

FIXED-INCOME FUND

**PHILLIPS, HAGER & NORTH
TOTAL RETURN BOND FUND**

December 31, 2012

Portfolio Manager RBC Global Asset Management Inc. ("RBC GAM")

The Board of Directors of RBC Global Asset Management Inc. approved this annual management report of fund performance on March 1, 2013.

A Note on Forward-looking Statements

This report may contain forward-looking statements about the Fund, its future performance, strategies or prospects, and possible future Fund action. The words "may," "could," "should," "would," "suspect," "outlook," "believe," "plan," "anticipate," "estimate," "expect," "intend," "forecast," "objective" and similar expressions are intended to identify forward-looking statements.

Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties, both about the Fund and general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made in relation to the Fund. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events.

The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.

This annual management report of fund performance ("MRFP") contains financial highlights but does not contain the complete annual financial statements of the Fund. You can get a copy of the financial statements at your request, and at no cost, by calling 1-800-661-6141, by writing to us at RBC Global Asset Management Inc., Phillips, Hager & North Investment Management, Investment Funds Centre, 20th Floor, 200 Burrard Street, Vancouver, B.C., V6C 3N5, or by visiting our website at www.rbcgam.com/reports or SEDAR at www.sedar.com. Security holders 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.

Phillips, Hager & North Investment Management is a division within RBC Global Asset Management Inc., the manager of the Fund and an indirect wholly-owned subsidiary of Royal Bank of Canada.

MANAGEMENT DISCUSSION OF FUND PERFORMANCE**Investment Objective and Strategies**

The Fund seeks to provide investors with stability of capital by investing primarily in a well-diversified portfolio of fixed-income securities issued primarily by Canadian governments and corporations. It also invests in derivatives. Through a mix of interest income and capital appreciation, the Fund aims to provide a competitive rate of return while controlling the interest rate and credit risks to which it is exposed. To achieve the Fund's investment objective, we invest primarily in medium- to high-quality corporate bonds and government bonds of Canadian, U.S. and other foreign issuers. The Fund may also invest in asset-backed commercial paper to enhance its return (the Fund's weighting in high-yield bonds is generally restricted to a maximum of 20% of its total assets). The average term to maturity of the portfolio is managed within strict guidelines, and typically falls between seven and 12 years.

Risk

There were no significant changes to the investment objective and strategies that affected the Fund's overall level of risk during the reporting period. The risks of investing in the Fund and the suitability of the Fund for particular investors remains as discussed in the Simplified Prospectus.

Results of Operations

The Fund's net asset value increased to \$2.9 billion as of December 31, 2012, from \$2.5 billion at the end of 2011. Of the change, \$259.3 million was due to net inflows and \$111.1 million to investment returns.

Over the past year, the Fund's Series D units gained 3.9%, which outperformed the benchmark return of 3.6%. The Fund's return is after the deduction of fees and expenses. See the Financial Highlights section for the management expense ratios and the Past Performance section for the returns of other series, which may vary because of differences in management fees and expenses.

The Fund was defensively positioned throughout 2012 with a shorter maturity duration (a measure of a bond's sensitivity to interest rate changes) than its benchmark to make it less susceptible to the negative effects of rising interest rates. Interest rate strategies were approximately neutral to performance over the entire year.

Rising interest rates are often accompanied by improving economic fundamentals, which bode well for corporate and provincial bonds. We maintained a high allocation to both of these sectors, as we expect corporate and provincial bonds to perform well in an environment that would accompany higher rates. This strategy can be helpful to the Fund in two ways: (1) corporate and provincial

bonds tend to outperform federal bonds during periods of rising rates; and (2) they increase the Fund's yield, which is always helpful for performance, regardless of the direction of interest rates. Over the full year, both of these effects occurred. The small allocation to high-yield bonds added to performance over the year as a result of their very strong performance compared to investment-grade bonds.

We continue to maintain a meaningful short duration in the Fund relative to its benchmark in anticipation that interest rates will continue to rise. We are also maintaining an overweight allocation to provincial and corporate bonds to increase the yield of the Fund, against the backdrop of what we believe is a fundamentally healthy environment for credit. For now, exposure to provincial bonds exceeds exposure to corporate bonds. The Fund maintains its position in high-yield bonds, which continues to be an important source of yield.

