September 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	**6.1%**	**12.5%**	**28.6%**	**14.6%**	**-4.0%**	**6.1%**	**8.5%**	**21.5%**	**16.1%**	**18.0%**
S&P/TSX Composite Index	10.3%	7.5%	11.6%	5.9%	-1.3%	4.2%	5.2%	4.1%	9.1%	9.6%
S&P 500 (in U.S. Dollars)	11.3%	3.9%	10.2%	1.3%	-7.2%	-1.8%	0.6%	-0.4%	6.5%	7.5%

With the shock of the 2008 global financial panic still fresh in everybody's mind, listening to ultra-bearish economic forecasts has become a fashionable pastime. An entire industry (and a very profitable one) of doom and gloom economic forecasters and outlook conferences has emerged. The result . . . the world's woes are well known and well publicized . . . the Greece crisis, the Irish crisis, the Euro crisis, the global debt glut, the anemic economic recovery, slow employment growth, currency woes, global warming, the Afghan war . . . and on and on. The problems are not "black swans" (unexpected events). None of them are going to surprise us.

Meanwhile, life goes on. People still require food, drink, transportation, homes, entertainment, energy. Businesses will provide these products and services and some will profit handsomely doing it. As professional investors, our job is to make use of the global climate of pessimism as an opportunity to purchase those very businesses, at valuations that are lower and more attractive now than they would otherwise be in a Goldilocks environment.

Looking at the broad measures of equity valuations illustrates our point. The U.S. S&P 500 index peaked in September 2007 at 1565.15 . . . the tail end of the Goldilocks era. During the ensuing financial panic and recession, the index declined 56.8% to 676.53 in March 2009. At September 30th it had recovered to 1141.2. At that level, it is still 27.1% below the peak 2007 valuation. However, earnings for the index, after dipping in 2008 and 2009, are back to the same level in 2010 as they were in 2007. Moreover, debt levels carried by the individual companies in the index are significantly lower and cash levels are significantly higher. Same businesses, same earnings, better balance sheets . . . 27.1% cheaper.

[1] Returns longer than one year are annualized.

As a consequence of having stronger balance sheets, during the second quarter of 2010, 251 companies of the 500 in the index bought back their own shares in the market. A total of $77.6 billion was invested in their own shares, an increase of 220% from the low point of buybacks reached in the second quarter of 2009. It marked the fourth consecutive quarter that S&P 500 companies have increased their stock buyback activity.

The smart money is buying while the not so smart money is selling. The not so smart money is the typical mutual fund investor. History has clearly demonstrated that they have a propensity to buy when the news is all good and businesses are expensive, and sell when the news is bad and businesses are available at more attractive valuations. The mutual fund flow data for 2010 in the U.S. show that the retail investors have been pulling money out of money market funds (interest rates at record lows) and equity funds (fear factor), and pouring money into bond funds (chasing yield and perceived safety). In our opinion, these investors are paying far too much for bonds and are not receiving adequate compensation for the risks that are being assumed. Investors, Canada or U.S., should ask themselves this simple question . . . Should I lend my hard-earned money to the government for 10 years at 2½%? . . . Our answer is a resounding NO. Moreover, investment grade corporate bonds of roughly the same term yield a meager 1% more. Our view is that this mindless surge out of equities and into low-yielding bonds will likely end badly for the retail investor.

Like the S&P 500 companies, our own investee companies are also in better shape now than they were in 2007. Although not all companies have seen their revenues recover to pre-recession levels, earnings have recovered substantially as most of the companies have become more efficient and lower cost providers. Moreover, capacity has been removed in most industries – auto parts and lumber being prime examples. In both industries, high cost production has been shut down either voluntarily or because of bankruptcies. Those companies that have survived are the low cost operators. The result today is that these companies face fewer competitors. As auto production and housing construction move higher from recession lows, those strong companies capture more of the business as they face less competitors and less capacity. It does not happen overnight. It takes time. The recovery needs time to make the painstaking adjustments following a global financial panic and very severe global economic slowdown.

We have done a significant amount of travel in the past quarter. We see signs that positive adjustments, particularly in hard hit industries, are beginning to take place. For example, we have spoken to a number of big players in the U.S. commercial real estate market. We all know that this was an industry that became overbuilt, over-priced, and over-leveraged prior to the recession. Until recently, the over-leveraged owners of the properties were reluctant to break price and reluctant to sell. Moreover, banks were rebuilding their balance sheets and reluctant to make loans in this area.

