December 31, 2013

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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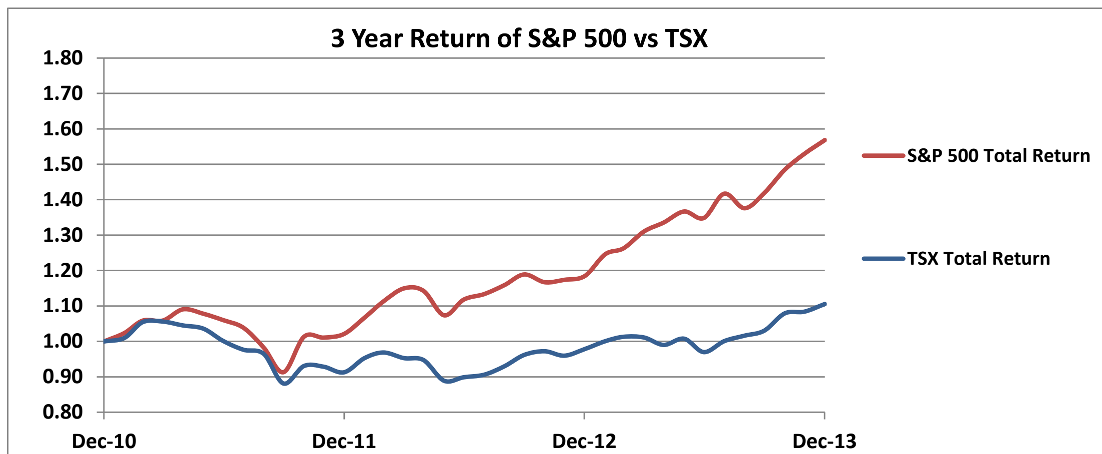
Quarterly Report
December 31, 2013

Rates of Return[1]

	3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception March 31, 1993
DK Equity Growth Fund	**6.3%**	**14.6%**	**3.1%**	**1.1%**	**-5.2%**	**4.4%**	**13.8%**	**11.0%**	**15.7%**	**13.9%**	**15.3%**
S&P/TSX Composite Index	7.3%	14.0%	13.0%	10.1%	3.4%	6.8%	11.9%	8.0%	7.5%	8.3%	9.0%
S&P 500 (in U.S. Dollars)	10.5%	16.3%	32.4%	23.9%	16.2%	15.9%	17.9%	7.4%	4.7%	9.2%	9.1%

Recently, it has been tough being an investor in Canadian publicly listed companies. The Canadian broad market index (TSX) has underperformed many of the major international indices, particularly the U.S., and this underperformance has been outsized in the most recent three years.



We have always maintained that it is important to keep matters of the market in historical perspective. This outperformance of the U.S. market is a relatively recent phenomenon. While we have witnessed a very powerful rally from the lows of the great recession in March 2009 for S&P 500, the five year returns prior to that were -2.2% annualized. To put this in a longer term context what we have seen recently is a tendency of the S&P 500 index to revert to its long-term 'mean' return.

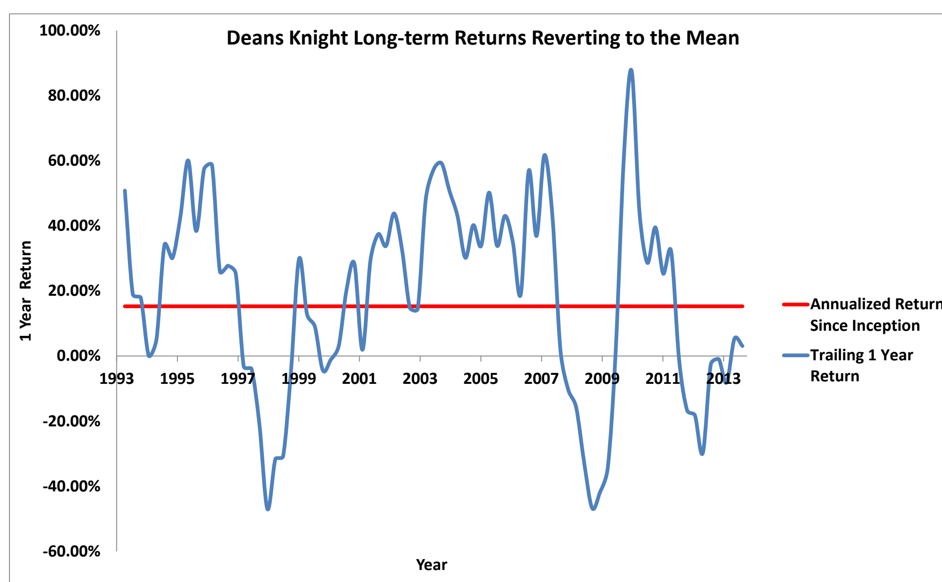
[1] Returns longer than one year are annualized gross of management fees.