Recent Developments

Global bond yields continue to fluctuate after spending several months trading in a fairly tight range while new rounds of monetary stimulus and U.S. fiscal worries preoccupied the bond market. Broadly speaking, very low bond yields continue to make sense in a world of slow growth, moderate inflation, risk aversion, low policy rates and unconventional central bank actions. That said, we believe yields will not remain this low forever. The question, then, is primarily one of timing. Our sense is that 2013 could usher in moderately higher bond yields as policy clarity improves and global growth begins to revive. But an outright tightening of monetary policy at the shortest end of the yield curve is likely still far away for many countries, and so relatively low government bond yields are likely to remain with us for some time.

All outstanding Series B units were redesignated as Series D units effective July 27, 2012. The redesignated units have a lower management fee as compared to the Series B units.

Effective July 27, 2012, Royal Bank of Canada ("Royal Bank") owns 100% of RBC Investor Services Trust (formerly, RBC Dexia Investor Services Trust, referred to throughout as "RBC IS").

Related-Party Transactions***Manager, Portfolio Advisor and Registrar***

RBC GAM is an indirect, wholly-owned subsidiary of Royal Bank and is the manager, principal portfolio advisor and registrar of the Fund. RBC GAM is responsible for the Fund's day-to-day operations, provides investment advice and portfolio management services to the Fund and appoints distributors for the Fund. RBC GAM, as registrar, also keeps the records of who owns the units of the Fund. RBC GAM is paid a management fee by the Fund as compensation for its services. The Fund pays a fixed administration fee to RBC GAM, which, in turn, pays certain operating expenses of the Fund.

Affiliates of RBC GAM that provide services to the Fund in the course of their normal businesses are discussed below.

Distributors

RBC GAM, Phillips, Hager & North Investment Funds Ltd., Royal Mutual Funds Inc., RBC Direct Investing Inc. and RBC Dominion Securities Inc. are principal distributors of, or distribute certain series of units of, the Fund. Dealers receive an ongoing commission based on the total value of their clients' Series C, Advisor Series and Series D units.

Trustee and Custodian

RBC IS is the trustee and custodian of the Fund. The fees paid to RBC IS are paid by RBC GAM and not the Fund.

RBC IS holds title to the Fund's property on behalf of unitholders and holds the assets of the Fund.

Other Related-Party Transactions

Pursuant to applicable securities legislation, the Fund relied on the standing instructions from the Board of Governors ("BoG") in its capacity as the Independent Review Committee with respect to one or more of the following transactions:

Related-Party Trading Activities

- (a) trades in securities of Royal Bank;
- (b) investments in the securities of issuers for which a related-party dealer acted as an underwriter during the distribution of such securities and the 60-day period following the conclusion of such distribution of the underwritten securities to the public;
- (c) purchases of equity and debt securities from or sales of equity or debt securities to a related-party dealer, where it acted as principal; and

Inter-Fund Trading

- (d) purchases or sales of securities of an issuer from or to another investment fund or managed account managed by RBC GAM.

The applicable standing instructions require that Related-Party Trading Activities and Inter-Fund Trading be conducted in accordance with RBC GAM policy and that RBC GAM advise the BoG of a material breach of any standing instruction. RBC GAM policy requires that an investment decision in respect of Related-Party Trading Activities (i) is made free from any influence of Royal Bank or its associates or affiliates and without taking into account any consideration relevant to Royal Bank or its affiliates or associates, (ii) represents the business judgment of the portfolio manager, uninfluenced by considerations other than the best interests of the Fund, (iii) is in compliance with RBC GAM policies and procedures, and (iv) achieves a fair and reasonable result for the Fund. RBC GAM policy requires that an investment decision in respect of Inter-Fund Trading is in the best interests of each Fund.

