

DK EQUITY GROWTH FUND

Quarter and Year End Review

December 31, 2001

Rates of Return

	<u>3 Mths</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>6Yrs</u>	<u>7 Yrs</u>	<u>8 Yrs</u>
DK Equity Growth Fund	22.8%	29.3%	15.5%	14.6%	0.7%	-0.1%	7.9%	12.4%	10.7%
Nesbitt Burns Small Cap Index (Unweighted)	20.8%	4.1%	-0.2%	5.1%	-2.3%	-1.3%	3.0%	4.3%	2.5%
TSE 300	12.9%	-12.6%	-3.1%	7.3%	5.0%	7.0%	10.3%	10.9%	9.4%

The year 2001 saw the second year of a bear market. The first significant downturn in North American stock markets in 10 years began with the peak of the NASDAQ, the S&P 500, and the Dow Industrials in the Spring of 2000 and the peak of the TSE 300 Index in late summer of 2000. The low point for all four indices was in late September of 2001, following the September 11 terrorist attacks on America. The indices staged a recovery in the final quarter and closed the year at a higher level than prior to September 11. The table below illustrates the magnitude and the duration of the correction in stock prices.

	<u>TSE300</u>		<u>S&P500</u>		<u>DJIA</u>		<u>NASDAQ</u>	
Peak (date)	11,389	(01-Sep-00)	1,527	(24-Mar-00)	11,723	(14-Jan-00)	5,049	(10-Mar-00)
Low (date)	6,513	(21-Sep-01)	956	(21-Sep-01)	8,236	(21-Sep-01)	1,423	(21-Sep-01)
Decline (%)	-43%		-37%		-30%		-72%	
Close Dec 31	7,688		1,148		10,022		1,950	
Recovery From Low	18%		20%		22%		37%	
Bear Market Duration (months)	13		18		20		18	

As we pointed out in September, the current market correction shows strong similarities in terms of magnitude and duration to the 1973/74 North American market correction.

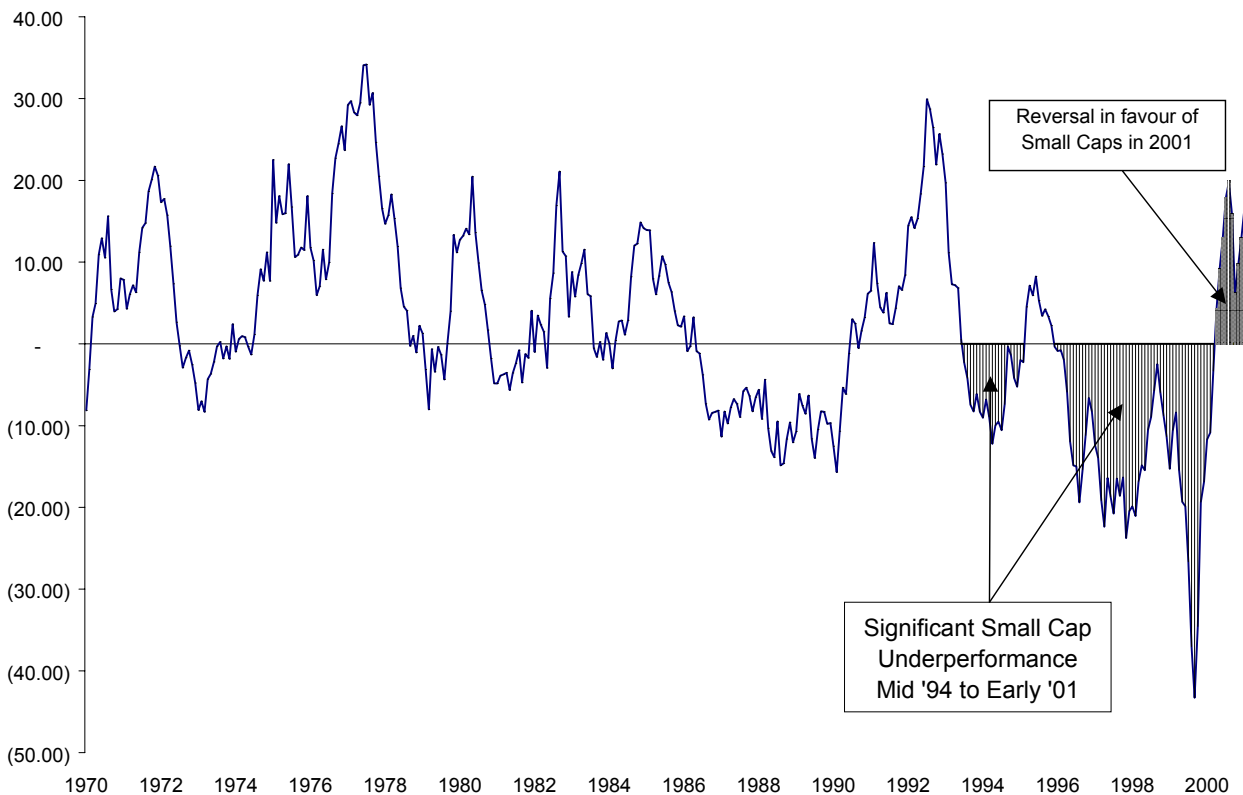
	<u>Bear Market Start</u>	<u>Duration Months</u>	<u>% Decline</u>
Dow Jones Industrial	01-Nov-73	23.1	45%
S&P 500	01-Nov-73	21.0	48%
NASDAQ Composite	01-Nov-73	21.0	60%