The annualized return of the S&P 500 for the 100 years ended December 2013 has been in the 9 – 10% range. It is interesting to note that the long-term returns for the TSX are similar. And although long-term returns from both the TSX and the U.S. S&P 500 are similar, in the shorter run we can witness significant variances, such as the recent outperformance of the S&P 500. If history is any guide, this is unlikely to persist.

Another thing most investors do not appreciate, and must keep in context . . . volatility is NORMAL. For example, although the long-term returns from equities are in the 9 – 10% range, in two-thirds of the past 100 years the annual returns are either 10 percentage points higher or lower than the long-term average. Returns in a ‘normal range’ i.e. 8 – 10% per annum are extremely rare, occurring less than 1 out of every 10 years.

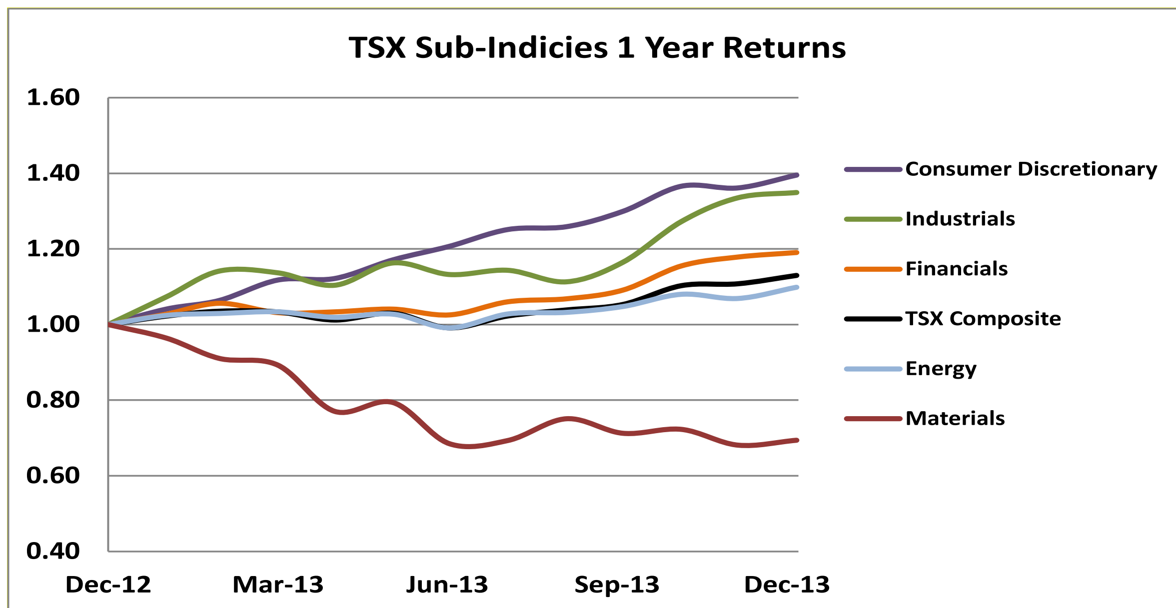
We are reminded that a majority of our investors have not been with us for our 20 years, and some perhaps less than 5 years. Therefore, it is worth pointing out that unlike the TSX and the S&P, over the past 20 years, returns from the Deans Knight Equity Growth Fund have not been in the 9-10% range. In fact, the 20 year return is 15.3% annualized.

