June 30, 2016

DK EQUITY GROWTH FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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Quarterly Report
June 30, 2016

Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception March 31, 1993
DK EQUITY GROWTH FUND	**8.6%**	**14.9%**	**2.5%**	**2.4%**	**13.8%**	**1.7%**	**6.4%**	**14.8%**	**11.8%**	**14.8%**
S&P/TSX Composite Index	5.1%	9.8%	-0.2%	-0.7%	8.3%	4.2%	4.9%	6.7%	7.7%	8.5%
S&P 500 (in U.S. Dollars)	2.5%	3.8%	4.0%	5.7%	11.6%	12.1%	7.4%	5.8%	7.9%	9.0%

I stepped into the elevator in our office building the other day and, as I always do, I glanced up at that small TV screen over the door. It shows time, weather and news headlines. The headline on the screen this day was . . .

"aliens invade Earth. Governments urge all citizens to return to their homes".

I presume it was designed to catch the eye, and to advertise something. I don't recall what the something was. However, it reminds us of most financial news. Catchy headlines, intended to grab attention by alarming the viewer, ultimately intended to advertise something.

There are many such catchy headlines. Most are designed to play to our fears. Below is a list of some of the issues that have been dominating the airwaves in the past 6 months and a sampling of some of the related attention grabbing headlines associated with each (all taken from "reputable news sources"):

<u>Sluggish global economic growth</u>

- "Global economy faltering"
- "World Bank predicts sluggish global growth"
- "Leaders at G7 summit in Japan to grapple with sluggish world economy"
- "World Bank slashes global growth forecast to insipid 2.4%"

[1] Returns are presented gross of management fees.

<u>U.S. recession</u>

- "Could the economy tank in 2016?"
- "Economists see rising threat of recession"
- "Economists say recession threat looms for next President"

<u>Rising interest rates</u>

- "Higher rates are the biggest threat to the global economy"
- "Time to focus on the threat of higher rates"
- "Threats of interest rate risk in Stock Investments"
- "Interest rates: is rates uncertainty the real threat now?"

<u>Weak Commodity Prices</u>

- "More commodity price weakness ahead"
- "Why commodities have crashed"
- "Weak commodities weigh on global stocks"
- "Commodities: the Great Bear Market"

<u>Britain exits the European Union (Brexit)</u>

- "Media calling Brexit the largest threat to global markets since the Lehman Brothers collapse in 2008"
- "IMF lays out grave consequences of Brexit"
- "Brexit will destroy the City of London as we know it"
- "France's plan for a bloody Brexit"
- "Panic is palpable as markets swoon on Brexit vote result few expected"

<u>China's slowing economic growth</u>

- "World worried over China's economic slowdown"
- "China's Economic Growth in 2015 is slowest in 25 years"
- "IMF warns: China's slowdown is much worse for the world than we thought"
- "Stocks fall most in 4 years as China dread infects Global Markets"

Just look at the key words in these headlines . . . **"faltering, sluggish, slashes, insipid, threat (7 times), risk, uncertainty, weakness, crashed, grave, destroy, bloody, panic, palpable, swoon, worried, slowest, warns, and dread".** Makes the **'aliens'** look like a cakewalk.

There has always been, and always will be, much to worry about in life. However, the media worry meter is currently registering off the dial. History has taught us that when the public and media attention tends to lean toward the negative headlines, it is a good time to consider buying, not selling businesses.

Excessive pessimism is usually evident during market bottoms and excessive optimism at market tops. Leon Tuey, a friend of Deans Knight for many years, and arguably one of the most astute market observers we know, argues that media headlines and investor behavior are now signaling excessive pessimism. Investors are so fearful that they are currently drowning in liquidity. Witness a recent headline, "Investors hold biggest cash pile since 2008 as world gloom deepens". Leon reminds us of the famous words of the wise investor, Sir John Templeton . . . "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". It looks to us like we are somewhere between pessimism and skepticism.

Enough about the macro. Let's focus our attention on actions we have taken in the portfolio in recent months, and also report on any noteworthy developments with regard to our companies. Recall that Lowes announced a bid for our **Rona Inc.** on February 3 for $24 per share, a 100% premium to the previous closing price. The transaction closed on May 20. Subsequent to February 3 we gradually sold down our Rona shares and began deploying the proceeds into a number of our other existing holdings.

Our two gold companies, **Asanko Gold Inc.** and **Lundin Gold Inc.** have seen significant appreciation in market value this year (+143% and +44%) respectively. In both cases the moves were largely due to a positive change in sentiment towards gold. The negative headlines and bearish views about the world economy often translate into a higher gold price (+24.6% year to date). In addition to this improvement in sentiment, Asanko began initial production at their Ghana mine in January. In April, they announced commercial production (190,000 ounces p.a.). In May, they released an update on their planned expansion to 280,000 ounces per year beginning in 2018 (then 480,000 ounces per year in 2022). In early June, Lundin Gold released the independent feasibility study for their Fruite del Norte gold project in Ecuador. The study supports the view that this is one of the largest and lowest cost, high grade gold projects in the world. Lundin Gold now begins to arrange the financing (a combination of debt and equity) to put the project into production by 2020.

