

**March 31, 2007**

**DK EQUITY GROWTH FUND**

**DEANS KNIGHT**  
CAPITAL MANAGEMENT LTD

**DK EQUITY GROWTH FUND**

**Quarterly Review**

**March 31, 2007**

**Rates of Return<sup>1</sup>**

	<u>3 Mths</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>10 Yrs</u>	<u>Since Inception March 31,1993</u>
<b>DK Equity Growth Fund</b>	<b>4.5%</b>	<b>36.9%</b>	<b>40.0%</b>	<b>40.1%</b>	<b>44.6%</b>	<b>38.1%</b>	<b>19.7%</b>	<b>23.5%</b>
Nesbitt Burns Small Cap Index (unweighted)	5.2%	5.3%	14.6%	12.2%	24.2%	14.3%	7.3%	9.1%
S&P/TSX Composite Index	2.6%	11.4%	19.6%	17.7%	22.4%	13.1%	10.3%	11.8%
DJIA	-0.3%	13.8%	11.0%	8.5%	14.1%	5.9%	8.6%	11.9%
S&P 500	0.6%	11.8%	11.8%	10.1%	15.8%	6.3%	8.2%	10.6%

There were important developments this quarter that affected two of the key holdings in the portfolio. Firstly, on March 26<sup>th</sup>, **LionOre Mining International** received a friendly all cash bid of \$18.50 per share from Swiss-based Xstrata. Xstrata is a major diversified mining group involved in the production of alloys, aluminum, coal, copper, nickel, and zinc. The Company is listed on the London and Swiss stock exchanges and has a market capitalization of Cdn \$60 billion. Xstrata acquired Falconbridge Ltd. in a Cdn \$24.8 billion deal in 2006. The LionOre deal is valued at Cdn \$4.6 billion. In our opinion it is a fair deal and we support LionOre's Board of Directors and its management in their recommendation that shareholders accept the bid.

Deans Knight has had a long relationship with LionOre, its founders, and its management group. The Company was founded in 1996 and has grown into an important international nickel concentrate producer with operations in Western Australia, South Africa, and Botswana. The Company also owns the Thunderbox Gold Mine in Western Australia. The nickel production also throws off significant by-product credits in the form of copper, cobalt, platinum group metals, and gold.

On behalf of our clients, Deans Knight has been a shareholder since 1996 and we have been opportunistic buyers over the past 10 years. We have also supported the Company by participating in debt issues to provide expansion capital at times when it was unwise to issue equity.

In our opinion, for most of the last 10 years, LionOre has been an under followed, underappreciated, and undervalued mining asset. It was not until the takeover of Falconbridge and

<sup>1</sup> Returns longer than one year are annualized.

Inco last year that LionOre began to attract a following. Only in the early part of 2007, with record high nickel prices, has it begun to trade at levels that reflect its true value.

It is our view that this is the proper time to accept what we believe is a fair price for the business. The management and board have built a very successful nickel company. In the current environment of record nickel prices (\$20 per pound) we are susceptible to looking at the future through our rose coloured glasses. However, we remember very clearly in the days of 1998, following the Asian “meltdown”, when nickel was \$1.75 per pound. With the benefit of hindsight, we were wise to have been a buyer in those dark days of low nickel prices and the shareholders may be wise to tender to a bid in this environment of record high prices.

Between the day the bid was announced and April 5, 100 million shares of LionOre have traded at prices 50¢ to \$1 above Xstrata’s offer. This represents more than 40% of the outstanding shares. Xstrata needs to attract 66<sup>2/3</sup>% of the outstanding shares to consummate the deal. The shares that have traded have gone to investors that believe either another bidder will appear and pay a higher price, or they can force Xstrata to pay a higher price. We shall see.

It is worth clearing up one point here. At the time the takeover bid was announced, the Canadian media made much of the fact that another Canadian mining company was being gobbled up by a foreign giant. Well, unlike Inco and Falconbridge, LionOre mines nothing in Canada. LionOre is a Canadian registered company simply because Canada is the centre of global mining finance. Roughly 2/3’s of the public capital raised for global mining is done through the auspices of the Toronto Stock Exchange. The Company has one employee in Canada. It is run by non-Canadians, from its main office in London, and its operators are in Australia and Africa. Canada is losing no jobs, but it is gaining more prominence as the centre of global mining finance which will attract more international companies to come here to finance their expansion, as LionOre did 10 years ago.

