September 30, 2009

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

September 30, 2009

Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since Inception March 31,1993
DK Equity Growth Fund	**19.1%**	**40.3%**	**2.1%**	**-17.1%**	**-0.5%**	**4.0%**	**12.0%**	**18.4%**	**17.4%**
S&P/TSX Composite Index	10.6%	30.0%	0.5%	-7.2%	1.9%	3.7%	8.3%	7.3%	9.5%
S&P 500 (in U.S.Dollars)	15.6%	19.3%	-6.9%	-14.8%	-5.4%	-1.6%	1.0%	-0.2%	7.3%

One year ago, September 15th to be exact, Lehman Brothers, the United States' 4th largest investment bank filed for Chapter 11 bankruptcy protection. With roughly $660 billion of assets, this was the largest bankruptcy in global economic history.

Lehman was the biggest casualty when the largest credit and housing bubble in economic history finally popped. When Lehman went down, it unleashed a cavalcade of events that brought the world financial system to the brink of collapse and it brought on the most severe global recession and biggest bear market since the 1930's.

The origins of the U.S. housing bubble can be traced back to the Clinton administration. New legislation was enacted at that time, which not just encouraged mortgage lenders to make home loans to less credit worthy borrowers, but punished them for not doing so. Overnight, it was everybody's right to own a home, regardless of one's ability to service or repay the debt. Hence began the emergence of NINJA mortgages . . . no income, no job, no assets. The abandonment of traditional standards of credit worthiness and the explosive growth in mortgage lending, combined with the low interest rate and easy money policy of the U.S. Federal Reserve, resulted in the U.S. real estate market being pumped up like an athlete on steroids.

Mortgage lenders, also known as shadow banks, through a network of mortgage brokers, began originating mortgages at record rates in 2001. These mortgages were purchased by the Wall Street investment banks who in turn packaged them into collateralized debt obligations (CDO's). Using risk models that we now know were flawed, Moodys and Standard and Poors granted the CDO's a AAA rating. However, these instruments were really AAA investment grade bonds backed by

[1] Returns longer than one year are annualized.

American trailer trash. They were then sold to banks, hedge funds, and other investors domestically and globally. In fact, CDO's became America's biggest export. The investment banks that created the CDO's reaped huge fees by doing so. Furthermore, they kept billions of dollars worth on their own balance sheets and financed them profitably because of the Fed's easy money policy and the positive carry trade. They could finance the CDO's by borrowing cheaply in the 30-day commercial paper market, or from a commercial bank at 3%, and hold the CDO's that paid 6%.

Underpinning the bubble was the belief that U.S. housing prices, which had never declined by more than 5% in any one year since the 1930's, would continue to appreciate. The financial models on which the CDO's were designed, and on which the rating agencies granted them AAA status, were based on this premise. What the quants failed to realize is that you cannot model human behavior.

The air began to seep out of the bubble in 2006, when the first signs of a stall in U.S. home demand and home prices became apparent. Many subprime borrowers had been able to borrow the entire purchase price of the home and in some cases more than the purchase price. Many of the subprime borrowers were enticed by step-up mortgages. These mortgages had extremely low interest rates for the first few years, then the rates reset much higher in ensuing years. When faced with this step-up and a decline in home values, borrowers began to default in record numbers. This pushed housing prices even lower, mortgage lenders (shadow banks) began to file for bankruptcy, and ultimately the banks themselves in the U.S. and Europe, which were caught holding the devalued CDO's, began to teeter and had to be rescued by government funding and forced mergers.

The G20 governments subsequently unleashed coordinated stimulus packages targeted at lubricating a locked financial system, and stimulating global demand for goods and services. At this point, it looks like the patient has stopped hemorrhaging and has been stabilized. Armageddon has been called off.

As we have pointed out in recent reports to our clients, the economy will recover. Prior to this current recession, since 1900, there have been 21 recessions in the U.S. and there have been 21 recoveries. It is unlikely that it will be different this time. What we do not know is what the recovery will look like, and how long it will take to get back to or exceed the level of economic output we were at before the recession began in the fourth quarter of 2007.

Our best guess is that this recovery will be a bit of a struggle. Roughly 50% of the economic growth in the U.S. between 2002 and 2007 was illusionary. It was not real growth in economic output, rather it was a bubble created by excessive and cheap money. It created a false sense of economic well being and massive consumer spending. This will not return anytime soon, nor should we want it to. The consumer must pay down debt and increase savings. In the interim, the economy is being held aloft by a transfer of the leverage to governments as they spend to stimulate economic activity. The current level of government stimulus cannot be sustained. The private sector will ultimately determine the level of future growth and the private sector will take some time to heal.

That said, there are some signs for optimism. The TSX, the S&P 500, and the Dow all lost roughly 50% of their value during the recession. However, since the March 2009 lows, all the major stock market indices have shown remarkably strong rallies and are currently trading roughly 45% - 50% above those lows. As a consequence, U.S. household net worth has stabilized and is beginning to show some small increases. Housing starts, auto sales and housing prices have all bottomed, and have shown tentative signs of recovery. The financial system is showing signs of life again. On one September day alone, $5 billion of new equity capital was raised by TSX listed companies.

Our long standing clients know full well that we at Deans Knight place very little importance on economic predictions. Perhaps part of the reason is the author's 10 years spent with the Bank of Canada. The Bank employs the brightest and best economists in the land and has no better forecasting average than my dog Spencer regarding the future outcomes of the economy. Furthermore, there is not a shred of evidence to suggest that the Federal Reserve anticipated what was to come in 2007 and 2008.

We have been around long enough to know that booms/busts, recessions/depressions, bull markets/ bear markets are reoccurring phenomena . . . triggered by the vagaries of human beings, which as we pointed out earlier cannot be modeled.

We prefer to keep it simple. In the words of the late legendary investor Benjamin Graham "the chief cause of recessions/depressions in the modern world is the public's lack of purchasing power to absorb the increased production resulting from the preceding economic boom." This is precisely what happened in 2007/2008. The U.S. consumer's growing purchasing power between 2001 and 2007, which powered global growth, was based on rising real estate values. When that reversed, the consumer's purchasing power declined, demands for goods and services declined, inventories of unsold goods rose (car, houses, etc.), production was curtailed, and unemployment jumped. On top of this, we have a badly wounded global banking system, reluctant to lend because of their weakened capital base due to their holdings of toxic CDO's, CLO's, CDS's, etc. This will take some time to heal.

Given all of this, instead of fretting about the "when" and the "shape" of the recovery, we should be focusing on acquiring stakes in businesses that are out of favour and attractively priced; that do not need access to fresh capital to carry on during the slowdown; and that operate in industries where excess inventories and capacity have been worked down or are poised to come down.

If we worry excessively about the shape of the recovery or what the stock market is going to do next quarter, we will surely miss these opportunities. We have highlighted in recent reports those industries and specific companies we have built positions in over the past 9 months. To highlight a few:

Autoparts – Linamar Corp., Martinrea Intl.
Lumber – West Fraser Timber Co. Ltd.
Natural Gas – Crew Energy Inc.
Base Metals – Capstone Mining Corp. (copper), Mantra Resources Ltd. (uranium).