

June 30, 2009

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

June 30, 2009

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	17.9%	17.9%	-34.3%	-25.6%	-3.6%	4.9%	10.1%	16.5%	16.4%
S&P/TSX Composite Index	20.0%	17.6%	-25.7%	-10.9%	-0.9%	3.9%	6.6%	6.2%	8.9%
S&P 500 (in U.S.Dollars)	15.9%	3.2%	-26.2%	-19.9%	-8.2%	-4.3%	-2.2%	-2.2%	6.5%

In this past calendar quarter we saw a significant increase in the valuations of many of our companies. This should not come as a surprise. We have posited for some time that last year's devaluation was overdone, particularly in November and December, when we saw massive and indiscriminate tax loss selling. Many of our businesses at the time were valued at prices suggesting that they were no longer going concerns.

That is not to say there weren't, and still aren't problems. The global economy did fall off the cliff in the latter part of 2008, following the bankruptcy of Lehman Bros., and the economy is still searching for a bottom. The recession in the U.S., which began in the last quarter of 2007, is now officially the longest running recession since the 1930's. We have also witnessed the first global economic contraction in 50 years.

A significant amount of media time is now devoted to the musings of learned economists who debate as to when the recession will end, and how it will end . . . V shaped . . . U shaped? The shape of the recovery is not important.

Here is all that you need to know about this recession. Prior to this recession, there have been 21 recessions in the U.S. since 1900. How many recoveries have there been? Answer: 21. Will this be different? Not likely. Moreover each recovery and expansion has been longer in duration than the prior contraction, and in every case the expansion took GDP to a higher level than prior to the previous contraction.

Has the rebound in valuations in this past quarter made our companies expensive? No. Valuations in many cases are still well below peak valuations of 12 – 24 months ago. Furthermore, some of our companies are still trading at substantial discounts to hard book value.

¹ Returns longer than one year are annualized.

Let's look at a few of our holdings. We own shares in two auto parts manufacturers, **Linamar Corp.** and **Martinrea Intl.** This is a very tough business right now. As we all know, the global auto business was one of the hardest hit by the recession. In the U.S. alone, car sales fell from an annualized peak rate of close to 20 million units in mid 2007 to just under 10 million units in May this year. Little wonder that Chrysler and G.M. are being restructured, and scores of parts manufacturers have gone out of business. What is not well reported however, is that auto production is lagging auto sales and the inventory overhang is coming down. As we approach the 2010 model year, production will have to rise dramatically.

Meanwhile, Linamar and Martinrea are not going out of business. Both companies have the resources to weather the storm. In fact, they both may emerge from this recession in a stronger competitive position than when the recession began. It is highly likely that auto manufacturers will increasingly consolidate their business with a smaller number of well-capitalized suppliers. In this regard, Ford recently announced that it would reduce its supplier base by 50% by the end of 2009. G.M.'s restructuring plan includes a 30% reduction in suppliers by 2011, and Chrysler has already reduced its supplier base by roughly 100 companies.

Also positive for our two companies was the announcement in May by the Obama administration of the first ever national emissions and fuel efficiency guidelines, to take effect in 2016. This is a very important and positive development for parts suppliers. Much of the technology to achieve these new standards resides with the supply base, and companies like Linamar and Martinrea will play an increasingly important role in helping the auto manufacturers achieve these standards.

At the market low in March, Linamar and Martinrea both were valued at an astonishing 15 – 30% of book value. By contrast, in late 2007 both companies were valued at 2 times book.

The other industry that was at the epicenter of the recession, and that was similarly crushed by it, is housing. U.S. housing starts early this year fell to under 500,000 units, the lowest level since the Commerce Department started keeping records in 1959, and down from a pre-recession peak of over 2 million units. However, existing house sales, which account for a much larger share of the market than new homes, have risen in each of the last two months and the inventory of unsold homes has dropped. Similar to autos, as inventory comes down, ultimately more units will need to be manufactured.