Furthermore 2000 and 2001 was the first time since 1973/74 that all three major U.S. stock indices declined for two consecutive years.

There is one major and troubling difference between this most recent correction and 1973/74. Following the 73/74 correction, the price/earnings ratio of the S&P 500 stocks got down close to 7 times. However, at the bottom of the 2000/01 correction the ratio was still close to 20 times. The love affair with the big cap stocks that drive the major indices was so wild this time that even following a significant correction, prices of many major big cap stocks are still very high by historical measures. This means going forward many stocks will be fighting this headwind of high valuations, even if the major world economies do improve in 2002.

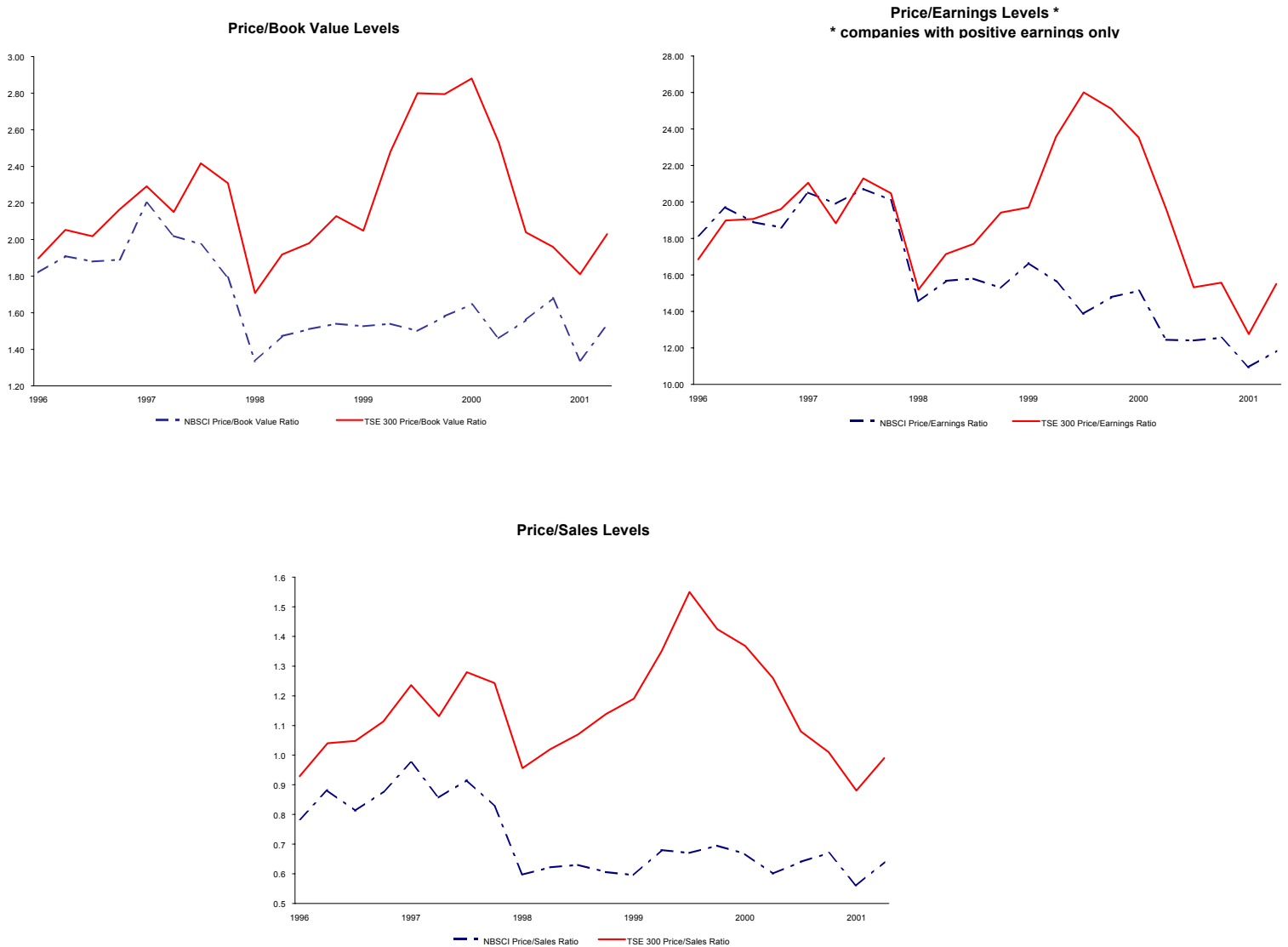
Our area of specialization is smaller capitalization stocks. Small cap stocks in Canada and the U.S. lagged the big caps for the latter part of the 1990's. In Canada, from 1994 to early 2001, it was the longest and most severe period of underperformance by small caps since the data was initially compiled in 1969. However, since early 2001, the trend has reversed in favour of small cap stocks.