From these discussions with industry players, we came away with the impression that adjustments that are necessary to clear this market are now slowly beginning to take place. Regulators are pressuring banks that have under-performing commercial real estate related assets on their books, to clean them up. Private equity funds that invested in commercial real estate in the boom times have a need to provide liquidity to their investors, and are being forced to sell. Capitalism at work. Those with cash are taking advantage of those with too much debt. Projects are changing hands at prices that work: i.e. the cash flow from rents exceed the financing costs. A very positive sign.

We also came away from our travels with a view that most investors are excessively focused on, and concerned about the anemic recovery in the U.S. and Eurozone. It is a big and rapidly changing world out there. The rapidly expanding influence of the BRICs – Brazil, Russia, India, and China, is becoming widely recognized. However Africa is not. Although the economies of the individual countries of Africa are small, in aggregate it is huge. The collective annual GDP of its 53 countries is $1.6 trillion, roughly the size of Brazil or Russia. The Chinese recognize this. Visit Africa and you are startled by the Chinese presence and influence. Trade between China and Africa has increased from $3.5 billion in 1990 to $100 billion. Significant investments are being made in Africa by major global corporations – HSBC, Wal-Mart, Bharti (Indian Telecom giant). We are all familiar with the story that India's middle class is larger than the population of the U.S. Well Africa, in aggregate, now has more middle class than India, according to the global consulting firm, McKinsey. Thanks to the internet, these people have been exposed to, and they want, a better material life.

In the recent quarter, decisions were made that added one new strategic investment in the account, and eliminated one.

Coalspur Mines Ltd. (purchased October 6, 2010) is a coal exploration company currently developing its flagship Vista Coal project in the heart of the Alberta coal belt near the town of Hinton, west of Edmonton. Once in production, we anticipate Coalspur will be the largest export thermal coal project in North America. The Company currently has over 900 million tons of thermal coal resource on a land base of 28,000 hectares.

Thermal coal is widely used as fuel for power plants. The world has an abundance of thermal coal. However, much of this coal is uneconomical to produce due to low grades and the high cost of transporting the coal to the end user. Coalspur's deposit is near the surface, allowing for the use of the cheapest mining methods in the industry. Furthermore, the land-base sits directly beside the CN rail line on which the coal will travel west to Ridley Terminals, a deep water port in Prince Rupert, B.C. Both the rail and port have ample capacity to handle the planned production from Coalspur.

As populations grow in developing countries like China and India, so too will demand for electricity. With a majority of power coming from nuclear and coal fired power plants and a shortage of domestic thermal coal supply, these countries must look internationally to supply their power needs. Currently China's biggest supplier of thermal coal is Australia, which ships much of its coal out of the port at Newcastle on the southwest coast. The shipping time from Prince Rupert, Canada is about 10-15% shorter, hence cheaper, than the trip from Newcastle, Australia. Therefore, Coalspur's high-quality deposit, adjacent infrastructure and its geographical location will allow it to get its product to market both faster and cheaper than the competition.

Once in production, at current coal prices and using conservative production estimates of 4 million tonnes per annum, Coalspur will generate $200 million of cash flow per year. With a market capitalization of $350 million, there is significant upside potential as the Company further delineates its resource and moves forward with permitting and into production.

A recent site-visit allowed us to become more familiar with the land base as well as the management team led by 25 year coal-mining veteran, Gene Wusaty. Gene's proven track record includes the development of Ivanhoe's South Gobi Coal mine in Mongolia, and the Grand Cache Coal mine in Alberta. Gene has surrounded himself with experts in various areas of coal mining from regulatory procedures to wash-plant design. Coalspur will also benefit from the expertise brought by the Highland Park group of investors, led by long time friends of Deans Knight and the former management team of LionOre Mining. Highland Park owns roughly 20% of the Company and has a representative on the Board of Directors.

Currently Coalspur is listed only on the Australian Stock Exchange (ASX) and is largely unknown within the Canadian investing community. Management plans a TSX-listing sometime in the fourth quarter of 2010. We also expect an updated resource estimate in the New Year. These events will help this under-followed company attract more attention as it moves toward its expected 2013/14 production date.

Menu Foods (4.1% of the portfolio), the largest wet pet food manufacturer in North America, announced on August 8th they had reached an agreement with a private company, Simmons Pet Food Inc., to be acquired for $4.80 per share in an all-cash deal. The transaction has now received all necessary approvals and is expected to close in early November. We had locked up all of our clients' shares in Q3 as a condition to Simmons making the bid.

The deal price represented a 47% premium to the price Menu had been trading at before the announcement and capped a terrific recovery since the Company was embroiled in a large pet food recall in early 2007. In December 2008, at the depths of the recession and the height of Menu's debt load from the recall costs, the stock traded at $0.65 per share - near bankruptcy levels. While it has been a rocky ride for investors, management and the board led the Company through the difficult times and shareholders ultimately recovered a significant amount of value.