DEANS KNIGHT
CAPITAL MANAGEMENT LTD

# DK EQUITY GROWTH FUND

## Quarterly Review
## December 31, 2005

## Rates of Return[1]

| | 3 Mths | 1 Yr | 2 Yrs | 3 Yrs | 4 Yrs | 5 Yrs | 10 Yrs | Since Inception March 31, 1993 |
|---|---|---|---|---|---|---|---|---|
| **DK Equity Growth Fund** | **-2.3%** | **33.9%** | **32.0%** | **40.0%** | **38.1%** | **36.3%** | **19.1%** | **21.3%** |
| Nesbitt Burns Small Cap Index (Unweighted) | 4.4% | 13.7% | 13.2% | 23.3% | 16.3% | 13.7% | 8.1% | 8.6% |
| S&P/TSX Composite Index | 2.9% | 24.1% | 19.2% | 21.7% | 12.1% | 6.6% | 11.0% | 11.4% |
| DJIA | 2.1% | 1.7% | 3.5% | 11.2% | 4.0% | 2.0% | 9.8% | 11.6% |
| S&P 500 | 2.1% | 4.9% | 7.9% | 14.4% | 3.9% | 0.5% | 9.1% | 10.3% |

At year end 2005 the market experts and prognosticators are all talking about oil and gas. Oil and gas companies now represent 27.5% of the S&P/TSX Index and this subgroup appreciated in value by 63.5% in 2005. The experts smugly announce in the media that you could not have beaten the market in 2005 unless you had "overweight" positions in oil and gas. Although our portfolio benefited from oil and gas stocks in 2005, as with most expert analysis reported in the popular media, this statement is misleading and untrue. It is based on the popular concept of "industry overweighting" and "underweighting", used by pension fund consultants and other analysts to justify the exorbitant fees that they charge their clients. If an investor held a targeted portfolio of common stocks in 2005, he or she could have beaten the market (the TSX/S&P index) without owning a single oil and gas stock. Of the 1,762 stocks that were listed on the TSX for the entire year, 385 non oil and gas stocks had a price return greater than the market return. So an investor did not need to own any oil and gas stocks and could have held an endless combination of concentrated portfolios that could have beaten the market in 2005.

Since the origins of this current bull run in oil and gas prices in 1999, the majority of analysts have been skeptical and even negative on the outlook. This skepticism existed in the face of a strong up-trend in average annual oil and natural gas prices over the past 8 years:

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| Crude Oil (WTI $per bl) | 14.40 | 19.27 | 30.37 | 25.96 | 26.14 | 31.06 | 41.47 | 56.59 |
| Natural Gas (Hery Hub $per mcf) | 2.08 | 2.27 | 4.30 | 3.96 | 3.37 | 5.49 | 5.90 | 8.89 |

[1] Returns longer than one year are annualized.

However we now detect a big change. Anecdotally, most analysts have now capitulated, and are predicting endless gains and profits in oil and gas shares. We have preached this before and we believe it is worth repeating again . . . now is the time to be more cautious and vigilant when looking at public oil and gas companies.

Because the sector has generated such high returns, many public energy companies are very expensive. We still have substantial dollars invested in oil and gas shares at the end of 2005. However, the valuation increases have masked the fact that our oil and gas investments are concentrated in fewer companies and in some of these companies we now own fewer shares than one year ago. This trend will likely continue into 2006.

Let us make one thing clear. In these pages over many years we have stressed that we do not base investment decisions on predictions about the economy or commodity prices. In this regard we are not predicting lower oil and gas prices. We are simply saying that publicly traded oil and gas companies, by any valuation metric (price/cash flow, price per flowing barrel, etc.), are more expensive now than when this bull run began in 1999.

This rise in oil and gas prices in the last 8 years has been the result of steadily increasing global demand eating into available supply. We are now at the point where there is very little excess capacity available on a global basis. The amount of current excess capacity may be debatable, but it is certainly significantly lower than it was 8 years ago. Furthermore, future capacity additions (including the Canadian tar sands) are available only at a higher cost. This is a reality that the world cannot escape.

