

# Annual Management Report of Fund Performance

December 31, 2008

Galileo Small/Mid Cap Fund

## Management Discussion of Fund Performance

### INVESTMENT OBJECTIVE AND STRATEGIES

The Fund invests primarily in shares of smaller and medium North American companies that are expected to profit from future economic growth, and may also invest in income and royalty trusts.

The portfolio manager uses a bottom-up, growth investment style. It seeks to invest in companies at an early stage of their development and hold them until they achieve success through rising sales, earnings and cash flow.

As part of its strategy, the Fund may engage in short selling as a result of special relief it obtained from the Canadian securities regulators and engage in securities lending as permitted by securities regulators.

### RISK

In anticipation of the highly volatile markets in 2008, the fund maintained a very large cash position. The cash & cash equivalents position is now 36.5% of the total assets of the fund. The portfolio held only North American securities at year-end. The fund increased its holdings in traditionally more conservative sectors, Consumer Staples, Health Care and Utilities compared with earlier in the year. US Equities comprised 10.4% of the portfolio at year end.

Investors in the Fund should have a long-term investment horizon. As this Fund invests in smaller and medium sized companies, there are general risks such as stock market and smaller company risks, among other risks, which are associated with such investments. The Fund did not participate in any short selling or securities lending during 2008.

### RESULTS OF OPERATIONS

The Fund had net redemptions for the year of over \$500,000. This combined with the negative performance resulted in the net assets of the Fund decreasing by over 60% in 2008. Interest income declined from 2007 as interest rates in Canada were repeatedly cut by the Bank of Canada. The dividends increased in 2008, as the portfolio held more dividend yielding securities.

The Fund strongly outperformed its benchmark by over 13% in 2008. The Class A and Class F units of the Fund had performance of (28.76%) and (28.01%) respectively for 2008. The benchmark is a blend of 50% the S&P/TSX Small Cap Index and 50% the S&P/TSX Mid Cap Index. The blended benchmark had a return of (42.13%). The S&P/TSX Mid Cap Index had a return of (38.78%) and the S&P/TSX Small Cap Index had a return of (45.49)% for the period.

The Fund outperformed relative to the Index as a result of holding a large cash position during the year while securities prices dropped and also the Fund underweighted a couple of key sectors financials and energy relative to the benchmark. These sectors were particularly hard hit by falling values in 2008. The Fund increased its cash position in the 3<sup>rd</sup> quarter and then after the market dropped in September and October, the fund increased its equity holdings. In anticipation of future government stimulus packages, the fund increased its holding in infrastructure companies such as Aecon.

In the Canadian markets, the performance of the TSX was driven by a small handful of large cap securities in the energy and materials sectors. The smaller and mid cap securities underperformed the large cap index.

### RECENT DEVELOPMENTS

The Fund's Manager has called a special meeting of unitholders for May 15<sup>th</sup>, at which unitholders will vote on whether to allow the Galileo Absolute Return Fund, Galileo Canadian Active/Passive Fund, Galileo Fund and the Galileo Global Active/Passive Fund to merge into the Galileo Small Mid Cap Fund.

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This annual management report of fund performance contains financial highlights but does not contain the complete financial statements of the Fund. You can get a copy of the financial statements at your request, and at no cost, by calling 1-866-912-2288, by writing to us at Galileo Funds Inc., TD Canada Trust Tower, Suite 4730, 161 Bay Street, PO Box 205, Toronto, ON M5J 2S1, or by visiting our website at [www.galileofunds.ca](http://www.galileofunds.ca), or SEDAR at [www.sedar.com](http://www.sedar.com).

Unitholders 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 disclosure record, or quarterly portfolio disclosure.

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**RECENT DEVELOPMENTS (cont'd)**

The Fund has been given exemptive relief from the regulators to invest in the BetaPro family of closed end funds.

**RELATED PARTY TRANSACTIONS**

Galileo Funds Inc., the Fund's Manager and Trustee, is a wholly owned subsidiary of Galileo Global Equity Advisors Inc., which is the Fund's Portfolio Advisor. Galileo Funds Inc. receives management fees based on the average net assets of the Fund. The management fees are used to pay for sales and commissions, the investment management of the Fund and other general administration. For the period ended December 31, 2008, the total management fees charged by Galileo Funds Inc. to the Fund was \$59,011 (2007 - \$70,634).

