

June 30, 2008

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

June 30, 2008

Rates of Return¹

	<u>3 Mths</u>	<u>YTD</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	4.2%	-4.4%	-15.7%	16.7%	22.6%	25.3%	30.0%	20.9%	20.9%
S&P/TSX Composite Index	9.1%	6.0%	6.7%	14.5%	16.2%	16.6%	18.2%	9.0%	11.7%
DJIA (in U.S.Dollars)	-6.9%	-13.4%	-13.3%	3.3%	5.8%	4.5%	7.2%	4.5%	10.5%
S&P 500 (in U.S.Dollars)	-2.7%	-11.9%	-13.1%	2.4%	4.4%	4.9%	7.6%	2.9%	9.1%

We left off our March report in the midst of a global credit crisis and staring at the prospect of a U.S. recession. We are writing the current report in the midst of a global credit crisis and still awaiting the U.S. recession. In addition to these worries, we can now include “crisis level” energy prices, and “crisis level” food prices.

The result of all these worries . . . we are now flirting with a bear market. The accepted definition of a bear market is a decline from a high point of at least 20%. At the time of writing, the Dow Jones Industrial is down 20.8% from its October 2007 high. The more broadly based S&P 500 Index is down 19.4% from its 2007 high. Canada’s S&P/TSX is down only 1.6%, because its decline has been muted by a much higher weight in oil and gas companies. When we remove the oil and gas component from each of these major indices, the declines are steeper, particularly in the S&P/TSX.

	<u>Decline From 2007 High</u>	<u>Decline ex Oil & Gas Component</u>
Dow Jones Industrial Average	-20.8%	-21.7%
S&P 500 Composite Index	-19.4%	-22.9%
S&P/TSX Composite Index	-1.6%	-9.9%

Just to stretch it a bit further, in addition to removing oil and gas, if you also remove heavily weighted Research in Motion and Potash Corp. from the S&P/TSX Composite, the index is down 14.2% from its high.

¹ Returns longer than one year are annualized.

If you recall from our March report, we wrote about the “cascade effect”. Specifically, the more attention a danger gets, the more worried people become, leading to more news coverage on the subject, and more fear. For example, the media gives us incessant coverage about the credit crisis . . . which banks have more write-downs coming? . . . will Lehman Brothers be bought out? . . . regional banks are choking on bad construction loans. The media parade out one pundit after another, each with a view on the severity of the coming recession, as if a recession is a foregone conclusion, or as if a recession was a rare event. The media have created “the oil crisis”. We don’t have an oil crisis, we have high oil prices. If you would believe the media, we suddenly have a food crisis. The media conjures up images of millions upon millions of people lining up for food as the world’s food supply dwindles.

As this cascading effect gathers momentum, the public want more confirming information and the media gives it to us. Moreover, as momentum gathers, opinions and points of view that challenge the popular wisdom are dismissed.

Let me let you in on a simple little secret that I think that I have learned over 40 years in the financial industry. When everything is rosy and share valuations are rising; when complacency is rampant, and nobody will listen to a bearish story . . . then be a reluctant investor. Conversely, when the cascade effect is negative; share valuations are falling, and there is no room for an optimistic view . . . then be an interested buyer.

What the media does in this cascade, reminds me of the wise statement made by a doyenne of Edwardian high society . . . “*it doesn’t matter what you do in the bedroom, as long as you don’t do it in the street and frighten the horses*”. Well, the media is getting hysterical and it is frightening the horses.

Let us try to keep our fears in perspective. The cause of the global credit crisis was simply increasingly sloppy credit allocation on the part of financial intermediaries over a period of many years. When the mindless speculation in housing finally ended, housing prices began to come down hard, and the value of the loans against them began eroding. The housing debt had been widely syndicated and imbedded in complex forms of credit instruments. As a result, two of Bear Stearns hedge funds went bust last summer and over the next year Bear Stearns itself was rescued by J. P. Morgan in a bailout backed by the U.S. Federal Reserve. Globally, banks have taken writedowns approaching \$500 billion. What we are experiencing is a natural and very painful unwinding of bad debt. For some time, credit will not be as readily available, lending and borrowing will become more disciplined, and global economic growth will be more moderate. But in the end, the global economy will be on stronger foundations.