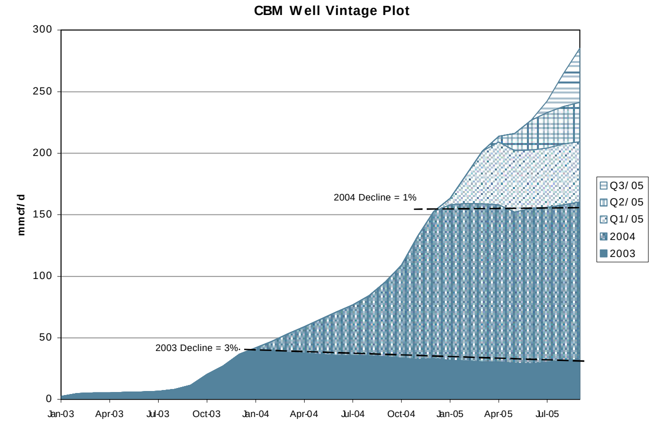
However in the short term, the demand/supply balance and the price of oil can be altered in a significant manner. For instance, the U.S. is the largest consumer of oil in the world, accounting for roughly 22 million barrels per day of the total estimated global consumption of 84 million barrels per day. So changes in U.S. demand can have a big impact on the price of oil. Although we have not seen any noticeable demand destruction yet as a result of higher prices, it may simply be too soon to make any conclusions.

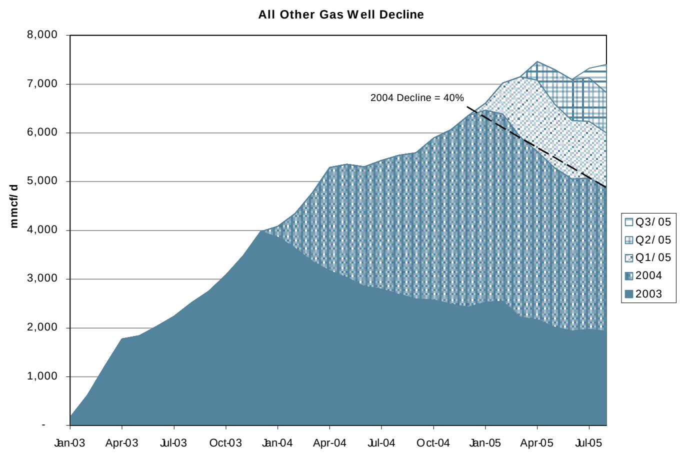
However, there is anecdotal evidence that major U.S. companies are putting plans in place to significantly conserve energy consumption. Also the spike in oil prices in the latter part of the year has caused a sharp drop in S.U.V. sales.

Recent information put forward by the Rocky Mountain Institute, a non-profit energy research group, shows that a barrel of oil today does twice as much work as it did in 1975. Motor vehicles in the U.S. account for 40% of domestic oil consumption. The Institute figures that in moving to more fuel efficient vehicles, the U.S. could double that efficiency again. Furthermore, they suggest that the savings from using electricity more efficiently could be even greater.

The point here is that as oil prices have moved on an average annual basis from roughly $14 a barrel to $57 (a 4-fold increase), it has produced big profits for investors in oil shares. We are not forecasting a dramatic drop in prices, however we are wary of forces that are out there that may limit profits in the sector in the future – demand destruction and high valuations.

Your portfolio has certainly benefited handsomely from investments in oil and natural gas, and we will continue to maintain investments in certain situations. It is worth pointing out that we did make one major new investment in this area in 2005 – **Mahalo Energy**. Mahalo has built a substantial portfolio of non-conventional natural gas properties in the U.S. and Canada. By non-conventional, in Mahalo's case we mean coal bed methane. As conventional sources of natural gas are rapidly being depleted, the industry, through new technology, is turning its attention to alternative sources such as extracting gas from coal beds. The two pictures below tell the story clearly.




The pictures above show production from recent wells drilled into the coals (CBM) declining at 1% whereas production from recently drilled conventional wells are declining at roughly 40%.

To a slightly lesser extent, what has been happening in oil and gas is also happening in base metals and gold. Although not all base metals (zinc, copper, nickel, lead, etc,) have behaved in exactly the same manner, the general trend has been higher in recent years and share valuations have followed suit. Gold, also late this year, reached a 17 year high of U.S. $520 per ounce and the precious metal's rise has spawned a renewed interest in the shares of some gold producers.

In the metals area in 2005 there were also some handsome profits made by the portfolio. **First Quantum Minerals** (copper) began the year at $18.65 per share. The shares were originally purchased 4 years ago at an average cost of $3.43. With the steep rise in copper prices to a high of just over $2 per pound late in 2005, we gradually liquidated the shares, with the highest sale price of roughly $30 in November. **Kagara Zinc** was acquired early in the year (and is currently the largest metals investment) at an average price of 97¢ per share and closed the year at $1.95, a return of 101% in 2005. We also built a significant position in **Paladin Resources**, an emerging uranium producer. Paladin's Namibia mine will be in production in the second half of 2006. The fundamentals for uranium are strong. Stockpiles have been eroded over the past 25 years, while demand growth will accelerate over the next 10 years as the world turns more toward nuclear as an alternative power source. The average cost on Paladin is about 65¢ and it closed the year at $1.76.

