



## CANADIAN MEDICAL DISCOVERIES FUND INC.

### MANAGEMENT REPORT OF FUND PERFORMANCE

Year ended August 31, 2005

#### CANADIAN MEDICAL DISCOVERIES FUND INC. (“CMDF” or “the Fund”) MANAGEMENT REPORT OF FUND PERFORMANCE

Year ended August 31, 2005

This annual management report of fund performance contains financial highlights. A copy of the annual financial statements are available by request and at no cost by calling the following toll free number 1-800-268-8258; by writing to us at 100 International Boulevard, Toronto, Ontario, M9W 6J6; by visiting our website at [www.cmdf.com](http://www.cmdf.com); or at [www.sedar.com](http://www.sedar.com).

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

#### MANAGEMENT DISCUSSION OF FUND PERFORMANCE:

##### (i) INVESTMENT OBJECTIVES AND STRATEGIES

The Fund's primary objective is to achieve long-term capital appreciation through investment in eligible Canadian businesses engaged in the health sciences sector, with emphasis on those businesses involved in early-stage commercialization of research and/or product development. The health sciences sector encompasses a broad range of scientific disciplines and industries that relate to or have an impact on health care including, without limitation, life sciences, biotechnology, diagnostics, medical devices, drug discovery and development, health care delivery services and e-health. The Fund invests in a variety of product development initiatives as well as businesses with products, technologies or services in different stages of development. The Fund currently intends to invest in all four stages of development of the health science sector, namely:

- (1) Academic Research and Early Discovery;
- (2) Commercialization of Research;
- (3) Product Testing and Development; and
- (4) Production and Marketing.

Prospective investments by the Fund will be evaluated in terms of a number of criteria, including the commercial potential of the expected applications of the product, technology or service, management experience, and the potential for a sustainable competitive advantage associated with patented products, technology, market position, and distribution in the market.

## **(ii) RISK**

There are certain risks associated with the Class A shares of the Fund that investors should carefully consider. A discussion of the risk factors that are considered to pertain to an investment in Class A shares of the Fund are described in the Fund's prospectus. However, additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impair the Fund's investments or business and cause the net asset value of the Fund to decline.

A number of changes have occurred in the Fund over the year that investors should carefully consider. The principal changes that have occurred are as follows:

### *1. Redemptions*

Net redemptions of \$26.1 million occurred during the year which means that more Class A shares were redeemed during the year than were sold. Net assets therefore were reduced by this amount as cash was returned to shareholders who, for the most part, had held their units for the period required by law such that no claw back was made of the tax credits received on their original investment. The management of the Fund anticipated this increase in redemptions and adequate levels of cash have been maintained to offset the increase in redemptions.

### *2. Reduced liquidity*

The net asset value of the Fund has fallen by \$55 million as a result of losses on investments in the portfolio, redemptions and management expenses, which have eroded cash balances. The liquid portion of the Fund's portfolio at the year end consists of \$22.7 million of cash and cash equivalents and more than \$55 million of investments held in the public company portfolio.

### *3. Portfolio losses*

During the year net unrealized losses of \$11.8 million were recognized as market values were depressed in the sector due to a slow down in financings for emerging health care companies. This amount is comprised of three significant write-offs due to Portfolio company failures which were offset by unrealized gains.

### *4. Legislative Changes – Tax credit changes in Ontario*

In September 2005 the Ontario Government announced its intentions, after consultations with industry representatives, to extend tax credits for LSIF investments until the end of the 2010 taxation year. These proposed changes mean that tax credits, as currently available, will continue to be available for the next four years and then will be phased out over a further two years.

### *5. External Factors – Financings for emerging health care companies*

Financings for emerging public and private health care companies slowed down in the latter half of 2004 and the first half of 2005. This challenging market place for financings lowered valuations which has had a negative impact on the net asset value of the Fund.

## **(iii) RESULTS OF OPERATIONS**

The Fund's fundamental investment objective is to achieve long-term capital appreciation through investment in eligible Canadian businesses engaged in the health science sector, with emphasis on those businesses involved in early stage commercialization of research or product development. The application of the Fund's strategy of building value by realizing gains on investments that have matured to later stages of development and reinvesting in companies at the earlier stages of development with potentially higher rates of return continued to be executed during the year.

