

September 30, 2006

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

September 30, 2006

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	8.4%	21.8%	19.0%	33.7%	36.7%	39.5%	40.3%	16.8%	21.8%
Nesbitt Burns Small Cap Index (unweighted)	-0.7%	5.3%	9.9%	14.6%	16.1%	21.9%	18.4%	6.7%	8.5%
S&P/TSX Composite Index	1.9%	6.2%	9.2%	18.9%	18.9%	19.7%	13.6%	10.2%	11.2%
DJIA	5.4%	10.9%	13.1%	10.1%	10.4%	13.9%	8.1%	9.2%	11.8%
S&P 500	5.7%	8.5%	10.8%	11.5%	12.3%	15.2%	7.0%	8.6%	10.4%

The recent downturn in commodity prices has brought out the inevitable hyperbole and misinformation in the financial press. Popular thinking is now focused on a U.S. housing-led recession, resulting in a global economic slowdown, and a collapse in commodity prices. Much of what is being written, as usual, has a very short term focus and it also tends to ignore the facts. As a result, it is once again worth spending some time reviewing the fundamentals behind oil and gas and other commodity markets.

Commodity prices have been volatile in 2006 and, as you can see from the table below, they have come off their recent highs this autumn.

	<u>High</u>	<u>Subsequent Low</u>	<u>% Change</u>
Oil (WTI) per barrel	\$77.03 (Jul 14/06)	\$58.52 (Oct 10/06)	-24%
Natural Gas (NYMEX) per mcf	\$15.39 (Dec 13/05)	\$5.39 (Sep 28/06)	-65%
Gold per oz	\$714.80 (May 12/06)	\$567.00 (Oct 4/06)	-21%
Nickel per lb	\$15.50 (Aug 30/06)	\$13.80 (Oct 4/06)	-11%
Copper per lb	\$3.95 (May 11/06)	\$3.19 (Oct 4/06)	-19%
Zinc per lb	\$1.74 (May 11/06)	\$1.43 (Sep 15/06)	-18%

¹ Returns longer than one year are annualized.

There has been a commensurate decline in the valuations of many commodity producing companies, particularly North American natural gas producers.

	<u>Commodity</u>	<u>High</u>	<u>Subsequent Low</u>	<u>% Change</u>
Mahalo Energy	Gas	\$7.85 (Jan 16/06)	\$2.20 (Oct 4/06)	-72%
Paramount Resources	Gas	\$46.73 (Apr 10/06)	\$25.00 (Oct. 3/06)	-46%
Kereco Energy	Oil & Gas	\$15.90 (Jan 03/06)	\$8.70 (Oct 4/06)	-45%
Petrobank Energy	Oil	\$20.60 (May 11/06)	\$10.50 (Sep 25/06)	-49%
West Energy	Oil	\$8.85 (Jan 13/06)	\$3.50 (Jun 13/06)	-60%
Anvil Mining	Copper	\$9.50 (Aug 16/06)	\$8.16 (Sep 25/06)	-14%
First Quantum	Copper	\$67.69 (Sep 05/06)	\$48.00 (Sep 25/06)	-29%
LionOre Ming Intl.	Nickel	\$7.37 (Sep 05/06)	\$6.43 (Sep 25/06)	-13%
Perilya Limited	Zinc	A\$3.45 (Aug 12/06)	A\$2.61 (Sep 26/06)	-24%

Firstly let us address this matter of a looming slowdown / recession in the U.S. economy. We have always believed in making our investment decisions based on fact rather than conjecture. We do not know what will happen to the U.S. economy in the coming quarters or years . . . and for a fact, nobody else knows either. It is worth remembering however, that in spite of the fears at the time, the U.S. and the global economy and commodity prices recovered quickly from two back-to-back body blows in 2000 and 2001 . . . the collapse of technology stock valuations which knocked \$3 trillion in market capitalization from the S&P 500, and the terrorist attacks in September 2001.

We are currently in the midst of the second major commodity cycle of the past 30 years. The previous one lasted through much of the decade of the 1970's. These two cycles are fundamentally very different and our conclusion is this cycle could last substantially longer. The price of oil in the 1970's and in this current cycle behaved in a similar fashion, but for very different reasons. The price of oil rose from \$3 per barrel in 1970 to \$31 per barrel at the end of the decade. At the time there was plenty of global production capacity, however it was concentrated in the hands of Arab countries that refused to deliver it to the U.S. for political reasons.

The fundamentals of the world oil market are very different today. By the early 1980's the world consumed just over 50 million barrels of oil per day. However global production capacity was almost 20% greater than demand. As a result, the price of oil fell for the next 20 years until it bottomed at roughly \$11 per barrel. Declining pricing and declining corporate cash flows resulted in underinvestment and slow growth in production capacity. All the while, global demand grew relentlessly by an average 1½% per annum. Today the world consumes 85 million barrels of oil per day. There is less than 2% excess capacity in the system, and no way to dramatically increase this in the short term.

