June 30, 2010

DK EQUITY GROWTH FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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Quarterly Review

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Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	Since Inception March 31,1993
DK Equity Growth Fund	**-9.4%**	**6.0%**	**44.3%**	**-2.6%**	**-7.2%**	**6.6%**	**11.8%**	**21.4%**	**15.7%**	**17.9%**
S&P/TSX Composite Index	-5.5%	-2.5%	12.0%	-8.8%	-3.9%	2.2%	5.5%	3.3%	8.5%	9.1%
S&P 500 (in U.S.Dollars)	-13.4%	-8.1%	12.7%	-8.8%	-10.3%	-3.4%	-1.1%	-1.7%	6.1%	6.8%

In the most recent quarter, the broad stock market indices gave up most of the gains that had been made earlier in the year. The valuations on our companies followed a similar trend. This does not portend a trend for the future, nor should this pullback be a surprise. From the market low point of March 2009, we have witnessed the most powerful rally in history. A timeout is not out of the question. Moreover, investors are being bombarded constantly by the mainstream media with a negative spin on just about everything economic . . . the collapse of the EURO, the sovereign debt crisis in Europe, the faltering global economic recovery, massive government deficits, the economic threat of the withdrawal of government stimulus . . . the list is endless.

The positive side to all this angst is that the worst case scenario is well known. It is when the worst case scenario is not well known, that trouble is often just around the corner. For example, take the giddiness, the "goldilocks" economy, which preceded the 2008/09 meltdown. The media hyped nothing but good news until the financial crisis/recession. Investors forgot about risk. Businesses (stock prices) became expensive.

The scenario has now done a 180. We are now collectively worried about everything. Furthermore, after the biggest rally ever from a bear market, stock market indices are still 25 – 30% below the previous peaks. Businesses (stock prices) are cheaper and more attractive than before the recession.

We are not attempting to belittle the challenges ahead. There are many of them, and some are monumental. Our good friend Tony Boeckh has just published a book, "**The Great Reflation**". It is a terrific economic history of cycles, bubbles, and financial panics. It puts the most recent financial panic and recession into historical perspective. It highlights the fact that the government stimulus efforts and the bourgeoning government debt levels are unprecedented in peacetime. It highlights the potential risks of this strategy and potential opportunities for profit. Make no

[1] Returns longer than one year are annualized.

mistake, as the book points out, the risks associated with potential policy missteps are substantial. Any client that would like a copy of the book, please contact us and we would be happy to dispatch one to you.

Also important reading is a recent article written by Niall Ferguson. Ferguson is a renowned historian and author of **"The Ascent of Money: A Financial History of the World"**. The article entitled **"Empires on the Edge of Chaos",** published by the Council on Foreign Relations, can be found on the internet http://www.informationclearinghouse.info/article24874.htm. Its premise is the collapse of great empires is often preceded by the unsustainable build up of debt. In the article, Ferguson makes one overridingly important observation: complex systems (i.e. economies) are "*wholly nondeterministic, meaning that it is impossible to make predictions about their future behavior based on existing data. When things go wrong in a complex system, the scale of the disruption is nearly impossible to anticipate"*. Witness the 2008/09 financial panic as a classic example.

We bring this reading to your attention, not because it helps us predict the future, but rather it places current issues in a common sense historical context, rather than the hyperbolic *"this is the first time ever"* context that is promoted in the mainstream media. Remember, *"Those who ignore history are doomed to repeat it"*.

Also on the subject of interesting reading, is the May edition of the Fraser Forum, a regular publication of the Fraser Institute. The Institute is well known for debunking myths made popular by the media and government. In this issue they point out that we have accepted as common knowledge the media's hysterical assertion that the recent recession, dubbed The Great Recession, was the worst since the Great Depression. Since January 2009 they point out that the phrase "Great Recession" has been used in roughly 750 articles in Canadian newspapers. Canadian politicians have repeatedly referred to the 2008/09 recession as "*the most serious economic crisis since the 1930's", "the most serious economic crisis since the Second World War", "our biggest economic crisis in 80 years"*. Governments have used this rhetoric to justify huge spending sprees. The Fraser Institute compared the recent recession to the 11 previous Canadian recessions since 1929, and concluded this was not the most serious crisis since the 1930's, but rather it was a relatively mild recession. The study compares the recessions using three criteria – decline in economic output, decline in employment, and unemployment rate. In terms of decline in output, 2008/09 was relatively mild at -3.1%, compared to -5% in 1981/82. Decline in employment in 2008/09 saw -1.8% compared to -5.1% in 1981/82. The unemployment rate topped out at 8.5% in Q3 2009, compared to 13% in 1982 and 11% in 1991. As they point out, "*labeling the recession the worst since the Great Depression or the Second World War might make for great political speeches and media reports, the allegations are simply not factual*".