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 five years or for the periods since inception. This information is derived from the Fund's audited annual financial statements. "Net Assets" are calculated in accordance with Canadian generally accepted accounting principles, which are used to prepare the financial statements (see table below). "Net Asset Value" is derived from the valuation method disclosed in the Phillips, Hager & North Funds' Annual Information Form and is used for transactional purposes (see Ratios and Supplemental Data). All other calculations for the purposes of this MRFP are made using Net Asset Value.

Change in Net Assets Per Unit (\$)

For the Year/ Period Ended	Net Assets Beginning of Year/Period	Increase (Decrease) from Operations ¹					Annual Distributions ²					Net Assets End of Year
		Total Revenue (Loss)	Total Expenses	Realized Gains (Losses)	Unrealized Gains (Losses)	Total	From Income (Excluding Dividends)	From Dividends	From Capital Gains	Return of Capital	Total	
Series C												
Dec. 31, 2012	11.62	0.45	(0.14)	0.07	–	0.38	(0.32)	–	–	–	(0.32)	11.69
Dec. 31, 2011	11.18	0.48	(0.13)	0.18	0.29	0.82	(0.35)	–	(0.04)	–	(0.39)	11.62
Dec. 31, 2010	11.05	0.48	(0.12)	0.19	0.12	0.67	(0.35)	–	(0.17)	–	(0.52)	11.18
Dec. 31, 2009	10.50	0.57	(0.12)	0.18	0.27	0.90	(0.46)	–	(0.10)	–	(0.56)	11.05
Dec. 31, 2008 ³	10.33 [†]	(0.04)	(0.02)	(0.08)	0.44	0.30	–	–	–	–	–	10.50
Advisor Series												
Dec. 31, 2012	11.62	0.45	(0.14)	0.07	–	0.38	(0.32)	–	–	–	(0.32)	11.69
Dec. 31, 2011	11.18	0.48	(0.13)	0.18	0.29	0.82	(0.35)	–	(0.04)	–	(0.39)	11.62
Dec. 31, 2010 ⁴	11.52 [†]	0.08	(0.02)	0.03	0.02	0.11	(0.05)	–	(0.17)	–	(0.22)	11.18
Series D⁵												
Dec. 31, 2012	11.61	0.46	(0.07)	0.07	–	0.46	(0.38)	–	–	–	(0.38)	11.68
Dec. 31, 2011	11.18	0.48	(0.06)	0.18	0.29	0.89	(0.43)	–	(0.04)	–	(0.47)	11.61
Dec. 31, 2010	11.03	0.48	(0.06)	0.19	0.12	0.73	(0.40)	–	(0.17)	–	(0.57)	11.18
Dec. 31, 2009	10.48	0.58	(0.06)	0.20	0.44	1.16	(0.51)	–	(0.10)	–	(0.61)	11.03
Dec. 31, 2008	10.75	0.43	(0.07)	0.02	(0.31)	0.07	(0.36)	–	–	–	(0.36)	10.48
Series F												
Dec. 31, 2012	11.62	0.45	(0.07)	0.07	–	0.45	(0.38)	–	–	–	(0.38)	11.70
Dec. 31, 2011	11.20	0.48	(0.07)	0.18	0.29	0.88	(0.43)	–	(0.04)	–	(0.47)	11.62
Dec. 31, 2010	11.05	0.48	(0.07)	0.19	0.12	0.72	(0.40)	–	(0.17)	–	(0.57)	11.20
Dec. 31, 2009	10.50	0.56	(0.06)	0.19	0.31	1.00	(0.51)	–	(0.10)	–	(0.61)	11.05
Dec. 31, 2008	10.77	0.28	(0.06)	(0.15)	(0.07)	–	(0.35)	–	–	–	(0.35)	10.50
Series O												
Dec. 31, 2012	11.54	0.45	–	0.07	–	0.52	(0.44)	–	–	–	(0.44)	11.62
Dec. 31, 2011	11.12	0.48	–	0.18	0.29	0.95	(0.49)	–	(0.04)	–	(0.53)	11.54
Dec. 31, 2010	10.99	0.47	–	0.19	0.12	0.78	(0.47)	–	(0.17)	–	(0.64)	11.12
Dec. 31, 2009	10.45	0.58	–	0.20	0.46	1.24	(0.58)	–	(0.10)	–	(0.68)	10.99
Dec. 31, 2008	10.78	0.45	–	0.05	(0.31)	0.19	(0.47)	–	–	–	(0.47)	10.45

¹ 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. This table is not intended to be a reconciliation of beginning to ending net assets per unit.