NBSC Index vs. TSE 300 Relative Performance (%) on an annual basis



We strongly believe that for long-term investors small cap stocks offer higher potential returns. Small companies can grow faster than large companies. Furthermore, they are not as widely followed by analysts and as a result they often can be purchased at valuations more favourable to the investor.

The following 3 graphs compare price/book, price/earnings, and price/sales ratios for small caps versus big caps over the past 6 years. Although the valuation gaps have narrowed from the extremes of 1 ½ years ago, they still favour small caps.



In response to a request from one of our corporate clients we have done some analytics on our historical returns and the returns of Nesbitt Burns Small Cap Index (NBSC) relative to larger company stocks as represented by the TSE 300 index. The questions we were trying to answer are:

Do small cap stocks generate higher long-term returns?

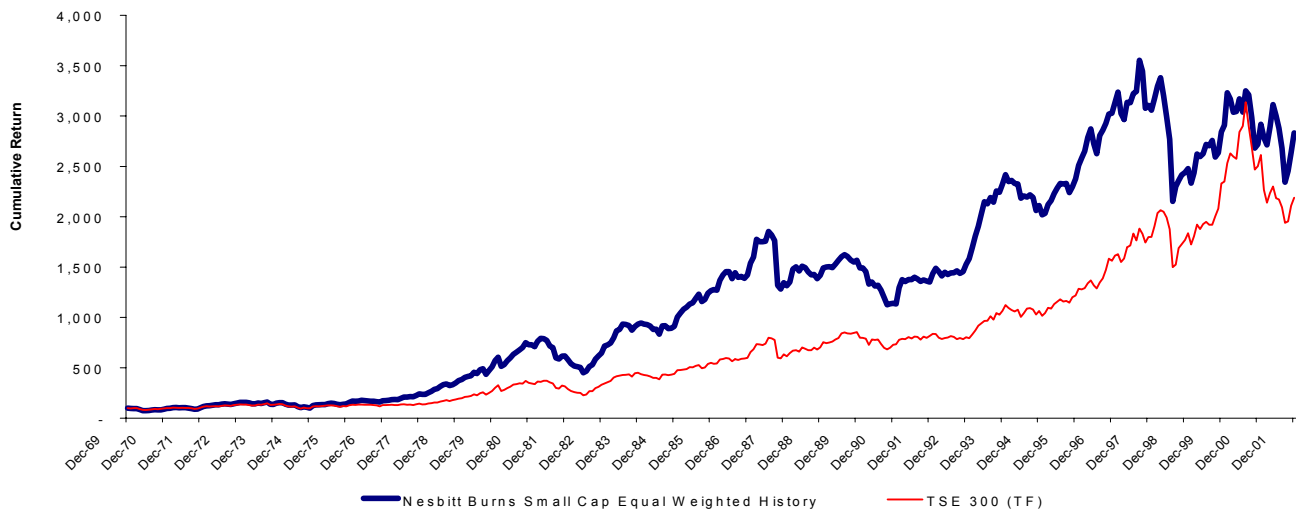
Are small cap returns more volatile?