The Manager is also the Trustee of the Fund and is responsible for certain aspects of the day-to-day administration. The Fund reimbursed the Manager for certain operating costs incurred in administering the Fund of approximately \$92,300. The Manager absorbed approximately \$39,999 of total expenses. Such absorptions may be terminated at any time without notice.

The Fund invests in units of the Galileo Money Market Fund. To avoid duplication of management fees, the Fund reverses the fee that is charged by the Galileo Money Market 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 3 periods. This information is derived from the Fund's audited annual financial statements.

**Net Assets per Unit <sup>(4)</sup>**

<b>Class A</b>	<b>12/31/2008</b>	<b>12/31/2007</b>	<b>12/31/2006</b>
<b>Net assets, beginning of period <sup>(1)(2)</sup></b>	<b>\$ 14.77</b>	<b>\$ 12.47</b>	<b>\$ 11.53</b>
<b>Increase (decrease) from operations:</b>			
Total revenue	0.27	0.33	0.05
Total expenses	(0.32)	(0.35)	(0.02)
Realized gains (losses) for the period	(1.19)	2.04	0.11
Unrealized gains (losses) for the period	(2.66)	(2.15)	0.30
<b>Total increase (decrease) from operations <sup>(1)</sup></b>	<b>(3.90)</b>	<b>(0.13)</b>	<b>0.44</b>
<b>Distributions:</b>			
From income (excluding dividends)	-	-	-
From dividends	-	-	-
From capital gains	-	-	-
Return of capital	-	-	-
<b>Total annual distributions<sup>(3)</sup></b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net assets, end of period</b>	<b>\$ 10.54</b>	<b>\$ 14.77</b>	<b>\$ 12.47</b>

**FINANCIAL HIGHLIGHTS (cont'd)**  
**Net Assets per Unit <sup>(4)</sup> (cont'd)**

Class F	12/31/2008	12/31/2007	12/31/2006
<b>Net assets, beginning of period <sup>(1)(2)</sup></b>	<b>\$ 14.40</b>	<b>\$ 12.11</b>	<b>\$ 11.12</b>
<b>Increase (decrease) from operations:</b>			
Total revenue	0.26	0.31	0.36
Total expenses	(0.18)	(0.19)	(0.06)
Realized gains (losses) for the period	(1.14)	1.93	1.99
Unrealized gains (losses) for the period	(2.97)	0.42	(0.93)
<b>Total increase (decrease) from operations <sup>(1)</sup></b>	<b>(4.03)</b>	<b>2.47</b>	<b>1.36</b>
<b>Distributions:</b>			
From income (excluding dividends)	0.02	0.03	0.31
From dividends	0.08	0.11	-
From capital gains	-	-	-
Return of capital	-	-	-
<b>Total annual distributions<sup>(3)</sup></b>	<b>0.10</b>	<b>0.14</b>	<b>0.31</b>
<b>Net assets, end of period</b>	<b>\$ 10.28</b>	<b>\$ 14.40</b>	<b>\$ 12.15</b>

- (1) Net assets and distributions are based on 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.
- (2) The Fund was launched in September 2000 with 1 class of units. It was sold via an offering memorandum and was therefore open only to accredited investors. In November 2006, the various provincial securities commissions approved the prospectus of the Fund. At this time, the original class of units became Class F and a 2<sup>nd</sup> class of units, Class A, was launched. As such, the beginning of the 2006 period for Class A is November 14<sup>th</sup>, 2006 and for Class F is January 1<sup>st</sup>, 2006.
- (3) Distributions were reinvested in additional units of the Fund.
- (4) This information is derived from the Fund's audited annual financial statements. The net assets per unit presented in the financial statements differs from the net asset value calculated for fund pricing purposes. An explanation of these differences can be found in the notes to the financial statements.

