound returns compared to the DEX Canada Mortgage Market Index, and a blended benchmark consisting of 33.3%, 33.3% and 33.3% of DEX Mortgage Market Index 1 year, 3 year, and 5 year respectively, for the periods shown ending December 31, 2011.

		1 year	3 year	5 year	10 year	since inception[1]
Series A Units	%	0.99	1.95	2.77	2.91	–
DEX Canada Mortgage Market Index	%	4.99	6.61	6.88	6.28	–
Blended Index	%	4.69	6.26	6.53	6.12	–
Series F Units	%	1.66	2.60	–	–	3.59
DEX Canada Mortgage Market Index	%	4.99	6.61	–	–	7.53
Blended Index	%	4.69	6.26	–	–	7.09
Series I Units	%	2.46	3.25	4.14	–	4.31
DEX Canada Mortgage Market Index	%	4.99	6.61	6.88	–	6.49
Blended Index	%	4.69	6.26	6.53	–	6.27

1 Inception Dates: Series F Units Jul. 23, 2007, Series I Units Apr. 28, 2003.

The DEX Canada Mortgage Market Index represents yields on a sample of mortgages from Canadian chartered banks. The index assumes a 5-year term before December 1980 and a 3-year term from December 1980, and an amortization period of 25 years.

Please see the "Results of Operations" section for a discussion of the fund's performance relative to the index.

Summary of Investment Portfolio

(as at December 31, 2011)

This is a breakdown of the fund's investments and a list of up to 25 of its largest holdings. The holdings will change as the portfolio advisor buys and sells securities. You can obtain a list of portfolio holdings on a quarterly basis by calling 1 800 268-9269, or by visiting www.scotiafunds.com.

Sector Mix(1)

	% of net asset value(2)
Conventional mortgages	89.0

(1) 11.0% of the fund's assets are held in Cash, Other Assets and Liabilities.
(2) Based on Pricing NAV.

Top Holdings

Issuer	% of net asset value[1]
Mortgages of 3 year remaining maturity	27.0
Mortgages of 2 year remaining maturity	24.2
Mortgages of 1 year remaining maturity	15.6
Mortgages of 4 year remaining maturity	14.6
Cash and cash equivalents	10.7
Mortgages of 6 month remaining maturity	5.9
Mortgages of 5 year remaining maturity	1.1
Mortgages of 6 year remaining maturity	0.6
Mortgages of 7 year remaining maturity	0.1
Total Net Asset Value (000's)	$458,178

(1) Based on Pricing NAV.