The debate about recession still rages on. We prefer Warren Buffet’s style of economic forecasting . . . “*I live in a world that is better off than my parents were born to; my kids live in one better than I was born to; my grandkids in one better than my kids; and it will go on that way*”. Although there is doubt about whether the U.S. economy is in or going into a recession (defined as 2 consecutive quarters of negative growth in GDP), there is no doubt that the auto industry and the housing industry in the U.S. are in recession.

Let's look at the auto industry. The media headlines are frightening . . . "*Toy car maker Mattel has a bigger market cap than GM*". How about a different perspective? U.S. auto sales peaked at 15.6 million annualized units in June 2007. In June 2008, sales were 13.6 annualized units. Should this be a surprise? Of course not. The consumer is being squeezed by falling real estate prices, and rising food and fuel prices. Obviously they are going to curtail spending on gas guzzling trucks and seek more efficient forms of transportation. The supply of vehicles offered by all car companies in the U.S. (domestic and foreign) has been heavily skewed to big gas guzzling SUV and pickup trucks. Naturally sales of these vehicles will drop. Fuel efficient cars are in short supply at the present time. As they become more available auto sales will pick up again. People and goods still need to be moved. Those companies that are strong enough to withstand the transition will grow and profit.

The housing recession . . . you would think from the media that this is the first U.S. housing recession in history. Well, since the mid 1960's, this is the 7th U.S. housing recession. In each instance U.S. single family housing starts fell to an annual rate of between 600,000 – 700,000 units. From a peak two years ago of approximately 2 million units, U.S. housing starts have fallen to a current annualized rate of 674,000 units . . . not surprising given the previous 15 year real estate boom and the mindless level of speculation that was witnessed. It is not a pleasant outcome, but nonetheless a necessary unwinding after a period of excess. Housing starts will likely bottom at some point this year and gradually begin to rise again. The fact of the matter is the overall U.S. economy has shown a remarkable degree of resilience in the face of slowdowns in auto and housing and rising energy and food prices. We have yet to experience a quarter of negative GDP growth. The media makes nothing of this.

The price of oil has doubled over the past 12 months and is flirting close to \$150 per barrel. CNBC calls it "*America's Energy Crisis*". We don't have an energy crisis. We have high oil prices because global demand has been rising faster than supply. We have been preaching in these pages for some time that the price of oil needs to be high enough to alter consumption patterns and reduce demand. Current oil prices are having that effect. Consumption patterns in the U.S. are changing dramatically and demand destruction is accelerating. U.S. consumption of oil this past April was 811,000 barrels per day less than April 2007, and was the lowest level for any April in the past 6 years. June auto sales show clearly that purchases of SUV's and trucks are plunging dramatically. In the U.S., total vehicle miles travelled grew by roughly 3% per year from 1984 to 2004. In 2005, 2006, and 2007 growth slowed. Now for each of the 6 months ended this past April, vehicle miles travelled have declined year over year. This is the first time this has happened since the late 1970's. In our opinion, demand destruction will continue to accelerate and will eventually result in lower oil prices.

You really know that high oil prices are having an impact when the world of auto racing takes notice. The pinnacle of auto sports, Formula One, is allowing the introduction of KERS energy recovery system for 2009. KERS (Kinetic Energy Recovery System) harnesses the energy created by a car under braking and stores and reuses the energy to power the car. Furthermore, it has been rumoured that Formula One is considering a rule that will require teams to reduce fuel consumption by 50% by 2011.

Demand destruction is necessary because the world will continue to face supply constraints. The biggest obstacle to growing supply is that roughly 90% of the world's 1.1 trillion barrels of proven oil reserves are controlled by governments. Exxon Mobil, the world's largest privately owned oil company, owns only 1.08% of the world's reserves, and the 5 largest private sector global oil companies together own only 4% of the world's oil reserves. As a general rule, government controlled oil companies have under-invested in exploration and development and have mismanaged the production they have. In Mexico for example, Pemex, the state oil company, has a monopoly over oil production. Mexico is the 6th largest oil producer in the world (3.7 million barrels per day), but in the past few years, production has begun to decline sharply. Pemex has insufficient capital to develop new reserves on its own, and cannot take on foreign partners to supply money and technology it lacks. Venezuela produces roughly 2.8 million barrels per day, all government controlled. Due mainly to estimated decline rates of 25% per year, the government needs to spend \$3 billion per year just to maintain existing production levels. As a consequence, production has been falling for the past few years.