During fiscal 2005 CMDF invested \$31.0 million in eight new investments and \$27.3 million in twelve follow-on investments. New investments were made in companies developing: 1) antibiotics to treat acute and chronic disease caused by bacterial infections; 2) pharmaceuticals to treat obesity; 3) drugs to treat central nervous systems disorders, cancer and inflammation; 4) computer-assisted surgery; and 5) the treatment of inflammatory disorders.

The Fund's net asset mix at August 31, 2005 consisted of 44.4% invested in companies in drug discovery and development, 19.2% in early stage companies and intellectual property, 13.6% in health care delivery and IT, 11.0% in medical equipment and devices, 9.5% in cash and short term investments and 2.3% in other assets net of liabilities. This compares to the Fund's asset mix at August 31, 2004, which consisted of 38.7% invested in companies in drug discovery and development, 17.4% in early stage companies and intellectual property, 9.5% in health care delivery and IT, 5.5% in medical equipment and devices, 27.4% in cash and short term investments and 1.5% in other assets net of liabilities.

The Fund experienced an increase in redemptions from approximately \$15.8 million in fiscal 2004 to \$31.2 million in fiscal 2005 and a decrease in sales from approximately \$14.5 million in fiscal 2004 to \$5.1 million in fiscal 2005. The increase in redemptions can be attributed in part to changes relating to labour sponsored funds that occurred in May 1996. These changes included an extension of the holding period, after which a unitholder can redeem his or her Class A shares without the repayment of tax credits, from five years to eight years. As a result of this change, after May 2004 shares that had been previously subject to the repayment of tax credits upon redemption were now free to be redeemed. The manager of the Fund anticipated this increase in redemptions and adequate levels of cash have been maintained to offset the increase in redemptions. The manager of the Fund continuously monitors the cash position of the Fund and the liquidity of all of its investments. At August 31, 2005, the Fund had approximately \$22.7 million in cash and short-term investments. Sales of shares have also been impacted over the last year by the performance of the industry and the performance of the fund.

The performance of the Fund is affected by a number of factors, including, but not limited to: economic trends; the health care sector; public and private financings for emerging health care and life science companies; general stock market performance and the market for initial public offerings (IPOs). During fiscal 2005, the Fund was affected by all of the above factors.

The significant components of the Fund's revenue are interest income from both marketable securities and venture investments. During the year there was a decrease in interest income from marketable securities due to the reduction in cash and short-term investments. There was no significant change in interest income from venture investments when compared to the prior year.

The significant components of the Fund's expenses are management and administration fees and audit, legal and administrative expenses. Management and administration fees are calculated as a percentage of the net asset value of the Fund and decreased in real dollar terms during the year as a result of the decreased net asset value. Audit, legal and administrative expenses were in line with those of the prior year.

During the year the Fund recognized three significant write-downs in value in its investments for a total of \$28.7 million. These write-downs were partially offset by significant unrealized gains in two of the investments in the amount of \$16.0 million. In addition, the Fund disposed of several investments during the year resulting in a net realized loss of \$5.7 million.

#### **(iv) RECENT DEVELOPMENTS**

##### *Ontario LSIF Tax Credit Program*

The Ontario government had previously announced on August 29, 2005 that it would end its involvement in the LSIF tax credit program and harmonize certain requirements to help funds move to the federal government's Labour Sponsored Venture Capital Corporation program. On September 30, 2005 they announced that the Labour Sponsored Investment Fund (LSIF) tax credit would be continued until the end of the 2010 taxation year. The proposed extension of the tax credit is as follows:

TAXATION YEAR	RSP SALES SEASON	LSIF TAX CREDIT
2005	2006	15%
2006	2007	15%
2007	2008	15%
2008	2009	15%
2009	2010	10%
2010	2011	5%

The incremental tax credit offered for Research Oriented Investment Funds would be phased out on the same timetable.

The Fund has currently qualified as a Research Oriented Investment Fund. This allows an eligible investor in Ontario the opportunity to receive a tax credit of 15% from the Federal government and an additional 20% from the Ontario government for investments in CMDF on amounts invested up to \$5,000 per year.

### *Change of Control of The Fund's Manager*

Medical Discovery Management Corporation ("MDMC" or the "Manager") is the manager of CMDF. MDS Capital Corp. ("MDSCC") entered into an agreement with Stilco Investments Limited ("Stilco"), whereby MDSCC acquired all of the shares of MDMC that were owned by Stilco (the "Transaction") thereby becoming the sole shareholder of MDMC. Stilco is controlled by Dr. Calvin R. Stiller, who has resigned as Chairman and Chief Executive Officer of MDMC and the Fund. The Transaction became effective on October 17, 2005 after all requisite regulatory requirements were met, including approval from securities regulators.