The second corporate development this quarter was negative. On Friday March 16, **Menu Foods** announced a major product recall of 60 million cans and pouches of “cuts and gravy” style pet food. Toronto-based Menu Foods is the largest private label wet pet food manufacturer in North America. The recall came following the deaths of 14 cats and dogs (mostly cats) and the cause was traced back to products that came from Menu’s Kansas City and New Jersey facilities. The Company has estimated the cost of the recall to be \$30 - \$40 million. If accurate, this represents an amount roughly equal to current annualized cash flow.

As of the time of writing, the cause of the problem had been traced to contaminated wheat gluten from one supplier. At least four other well known U.S. pet food manufacturers have subsequently issued recalls because they were supplied wheat gluten by the same company.

As shareholders of Menu Foods we are in the unenviable position of not having enough information to predict the outcome of this very difficult situation. It is highly likely that the Company could face near term liquidity challenges, depending on the ultimate cost of the recall and the reaction of their creditors. Furthermore, it is impossible to assess at this time the potential damage to Menu’s relationships with the customers for whom they manufacture pet food under private labels, and their credibility with the North American consumer. All we can do is focus on

what we do know. Incidents of pet and human food causing illness and death are not unheard of in North America. It does happen, and the record suggests that if the incident is dealt with in a decisive, honest, and timely manner, the industry and the company will endure. In the case of Menu Foods, we know the management and a number of the board members very well. They are first class. We are fully confident that they will do the right thing by their customers and the affected public.

On a more positive note, we sold the last of the shares in **Paladin Resources** in the first quarter at a substantial profit. We had begun purchasing shares in the latter part of 2004 after studying the uranium industry. We had written in these reports on a number of occasions that we believed the price of physical uranium was likely to rise significantly. No new sources of supply had been developed in over 20 years. The cold war stockpiles had been eroded, and with growth in demand for power, more nuclear plants would be built. After bottoming out at roughly \$7.10 per pound in 2000, spot uranium reached \$95 this year. During the rise, the investment banking industry created and financed hundreds of new uranium companies to satisfy the demand from investors for new uranium plays. None of these new vehicles actually produce uranium.

Last year, Paladin Resources put the world's first new uranium mine into production since the 1970's. However, valuations have become too aggressive for us. Purchasing Paladin when it had a market value of \$130 million was not seen as risky to us. However, holding it with a valuation of \$4.5 billion did seem to be.

We have begun to add to our holding in natural gas weighted exploration and production companies. Because of the warmer than normal year in the U.S. in 2006, coupled with the worries about a U.S. recession, natural gas prices declined from a high of \$15.39/mcf in late 2005 to a low of \$3.63/mcf in September 2006. Valuations on gas weighted companies have similarly declined. We are seeing companies trade down to 3 times cashflow and at, or below, net asset value. A year and a half ago, at the peak of the frenzy for oil and gas stocks, these companies traded at 6 – 8 times cashflow and 2 – 3 times NAV.

In our view we are setting up for a recovery in natural gas prices late in 2007. Although gas drilling in the U.S. is continuing at record levels, production is flat as decline rates on existing wells is offsetting new production. Furthermore, because of lower prices, drilling for new gas has slowed in Canada and production is declining. A normal weather pattern combined with rising demand for natural gas for cogeneration facilities will lead to declining inventory levels and rising prices.

We continue to witness positive developments in **Linamar Corp.**, our auto parts business, in spite of the continuing woes at the big three North American auto manufacturers. We hold to the view expressed before in these reports, that car manufacturers will increasingly be compelled to outsource more parts manufacturing to a smaller circle of efficient suppliers, in order to drive down their cost structures.

We have begun to gradually build a position in **Loblaws**, Canada's largest grocery chain. Loblaws was once a darling stock that could do no wrong. The Company's stock traded as high as \$76 in April 2005, and has since declined to the mid \$40 range. Fears of increased competition from

Walmart's Canadian expansion, declining profitability and write-offs, and a poor integration of its Provigo acquisition in Quebec, have combined to put the Company in the doghouse. Rightly so. Add to this the Weston Family, which controls 63% of the stock, have installed Galen Weston Jr. as CEO and the market has reason for piling on.

The market is currently valuing the Company at \$12.7 billion. We can develop a reasonable case that suggests that the value of the Company's real estate and private label President's Choice brand combined could be worth almost that amount. If our view is accurate, then we are getting the retail operation for free. It produced an operating profit of \$1.3 billion last year.