December 31, 2008

DK EQUITY GROWTH FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

December 31, 2008

Rates of Return[1]

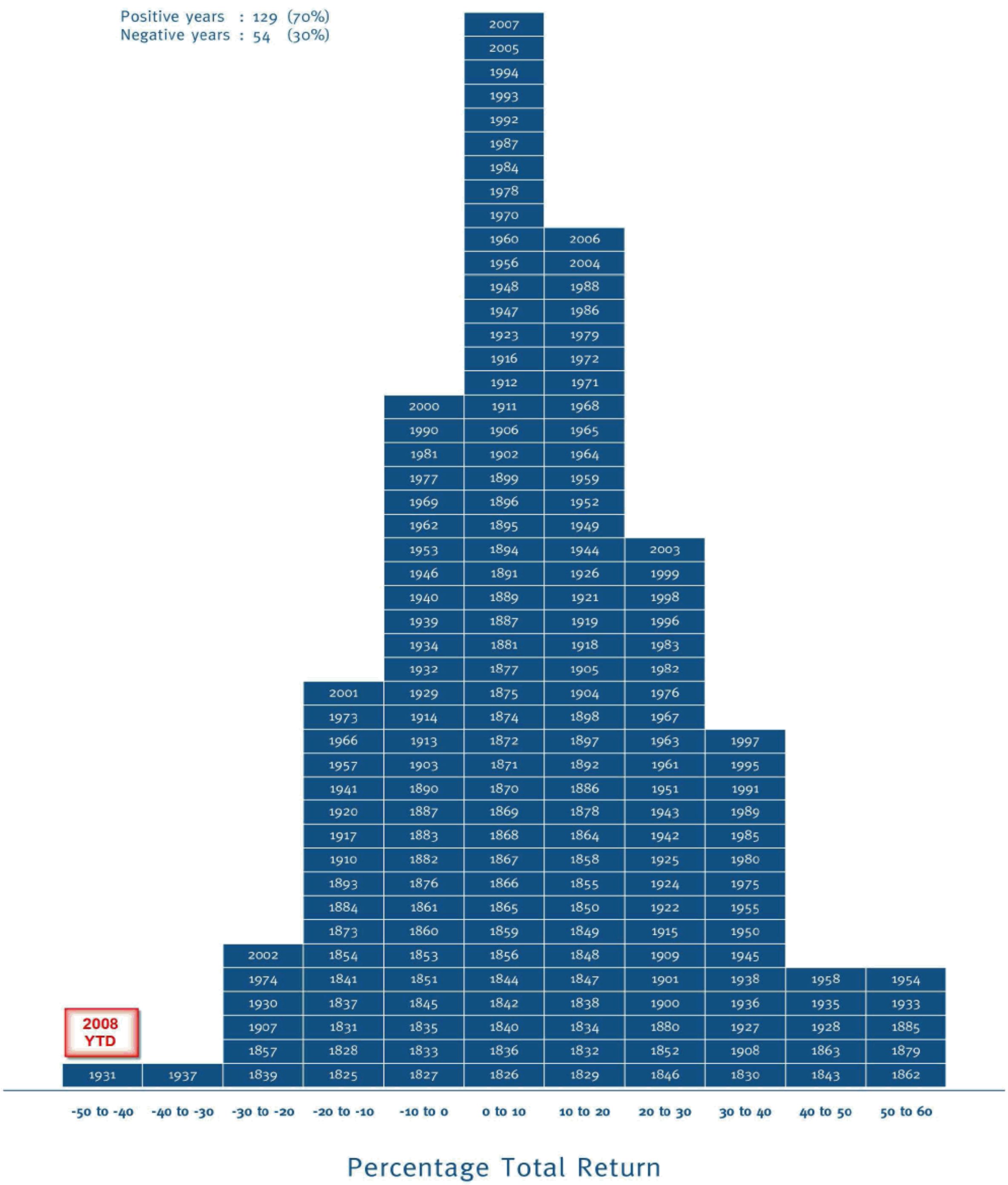
	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since Inception March 31,1993
DK Equity Growth Fund	**-27.3%**	**-46.7%**	**-26.2%**	**-5.1%**	**3.4%**	**8.3%**	**16.7%**	**15.8%**
S&P/TSX Composite Index	-22.7%	-33.0%	-14.2%	-4.8%	1.7%	4.2%	5.3%	8.1%
S&P 500 (in U.S.Dollars)	-21.9%	-37.0%	-18.5%	-8.4%	-5.2%	-2.2%	-1.4%	6.5%

The U.S. S&P 500 index has declined from a peak on September 10, 2007 to a low on November 20, 2008 by 52%. Although there have been 20 bear markets in the past 100 years, the magnitude of this bear market has only been exceeded once before, the 86% decline between 1929 and 1932. However, this bear has been much swifter and steeper than any on record. This decline of 52% occurred in 14 months. The 1929/32 bear market took almost two years to reach this same magnitude of decline.

