

March 31, 2008

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

March 31, 2008

Rates of Return¹

	<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>
DK Equity Growth Fund	-8.2%	-10.3%	10.8%	20.7%	25.3%	31.4%	18.9%	20.9%
S&P/TSX Composite Index	-2.8%	4.0%	7.6%	14.2%	14.1%	18.5%	7.8%	11.3%
DJIA (in U.S.Dollars)	-7.0%	1.6%	7.5%	7.8%	6.7%	11.4%	5.5%	11.2%
S&P 500 (in U.S.Dollars)	-9.4%	-5.1%	3.0%	5.9%	6.1%	11.3%	3.5%	9.4%

Since last summer, economists, financial market experts, and bloggers have been obsessed with the current or coming U.S. recession. As we pointed out in our September 2007 commentary, your author has lived through six recessions since beginning a career in finance in 1970. Based on this experience it is fair to say that this recession is different in two respects. One, it is by far the most predicted, written about, talked about, analyzed recession in modern history. It is impossible to pick up a newspaper or watch television news without witnessing the ongoing debate – are we in a recession now, if not, then when, if so, how long will it last, how deep will it be? Two, this recession has, to a greater extent than others, originated on Wall Street.

On a January visit to New York City it was remarkable to note the much higher level of fear and tension in the air than in other parts of the country. Wall Street and foreign financial firms are feeling the initial brunt of the decline in the U.S. housing market, and because of leverage, they are feeling it big time. The financial industry is more important to New York City today than at any time in modern history. An astounding one in every three dollars earned in New York is generated by the financial industry. Moreover, every financial sector job supports an estimated 3 more jobs.

All bubbles must pop. The mindless speculation that U.S. housing prices would continue to rise forever led to ridiculously slack mortgage lending practices. These mortgages were packaged with other debt instruments and found their way on to the books of hedge funds and investment and commercial banks, in many cases levered 25 times or more. As the housing bubble popped last year, defaults have risen and the value of these debt instruments has been called into question. A number of hedge funds have been forced into liquidation and banks have taken huge writedowns. On Sunday March 16th, Bear Stearns, the 5th largest U.S. investment bank, was rescued by the Federal Reserve and J. P. Morgan Chase. The Fed could not allow Bear Stearns to fail because of

¹ Returns longer than one year are annualized.

the negative chain reaction that would result from their counterparties taking further writedowns. If you live and work on Wall Street you are definitely in a recession or even a depression. Compensation is declining and jobs are evaporating. Many shareholders of Bear Stearns have been wiped out. Bear's share price plummeted from a high of \$171.50 per share in January of last year, to the final bailout price of \$10, a reduction in market value of 94%. If you are not yet convinced there is a recession on Wall Street, check out Porsche's March U.S. sales numbers – down 25% from March 2007.

The big question is, to what extent will the recession on Wall Street spread to Main Street? As readers of our commentaries well know, we do not dally on predictions. Rather we prefer to deal with the facts. As yet, we do not have the facts to suggest the U.S. economy is in recession or heading into recession. A recession is defined as two consecutive calendar quarters of negative growth in Gross Domestic Product. We do not yet have any reported negative quarters. The latest reported quarter, Q4 2007, showed a positive real GDP growth rate of 0.6%, albeit much lower than the Q3 rate of 4.9%. Would it be a surprise to see a recession in 2008 in the U.S.? It would not. It has been 7 years since the last U.S. recession and since 1970, recessions have occurred on average every 7 years. If a recession is possible, is a recession inevitable? No, it is not. Let us not forget, the Federal Reserve has aggressively reduced the Fed Funds Rate (the rate at which banks lend to each other) on 6 occasions since September 2007, from 5¼% to 2¼% (the lowest level since 2004). Furthermore, the Fed, along with other foreign central banks, has pumped hundreds of billions of dollars of liquidity into the global financial system. Also, don't forget the billions of dollars in tax rebate cheques that the U.S. federal government is mailing to 130 million U.S. households in May.