Prior to this transaction, MDSCC owned 50% of the shares of MDMC. It has assisted in the management of the Fund since its inception in 1994. Upon completion of the Transaction, MDSCC became the sole owner and operator of MDMC and will continue to manage the Fund under the existing management agreements and fee arrangements. Management expects minimal changes in the day-to-day operations of the Fund following completion of the Transaction.

## **(v) RELATED PARTY DISCLOSURE**

### *The Manager*

MDMC is the Manager of the Fund by agreement dated December 1, 2004. The agreement has an initial term of ten years and shall be automatically extended for successive one-year periods on each anniversary date of the agreement. Either party may terminate further automatic extensions by providing written notice to the other party. The Manager is entitled to receive a management fee of 3.0% of the daily net asset value of the Fund calculated and charged monthly in arrears. During the fiscal year the Manager earned a fee of \$8.2 million (excluding GST). The Manager is also entitled to a performance fee when certain conditions are met.

See previous section – RECENT DEVELOPMENTS – for a discussion of recent transactions.

### *The Sponsor*

The sponsor of the Fund is The Professional Institute of the Public Service of Canada (the "Sponsor"). The Sponsor, being the sole shareholder owning the one issued and outstanding Class B Share of the Fund (the "Class B Share"), is entitled to elect two-thirds of the directors of the Fund.

The Fund currently has a board of nine directors. (As at October 31, 2005 there is one vacancy.) The Sponsor elects six directors and the holders of Class A Shares of the Fund elect three directors. The Sponsor has agreed to support for election three directors nominated by the Sponsor, three directors nominated by the Manager, and three other directors acceptable to the Sponsor and the Manager.

The Sponsor is entitled to be reimbursed from the Manager for all reasonable costs and expenses incurred in relation to the Fund and in relation to maintaining the Sponsor as a valid and subsisting corporate entity. During the fiscal year the Sponsor was reimbursed \$17,843 by the Manager.

### *MDS Capital Corp.*

MDSCC has been retained by the Manager to assist the Manager in performing certain of its duties including the identification, screening and analysis of investment and divestment opportunities. In addition, MDSCC will assist the Fund by monitoring its investments and providing strategic assistance to eligible health businesses. MDSCC receives a fee from the Manager for these services equal to 2% of the daily net asset value of the Fund calculated monthly and paid in arrears. During the fiscal year, MDSCC received \$5.3 million (excluding GST) from the Manager. MDSCC is further entitled to receive a performance fee equal to 80% of the performance fee payable to the Manager if and only if the Manager is entitled to receive a performance fee.

One of the directors nominated by the Manager is an employee of MDSCC.

### *The Directors*

On September 27, 2005, the Chairman and Chief Executive Officer of the Fund entered into a consulting arrangement with the Manager to provide certain services. The director could receive \$284,000 as compensation from the manager for these services to be provided to CMDF and CMDF II in the upcoming fiscal year.

## FINANCIAL HIGHLIGHTS:

### (i) 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 for the past 5 years. This information is derived from the Fund's audited financial statements.

#### *The Fund's Net Asset Value (NAV) per Share*

	2005	2004	2003	2002	2001
NET ASSET VALUE, BEGINNING OF YEAR <sup>(1)</sup>	\$8.68	\$10.10	\$9.35	\$11.16	\$11.60
<b>INCREASE (DECREASE) FROM OPERATIONS:</b>					
TOTAL REVENUE	\$0.04	\$0.09	\$0.15	\$0.25	\$0.35
TOTAL EXPENSES	\$0.35	\$0.45	\$0.43	\$0.44	\$0.57
REALIZED GAINS (LOSSES) FOR THE PERIOD	(\$0.17)	\$0.25	(\$0.77)	\$0.66	\$0.39
UNREALIZED GAINS (LOSSES) FOR THE PERIOD	(\$0.36)	(\$0.99)	\$1.91	(\$2.16)	(\$0.65)
TOTAL INCREASE (DECREASE) FROM OPERATIONS <sup>(2)</sup>	(\$0.84)	(\$1.10)	\$0.86	(\$1.69)	(\$0.48)
NET ASSET VALUE AT AUGUST 31 OF YEAR SHOWN <sup>(1)</sup> :	\$7.79	\$8.68	\$10.10	\$9.35	\$11.16

(1) Net asset value and distributions are based on the actual number of shares outstanding at the relevant time.