A client sent us the chart on the following page. It measures the annual returns for the S&P Index for the past 183 years. It puts 2008 in perspective . . . the second worst annual return in history, exceeded only by 1931.

[1] Returns longer than one year are annualized.

S&P Index van 1825 tot 2007



Bron: Value Square Asset Management, Yale University

The S&P/TSX arrived at a similar point in 2008 but took a slightly different path. Held up temporarily by the continued bull market in most commodities, the TSX peaked on June 18, 2008, and declined by 49% to its low on November 20, a breathtakingly quick catch-up.

The market valuation of our portfolio took it on the chin. No areas of the investment markets were immune. We are not pleased, nor proud, of the outcome. It never feels good at the end of a period like this. It is not the first time in the 16 year history of Deans Knight that we have had to persevere through adverse conditions. For those who have been with us long enough, you may recall that we endured an equally difficult period from late 1997 to late 1998. In reaction to the "Asian Crisis", the Russian debt default, and the collapse of hedge fund, Long Term Capital, our valuations declined by -47%. We kept our cool, it took a while, but valuations did recover the lost value, and then some.

As a result of the dramatic destruction of value this year, mainstream media and bloggers have bombarded us with alarming news, dire predictions, and the apportioning of blame. In the blame game, the culprits have been Fed Chairman Alan Greenspan's abundant cheap money policies; lack of SEC oversight; the Bush Administration's pro free market policies; the explosive growth of derivative securities; the greed of Wall Street . . . it is endless. All the aforementioned played a role in creating the cauldron of crap we currently find ourselves in, but let's face it, the finger pointing is useless.

Boom/bust cycles are natural and recurring phenomena associated with a free market system and those most common traits of humankind . . . fear and greed.

As Winston Churchill allegedly once said, *"capitalism is the worst economic system on the planet, except for all the others"*. In just the past 10 years alone we have seen two major boom/bust cycles. First the technology bubble of the late 1990's that went bust in 2000, taking the S&P 500 down 49% and the tech-laden NASDAQ down roughly 80% over the ensuing two years (much like the 1929-30 correction). The current boom was fuelled by the collective madness that led the masses to believe that U.S. home prices could never go down. To suggest now that the mortgage lending practices that helped enable this psychosis were sloppy is an understatement of gross proportions. When housing prices did begin to trend down, the world learned just how ridiculous the lending practices were and how imbedded these shaky loans had become in the portfolios of financial institutions worldwide. The rest of the story is well known . . . failing financial institutions; a dysfunctional global credit system; a collapse of business and consumer confidence; unprecedented government and central bank intervention; and a fierce global recession.

The National Bureau of Economic Statistics declared recently that a recession officially began in the U.S. at the end of 2007. Most European economies are now also in recession. The global engines of growth, the BRIC's (Brazil, Russia, Indian, and China), are slowing dramatically. The current economic picture isn't pretty, and the die is cast . . . the economic numbers will get much worse before they get better. Based on the indicators already available, U.S. real domestic product (the broadest measure of economic activity) will likely show a steep contraction in the 4th quarter. We already know that auto sales have been annualizing 10 million units in recent months, the lowest levels since the early 1980's, and far below the 16 million units that were sold on an annual basis each year from 1999 to 2007. U.S. consumer confidence has declined to an all time low.

U.S. housing starts have dropped to the lowest level since the recession in the early 1980's. U.S. retail sales are down sharply, and this past holiday shopping season will undoubtedly go down as one of the worst on record.

The easy money debt binge of the past 10 years is over. U.S. consumers have finally hit the wall and have begun the necessary deleveraging process, and they have begun with a vengeance. That part of the corporate sector that was leveraged up, because of the private equity craze, is also going through the same process. As the economic contraction accelerates, all the weaknesses and cracks become more obvious. The result . . . rising bankruptcies and restructurings.

