

March 31, 2009

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

March 31, 2009

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 | 0.0% | -41.9% | -27.8% | -10.7% | 0.5% | 7.4% | 16.8% | 15.5% |
| S&P/TSX Composite Index | -2.0% | -32.4% | -16.2% | -7.8% | 0.1% | 2.8% | 4.9% | 7.8% |
| S&P 500 (in U.S.Dollars) | -11.0% | -38.1% | -23.3% | -13.1% | -7.4% | -4.8% | -3.0% | 5.6% |

As Warren Buffet succinctly put it during an appearance on CNBC on the morning of March 9th “*the U.S. economy fell off a cliff in September*”. It is clear to us now, that following the bankruptcy of Lehman Brothers on September 15th, the already weakened global banking system was rendered dysfunctional. As a consequence, in the final quarter of 2008, U.S. real domestic product contracted at an annual rate of 6.3%. This was the worst decline since the recession of the early 1980’s, when in the first quarter of 1982 U.S. real G.D.P. dropped 6.4%. Moreover, according to a March 19th forecast by the World Bank, we will witness in 2009 the first global recession in 60 years. The World Bank suggests that for the year 2009, world output will decline between .5% and 1%. Advanced economies will suffer a deeper contraction of 3% to 3.5%. This compares with global growth of 3.2% for 2008. Their projection for 2010 is a resumption of growth to a paltry 1.5% to 2.5%.

If you, the reader, are confused by the myriad policy responses to this downturn . . . join the club. Let’s simplify a confusing situation. The single most important objective of policy makers globally should be to restore confidence in, and the normal functioning of the global banking system. Without a functioning financial system, the economy as we know it will not function. It is not clear exactly how or when this will be accomplished, but the “big fix” led by the U.S. is well underway. Although there may be many critics of the actions taken by the U.S. Treasury and the Federal Reserve to date, much needed dramatic action has, and will continue to be taken, to “oil” the financial system and encourage it gradually back to reasonable health. With that accomplished, it will be the freedom and the entrepreneurial spirit of individuals that will lift the global economy out of recession.

¹ Returns longer than one year are annualized.

No question about it, this is a doozie of a recession. Also, make no mistake about it . . . the economic numbers will get worse before they get better. Unemployment for example, will continue to rise after the economy has bottomed and begun to recover. Unfortunately, this is part of the cleansing process that occurs in every recession. When the economy emerges from recession it will be leaner, more efficient, and more productive than before.

The reaction of financial markets to this major economic decline is not unusual. In the U.S., the Dow and the S&P 500 indices both peaked on September 10, 2007, declined to an initial low on November 20, 2008, and then made new lows in early March. From the peak to the lows of early March, the Dow and the S&P were down 54% and 57% respectively . . . the second worst bear market since the early 1930's. The more heavily resource weighted Toronto Stock Exchange index peaked later, on June 18, 2008, held aloft as the price of oil and other commodities continued to remain strong until mid 2008. The TSX also made an initial low on November 20 and also breached that level in early March. From peak to trough the TSX declined 50%. The TSX fared slightly better because the valuation of Canada's banks, albeit down substantially, were not trashed to the same extent as the U.S. banks.

This is the most troublesome economic morass we have seen in 60 years and it could take some time to right the listing economic ship. That said, don't forget, stock prices in most cases already do reflect the seriousness of the situation and in some cases we would argue there have been overreactions. Also, do not forget, stock valuations will recover well before the economy does. Stocks do climb that "wall of worry".