(2) The increase/decrease from operations is based on the weighted average number of shares outstanding over the financial period.

#### *Ratios and Supplemental Data*

	2005	2004	2003	2002	2001
NET ASSETS ('000's) <sup>(1)</sup>	\$239,685	\$294,089	\$344,042	\$315,318	\$350,996
NUMBER OF CLASS A SHARES OUTSTANDING <sup>(1)</sup>	30,779,619	33,892,055	34,054,870	33,728,363	31,454,434
MANAGEMENT EXPENSE RATIO <sup>(2)</sup>	4.28 %	4.61 %	4.59 %	4.30 %	3.70 %
PORTFOLIO TURNOVER RATE <sup>(3)</sup>	15.79 %	15.86 %	23.39 %	8.89 %	8.63 %
TRADING EXPENSE RATIO <sup>(4)</sup>	0.21 %	0.31 %	0.28 %	0.79 %	1.87 %
CLOSING OF MARKET PRICE OR PRICING NAV	\$7.79	\$8.68	\$10.10	\$9.35	\$11.16

(1) This information is provided as at August 31 of the year shown.

(2) Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of daily average net assets during the period.

(3) The Fund's portfolio turnover rate indicates how actively the Fund's portfolio adviser 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.

(4) 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.

### (ii) MANAGEMENT FEES

The management fee is based on 3% of the daily net asset value calculated and charged monthly in arrears. The services received in exchange for the management fee are as follows:

- Provision of office facilities and personnel, financial reporting, marketing, registrar, transfer agency and other shareholder administrative services;
- Retention and supervision of investment advisors;
- Assistance with the formulation and refinement of the investment objectives, restrictions, policies and procedures of the Fund as well as the identification and evaluation of potential eligible investments, the negotiation of the terms and conditions attributable to the investments, the monitoring of the business and financial performance of the investments and the provision of management assistance and advice to the investments as may be considered necessary;
- Preparation and filing of all prospectus documents, information documents, notices and other material in connection with the meetings of shareholders of the Fund.

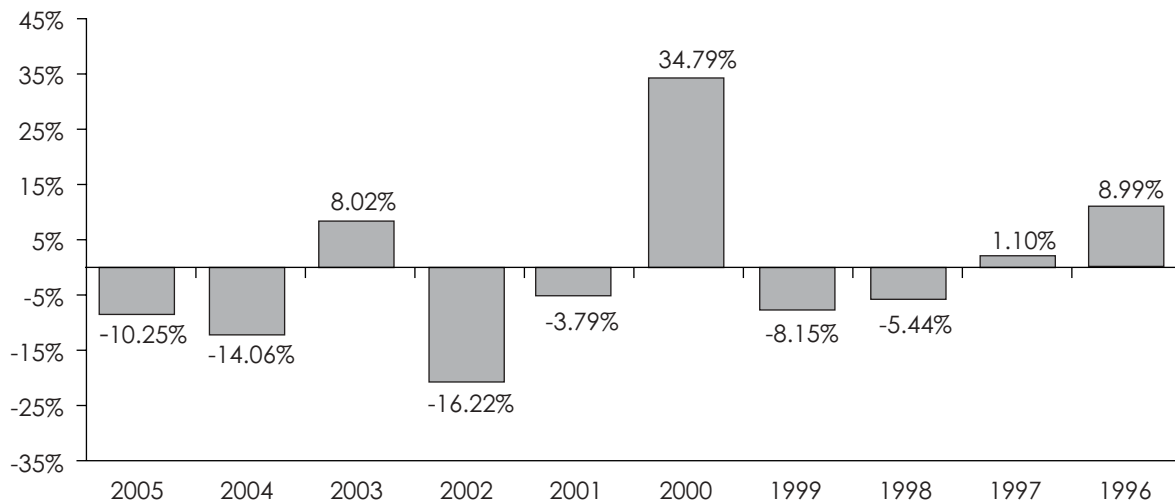
## PAST PERFORMANCE:

### (i) GENERAL

The performance data provided assumes reinvestment of distributions and does not take into account sales, redemptions, distributions or other optional charges payable by any unitholder that would have reduced returns. Past performance does not necessarily indicate how a fund will perform in the future.

### (ii) YEAR BY YEAR RETURNS

The bar chart below shows the Fund's annual performance for each of the years shown, and illustrates how the Fund's performance has changed from year to year. The bar chart shows in percentage terms, how much the net asset value per share (NAVPS) on September 1st (the first day of the Fund's financial year) would have increased or decreased by August 31st (the last day of the Fund's financial year).