² Distributions are reinvested in additional units of the Fund or paid in cash.

³ From November 2008.

⁴ From October 2010.

⁵ Series D was known as Series A prior to November 17, 2008.

[†] Initial offering net asset value per unit.

FINANCIAL HIGHLIGHTS (cont.)

Ratios and Supplemental Data

As at	Net Asset Value Per Unit (\$)	Net Asset Value (\$000s)	Number of Units Outstanding (000s)	Management Expense Ratio (%) ¹	MER Before Absorption (%) ¹	Portfolio Turnover Rate (%) ²	Trading Expense Ratio (%) ³
Series C							
Dec. 31, 2012	11.70	253 997	21 710	1.16	1.16	207.49	—
Dec. 31, 2011	11.63	218 565	18 788	1.16	1.16	123.09	—
Dec. 31, 2010	11.20	190 033	16 969	1.14	1.14	136.37	—
Dec. 31, 2009	11.07	108 239	9 778	1.11 ⁴	1.13	84.61	—
Dec. 31, 2008 ⁵	10.53	4 245	403	1.11	1.26	78.55	—
Advisor Series							
Dec. 31, 2012	11.70	120 449	10 295	1.16	1.16	207.49	—
Dec. 31, 2011	11.63	45 403	3 903	1.16	1.16	123.09	—
Dec. 31, 2010 ⁶	11.20	2 800	250	1.14	1.14	136.37	—
Series D⁷							
Dec. 31, 2012	11.69	725 163	62 034	0.60	0.60	207.49	—
Dec. 31, 2011	11.62	804 147	69 210	0.60	0.60	123.09	—
Dec. 31, 2010	11.20	826 458	73 803	0.58	0.58	136.37	—
Dec. 31, 2009	11.05	874 988	79 151	0.57 ⁴	0.57	84.61	—
Dec. 31, 2008	10.51	890 669	84 765	0.58	0.58	78.55	—
Series F							
Dec. 31, 2012	11.71	320 752	27 394	0.61	0.61	207.49	—
Dec. 31, 2011	11.64	223 472	19 202	0.61	0.61	123.09	—
Dec. 31, 2010	11.22	156 757	13 977	0.60	0.60	136.37	—
Dec. 31, 2009	11.07	79 581	7 187	0.58 ⁴	0.59	84.61	—
Dec. 31, 2008	10.52	14 393	1 368	0.58	0.61	78.55	—
Series O							
Dec. 31, 2012	11.63	1 494 742	128 536	0.02	0.02	207.49	—
Dec. 31, 2011	11.56	1 249 599	108 130	0.02	0.02	123.09	—
Dec. 31, 2010	11.14	1 263 961	113 481	0.02	0.02	136.37	—
Dec. 31, 2009	11.01	1 285 874	116 803	0.02 ⁴	0.02	84.61	—
Dec. 31, 2008	10.48	1 160 448	110 753	0.03	0.03	78.55	—

¹ The management expense ratio ("MER") is based on expenses for the stated period, excluding commissions and other portfolio transaction costs, and is expressed as an annualized percentage of the daily average net asset value during the period. RBC GAM may, at its discretion and without notice to unitholders, waive or absorb certain operating expenses. MER includes the waiver or absorption by RBC GAM of certain operating expenses, while the MER before absorption shows the MER prior to operating expenses being waived or absorbed by RBC GAM.

² The Fund's portfolio turnover rate gives an indication of the level of activity employed by the portfolio manager. 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 the 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 high turnover rate and the performance of the Fund. The portfolio turnover rate is not applicable to money market funds.

³ The trading expense ratio represents total commissions and other portfolio transaction costs expressed as a percentage of daily average net asset value during the period. The trading expense ratio is not applicable to fixed-income transactions.