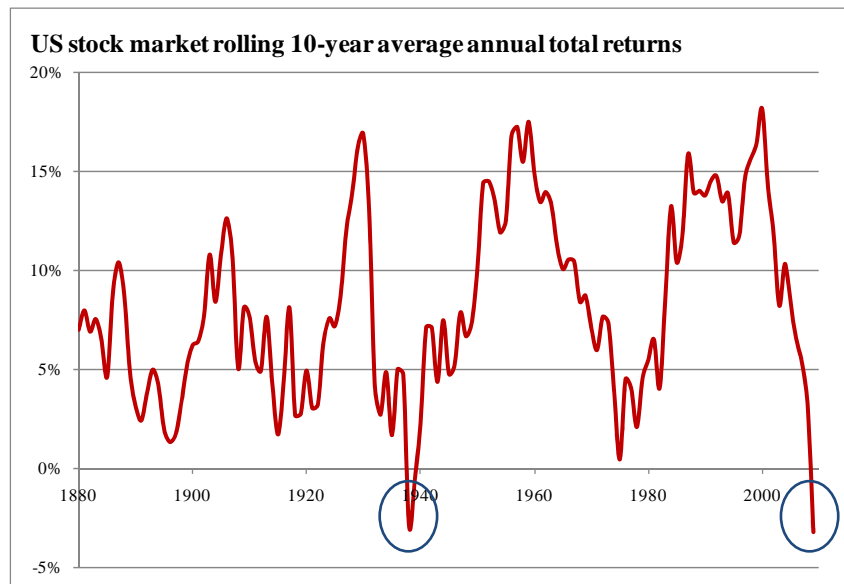
The big risk is that investors succumb to the constant barrage of negative information spun by the media. The objective of the media is to sell advertising, not sensible investment advice. You sell more advertising if you have more viewers or more readers. You get more viewers and more readers if you deliver more entertainment value.

In a bull market you get more entertainment value by "feeding the bull". Conversely, in a bear market the media delivers more entertainment value by feeding the readers and viewers more negative news. Scare the crap out of them, and they will tune in again tomorrow to see how much worse the news has become. Rarely do we see any sensible or reasonable investment advice delivered through the media. Moreover the rare words of wisdom are often misreported or greeted with derision.

A case in point was the March 9th appearance of Warren Buffet on CNBC. Buffet appeared live from the floor of the Nebraska Furniture Mart at 4:30 a.m. Omaha time. Your author coincidentally awoke at 3:30 a.m. Pacific time that morning and happened to turn on the TV to CNBC and watched the entire 2½ hour performance. While acknowledging the serious issues facing the economy, Buffet's message was markedly upbeat regarding the future. However the headlines in the major financial newspapers the following day, and the tag lines on the major network and business newscasts, took only the negative sound bites and distorted his underlying message to a point that I was shocked. Case in point, we actually had a petrified customer call us to redeem their portfolio after reading reports of Buffet's appearance. Most of the mavens that inhabit the "important" business news networks are pompous, bombastic windbags, who know

little about investing. As the comic Jon Stewart recently remarked “*If I had only followed CNBC’s advice, I’d have a million dollars today, provided I’d started with \$100 million*”.

We try constantly to urge our clients to keep a balanced perspective about financial matters. Perhaps the graph below may help. It shows the U.S. stock market rolling 10 year average annual total (including dividends) returns. Only twice in 130 years have the 10 year returns gone negative – the mid 1930’s following the big bear from 1929 – 33 and today. Looking at this graph, would you be inclined to liquidate your portfolio now? The media has desperately been trying to induce you to do so.