Are small cap returns high enough to compensate for the volatility?

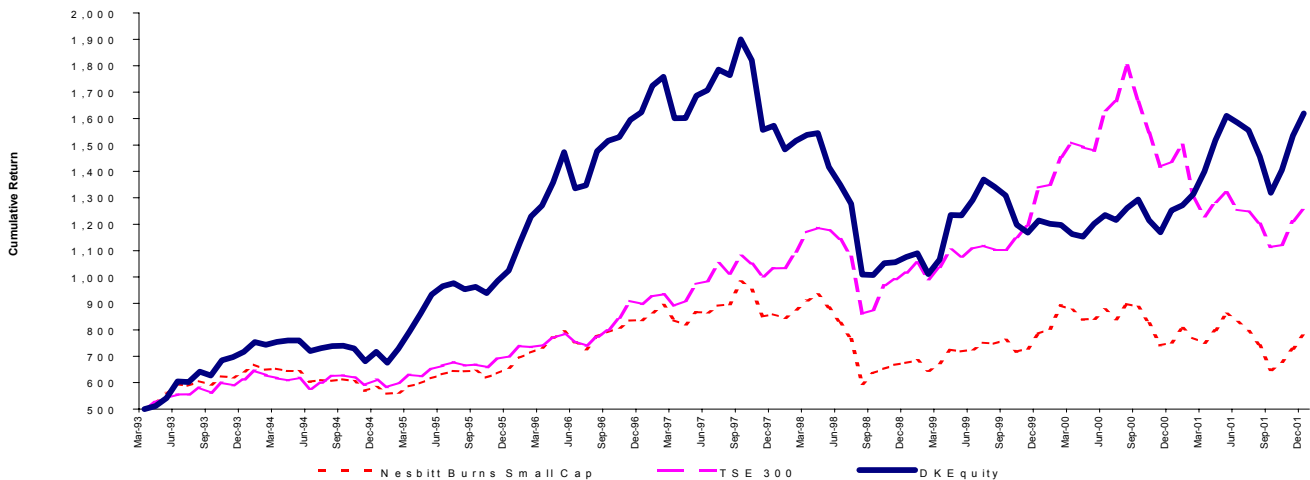
How do Deans Knight small cap returns compare to the Nesbitt Burns small cap index and the TSE 300?

The graph below shows the cumulative returns of the NBSC versus the TSE300 since 1969. It shows that patient investors enjoy higher returns in small caps.

Nesbitt Burns Small Cap Unweighted Index vs TSE 300: Cumulative Returns for 32 years through December 2001



The next graph below shows the cumulative returns of DKEquity (our oldest fund), NBSC and the TSE 300 since March 31, 1993. It shows higher cumulative returns for DKEquity.



The table below compares the returns of DKEquity with the TSE 300 index.