Hence our investment in **West Fraser Timber**. Vancouver-based West Fraser is a solid wood and pulp producer. It is one of the largest and lowest cost producers of lumber in North America. Even though the Company has faced the toughest environment in its 54 year history over the past two years, it has continued to produce positive annual EBITDA. CEO Hank Ketchum summed up the Company's business strategy in the 2008 Annual Report:

1. They continually invest in plant and equipment to ensure a low-cost operating structure.
2. They operate a lean, flat and flexible management structure.
3. They employ a talented and dedicated team of employees who live, breathe and promote a frugal cost control environment in good times and bad.
4. They maintain a solid and conservative balance sheet.

Most compelling, because of the currently dreadful operating environment, the shares trade at roughly 50% of book value. In a prolonged downturn they will be the last man standing. In a recovery the shares will be valued at book or higher.

We continue to have a big chunk of the portfolio invested in Oil & Gas exploration and production companies and related service companies ~ roughly 40%. In response to the precipitous decline in the price of crude oil from a peak of \$145.18 per barrel on July 14, 2008 to a low of \$31.41 per barrel on December 22, 2008, and a decline in natural gas from \$12.92 per mcf on July 7, 2008 to \$3.19 per mcf on April 27, 2009, valuations of exploration and production companies and service companies collapsed. For example, the S&P/TSX oil & gas index dropped from peak to trough by 50% and the services index by 71%.

The severity of the global recession resulted in a decline in global consumption of oil beginning in Q2 of 2008. From an estimated peak of 91.3 million barrels per day, demand declined to 82.1 million barrels per day by Q1 2009.

The price of crude oil has recovered from the lows to the \$60 - \$70 per barrel range. With the drop in global demand, the oil market appears to be adequately supplied for the foreseeable future. A resumption in oil consumption growth can be accommodated by additional supplies from OPEC. In our opinion, a speculative and sharp rise in oil prices is not likely. This is a good thing as any significant rise in oil prices from this point would delay and mute any economic recovery. Oil between \$60 - \$70 per barrel is good for the global economy, and provides decent returns for efficient producers.

North American natural gas has not recovered from the lows and currently is just over \$3 mcf. A reduction in U.S. demand as a result of a decline in industrial production, combined with increased production in the U.S. over the past 2 years, has produced a surplus of gas. These lower prices have resulted in sharply lower gas drilling in North America. In the U.S., the rig count is down by roughly 50% from 1 year ago. With decline rates of roughly 30% per year on existing production, U.S. natural gas production has begun to decline in the past two months. Moreover, with industrial production likely to pick up later this year (restarting idled auto plants alone) we expect to see a pickup in overall demand for natural gas, a gradual decline in inventories, and firmer prices.

In the energy space, there is one other position that we have been accumulating that is worth highlighting ~ **Mantra Resources**, an Australian Stock Exchange listed company. Mantra's flagship asset is a sandstone-hosted uranium deposit in Tanzania. With only a small portion of the project area having been drilled to date, the company has an inferred resource of 35.9 million pounds. The potential exists to substantially grow the resource with additional drilling. A recently completed scoping study has confirmed the technical and economic viability of the project. Based on existing resource estimates alone, the project could produce 2.5 million pounds of uranium per year for 10 years.

A pre-feasibility study is scheduled to be completed by Q4 2009, which will be followed by a bankable feasibility. Mantra intends to seek a TSE listing later this year. Meanwhile, drilling continues, and Mantra expects to release a revised resource estimate in Q1 2010. We expect Mantra to be producing uranium in 2012. Adding to the attractiveness of the investment, our close friends and former founders and executive officers of LionOre Mining Intl., are actively involved with the company. We were shareholders of LionOre for 10 years, until the company was sold in mid 2007 to Norlisk at a price that resulted in an extraordinary return to our clients.

A very important reminder for our readers

We wrote in our March letter that the reported economic numbers will get worse before they get better. Unfortunately, the North American employment numbers and the unemployment rate will worsen, even after the economy begins to bottom and recover. It happens in every recession. The media will make a big and negative fuss about this. But do not get derailed by this. Even though this is a very deep and widespread recession, the global economy will stop contracting, and will grow again.