However, just like the indices, Deans Knight’s equity returns, have experienced volatility over our 20 year history. When compared to those indices we have experienced more volatility, which one would expect from a portfolio of only 20 core companies, but we have also enjoyed a higher return. Following the same methodology from above, in our 20 year history we have had annual returns that are either 10 percentage points higher or lower than our 15.3% average 19 times. When our shorter term annualized returns have exceeded our long term returns, our returns have declined to revert back to the mean. Conversely, when our shorter term annualized returns have lagged the long term returns, the tendency has been for the returns to increase and again revert to the mean, as shown in the graph below. Clearly our returns for the past three years have lagged our mean return of 15.3%. As in the past, it will not always be this way.



For the past three years we've had a heavy commitment to oil & gas and mining companies. These areas have been a major drag on returns. Outside of these areas . . . forest products . . . auto parts . . . trucking . . . aircraft parts . . . returns have been very good.

This past year the TSX index itself has been a tale of two markets. Banks, railroads, airlines, and a narrow subset of bigger capitalization stocks have done well. But the mining and the energy sector, which represent a bigger part of the TSX (40%) than the U.S. S&P (13%), have been laggards. The mining sector has been an extraordinarily difficult one. Junior mining, the engine that creates new mines and drives growth in the industry, has been in the worst slump that we can remember; a slump that began in 2007 and gained momentum into 2013.



We pointed out in our mid-year 2013 report that we began to make changes to the portfolio. Although it is not possible to suddenly alter returns, our portfolio of stocks has been treated much better by the market in the last 6 months of 2013. While not abandoning the oil & gas and mining areas, we began to refocus investments in these areas on what we see as the best value, best management situations, while reducing or limiting exposure to higher risk situations. In oil & gas, the result is fewer names and bigger investments (weights) in these names. In mining, so far it has been a reduction in the number of names, with a focus on 3 key companies . . . **Coalspur Mines Ltd.** (thermal coal), **Lucara Diamond Corp.** (diamonds), and **Asanko Gold Inc.** (which is merging with **PMI Gold Inc.**) (gold) . . . with target weights of 2%.

We also wrote in our June report that we needed to broaden our net. The result has been the addition of 4 new companies to the portfolio over the latter part of 2013. . . **Winpak Ltd.** (packaging), **Uni Select Inc.** (aftermarket auto parts and auto paint distribution), **Rona Inc.** (retail building supplies and hardware), and **Transat A.T. Inc.** (Canada's largest tour operator). We wrote in some detail about the first three in our September letter.

Transat, the latest commitment, is a Montreal-based integrated tour operator, specializing in holiday travel. The company is the largest in Canada and one of the largest in the world, operating from Canada, U.K., and France. Transat offers destinations and holiday packages on all continents, but specializes in sun destinations.

The travel business is a difficult business . . . very competitive, with razor thin margins. So why Transat? Transat is run by co-founder Jean-Marc Eustache and a strong Board. Two years ago, in a period of shrinking margins and profitability, Transat initiated a major turnaround. Costs have been cut, the aircraft fleet has been rationalized and Transat has returned to profitability and is generating positive cash flow. With the stock trading at $12.50 the company has $7 per share of free cash on the balance sheet. With no direct debt (only non-recourse aircraft leases), net of cash we are paying $5.50 per share for a business that generated $3.25 per share in cash flow in fiscal 2013. We could see cash flow grow by $1 per share in the next 24 months as further cost reductions are realized.

We like the auto parts industry and we have been an investor in both **Linamar Corporation** and **Martinrea Intl.** for many years. Linamar has been a star performer. Martinrea is a younger company, formed by mergers and acquisitions and built into a $3 billion revenue supplier to the major auto manufacturers in a relatively short period of time. That said, it is clear to us corporate governance needs to be improved and changes need to be made. We have made that clear to the company, as have others.