**FINANCIAL HIGHLIGHTS (cont'd)**  
**Ratios and Supplemental Data**

<b>Class A</b>	<b>12/31/2008</b>	<b>12/31/2007</b>	<b>12/31/2006</b>
Net asset value <sup>(1)</sup>	\$ 41,420	\$ 77,962	\$ 13
Number of units outstanding <sup>(1)</sup>	3,923	5,260	1
Management expense ratio <sup>(2)</sup>	2.41%	2.42%	1.27%
Management expense ratio before waivers/absorptions	3.01%	2.86%	1.68%
Trading expense ratio <sup>(4)</sup>	0.32%	0.54%	0.63%
Portfolio turnover rate <sup>(3)</sup>	83.48%	96.96%	132.02%
Net asset value per unit	\$ 10.56	\$ 14.82	\$ 12.51

<b>Class F</b>	<b>12/31/2008</b>	<b>12/31/2007</b>	<b>12/31/2006</b>
Net asset value <sup>(1)</sup>	\$ 5,295,753	\$ 7,966,569	\$ 7,017,113
Number of units outstanding <sup>(1)</sup>	513,804	551,264	575,693
Management expense ratio <sup>(2)</sup>	1.37%	1.40%	0.54%
Management expense ratio before waivers/absorptions	1.96%	1.84%	1.23%
Trading expense ratio <sup>(4)</sup>	0.32%	0.54%	0.63%
Portfolio turnover rate <sup>(3)</sup>	83.48%	96.96%	132.02%
Net asset value per unit	\$ 10.31	\$ 14.45	\$ 12.19

- (1) This information is provided at December 31 of the period shown, as applicable.
- (2) Management expense ratio for each class of units is based on the total expenses of the Fund, incurred by or allocated to that class of units for the period shown, expressed as an annualized percentage of the daily average net asset value of that class during the period.
- (3) 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 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 investor receiving taxable capital gains in the period. 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 asset value during the period.

**MANAGEMENT FEES**

The Fund pays an annual fee of 1.95% of the net asset value of Class A and 0.95% of the net asset value of Class F plus GST to the Fund Manager in consideration for the provision of management, distribution and Fund advisory services. This management fee is calculated as a percentage of the Fund's net asset value per class and is calculated and credited daily. The Fund is required to pay Goods and Services Tax (GST) on the management fee.

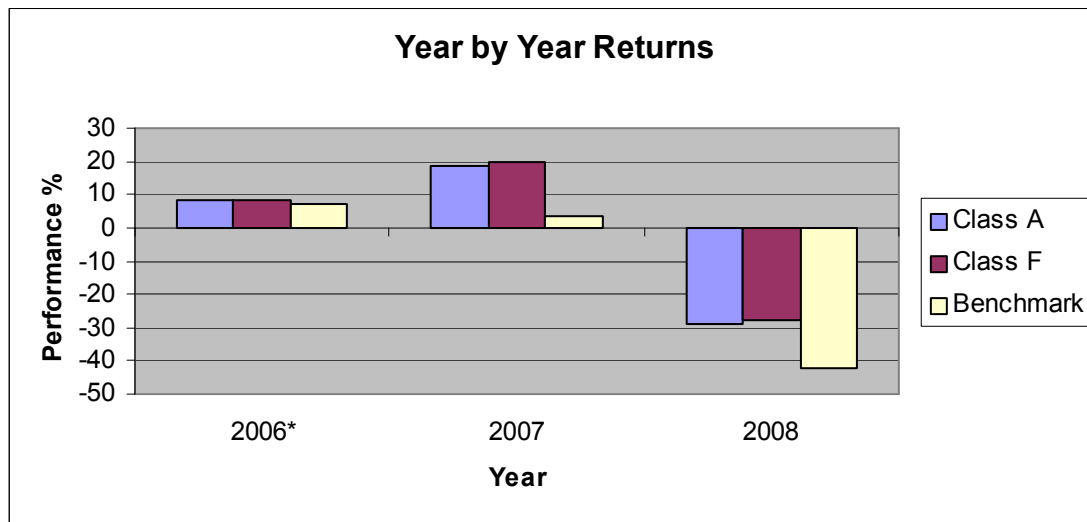
Of the management fees paid by the Fund to the Manager for the Class A units, approximately 50% was used to pay for sales and trailer commissions and 50% was for portfolio management services. Of the management fees paid by the Fund to the Manager for the Class F units, approximately 0% was used to pay for sales and trailer commissions and 100% was for portfolio management services.