### (iii) ANNUAL COMPOUND RETURNS

The table below shows the Fund's annual compound performance as at August 31, 2005 for the previous 3 months, 6 months, 1 year, 3 years, 5 years, 10 years, and since inception.

The mean annual compounded performance for the LSIF category is also shown below for comparison purposes. The LSIF category mean represents the average of the 109 labour-sponsored funds in Canada as tracked and reported by MorningStar Research Inc.

The indicated rates of return are the historical annual compounded total returns, including changes in share value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns.

FUND NAME	3MTH	6 MTH	1 Yr	3 Yr	5 Yr	10 Yr	SINCE INCEPTION
CANADIAN MEDICAL DISCOVERIES FUND	(3.71%)	(8.35%)	(10.25%)	(5.90%)	(9.53%)	(2.48%)	(2.27%)
LSIF CATEGORY MEAN*	(0.0%)	(1.7%)	(0.1%)	(3.3%)	(10.1%)	(1.1%)	N/A

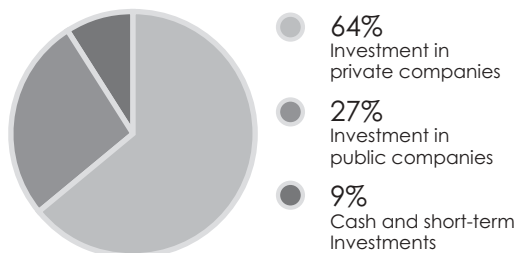
\* Source: MorningStar Research Inc., PALTrak report as at August 31, 2005.

In the five-year period, the Fund has performed better than the LSIF category median. Over the past year, and in the three and ten year periods, the Fund has underperformed in comparison to the LSIF category median. It should be noted that the majority of LSIF funds are multi-sector funds, whereas CMDF invests exclusively in the life sciences sector.

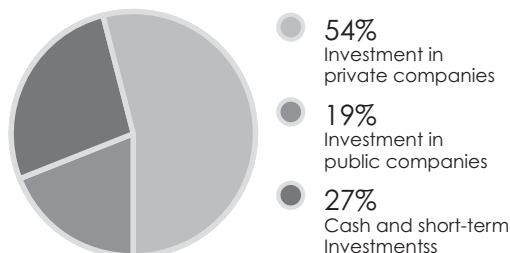
## SUMMARY OF INVESTMENT PORTFOLIO:

The first chart below shows that 64% of the Fund's assets was invested in private companies, 27% in public companies, and the remaining 9% in cash and short term investments as at August 31, 2005. This compares to 54%, 19% and 27% respectively as at August 31, 2004.

CMDF Net Asset Value  
\$239.7 Million  
as at August 31, 2005

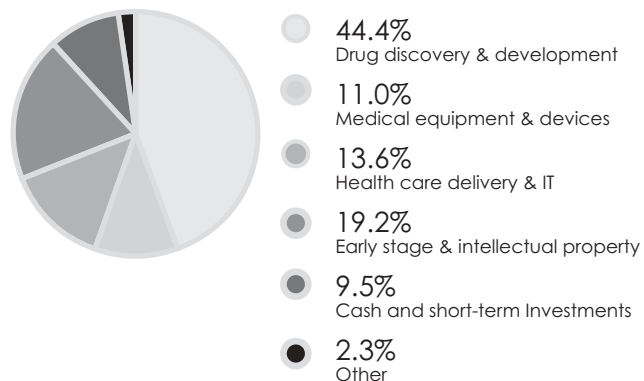


CMDF Net Asset Value  
\$294.1 Million  
as at August 31, 2004

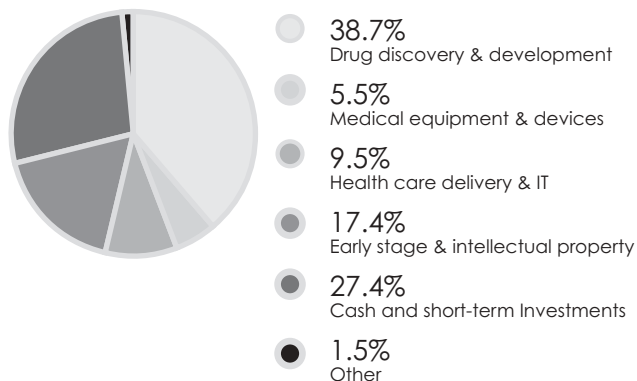


The next two charts reflect the percentage of the Fund's assets by investment classification. As at August 31, 2005, just over 44% of the Fund's assets was invested in companies involved in drug development and discovery, 19.2% in early stage and intellectual property, 13.6% in health delivery and information technology, 11% in medical equipment and devices, and 9.5% in cash and short term investments. This compares to 38.7% in drug development and discovery, 17.4% in early stage and intellectual property, 9.5% in health care delivery and information technology, 5.5% in medical equipment and devices, and 27.4% in cash and short term investments.