The more attention a danger gets, the more worried people become, leading to more news coverage on the subject, and more fear. Once this "cascade" is underway, experts become reluctant to dispute the popular wisdom, and they are either dismissed or ignored, if they do. Everybody now "knows" the U.S. economy is in a recession. However, don't forget that quote from our September 2007 report . . . "when everybody knows that something is so, nobody knows nothin'." An example of this cascading effect is the way we are bombarded daily in the media with information on the massive number of deaths from war, terrorism, and homicide. However it is never reported that more people in the world **kill themselves**, than are killed by other people. More than 1 million people commit suicide every year, more than war, terrorism, and homicide combined.

Remember as well in our September report, we referenced the remarkable new book "The Black Swan". The book argues that we fool ourselves into thinking we know more than we actually do. We restrict our thinking to what is irrelevant and inconsequential, while the large events continue to surprise us and shape our world. A black swan is defined as a highly improbable event – it is unpredictable; it carries massive impact; and after the fact, we concoct an explanation that makes it appear less random, and more predictable than it was. This U.S. recession is definitely not a "black swan".

The doom and gloom crew reminds us daily of the dire plight of the U.S. homeowner. Houses are worth less than the mortgages, they can't make payments, they are walking away en mass or they are being foreclosed on. The media reports that the mortgage foreclosure rate in the U.S. has risen 79% between December 2006 and December 2007. However, they do not trumpet the fact that the

national rate is still only 1.033%. Moreover, when we consider that 30% of homes are owned mortgage free, for all the noise about a crisis, only seven tenths of 1% of all homes were in foreclosure. Also, a close look at the data reveals that the foreclosure problem is definitely regional in nature, with the rates higher in those areas where the speculative excesses were greatest. Also, in the top 100 metropolitan areas, 14 actually saw a drop in foreclosure rates.

We are beginning to see more and more articles, and even a new book recently published, (Active Value Investing, Making Money in Range Bound Markets), that postulate we are entering into a “range bound” market. Over the past 200 years, the stock market’s steady upward march has been disrupted by long stretches, as long as a decade, where the broad market indices have traded up and down but added little or no value. The two most recent such periods were during the Great Depression of the 1930’s and the stagflation plagued 1970’s. One of the great weaknesses in forecasting is our tendency to forecast into the future, what we have experienced in the most recent past. Those that are so boldly forecasting a range bound market, neglect to point out that the most benchmarked index in the U.S., the S&P 500 index, has already been range bound for 9 years. The index reached 1362.80 in April of 1999 and closed March 31, 2008 at 1322.70. When dividends and inflation are included, the S&P 500 has returned an average of 1.3% per annum for the past 10 years, a negative of 0.37% for the past 9 years, and negative 1.4% for the past 8 years.

So what are we meant to do now? We are in the midst of a global credit crisis; we are staring at the prospect of a U.S. recession/depression; and we are in a “range bound” market environment. In our opinion, it is to stay to the course we have already charted. Valuations on many public companies have already been adjusted downward significantly from the highs of last summer. It would be unwise to sell in this environment. We intend to continue to keep approximately 50% of client assets in companies that own and produce oil and gas, base metals, and precious metals. The fundamentals in these areas remain solid – continued long term growth in global consumption driven by emerging economies like China, India, Brazil, and Russia - bumping up against supply growth constraints. Furthermore, there are tangible assets here that we can value. Our companies have assets in the ground that will be produced profitably at today’s prices or produced at some time in the future in what may be an even more robust pricing environment.

Also, we intend to hold on to and add to our investments in Canadian manufacturing companies such as **Linamar Corporation**, **Martinrea International** and **Velan Inc.** These companies have been significantly devalued in the market in the latter half of 2007 and into the first quarter of 2008. In November the Canadian dollar spiked to a record high of \$1.09 U.S. This, combined with the recession fears, has led to selling pressures and lower valuations. These companies are financially sound, have strong positions in the markets that they serve, and in a more challenging economic environment, they are in a strong position to capitalize on opportunities. Most important, in a range bound market, you do not want to replicate the broad market indices. We have always run concentrated non market-like portfolios and it is important in this environment to continue to do so.