September 30, 2011

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
September 30, 2011

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	**-20.6%**	**-20.2%**	**-1.0%**	**12.9%**	**9.1%**	**-3.3%**	**4.6%**	**21.2%**	**12.6%**	**16.9%**
S&P/TSX Composite Index	-12.0%	-11.9%	-3.6%	3.7%	2.7%	-1.9%	2.6%	8.0%	7.6%	8.8%
S&P 500 (in U.S. Dollars)	-13.9%	-8.7%	1.1%	5.6%	1.2%	-5.2%	-1.2%	2.8%	5.2%	7.1%

We are now into our second "bear" stock market in Canada in two and a half years. A "bear" market is conventionally defined as a decline of 20% or more in the broad stock market indices.

	Peak (date)	Low (date)	% Decline
TSX Composite	April 5, 2011	October 4, 2011	-21.7%
S&P 500	April 29, 2011	October 3, 2011	-19.4%
Dow Jones	April 29, 2011	October 3, 2011	-16.8%
MSCI World	May 12, 2011	October 4, 2011	-22.8%

We do not need to dwell on the reason for the decline in valuations. We outlined them clearly in our June 30, 2011 report: "growing concern that the U.S. economic recovery is slowing . . . that China's growth is slowing . . . and that Greece's debt woes will wreak havoc in the European banks." Nothing much has changed. That's the problem. More worry about the same issues, but no leadership to clarify these issues and lead us to solutions. The problems the world faces are big ones and they are complex. But they are not intractable. True leadership entails taking complex issues and distilling them to simple issues upon which action can be taken. Leadership is lacking.

The good news . . . the mood today is excessively pessimistic, even more so than it was when we outlined the bearish sentiment in our June report. The wise writer Robert Heinlein once wrote . . . "does history record any case in which the majority was right?"

The businesses that we own for you are in good shape. In many cases they are in better shape than they were two years ago. But that doesn't seem to matter right now. Investors, many of whom do not understand what they own or why they bought it, are panicky and want out. We have seen this movie many, many times before. We are seeing mutual fund investors redeem their mutual funds and this causes forced selling . . . selling without regard to value. We are seeing leveraged hedge funds selling because of margin calls.

[1] Returns longer than one year are annualized gross of management fees.

It is important to appreciate that the valuations on many of our companies will suffer a larger decline in a down market than the broad market indices. We know this from experience. For example, our valuations declined much further than the broad indices in the 1997/98 and 2008/09 downturns. Conversely, our valuations bounced back further in the ensuing recoveries.

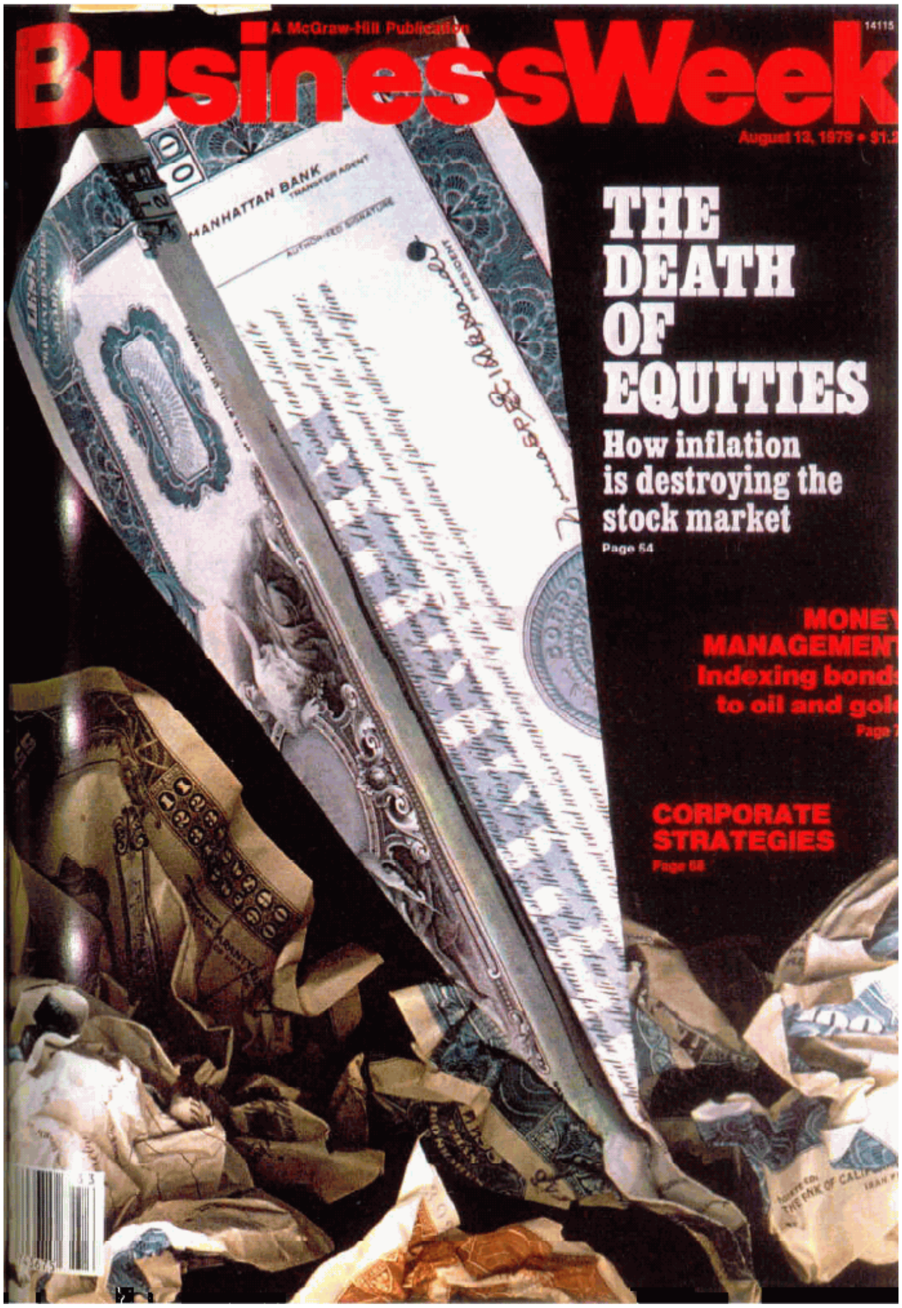
You would think from looking at the stock market decline and from reading the news, or watching the business channels, that the world is in "crisis" for the first time in history. We forget that the world is almost always in crisis. Crises are magnified today, because the media have become crisis junkies. Yes, the nature of the current crisis may be complex, but the world has had many difficult crises before.