Barring a major supply shock, such as an attack on Iran, we expect that demand destruction will result in lower oil prices by year end. That said, cheap oil can no longer be produced. Prices need to remain in the \$80 - \$100 per barrel range in order to provide sufficient free cash flow to induce further investment in exploration and technology.

As if we investors did not have enough to worry about, now we have a looming global food crisis. Rising global prosperity and rising demand for dairy and meat from a growing global middle class is putting pressure on supply and is leading to a sharp rise in prices. Layer on top of this, incidents of drought in some parts of the world, floods in the U.S. Mid West (where 50% of the world's corn is produced) and competition from biofuels, and the problem is intensifying. This problem will not quickly be solved and has implications for investors. High energy costs combined with rising food prices will continue to lead to higher living costs and inflationary pressure. We have been concerned about the threat of rising inflationary pressure for three years now. As a consequence, for those clients of Deans Knight that are invested in our income generating strategy, we have been reluctant to invest in fix dated debt instruments with terms longer than 3 years. In our view, income investors must restrict investments to short dated income vehicles in order to be able to take advantage of higher interest rates later on.

We had the opportunity in the past few months to visit two emerging economies – Russia and India. Both visits reinforce our view that it is important to avoid falling into the trap of a North American-centric view of the world. Yes, it is true that the U.S. is still the world's largest economy, but it is important to remember that the engine for the growth in demand for many of the world's resources is coming from emerging nations.

Your author had the good fortune to spend four days in Russia in early May . . . two days each in St. Petersburg and Moscow. We were hosted by a good friend and client, a Westerner, who maintains a residence in Moscow and has been developing his business interests in Russia since 1993. For someone of my era, whose impressions of Russia were formed during the cold war Soviet years and the 1972 Canada/Russia hockey super series, this trip was a monumental eye opener. My expectations of Russia were of stout, pale, expressionless, badly dressed people, chugging around in their smoke-belching Ladas. In addition to the stunning art and architecture,

and the rich history of both cities, the contrast between what I expected and what I saw was dramatic indeed.

We visited St. Petersburg first. The city was the home of the Czars for centuries until the Soviet communist era began following the Revolution of 1917. St. Petersburg is a city of roughly 5 million people. The architecture is magnificent and the art treasures that were accumulated by the czarist rulers (added to when the communist regime confiscated private collections after 1917, and from the defeated Nazis) are truly amazing. A visit to the Hermitage, the Czars winter palace, is awe-inspiring even to the author's inexperienced eye. The city is a busy place. Streets are literally teeming with people and vehicles.

Moscow was a real shock. The metropolitan area is home to 23 million people. The place is booming. It is here where the imprint of the Russian oligarchs is most evident. In Russia the term oligarch is synonymous with the western term "business magnate". The oligarchs emerged under Gorbachev during his period of market liberalization. Through the Yeltsin era they became increasingly politically connected, starting with nothing and becoming rich via connections to the corrupt but "democratically" elected government during the transition to a market-based economy. The staggering wealth accumulation by these oligarchs is highly visible in Moscow. The preponderance of luxury vehicles and luxury goods is more startling than London, New York, or Los Angeles. The streets are teeming with Audis, BMWs, Mercedes', Porches, and Ferraris. Prada, Dolce, Kiton, Brioni . . . all commonplace. There are more construction cranes on the horizon in Moscow today than any city in North America.

The hotels are great, the bars and restaurants are fantastic . . . better than what we are used to. It is all the result of unleashing private enterprise and freedom, combined with a boom in the prices of commodities of which Russia is abundantly endowed.

The potential Achilles heel? . . . corruption. From top to bottom corruption is rampant. The rule of law is not accepted nor enforced.

