December 31, 2011

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Report
December 31, 2011

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	Since Inception March 31,1993
DK Equity Growth Fund	**4.5%**	**-16.6%**	**7.9%**	**23.2%**	**-0.1%**	**0.3%**	**19.2%**	**12.4%**	**16.9%**
S&P/TSX Composite Index	3.6%	-8.7%	3.6%	13.2%	-0.7%	1.3%	7.0%	7.0%	8.9%
S&P 500 (in U.S. Dollars)	11.8%	2.1%	8.4%	14.1%	-1.6%	-0.2%	2.9%	5.5%	7.7%

As always, it is best to know where we have been, before we can anticipate where we may be going. The past twelve months have been dominated by unprecedented volatility in share prices and much hand wringing about the sorry state of the global economy. The news in 2011 was dominated by concerns about the health of the Eurozone economy, concerns about U.S. debt levels and the possibility that the U.S. economy will slip back into recession, and concerns about slowing growth in the recent engines of global growth, China and India. These concerns were prominent enough that, during the course of the past calendar year, we did actually experience a bear market. From peak valuations in April/May, the broad market indices (i.e. the Canadian TSX composite, the U.S. S&P 500, and the MSCI World index) all registered declines of roughly 20% before recovering some ground before year end.

For the year as a whole, the TSX composite declined by 8.7%, the MSCI World index declined by 7.6%, while the U.S. S&P 500 was flat. It is not surprising that the TSX was down, as the global economic growth concerns put downward pressure on the majority of commodity prices. Commodity producing companies are much more heavily weighted in the TSX than the S&P 500. Global growth concerns also put downward pressure on the MSCI World index because of the heavy representation of emerging economies, where stock exchanges suffered declines.

Year-end ... the time when a myriad of pundits are trotted out by the media to tell us what is going to happen this coming year. It is scary that people actually listen to this twaddle. The consensus is never even remotely correct. For example, a year ago, following two up years for the markets (2009 and 2010), the consensus forecast was positive for 2011. Now that 2011 was disappointing, the consensus for 2012 is negative. These pundits make fortune tellers look legit. Fact is we don't know what 2012 will hold for us. Odds are strong though that the negative consensus will be wrong.

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

Forecasting is a waste of time. How many pundits one year ago told us that Gadaffi would lose power and be killed in 2011? Who told us Mubarak would be overthrown and put on trial? They all told us that the global economy would expand and markets would be up. Then they panicked in April and changed their collective minds.

Yes there are big problems out there. Europe and the Euro are paying the price for the reckless overspending and the layering on of debt by the 'PIGS'...Portugal, Italy, Greece, and Spain. And greedy bankers bought all this unsupportable debt, thus threatening the banking system once again. Is there a solution? Yes. Will it be difficult to get there? Yes. Too much debt in Europe and too much debt globally caused the near meltdown in 2008 and continues to weigh heavily on the global economy today.

For a better understanding of the magnitude of the problem and the risks inherent in coming to solutions, a must read is Bank of Canada Governor Mark Carney's speech to the Empire Club of Canada on December 12, 2011 entitled "Growth in the Age of Deleveraging"[2]. Mark Carney was also recently appointed Chairman of the G20 Financial Stability Board.

Carney points out that accumulating the mountains of debt now weighing on advanced economies has been the work of a generation. Two important messages are worth noting. Firstly, the more that households and governments drive leverage, the less the productive capacity of the economy expands and the less sustainable the overall debt burden ultimately is. Secondly, excessive private debts usually end up in the public sector one way or another. Private defaults result in public rescues of banks, and recessions that result from deleveraging prompt expansionary fiscal policies. In both cases, more public debt.

Debt is unlike equity. It must be repaid on time and in full, or there are consequences. The outcome of this deleveraging process will depend to a large extent how policy makers handle these matters. There is no easy way out. Policy makers must create the proper climate and the necessary time for these adjustments to take place.

The pressure of all of these negative macro-economic issues causes the media and the majority of investors to see the world in terms of 'the glass is half empty'. We forget that the world is, and always has been, challenged by difficult situations … wars, famines, diseases, recessions, depressions. We are in a period where there has been a fair share of good news, but it is not being adequately appreciated. Even though it may not appear to be, the world is more peaceful than it has been in 50 years. Data from the Peace Research Institute shows that 55,000 people per year have died in wars in the past 10 years. This is about 1/2 the level for the decade of the 1990's; 1/3 of the rate during the Cold War (1946-1990), and 1/100th the rate of the Second World War. The U.S. economy, the world's largest, is improving. Roughly 1.8 million new jobs were created in 2011 and the unemployment rate has declined from 9.4% to 8.5%. Retail sales are strong. Auto sales are strong. The housing market in the U.S. is not in crisis, but rather it is adjusting in the proper, albeit painful, way to the excessive rate of new home construction of the first 7 years of the last decade. America is importing less oil … from 12 million barrels per day in 2005 to 8.8 million today. Cars are more efficient and more oil is being produced in the U.S. with new

---

[2] See http://www.bankofcanada.ca/2011/12/speeches/growth-in-the-age-of-deleveraging/

technology. Moreover, more of the U.S. imports of oil are now coming from friendly nations such as Mexico and Canada. And in the world's biggest economy, some social measures are improving … traffic fatalities are falling, violent crime is declining, air quality is improving.

While we are not paying attention, the world is becoming safer, cleaner, and more prosperous. More importantly, as markets obsess about the negatives, businesses become priced more attractively. We are supposed to be happy to buy businesses when everyone is frightened, and be worried about buying them when everyone is optimistic. Or to quote Warren Buffett's simple rule "be fearful when others are greedy, and be greedy when others are fearful".

During 2011, two substantial holdings were sold to takeover bids. Calgary-based Peak Energy Services was sold to Clean Harbours and our uranium company, Mantra Resources, was sold to the Russian state-owned uranium company, ARMZ. These deals provided what we deemed to be a reasonable profit for Deans Knight's clients.

It is worth noting that, as is always the case in a down year in share prices, such as 2011 the down movement is exacerbated in December by the pressure of tax loss selling. Investors who are holding stocks that are trading below their cost often sell them just prior to year end to lock in a capital loss, which they then use to shelter income from other sources. In smaller, less liquid stocks (as many of ours are) this has a greater negative impact on share prices. That said, as we move into the subsequent tax year, more often than not, the prices bounce back.

The single most important take away from today's environment is this simple one. Businesses in general, including the businesses we own, are in much better shape now than most were before the 2008/09 global recession ... less leverage, stronger sales, stronger earnings, bigger backlogs, more advanced development projects. But lower valuations!