Many investors today have a very short sense of history regarding markets. As the French say politely, your author is "un homme d'un certain age" (i.e. of a certain age = no longer young). I can remember the Cold War. I can remember weekly drills in school in the 50's where we were taught what to do in case of a nuclear attack. In an October 1961 speech, after a series of nail biting face-offs with the Soviets, President John F. Kennedy recommended a fallout shelter for all Americans as rapidly as possible. Imagine the havoc that CNN or CNBC, if they existed at the time, would have wrought with that piece of information. This would have dominated the airwaves for months, with learned experts on the topic of shelters being paraded across the screen 24/7.

We suggest to you that the events of the 1950's, 60's, 70's and 80's were just as scary as today. Just a partial list:

Cold War	1946 → early 90's
Vietnam War	1963 → 76
Assassination of John F. Kennedy	1963
Race riots in Los Angeles	1965
Race riots in Detroit	1967
Assassination of Martin Luther King	1968
Assassination of Robert Kennedy	1968
Worst inflation/stagflation in U.S. history	1970's
Arab oil embargos	1973/1979
Watergate scandal – Nixon resigns	1974
New York City nears bankruptcy	1975
Worst recession since the Great Depression	1980 → 82

There were times, particularly during the 1970's, when the stock market was convinced that the problems of the day were intractable. By the late 1970's there appeared to be no light at the end of the tunnel. Inflation and stagnant economic growth had ravaged the stock market. Things were so bad that in August 1979, Business Week ran a cover story entitled "The Death of Equities".



This reflected the popular wisdom of the day. U.S. stock market indices had shown no growth for 10 years and the world had lost confidence in the U.S. leadership. Guess what, U.S. stock market indices have shown no growth for the past 10 years, and the world has again lost confidence. Not long after the story ran, we witnessed the beginning of the biggest /longest bull market in history. Businesses, and by extension equities, do not just die. They just go through tough times. Equities are not dead and they will recover. As Warren Buffet has said many times "I know what will happen, I just don't know when." What we do know is that when the tough times are behind us, the majority of investors will be on the sidelines and miss out on the upside.

Yes, the U.S. economy and the global economy are struggling to regain traction after the deep recession in 2008/09. That recession was caused by the massive U.S. housing boom (or bubble) that popped and brought the banking system to its knees. Today, the part of the U.S. economy which is not dependent on the housing industry is doing well. Housing is still in a depressed state. Fix the housing industry and you will fix the economy. Housing isn't just another industry. It is the driving force for the entire U.S. economy. Residential investment accounts for 25% of overall capital investment. As Warren Buffet put it in a recent interview, when the U.S. gets back to 1 million annualized housing starts (the peak was over 2 million in 2005) the unemployment rate will be below 7%.

What led the economy out of the morass by the early 80's? Leadership did. That very thing that is so sorely lacking today. In 1979, Paul Volker, arguably the most important central banker in history, was appointed Chairman of the U.S. Federal Reserve and took simple but decisive action that broke the back of inflation. In 1979, Margaret Thatcher was elected Prime Minister of Britain and she enacted simple but tough policies that got the U.K. moving again. Then in 1981, Ronald Regan was elected President of the United States. He put confidence back in the American people and ignited an unprecedented period of growth and prosperity in the U.S.

Fed Chairman
1979-87

British Prime Minister
1979-90

U.S. President
1981-89

Will leadership emerge to show us the way out of the current woes? Who will it be? What is the solution to today's crises? "I know what will happen, I just don't know when."

Like the past, the solution will not become evident until it is behind us.