DKEquity vs. TSE 300

Since Mar. '93 to Dec '01

	Monthly Returns		Quarterly Returns	
	DK Equity	TSE 300	DK Equity	TSE 300
Average Returns	1.29%	1.01%	3.85%	2.86%
Standard Deviation	0.057	0.050	0.117	0.091
Sharpe Ratio	0.154	0.120	0.224	0.177
Correlation to DKEquity		0.627		0.474

The data shows that on a **monthly and quarterly basis the DK returns have been on average 30% higher** than the TSE 300. It also shows the DK returns have a higher standard deviation, i.e. more volatility. However, the DKEquity has a higher Sharpe Ratio, i.e. **the extra return more than compensates for the extra volatility**. Just as important, the data shows very low correlation between the DKEquity return and the TSE 300. **We are delivering something different than the index. This is what we set out to do in 1993.**

This next table compares the NBSC with the TSE 300 since 1969.

NBSC vs. TSE 300 Since Dec. '69 to Dec '01

	Monthly Returns		Quarterly Returns	
	NBSC	TSE 300	NBSC	TSE 300
Average Returns	1.01%	0.93%	3.17%	2.82%
Standard Deviation	0.053	0.049	0.104	0.089
Sharpe Ratio	<i>0.081</i>	<i>0.069</i>	<i>0.134</i>	<i>0.118</i>
Correlation to NBSC Index		0.872		0.880

It shows higher returns in favour of small caps, higher standard deviation, and a higher Sharpe Ratio.

In the year 2001 we continued to lose what we felt were undervalued and overlooked companies to takeover bids. Early this year we sold **Encal** (oil & gas) to a bid from U.S. based Calpine Corporation. We also sold our long held position in **Unican Security Systems** following a bid from a Swiss lock manufacturer, Kabba Holdings. Unican fit our selection criteria to a tee. Aaron Fish, a Montreal locksmith, started the company in the 1950's and gradually built the company into the largest key manufacturer in the world. The Company was also a major player in security entry systems (hotels & offices) and a major manufacturer of many types of locks. In the summer of 2000 the stock was languishing in the low \$20 range. Kabba paid \$36 cash for the company in a transaction that closed in April 2001. From the time Unican became a public company in 1967 until the Kabba purchase, Aaron Fish delivered his shareholders an annualized return of just over 15%. This is the way it is supposed to work. As Warren Buffet once said "It takes three things to be successful in business – brains, energy and character. Without the third, the first two will get you into trouble." Aaron Fish had all three. He cared about his customers, his employees, his community, and his shareholders, and served them all in an exemplary fashion.

A number of our companies in the portfolio appreciated substantially in value during the year. In most cases there was no significant change in their business. The revaluations were due mainly to a recognition that these business franchises were worth more than where they had been valued. **Winpak**, a specialized packaging manufacturer based in Winnipeg, appreciated from \$45 to roughly \$75 per share (66%). This occurred in spite of difficult conditions in the U.S. economy. We have owned Winpak since 1993 and will continue to as long as CEO Bob Lavery runs it. **Aber Diamond Corp.** went from \$14 to \$20 (43%). Aber is moving closer to putting the world's richest diamond mine into production (2003) in the NorthWest Territories with their partner RTZ

(the world's largest mining company). We look forward to enjoying \$4 of cash flow per share when the mine is in full production, i.e. a cash flow yield of 20% on today's price. **Masonite International Corporation** (formerly known as Premdor) is the world's largest door manufacturer. The stock appreciated during the year from \$7 to roughly \$20 (186%). The market ignored the \$1.50 per share earnings for the longest time and woke up following Premdor's acquisition of Masonite from International Paper. Masonite supplied all of Premdor's door skins and the transaction now makes the company fully integrated. **SNC-Lavalin**, Canada's largest engineering firm, went from \$14 to \$29 (107%) as more investors began to recognize the hidden value in the company's ownership position in Toronto's Highway 407 toll road. **Forzani Group**, Canada's largest sporting goods retailer, went from \$4 to \$15 (275%) as the company continued to grab market share and grow earnings in a difficult retailing environment. **LionOre International Mining** began the year at \$1 per share and finished at \$2.20 (120%). We wrote an extensive piece on the company in our year end 2000 review following our visit to their jointly owned Tati nickel mine in Botswana. LionOre is a low cost nickel producer and is in the process of increasing production from 2,500 tonnes per year to roughly 10,000 tonnes per year by bringing on their new Emily Ann mine in Western Australia and increasing production at Tati. The company also recently announced the decision to put into production their 60% owned Thunderbox gold discovery in Western Australia.