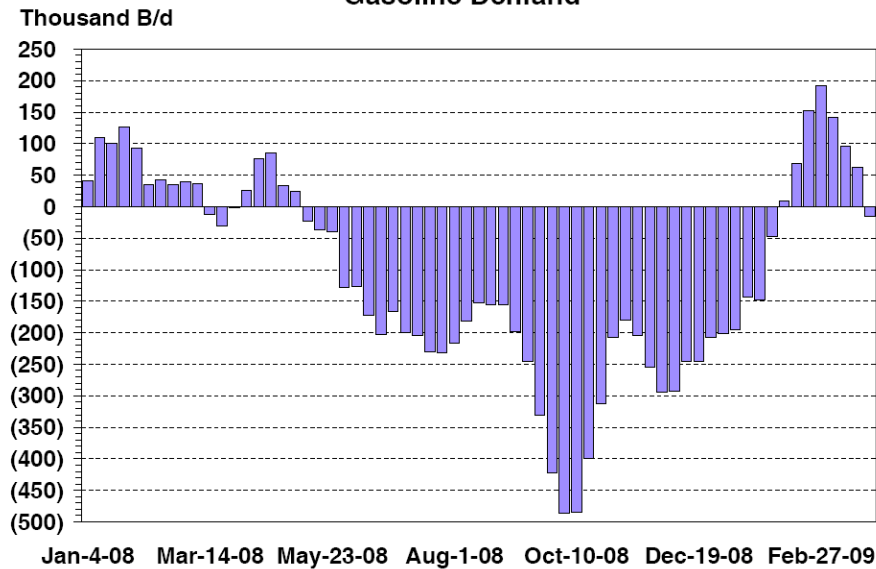


It is worth noting that we still have significant investments in oil and gas companies. With the decline in world oil from near \$150 per barrel to below \$40 per barrel, and North America natural gas from \$10 per mcf to below \$4 per mcf, there have been major declines in corporate valuations, capex, production, and projects have been delayed or mothballed. During the march upward to \$150 oil, CNBC reported daily on “America’s Energy Crisis”. We wrote at the time that America was not suffering from an energy crisis, but was experiencing high oil prices. With supply now contracting, the real energy crisis is now coming our way.

In the meantime, with the precipitous declines in the valuations of oil and gas producers it is, once again, cheaper to buy barrels of oil on the stock exchange, than it is to find it in the ground.

In developed countries, 50% of oil consumption is from transportation. The graph below, largely unreported, shows the year over year weekly change in gasoline consumption in the U.S. It shows that after a year of declining demand, consumption has begun to grow again. This is in a deep recession. What happens when the economy is in better shape? What happens when industrial demand is rekindled? At some point it is not unrealistic to expect much higher prices.

Weekly Year-over-Year Change in U.S. Gasoline Demand



We do not want to give the impression that oil and gas companies are the only attractive investment opportunities. Many good companies, in a broad range of industries, are trading at valuations that in many cases suggest these firms are going out of business . . . mining, auto parts, consumer products, industrial products. Most are not going out of business.

Bernie Madoff

The Ponzi scheme perpetuated by Bernie Madoff has shocked many investors. Some investors are concerned that it could happen to them. It is important to highlight the significant differences in the way Deans Knight (and other companies like ours) is structured compared to Madoff. First, Deans Knight uses an internationally recognized accounting firm (PricewaterhouseCoopers LLP) to audit the firm. Madoff used a small accounting practice with a local focus. Second, firms such as Deans Knight hold all securities purchased on behalf of its clients with a reputable independent third party, such as RBC Dexia (a division of Royal Bank of Canada). Madoff held his clients' assets in-house, thus making it easy to hide or sell securities without anyone noticing. With an independent auditor and custodian, firms in our industry will not likely be able to perpetuate a Ponzi scheme.

DK Income Corporation

On Wednesday March 18, 2009, Deans Knight completed a unique \$100 million investment transaction. As our clients well know, Deans Knight is an opportunistic investment company and we are always searching for new attractive investments. Last fall, after the bankruptcy of Lehman Brothers and the ensuing chaos, yield spreads between government bonds and less than investment grade corporate bonds widened to levels we had not witnessed in the past 25 years. Yield spreads do widen in every recession as investors become more concerned about the threat of defaults. In fact, default rates do increase in each recession but the lower bond prices and much higher yields more than compensate investors for this additional risk. The returns in fact, as the recession ends, are equity-like in nature, but with lower risk. Moreover, with yields in the 15% to 20% range, investors are handsomely rewarded to wait for the recession to end.

To enhance the returns, the funds were raised within a corporation (renamed DK Income Corporation) that had approximately \$90 million in tax losses. This enables us to shelter future income and capital gains earned within the corporation. The Company intends to pay regular dividends to shareholders. If the investor is taxable, their after-tax return will be enhanced by the dividend tax credit. The Company is listed and traded on the Toronto Stock Exchange (ticker symbol DNC).

As our clients are aware, our intent always at Deans Knight is to align our partners' interests along with our clients' interests. In this case the partners of Deans Knight invested \$5 million in DK Income Corporation.