CMDF Net Asset Value  
\$239.7 Million  
as at August 31, 2005



CMDF Net Asset Value  
\$294.1 Million  
as at August 31, 2004



## TOP 25 POSITIONS AS A PERCENTAGE OF THE NET ASSET VALUE

INVESTMENT	LOCATION	CLASSIFICATION
SYSTEMS XCELLENCE INC	MILTON, ON	HEALTH CARE DELIVERY & IT
TM BIOSCIENCE CORPORATION	TORONTO, ON	DRUG DISCOVERY & DEVELOPMENT
UNIVERSITY MEDICAL DISCOVERIES INC.	TORONTO, ON	INTELLECTUAL PROPERTY & EARLY STAGE
GEMIN X BIOTECHNOLOGIES INC.	MONTREAL, QC	DRUG DISCOVERY & DEVELOPMENT
MEDTECH PARTNERS INC.	OTTAWA, ON	INTELLECTUAL PROPERTY & EARLY STAGE
EXCEL-TECH LTD	OAKVILLE, ON	HEALTH CARE DELIVERY & IT
MEDINNOVA PARTNERS INC.	HALIFAX, NS	INTELLECTUAL PROPERTY & EARLY STAGE
VIRON THERAPEUTICS INC.	LONDON, ON	DRUG DISCOVERY & DEVELOPMENT
ACTIVBIOTICS (CANADA) INC.	TORONTO, ON	DRUG DISCOVERY & DEVELOPMENT
AMBIT BIOSCIENCES CANADA CORPORATION	TORONTO, ON	DRUG DISCOVERY & DEVELOPMENT
CANADIAN MEDICAL DISCOVERIES FUND II INC.	TORONTO, ON	OTHER
VIOPPIX CANADA INC.	TORONTO, ON	MEDICAL EQUIPMENT & DEVICES
XILLIX LTD.	RICHMOND, BC	MEDICAL EQUIPMENT & DEVICES
PRAXIM CORPORATION	TORONTO, ON	MEDICAL EQUIPMENT & DEVICES
ISOTIS S.A.	SWITZERLAND	MEDICAL EQUIPMENT & DEVICES
AEGERA THERAPEUTICS INC.	MONTREAL, QC	DRUG DISCOVERY & DEVELOPMENT
PAINCEPTOR PHARMA (ONTARIO) CORPORATION	OTTAWA, ON	DRUG DISCOVERY & DEVELOPMENT
PROTIVA BIOTHERAPEUTICS INC.	BURNABY, BC	DRUG DISCOVERY & DEVELOPMENT
TARGANTA THERAPEUTICS INC.	ST-LAURENT, QC	DRUG DISCOVERY & DEVELOPMENT
ANORMED INC.	LANGLEY, BC	DRUG DISCOVERY & DEVELOPMENT
TWINSTRAND THERAPEUTICS INC.	BURNABY, BC	DRUG DISCOVERY & DEVELOPMENT
CYTOCHROMA INC.	MARKHAM, ON	DRUG DISCOVERY & DEVELOPMENT
TRILLIUM THERAPEUTICS INC.	TORONTO, ON	DRUG DISCOVERY & DEVELOPMENT
RENOVIS, INC.	SAN FRANCISCO, CA	DRUG DISCOVERY & DEVELOPMENT
ADIPOGENIX (CANADA) INC.	TORONTO, ON	DRUG DISCOVERY & DEVELOPMENT

### TOP 25 HOLDINGS AS A PERCENTAGE OF TOTAL NET ASSETS

72.0%

The summary of investment portfolio may change due to ongoing portfolio transactions of the Fund. A quarterly update is available by calling [1-800-268-8258], writing to 100 International Blvd, Toronto, Ontario, M9W 6J6, or by visiting [www.cmdf.com](http://www.cmdf.com).



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