Things are working for now because, with the commodity boom, there is so much money sloshing around, that stealing a few billion here or there goes unnoticed. While I was there, the new President, Dimitri Medvedev, was sworn in. His inauguration speech focused on the need to fight corruption. Whether leaders have the will or the inclination to follow through is suspect. The political leaders themselves have been some of the biggest financial beneficiaries of the cozy relationship between politics and business.

In the meantime, consumerism will continue to march ahead. Russian consumers are not saddled with the debt of North America. At the end of the Soviet era, occupants of Soviet apartments were simply given the title to the dwelling and as a result, a large portion of the population live in homes that are mortgage free. Russian citizens are free to travel to any country that will grant them a visa. They are now exposed to so much more than 20 years ago.

In April we visited Canadian-based **Niko Resources'** assets in India (Niko is 6.1% of the portfolio). The trip provided us with the opportunity to see Niko's massive offshore gas development; to meet with their Indian partner, Reliance Industries; and to observe firsthand the booming Indian economy.

Niko (10%) and Reliance (90%) discovered a large offshore gas field (D6) in 2002. They will begin producing first gas from this discovery through their new onshore gas terminal this summer. Production will quickly ramp up to 2.8 billion cubic feet of gas per day (bcf/d) within six months, at which point it will represent half of India's domestic production. The production capacity of the project will be 4.2 bcf/d, equivalent to one-third of Canada's total natural gas production. The total cost to develop the gas field is approximately \$8 billion, and it will be completed on budget and ahead of schedule.

At full production, the D6 development will generate over \$500 million a year in cash flow for Niko. We estimate the D6 development is currently worth approximately \$2.5 billion to Niko shareholders. This value is derived from only one-third of the D6 block. The Company has already begun to explore the remaining two-thirds of the block.

Further North along India's East Coast, Niko and Reliance made another gas discovery on their NEC25 block. The partners have submitted a development plan for the NEC25 block and expect to proceed with developing this field beginning in 2009. Based on the proposed development plan, NEC25 could be worth another \$1 billion to Niko. The entire Company is trading today at \$4 billion, net of cash.

Niko also holds several other exploration assets. The most prospective of which is the D4 block off the East Coast of India, which according to the Company could be several times bigger than the D6 discovery. They commence exploration drilling on the D4 block next summer.

At today's price we are paying very little for the exploration upside on D6, D4 and the other exploration blocks they own. In addition to the East Coast of India, Niko has exploration assets and some production in other parts of India, Bangladesh, Pakistan, Kurdistan and Madagascar.

India is indeed buzzing with activity. In the 8 years since we last visited India, the population of Mumbai has ballooned from 8 million people to over 14 million. This is part of an ongoing urbanization trend, which is leaving the economy labour-rich and energy-poor.

India produces 2.9 bcf/d of natural gas domestically, yet they consume 3.9 bcf/d, and would likely consume more gas if it were available. The current shortfall in domestic supply is provided by imported LNG (liquefied natural gas), which at the time of our visit was selling for nearly twice the price of gas in North America. India is a promising natural gas market for domestic producers like Niko.

Looking forward, our investments in energy producers and related service companies will continue to add shareholder value in this ongoing supply constrained environment. Similarly, we also believe that those low cost base metal and gold producers, who can grow production over time, will also grow shareholder value. That said, we are seeing seriously attractive opportunities

increasingly in the manufacturing and consumer sectors, where valuations have been battered by the media-fed hysteria regarding a global economic meltdown.

The daily list of stocks that are registering 52 week lows is expanding rapidly. For example, on one recent trading day on the TSX, only one stock registered a new 52 week high and 103 stocks registered new 52 week lows. Rarely have we seen so many high quality, well managed public companies trading at, or below, tangible book value. They all are in industries that are currently out of favour with investors . . . transportation (**Transat A.T. Inc.**), retail (**Loblaws**), auto parts (**Linamar Corporation / Martinrea International**), forest products (**West Fraser Timber**). The list goes on. This is where the really serious returns will come from over the next five years and we are continuing to add to our investments in this area.