We sold one of our favourite companies late in the year. We had owned **Cott Corporation** for some time. Last year the stock moved from \$11 at the beginning of the year to a high of \$28 in early December (155%) where we sold the last of our position. Cott Corp. is the world's leading manufacturer of private label beverages. When we met with Frank Weiss, the incoming CEO in 1998, he laid out a very clear plan to improve the value of what was a very solid business franchise. He also "put his money where his mouth was" and purchased stock at \$10 per share. We together watched the stock drift below \$4 in early 1999 even when the franchise was being strengthened. Frank told us that day in 1998 that one of his goals was to get the stock over \$20. He accomplished this and more. At \$28 the Company was trading at 30 times earnings, a level we could not justify. It is always a risky bet to sell terrific companies based on valuations. Time will tell if the decision was correct.

It was not all rosy for us in 2001. Our oil and gas investments were a drag on the portfolio returns for the year. The onset of recession in 2001 resulted in a decline in demand for oil and natural gas in North America. However recessions do end. It is worth remembering we are already well into a recession in the U.S. We may be further from the onset and closer to the end of this recession. Don't forget that in response to the slackening economy the U.S. Federal Reserve has cut interest rates a record 11 times during 2001 to levels not seen in the last 50 years. Furthermore, before September 11th, the U.S. Government had already given the economy a shot in the arm with a round of personal income tax cuts. Subsequent to September 11 it is estimated an additional \$60 billion in fiscal stimulus was put into the system.

We do not know when the economy will begin growing again, but we do know it would be unwise to ignore the potential positive effects of the monetary and fiscal policy initiatives undertaken in the latter part of 2001. A recovery in U.S. growth will lead to a recovery in U.S. energy demand. We repeat what we have written many times before – there is not a lot of excess capacity in the global oil system nor in the North American natural gas system. Furthermore, the

long-term growth in the demand for and the consumption of natural resources (metals, oil, and gas) does not come from developed countries (North America and Western Europe) but comes from developing countries (China and India). In a bad year China's economy grows at 7 – 8 % . We suspect our holdings in oil and gas may be sleepers in the portfolio and may be the surprising winners going forward.

One other key stock worth noting is **Velan Engineering**. Velan is the world's largest designer and manufacturer of advanced technology steel valves. The Company produces from 11 plants – 6 in North America and 5 in Europe and the Far East. We have been building our position higher in the stock. This is a company that came to the public market in September of 1996 at \$16.50. The issue was massively oversubscribed. Today, nobody cares about the Company and the only analyst still covering the stock works for the investment bank that did the IPO. It trades at \$15. One would assume if the market is efficient, there must have been a destruction of shareholder value over the last five years. However, here are some facts from the company's May 31, 2001 annual report. In the last 5 years:

- Shareholders equity has increased 83% to \$250 million.
- Working capital has increased 71% to \$188 million.
- Cash on hand has increased 253% to \$55 million.

Earnings in the fiscal year ended May 2001 were \$1.40 per share. At \$15, the stock is valued at 11x latest fiscal earnings. Business is tough in a recession. Also it is tough to compete against the Europeans who have the benefit of a weak Euro versus the Canadian dollar. However, Velan still makes money and generates free cash flow which is piling up on the balance sheet. The stock trades barely above its \$12.50 book value. Furthermore, the net profit margin in the last fiscal year was 10%. The average net margin for all members of the Valve Manufacturers of America was 6.8%. This is a well-run family business. The founder A. K. Velan, is still there, assisted by his sons. They run it honestly and in a straightforward manner. Shareholders will be rewarded for their patience.

As of December 31st the portfolio breakdown by industry group stood as follows:

Metals	18%
Oil & Gas	23%
Consumer Products	8%
Industrial Products	26%
Transportation	4%
Merchandising	11%
Financial Services	5%
Biotechnology	4%
Cash & Short Term	1%
	100%