⁴ Effective November 1, 2009, a fixed administration fee was introduced in respect of each series of the Fund. If the fixed administration fee would have been in effect throughout 2009, the adjusted MER for each series of the Fund would be: Series C – 1.10%, Series D – 0.57%, Series F – 0.58%, Series O – 0.02%.

⁵ From November 2008.

⁶ From October 2010.

⁷ Series D was known as Series A prior to November 17, 2008.

FINANCIAL HIGHLIGHTS (cont.)

Management Fees

RBC GAM is the manager, portfolio advisor and registrar of the Fund. Management fees paid by each series of the Fund are calculated at the applicable annual percentages, before GST/HST, of the daily net asset value of each series of the Fund. The breakdown of the services received in consideration of the management fees for each series, as a percentage of the management fees, is as follows:

	Management Fees	Breakdown of Services	
		Distribution	Other*
Series C	1.00%	50%	50%
Advisor Series	1.00%	50%	50%
Series D	0.50%	30%	70%
Series F	0.50%	—	100%

Series O – no management fees are paid by the Fund in respect of Series O units. Series O unitholders pay a negotiated fee directly to RBC GAM for investment-counselling services.

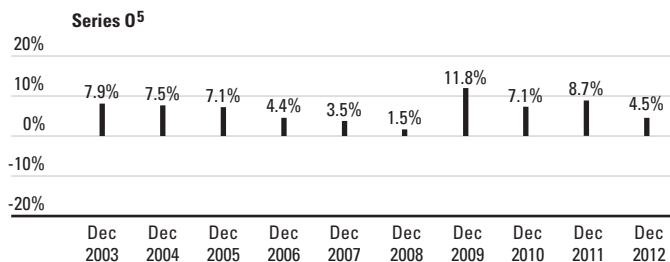
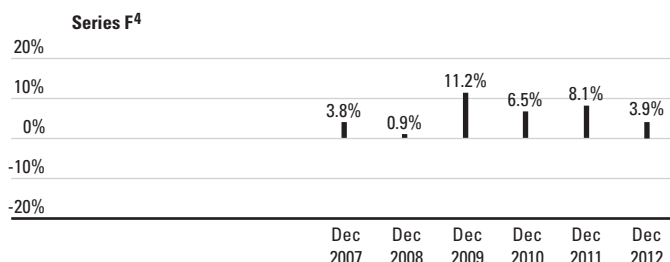
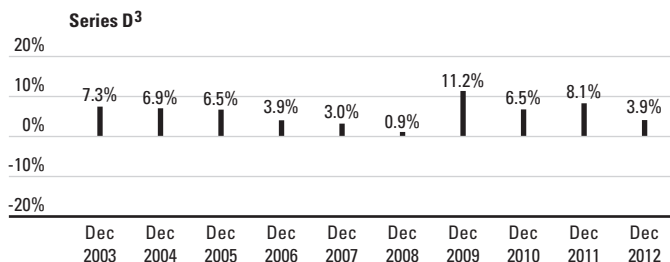
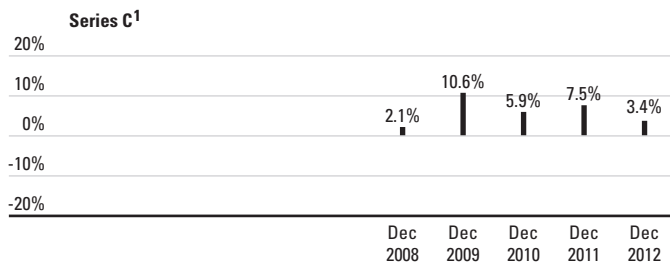
* Includes all costs related to management, investment advisory services, general administration and profit.

PAST PERFORMANCE

The performance information shown assumes that all distributions made by the Fund in the periods shown were reinvested in additional units of the Fund and would be lower if distributions were not reinvested. The performance information does not take into account sales, redemption, distribution, optional charges or income taxes payable that would have reduced returns or performance. Past performance does not necessarily indicate how the Fund may perform in the future. A fund with more than 10 years of performance history is only permitted to disclose the past 10 years.

Year-by-Year Returns (%)

The bar chart indicates the Fund's 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 an investment made on the first day of each financial year would have grown or decreased by the end of the financial year.