Hey – not a pretty picture, is it? But that is how a free market system works. It ain't pretty and it ain't perfect. But it is the best we got. And you know what? . . . when the economy does bottom, we will be left with a much leaner more efficient system to fuel the next cycle. That's how it works.

We forget, when caught up in the current malaise, that this is not the first such period in history. Your author remembers clearly the climate of malaise that afflicted North America in the late 1960's and into the decade of the 70's. From my recollections it felt much worse then, than now. In that period, there was real and palpable fear that the U.S., the strongest nation on earth, was literally falling apart.

Remember, in the 60's we witnessed the assassinations of President Kennedy, Martin Luther King, and Bobby Kennedy. We witnessed unprecedented race riots that destroyed portions of Detroit and Los Angeles. We saw the escalation of the most unpopular and useless war in history, Vietnam, and the massive unrest and domestic violence it caused. In the 1970's we saw the worst market correction and recession since the 1930's, three major oil price shocks, gasoline shortages, the impeachment of a President, and rampant inflation. In October 1970, we in Canada feared for the future of our nation. Separatist violence escalated in Montreal and resulted in the kidnapping of British diplomat James Cross, the invoking of the War Measures Act by Prime Minister Trudeau, and the murder of Quebec Cabinet Minister, Pierre Laporte. Lest we forget, those days were not a bed of roses!

A friend recently recounted a story of that time. He and his wife were married in 1973. In 1974 they were so distressed they had a serious discussion about whether they wanted to bring children into the world. Guess what? The economy not only survived, it prevailed and prospered. Our standard and quality of living is much higher today than it was then. They had two boys.

So what are we best to do from an investment perspective today in the face of troubled times and pervasive pessimism? Sell stocks? Avoid stocks? On the contrary. Every signal suggests the opposite.

1. We have already seen massive amounts of capitulation selling in the equity markets. In the U.S., equity based mutual funds have faced redemptions of $185 billion in the last five months. This has contributed to more than $625 billion of net inflows into money market funds in 2008. Capitulation selling is finite.
2. We have seen huge redemptions of hedge fund assets and hundreds of hedge funds going out of business. Redemptions are finite.

3. We have seen large amounts of forced liquidation due to margin calls. Fact ~ this is also finite. The result of all this selling, Bloomberg estimates there is roughly $8.5 trillion of cash on the sidelines in the United States alone. A massive amount of buying power that represents 75% of the U.S. total market cap.
4. We have seen unprecedented yearend tax loss selling. With all equity investors looking at substantial paper losses in November and December, there was a massive incentive to sell, register the losses and claim these losses, against any capital gains incurred over the previous three years. It is now over.
5. We have seen unprecedented fiscal and monetary stimulus on a global scale. The monetary stimulus is beginning to slowly have a positive impact. The 3 month LIBOR rate, the rate at which banks lend to each other, has declined to 1.4% from a peak of 4.8% at the time of the Lehman Brothers bankruptcy.
6. Interest rates in many countries are at generational lows. In Canada, the yield on the TSX index is higher than a 10-year Government bond for the first time in the author's 40-year career. Governments are printing money at unprecedented rates to spur the economy. Nervous investors are gobbling up treasury paper for little or no return. A consultant at Watson Wyatt calls this overconcentration on cash "reckless conservationism". There is a very strong incentive to move out of treasury securities and into stocks.
7. The process of deleveraging is well underway. Global financial institutions have written off over $1 trillion of bad loans. Consumers and corporations are deleveraging and restructuring.
8. In your author's 40-year career, there has never been a time when so many public companies are trading at such low valuations. Junior and intermediate oil and gas producers at 1 – 2 times cash flow . . . at 50% of NAV . . . and less than $15 per barrel in the ground. Oil sands development companies at less than 50¢ per barrel. Copper companies trading at less than 10¢ per pound of copper in the ground. This is the metal that traded at over $4 per pound in June. Almost 50% of the TSE listed stocks trade below their book value . . . some at a fraction of book value . . . some at not much more than net cash on the balance sheet.
9. The U.S. is the world's largest, but also the most flexible and adaptable economy. It has proven time and again that it can heal and recover.
10. Timing the market is a fool's game.