In terms of share price movement in 2005, the base metal company that did not fare well was **LionOre Mining International**. The share price actually declined 28% to close the year at $4.95. Short term operational factors negatively affected production, raised costs, and reduced profitability. In the spring, an unusual amount of rainfall in Botswana resulted in heavy flooding at the Tati open pit mine. It disrupted production and also resulted in the company mining lower grade ore. Our understanding is that the problems have been dealt with, and procedures have been put in place to enable the company to deal more effectively with such an occurrence in the future. In Western Australia, one of LionOre's contractors went bankrupt in Q2. This disrupted production while LionOre purchased the contractor's equipment out of bankruptcy court and began operating as contactors themselves. The Q4 2005 results, which will be reported in February, we expect will show a return to normalcy.

However the underlying value in LionOre will not necessarily be unlocked in the short term. The company has strategically built a portfolio of nickel assets in Africa and Western Australia, which will be developed over time. The key is that rather than using conventional smelting (more costly), LionOre will gradually deploy their proprietary Activox technology to extract the nickel and other minerals. We expect the first commercial scale plant will be in operation in late 2008 / early 2009. The four main benefits of the technology are substantially lower capital costs, lower operating costs, high recovery rates, and lower pollutants. One of our biggest concerns at this time is that the company could be taken over at a low valuation because of where the shares currently trade.

As pointed out earlier, there were areas to make profits outside of oil and gas and metals. For example, we built up a meaningful position in **Emergis Inc**., a once darling, but fallen tech stock. For us it now represents a simple value play, generating steady and growing cash flow, no debt, and $1.40 per share of cash on the balance sheet. We built a position even though we had to compete with the company itself, which was buying back up to 10% of its own stock. Emergis closed 2005 at $4.10, a gain of 29% for the portfolio. **CAE Inc**., the world's largest designer and manufacturer of flight simulators, appreciated 69% to close at $8.52. Also early in the year we sold the last of our **Algoma Steel** at just over $39, versus a cost of $6.31.
Going forward, as mentioned in our reports in 2005, we believe the best opportunities lie in those companies whose valuations have been beaten up by high input costs and lower profits. These include companies hurt by the rising Canadian dollar, higher oil prices, and steel prices. It is not so much that we believe that these input costs will necessarily reverse and decline, but rather

some of these companies will regain pricing power and will also be able to push through efficiency measures. We believe that in some cases there can be a margin expansion. If we can buy cheaply enough and are patient, the rewards can be substantial.

We are seeing anecdotal evidence that some industries are already showing signs of gaining pricing power. Although it is not yet reflected in inflation numbers, probably because it is not yet uniform throughout the economy, more companies and industries are having success in putting through price increases. Have you tried getting a hotel room in New York lately? The average price of a New York hotel room has surpassed its previous September 11, 2001 peak and has reached a record level, up 20% over 1 year ago. At the standard mid town hotels like the Waldorf, it is not possible to get a room mid week for less than $500 per night. The Four Seasons fetches $800. This industry does not need to fear the price depressing effects of globalization, or cheap imports from China.

In an October report from Morgan Stanley, they see the economy tilting toward more pricing power, not less. Among 45 industries they track, 15 had price increases of more than 3% per year, while 5 had falling prices. This compares with 7 and 10 respectively a year earlier.

It is difficult to predict which companies will regain pricing power and profit margins. However, there are signs to look for: strong or rising demand, lack of foreign competition, brand loyalty, and high or rising industry capacity utilization rates. If you look at your portfolio you will see some of these companies **– CAE Inc., Menu Foods, Velan Engineering, Shermag, Linamar Corporation, Husky Injection Molding,** and **Glendale International.** At present some of these positions are small, but you will see them grow in 2006.

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

| | |
|---|---|
| Energy | 40.1% |
| Industrials | 22.0% |
| Base Metals & Minerals | 18.9% |
| Consumer Discretionary | 6.9% |
| Utilities | 4.8% |
| Information Technology | 4.5% |
| Other Materials | 1.3% |
| Healthcare | 1.1% |
| Cash & Miscellaneous | 0.4% |
| | 100% |

As of December 31st, the 10 largest equity holdings were:

| | | |
|---|---|---|
| Mahalo Energy | 6.7% | Oil & Gas |
| CAE Inc. | 6.4% | Aerospace Equipment & Services |
| Kagara Zinc Ltd. | 6.1% | Zinc Mining |
| Paladin Resources | 5.7% | Uranium Mining |
| Kereco Energy Ltd. | 5.3% | Oil & Gas |
| West Energy Ltd. | 4.8% | Oil & Gas |
| Maxim Power Corporation | 4.8% | Utilities |
| Clear Energy Inc. | 4.7% | Oil & Gas |
| Paramount Resources Ltd. | 4.6% | Oil & Gas |
| Petrobank Energy & Resource | 4.5% | Oil & Gas |
| | 53.6% | |