We articulated in our September report that Martinrea and certain officers were accused, by a disgruntled former executive and Board member in a court filing September 26, of misusing their position for personal gain. As we wrote in September, Martinrea has done a remarkable job of building the business over the past 14 years into a significant tier 1 supplier in the global auto parts industry. Although these kinds of accusations give us the jitters, we do not want to react too quickly, or overreact. The Board has engaged PricewaterhouseCoopers to do an in-depth investigation into the allegations. One of the outcomes will likely be a stronger Board of Directors (we have been talking to the Executive Chairman and will have input) and some changes in the executive suite.

We made a small investment in January, 2008 in a private company, **DIRTT Environmental Solutions Inc.** DIRTT (Do It Right This Time) specializes in the design and construction of office interiors using proprietary computer design technology and environmentally sustainable materials (recycled materials). DIRTT's competitive advantages are speed (reduced design and construction time) and lower cost. The company completed an IPO in November to raise $45 million dollars to fund future growth. The IPO was completed at $3.00 per share.

As we enter 2014 can we predict what the year will bring? No. We cannot and we do not try. As we have written for 20 years, in our opinion predictions are useless. However, many are addicted to them anyway. As it is the end of another year it is time for the learned pundits to trot out predictions . . . both optimistic and pessimistic. Perhaps it is human nature to try to know the unknowable . . . to predict the unpredictable . . . in the face of overwhelming empirical data to conclusively prove the exercise is futile. A good friend sent along a copy of a recent investment

letter from a very well-known and very well respected investment letter writer. Investment letter writing has become a major growth industry in the past 10 years, particularly of the doom and gloom category. This letter in particular deals with the ultimate doom that will be vested on us by the U.S. Fed's QE (Quantitative Easing) and ZIRP (Zero Interest Rate Policy) since the financial crisis and recession of 2008/2009. Below is an excerpt from the response sent to our friend, including our comments regarding the writer's predictions:

> *". . . you always send me this stuff late at night and then I have a restless sleep and bad dreams . . . I wake up agitated and ready to jot down some thoughts." I must say that I actually do enjoy reading this guy's investment letter. He does write very well.*
>
> *And I don't always disagree with what he writes. In particular from my 10 years of experience as a Central Banker (1970 – 1980 at Bank of Canada) I at least agree with his view that central banks are hopeless at forecasting.*
>
> *Also, I think we would be naïve to disagree with him when he says that the QE exercise and the 6 years of ZIRP have created enormous distortions. Where all the "letter" writers begin to lose me, is that they are terrific at alarming us; they are good at pointing out the obvious; they are great at feeding our neuroses and picking at scabs . . . but they fail to tell us that they too cannot forecast. The world has been in dark places before . . . darker than today's dark place. The outcomes have been shockingly unforecastable. Churchill won a war that letter writers of that day would write as unwinnable . . . and did it while he was drunk. We know with the benefit of hindsight how the '08/09 financial calamity came about. We know that the policies that were put in place since then have saved us temporarily. But we also know that we have now created distortions like we have not experienced before. What we do NOT know is what the world looks like even 5 years from now.*
>
> *All I can say is, let's strive to make what appears very complicated, as simple as possible. That is not a very fashionable way of doing things in today's world. Perhaps two of these simple thoughts . . . firstly, don't lend your money long term (say 5 years or more) to governments or any organization at negative real interest rates. It is never a good idea . . . EVER. But people en masse are currently doing just that. In a yield starved world, lend shorter, at positive real rates, against reasonable collateral. Secondly, buy into a VARIETY of businesses as an owner . . . think like an owner . . . businesses that you can understand . . . and in this current ZIRP, be leery of those companies that have had an enormous run up in value in the market because of ZIRP . . . banks, utilities . . . and focus on those that have been out of favour and left behind . . . energy, mines, small caps in general."*