In the first half of this year, global oil markets began to show the signs of rebalancing. Oil declined from a peak of $107 per barrel in mid-2014 to a low of $26 per barrel this past February, and recovered to close June 30 at $48. The price decline caused a decline in exploration and a shuttering of higher cost production. As a result, in 2015, global discoveries of new oil resources dropped to the lowest level in more than 60 years. Meanwhile, global oil consumption continues to grow. In 2016 global consumption is forecasted to grow by 1.5 million barrels per day to 96 million barrels per day, and by another 1.4 million barrels per day in 2017. Consumption of 100 million barrels per day is expected by 2020.

Natural gas, which has seen an even greater percentage decline, has also showed some signs of life recently. The low price on AECO gas (the price generally received by Canadian gas producers) was just below $1 per mcf in April. AECO closed June 30 at $2.30 per mcf.

We added to our existing holdings in **Pine Cliff Energy Ltd.** (mostly natural gas) and **Paramount Resources Ltd.** (mix of oil and gas) over the past quarter.

We own two base metals producers . . . **Lundin Mining Corporation** (copper, nickel, zinc) and **Nevsun Resources Ltd**. (copper/zinc). In keeping with our views about commodity producers, we own those companies with the best management teams, the lowest cost production, and with the strongest balance sheets. Lundin and Nevsun fit the bill. Both Lundin and Nevsun, with their strong financial position, have been acquiring prime assets during the base minerals slump. We added to both our Lundin and Nevsun holdings this quarter on price weakness.

We sold our position in **Conifex Timber Inc.**, our B.C. based lumber producer, and deployed the proceeds into more shares of **West Fraser Timber Co. Ltd.** Shares of all the Canadian forest products producers have been under pressure, peaking in early 2015, and all declining by roughly 50% since then. They have been weighed down by the sluggish recovery in housing starts in the key U.S. market; a softening in demand from China; and the uncertainty resulting from the renegotiations currently underway regarding the Canada/U.S. softwood lumber agreement. Our decision to focus on West Fraser again is centered on owning the low-cost producer. Also, West Fraser is geographically diversified with production split between B.C., Alberta, and the U.S. Southeast. Most importantly, we are very comfortable with West Fraser's management team and corporate culture. We were not the only buyer of additional shares, as we were competing with the Company itself, which continues to buy back its stock.

The shares of our two auto parts manufacturers, **Linamar Corporation** and **Martinrea International Inc.** continue to be under downward pressure, perhaps because of that fear of an impending recession in the U.S. Linamar, the best-in-class, has declined in value by 48% since its peak 1 year ago. We added some shares in the past month.

AutoCanada Inc., the only publicly traded car dealer network in Canada, announced the appointment of Steve Landry as CEO effective May 2. We met with Steve in early June and came away with a very good feeling. He is a real car guy with 30 years' experience selling cars. He started at the bottom and rose to be the CEO of Chrysler Canada, and then became one of the top Chrysler global executives in Detroit. He was hand-picked by Pat Priestner, AutoCanada's founder, a car guy for whom we have the highest respect. We were able to add to our holdings and to buy stock at sub $20 per share during the past quarter.

On May 11 **Transat A.T. Inc.,** one of the world's largest integrated tour operators, announced the sale of their European operations for approximately $80 million. For us, Transat is a deep value investment. We believe the sum of Transat's business parts exceeds the market value of the company. Transat currently has roughly $125 million of net free cash. The European sale will provide another $80 million cash when it settles later this summer. In addition, Transat owns an interest in a group of Caribbean hotels which would easily be worth a minimum of $100 million. Add these up and it comes to $305 million. The market value of Transat is $260 million. In addition the shareholders get the tour business, with annual revenues of over $3 billion for free. We added to our position in the quarter.

Sleep Country Canada Holdings Inc. continued to report strong results. In particular, Q1 same store sales growth was 11.7%, the 8th consecutive quarter of high single digit or better, same store sales increases. We acquired more stock during the quarter.

New Look Vision Group Inc., our retail eyewear company, announced another small acquisition of 5 stores in Montreal and closed on a previously announced 15 store acquisition in southern Ontario.

Uni-Select Inc. (aftermarket auto parts and automotive paint) continues to report strong earnings growth; continues to make acquisitions; announced a 2 for 1 stock split; and increased the pace of share repurchases.

Cott Corporation continued to diversify away from their legacy carbonated soft drink business. On June 7, Cott announced that it had entered into an agreement to purchase Eden Springs, a leading European direct-to-customer water/coffee delivery business for $470 million euros. Cott is already one of the two largest such participants in that market in North America.

And finally, **Héroux-Devtek Inc.**, the world's third largest manufacturer of landing gear systems for commercial and military aircraft, met a significant milestone on their Boeing 777 contract. In September 2013 Héroux was awarded a contract to build the landing gear systems for Boeing's successful 777 aircraft, and for the planned 777X version of the aircraft. On June 1, almost 3 years later, and ahead of schedule, Héroux delivered the first of the assemblies to Boeing in Everett, Washington.

Pictured: (L) Martin Brassard VP & COO, and (R) Gilles Labbé, CEO, Héroux-Devtek

The surprise Brexit plebiscite results threw global markets into a tailspin on Friday, June 24. Pundits instantly emerged with predictions, mostly of dire consequences for the U.K. and the global economy. Frankly, anyone who claims to know whether Brexit will be a net economic gain or loss for Britain is either lying or gazing into a crystal ball. We have some cash in reserve. An exaggerated reaction to the vote provided opportunities to continue to deploy that cash.