In another article in the same publication, researchers debunk another government-promoted myth with the assertion, backed-up by data, that *"government stimulus spending had virtually no effect on Canada's economic recovery"*. We made a claim in our September 30, 2009 commentary that the private sector will ultimately determine the level of future growth and the private sector will take some time to heal. This claim is borne out by the data in the article. Why then should we angst about the possible negative effects of a withdrawal of government stimulus?

It is this message we constantly attempt to drive home to our clients . . . don't swallow what the media dishes out, and don't believe what the government tells you. Use common sense when all around you are losing theirs. Keep events in a historical perspective. Think contrarian. Remember the words of John Templeton . . . ***"it is impossible to produce superior returns unless you do something different from the majority"***.

It is also important to remember that the businesses we own on your behalf are doing fine. Most of our companies reigned in costs during the recession, and now that revenues are recovering, more cash flow and profit are falling to the bottom line.

Mantra Resources and **Athabasca Oil Sands** together accounted for approximately half of the decline in the portfolio this quarter. That said, both companies have been executing better than expected on their business plans. However, the market is not always right in its valuations and sometimes presents us with opportunities like these. We have been buying more shares of both companies for our clients.

Mantra Resources (5.0% of the portfolio) has recently announced successful drilling results at their uranium deposit in Tanzania. This will likely result in an increase from the current 84 million pounds of uranium resource at their Nyota project. The Company plans to release a final feasibility study on the Nyota project towards the end of this year. Furthermore, the Company has recently been putting the right operational people in place, led by CEO Peter Breese, to transition the company from a uranium exploration company to a uranium producer. Peter is the former COO of LionOre Mining, a very successful investment for Deans Knight clients in the past.

Based on the pre-feasibility study released in March, Mantra will be one of the lowest cost uranium producers and have a resource size comparable to the major uranium producers. The $300 million capital cost to bring the project into production provides a 37% return on the project, which assumes no future growth from today's reserves. Today, we are paying $6 per pound of uranium in the ground for the Company (uranium spot price is greater than $40 per pound). We believe we are paying a low valuation for a company that will graduate from junior uranium explorer to uranium producer by 2013.

Athabasca Oil Sands (6.8% of the portfolio) declined 38% since its IPO listing in early April, yet today is a stronger Company than when it listed. On June 9th, the Company released a 20% increase in their independent reserve evaluation. Successful drilling has increased reserves from 7.2 billion barrels to 8.7 billion barrels of oil. The Company also has cash and callable cash from their PetroChina Joint Venture of $8 per share, significant for a stock trading at $11 per share. This implies we are paying approximately 18¢ per barrel of oil in the ground. To put this value in perspective, Total SA recently offered 65¢ per barrel for UTS Energy's minority share of the Fort Hills oil sands project.

Other investments are worth noting this quarter. In August last year, Deans Knight provided part of the seed capital for **Whitecap Resources**, a private oil and gas producer (8.0% of the portfolio). Deans Knight invested, on behalf of our clients, $8.0 million in equity financing and $10 million in 8% convertible debentures. Whitecap is Grant Fagerheim's fourth junior oil and gas startup company. We have invested successfully with Grant in the past with Ketch Energy, Ketch Resources and Cadence Energy.

On June 1st, Whitecap announced an agreement to merge with Spitfire Energy Ltd., a public oil and gas producer with assets in Saskatchewan. With the completion of the merger on June 25th, the value of our equity investment has now doubled and the convertibles have increased 72%. The combined entity will have production of 1,360 boepd, half of which is oil, two core areas with 7 million BOE of reserves, $15 million in net debt and will be run by Grant and his team. We partnered with Grant in his new venture because we had confidence in his ability to find good acquisitions and grow shareholder value.

Also this quarter, we joined Hank Ketcham, CEO of **West Fraser Timber** (4.6% of the portfolio) and the rest of his management team on a two-day tour of their five Quesnel-based operations. Quesnel, B.C. is where Hank's father and two uncles started West Fraser in 1955 with one sawmill. West Fraser is now the largest lumber producer in North America. One resounding conclusion from the trip is that we have partnered with the right operators in the timber business. West Fraser is the lowest cost lumber producer in North America and seeing their operations you can understand why. The Company is continually investing in their assets and their managers are first-rate.

A combination of the lowest new home builds in the US since 1952; the mountain pine beetle destroying 75% of the pine timber supply in Western Canada; and a rising Canadian dollar has led to what Hank refers to as a "depression in the timber market, not a recession". Despite these headwinds, West Fraser's focus on low cost operations allowed them to consistently generate positive cash flow and pay down $250 million in debt during this period.

In their first quarter results, we had a glimpse of West Fraser's earnings power when lumber prices recovered. With lumber prices averaging $260 per linear board foot (mfbm) in the first quarter, West Fraser earned $100 million in EBITDA. If prices average $325 per mfbm during the next 5 years as most analysts predict, West Fraser could earn 50% more. The Company is valued today at $1.85 billion. Paying anywhere from 3 to 4.5 times EBITDA for the lowest cost, best run timber company in North America is an attractive investment to us.