## PAST PERFORMANCE

The performance information shown below assumes that all distributions made by the Fund in the period shown were reinvested in additional units of the Fund. The performance information does not take into account sales, redemptions, distributions or other optional charges that would have reduced returns or performance. It is important to note that the past performance of the Fund does not tell you how the Fund will perform in the future.

### Year-by-year Returns

The following bar chart indicates the Fund's historical annual returns, which will vary from period to period. It shows the percentage change in value of an investment from the first day to the last day of each fiscal period, as applicable.



\* Return is for a partial year starting November 14<sup>th</sup>, 2006 (the date the Fund first became eligible for purchase via simplified prospectus).

### Annual Compound Returns

The following table shows the Fund's historical average annual compound returns compared with its benchmark, a blend of 50% the S&P/TSX Small Cap Index and 50% the S&P/TSX Mid Cap Index for the periods shown ended December 31, 2008. The inception of the Fund was November 14, 2006.

	1-year	Since Inception
Class A	-28.76%	-4.06%
Class F	-28.01%	-3.18%
Blended Benchmark	-42.13%	-19.00%
S&P/TSX Small Cap Index	-45.49%	-21.84%
S&P/TSX Mid Cap Index	-38.78%	-16.17%

**SUMMARY OF INVESTMENT PORTFOLIO**  
**Portfolio breakdown as at December 31, 2008**

<b>Top 25 Positions</b>	<b>% of Net Assets*</b>	<b>Sector Allocation</b>	<b>% of Net Assets*</b>
Cash & cash equivalents	36.5%	Cash & cash equivalents	36.5%
Kinross Gold Corp.	9.4%	Industrials	27.4%
SNC-Lavalin Group Inc.	6.4%	Materials	14.2%
Aecon Group Inc.	5.0%	Energy	6.8%
CAE Inc.	4.4%	Information Technology	6.4%
Covanta Holding Corp.	4.3%	Consumer Staples	4.1%
ShawCor Ltd., Class 'A'	4.0%	Financials	3.2%
Agrium Inc.	3.5%	Utilities	1.3%
Thomson Reuters Corp.	3.5%	Other net assets	0.1%
Laurentian Bank of Canada	3.2%	<b>Total sector allocation</b>	<b>100.0%</b>
Open Text Corp.	2.9%		
BFI Canada Ltd.	2.8%		
Finning International Inc.	2.6%		
Colgate-Palmolive Co.	2.1%		
Actuant Corp., Class 'A'	2.1%		
Procter & Gamble Co.	2.0%		
Cameco Corp.	1.4%		
Inter Pipeline Fund, Class 'A'	1.3%		
Trinidad Drilling Ltd.	1.3%		
NaiKun Wind Energy Group Inc.	1.2%		
Other net assets	0.1%		
Nortel Networks Corp.	0.0%		
<b>Aggregate % of top holdings</b>	<b>100.0%</b>		

<b>Geographic Allocation</b>	<b>% of Net Assets*</b>
Canada	53.0%
Cash and cash equivalents	36.5%
United States	10.4%
Other net assets	0.1%
<b>Total sector allocation</b>	<b>100.0%</b>

\* calculated as a percent of the net asset value of the Fund as at December 31, 2008.

The summary of investment portfolio may change due to ongoing portfolio transactions of the Fund and updates will be available on a quarterly basis.

**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. Such statements are generally identifiable by the terminology used, such as “plan”, “anticipate”, “believe”, “intent”, “expect”, “estimate” or other similar wording.

Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties, which may cause actual results, levels of activity and achievements to differ materially from those expressed or implied by such statements. We do not undertake, and specifically disclaim, any obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.

# Galileo Funds

**Galileo Absolute Return Fund**  
**Galileo Canadian Active/Passive Fund**  
**Galileo Fund**  
**Galileo Global Active/Passive Fund**  
**Galileo Small/Mid Cap Fund**  
**Galileo Money Market Fund**  
**Galileo Small/Mid Cap Fund**

Additional information about the Galileo Funds is available in the Funds' Prospectus, Annual Information Form and Annual and Semi Annual Financial Statements.

You can get a copy of any of these documents and other information about the Galileo Funds, such as information circulars and material contracts, are also available on our website at [www.galileofunds.ca](http://www.galileofunds.ca) or at [www.sedar.com](http://www.sedar.com). Some of this information is available on our website in English only.

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