In this cycle, unlike the 1970's, we are facing a supply constrained environment. It will require persistently high prices to restrain consumption, to encourage the development of increasingly expensive marginal barrels of production, and to encourage the development of alternate sources of energy.

Some very serious oil experts also feel that increasing the production of oil on a global basis is an impossible task. They argue that the laws of nature have caught up with the industry and we have reached peak production. The concept of “peak oil” production was first put forward by M. King Hubbert in a paper that he presented to the American Petroleum Institute in 1956. Hubbert argued that the natural laws of geology cause all oil fields to reach a point of peak production and then enter a period of irreversible decline. Hubbert predicted in 1956 that oil production in the continental U.S. would peak between 1965 and 1970. It peaked in 1971 and has steadily declined by roughly 60% since then.

Furthermore, there is a very strong relationship between peak discoveries and peak production. In the U.S., new oilfield discoveries peaked in the mid 1930’s and peak production occurred roughly 40 years later. Globally, peak discoveries occurred in the early 1950’s. Peak oil theorists would argue that global production is now peaking as well. This is currently a contentious debate. However, there is no debate about these facts . . . the low hanging fruit has all been picked . . . discovery rates are in serious decline . . . production decline rates are steepening . . . new barrels to be developed cost more than old barrels . . . growth in demand for oil has been relentless for the past 20 years.

Besides the reduction in surplus capacity and the possibility of peak production looming, there are other compelling factors that argue for a strong price deck for oil going forward.

Firstly, the real push in growth in oil consumption is coming from developing countries. This is not going to go away. As economies like China and India continue to become more industrialized, their consumption of oil will continue to rise. For example, in the U.S., the current per capita consumption of oil is roughly 25 barrels per year. Although consumption of oil in China and India is growing strongly, it is coming off a tiny base. Each country consumes roughly 1 – 2 barrels per year per capita. If we take China, with 1.3 billion people, and assume per capita consumption rises from 2 to only 5 barrels per person per year, this alone will increase global demand by a staggering 11 million barrels per day. Bear in mind that global excess production capacity today is estimated to be roughly 1½ million barrels per day.

Secondly, there is evidence to suggest that \$60 per barrel is not high enough yet to ration demand in any meaningful way. Two important statistics . . .

1. the price of oil in today’s dollars reached roughly \$90 in 1981, 50% higher than where it is today.
2. oil expenditures accounted for roughly 7% of global gross domestic product in the 1970’s. Today it represents less than 4%.

What is true about oil also applies to natural gas. However, gas is a more regional market because it can only be transported cheaply by pipeline. It can be shipped by tanker but at a higher cost because of the need to turn gas into liquid form. As a result, over 95% of the natural gas consumed in North America is produced in North America.

We are currently in a situation where natural gas prices have fallen to approximately \$5 U.S. per mcf, a decline of 65% from the highs of one year ago. Due to an unusually warm winter last year,

the U.S. has a record level of gas in storage. However, underlying this is a steady decline in North American gas production. This is not a response to the storage surplus, but it is the result of the irreversible laws of nature. U.S. gas production peaked in the mid 1980's and the decline has been steady since that time. The differential between U.S. demand and supply has been made up by imports from Canada. But guess what? Canadian production has now entered that irreversible decline phase and total North American production is in decline. Production in the U.S. has declined in spite of well completions rising from roughly 6,000 in 1995 to 26,000 in 2005. Moreover, the average first year production per new well declined over this period from 1,100 mcf/d to roughly 500 mcf/d. The facts are . . . we are drilling more . . . we are recovering less . . . we cannot offset the natural decline rates of existing wells. If low natural gas prices persist, producers will begin to shut in production, and curtail drilling. This will further accelerate the production declines and lead to an eventual rebound in prices.

What is true for world oil and North American natural gas is also true for a number of other strategic commodities – copper, nickel, zinc, gold, and uranium. Although the “peak” production argument does not apply to metals, there has been a lack of investment over the past 20 years in the development of new productive capacity. Existing mines are depleting and new capacity has not been put in place quickly enough to meet demand. Furthermore, getting a new discovery permitted takes much longer than ten years ago. In the judgment of some major companies, it is cheaper to buy capacity than it is to explore for, and develop it. As evidence of this, just witness the rash of recent takeover activity . . . Barrick / Placer, CVRD / Canico, CVRD / Inco, and Xstrata / Falconbridge. This consolidation is not over yet.

Our strategy with regard to commodity stocks remains the same. The fundamentals for commodity producers remain strong in spite of the increasingly negative babble in the press in the last 30 days. That said, we reiterate that the easy money has been made in the last five years. Going forward the shareholder value creation in these companies will come from growing production and reserves per share, not from a big ramp up in underlying commodity prices. It is only the mid and smaller sized companies that can achieve this. This is where we continue to focus our attention.