PAST PERFORMANCE (cont.)**Annual Compound Returns (%)**

The table shows the annual compound returns for each series of the Fund and for each of the periods indicated ended on December 31, 2012, compared with the following benchmark:

DEX Universe Bond Index

	Past Year	Past 3 Years	Past 5 Years	Past 10 Years	Since Inception
Series C ¹	3.4	5.6	—	—	7.2
Benchmark	3.6	6.6	—	—	6.9
Advisor Series ²	3.4	—	—	—	4.6
Benchmark	3.6	—	—	—	5.6
Series D ³	3.9	6.2	6.1	5.8	—
Benchmark	3.6	6.6	6.3	6.0	—
Series F ⁴	3.9	6.2	6.1	—	6.2
Benchmark	3.6	6.6	6.3	—	6.6
Series O ⁵	4.5	6.8	6.7	6.4	—
Benchmark	3.6	6.6	6.3	6.0	—

The returns of each series may vary because of differences in management fees and expenses. The Benchmark index returns do not include any costs of investing. See Management Discussion of Fund Performance for a discussion of performance relative to the Benchmark index.

¹ Inception date November 2008.

² Inception date October 2010.

³ Inception date July 2000.

⁴ Inception date June 2007.

⁵ Inception date October 2002.

Series D was known as Series A prior to November 17, 2008. Although Series A units of the Fund were created in June 2000, units were not offered for sale under a Simplified Prospectus until July 2000. We are therefore not permitted to disclose performance data for this Fund for any period prior to July 2000.

INDEX DESCRIPTION

DEX Universe Bond Index This index is designed as a broad measure of the Canadian investment-grade fixed-income market and includes bonds with maturities of at least one year.

SUMMARY OF INVESTMENT PORTFOLIO

(after consideration of derivative products, if any)

As at December 31, 2012

Investment Mix

	% of Net Asset Value
Corporate Bonds	43.1
Provincial Bonds	31.7
Federal Bonds	5.6
Municipal Bonds	0.4
Mortgages	0.3
Cash/Other	18.9

Top 25 Holdings

	% of Net Asset Value
Cash & Cash Equivalents	18.3
Province of Ontario 7.600% Jun 2 27	10.4
Phillips, Hager & North High Yield Bond Fund	3.0
Province of Quebec 6.250% Jun 1 32	2.8
Government of Canada 1.500% Sep 1 17	2.4
Province of Quebec 3.500% Dec 1 22	2.2
Royal Bank of Canada 2.680% Dec 8 16	2.1
Province of Ontario 8.100% Sep 8 23	1.9
Province of Ontario 5.600% Jun 2 35	1.8
Canada Housing Trust No. 1 3.750% Mar 15 20	1.8
Province of Ontario 6.200% Jun 2 31	1.8
Province of Ontario 5.850% Mar 8 33	1.7
Province of Ontario 4.650% Jun 2 41	1.6
Bank of Nova Scotia 6.000% Oct 3 18	1.5
Province of Ontario 4.600% Jun 2 39	1.4
Ontario Electricity Financial Corp. 8.250% Jun 22 26	1.0
Province of Ontario 3.150% Jun 2 22	0.9
Canadian Imperial Bank of Commerce 3.100% Mar 2 15	0.9
Province of Ontario 8.500% Dec 2 25	0.9
American Express Canada Credit Corp. 5.900% Apr 2 13	0.8
Golden Credit Card Trust 3.510% May 15 16	0.8
Royal Bank of Canada 2.580% Apr 13 17	0.7
Merrill Lynch & Co. Inc. CAD 5.290% May 30 22	0.7
Bank of America Corp. CAD 1.818% Jun 1 16	0.7
Bank of Montreal 1.890% Oct 5 15	0.6
Top 25 Holdings	62.7

The Summary of Investment Portfolio may change due to ongoing portfolio transactions of the Fund. It is updated quarterly and may be obtained by calling our Investment Funds Centre at 1-800-661-6141, by viewing on our website, www.phn.com, or by emailing us at info@phn.com.

The Simplified Prospectus and other information about the underlying funds is available on SEDAR website at www.sedar.com.