March 31, 2014

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**1.2%**	**0.0%**	**3.2%**	**3.9%**	**7.5%**	**17.0%**	**12.5%**	**10.6%**	**11.2%**	**11.2%**
DEX Universe Bond Index	2.8%	0.8%	2.7%	5.0%	5.0%	5.0%	5.1%	5.7%	6.9%	6.8%
ML CDN High Yield	3.7%	7.8%	10.0%	8.8%	9.1%	17.7%	5.5%	4.5%		
ML USD High Yield	3.0%	7.5%	10.3%	8.7%	10.1%	18.2%	8.5%	7.4%	8.0%	7.9%
S&P/TSX Composite Index	6.1%	16.0%	10.9%	3.6%	7.5%	13.7%	8.1%	7.8%	8.6%	8.8%

Let's look back at the history of our income strategy returns. Since inception, 20 years ago, our income strategy has produced an annualized return of just over 11%. This is well above the benchmark DEX Index, an index of government and investment grade debt, and the Merrill Lynch U.S. High Yield Index. Because Deans Knight was one of the early practitioners (some would say Founder) of the Canadian High Yield debt market, our returns predate the establishment of the Merrill Lynch Canadian High Yield Index. Owning income producing securities is always less risky than owning equity in a Company given their position on the capital structure, yet our income portfolio has also produced 20 year returns that have exceeded the equity returns of the S&P/TSX Composite Index.

That said, short-term returns from time to time, underperform the benchmark. This occurred in the latter part of the 1990's/early 2000's and it has occurred again recently. When we do underperform, it is caused primarily by credit problems . . . i.e. defaults. Over the course of our 20 year history we have had 18 defaults. Unfortunately, they are a necessary part of the process of lending money. As Howard Marks of Oaktree Capital wrote quoting his partner "if you don't have any defaults, you're taking too little risk". The key is to limit your defaults over the long term but accept that there will be years where you will underperform. 2013 was one of those years for us as we had two credit problems, Mirabela Nickel and Northlands Resources. While we have outperformed the ML Canadian High Yield Index in 3 of the last 5 calendar years, our five year annualized return of 17% is slightly below the index at 17.7%. This is largely a result of our 2013 underperformance.

When we incur defaults, our job is to deal with the situation as best we can to recover as much value as possible. Our experience with defaults has varied widely. There have been cases where recovery of value has been minimal, cases where we have recovered 100% and a small number of cases where we actually made more money than our original investment. Each case is unique. In the case of Mirabela and Northlands, these issues are now behind us. We sold our entire position in Northlands

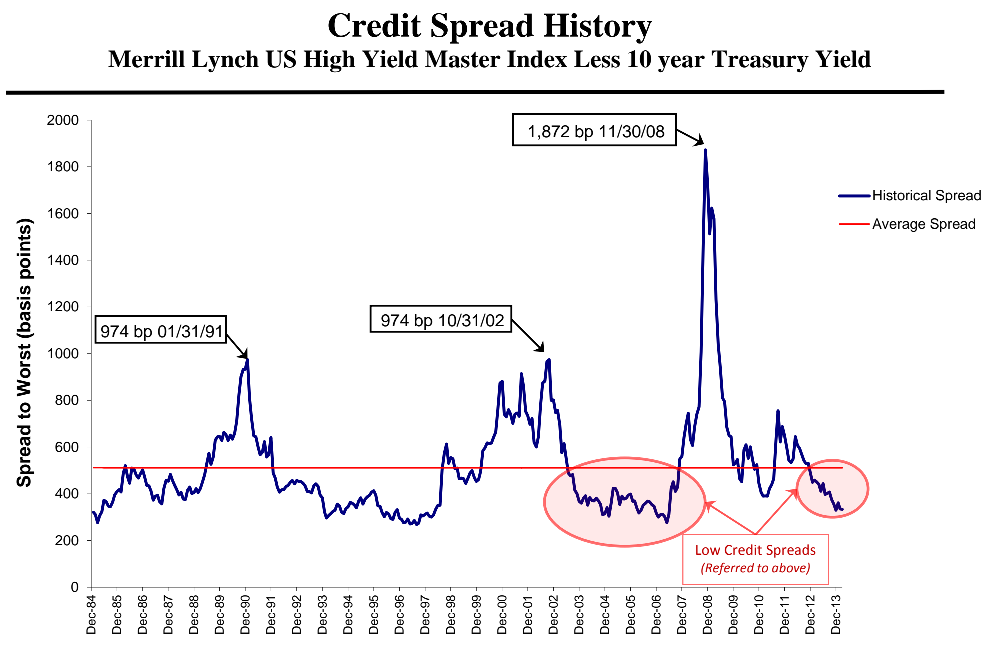
[1] Returns longer than one year are annualized gross of management fees.

last year at $29 per $100 par value and are currently pricing Mirabela bonds at $10 per $100 par value. We are a member of Mirabela's bondholder committee and are in the process of developing a plan to inject capital to restructure the business. This will give Mirabela time to wait for higher nickel prices, which are up over 20% year to date. Any recovery on Mirabela bonds will be reflected in future returns. In both cases, it highlights the importance of access to capital in the mining industry. Without it, companies struggle to survive. A painful lesson, but a lesson learned.

The key for us going forward will be to learn from our mistakes and focus on our main objective: to provide our investors with a stable stream of income. Options for investors to earn income today are scarce. The DEX Universe is currently yielding 2.6%, which isn't much higher than the average inflation rate in Canada over the last 30 years of 2.5%. Lending money long term to governments or any organization at zero to negative real interest rates is never a good idea, but people en masse are currently doing just that. It makes more sense to assume credit risk, lend shorter at positive real rates, against reasonable collateral.

Although we are predominantly invested in high yield bonds, 61% of the portfolio, we also invest in private debt financings and dividend paying equities. Our exposure to private debt and dividend paying equity typically fluctuates depending on opportunities in the high yield market. This flexibility is one of the main reasons for our outperformance of the high yield indices since inception.

As the graph below depicts, we are in a period similar to the mid 2000's. Credits spreads (the difference between high yield and 10 year US treasury yields) are below the long term average and interest rates are at 50 year lows, with few corporate bonds representing attractive investment opportunities today. As a result, we are actively looking for private debt financings and our investment in dividend paying equities has increased over the past 12 months.



Source: Bank of America Merrill Lynch

It is important for investors to understand how, in the mid 2000's, we came to include investments outside of traditional high yield debt into the fund. With historically low credit spreads and interest rates, it became difficult to achieve our objective of maximizing income investing solely in high yield debt. Rather than accept the new reality, we began to think more creatively about generating income for our clients.

One opportunity, which we had already identified in April 2000 when we lent money to LionOre Mining, was to use our expertise in debt markets to structure private debt financings. Inefficiencies in the banking system present obstacles to businesses looking for an alternative to issuing equity. Private debt can fill this void, but it requires a large network to source the right opportunities and a significant amount of lending experience to properly structure each deal. These financings offer investors security, are typically short term, pay a higher coupon and, most importantly, provide capital growth through "equity kickers" in the form of warrants, convertible debt, or ongoing royalties. Including our original loan to LionOre, we have participated in 35 private debt financings, providing over $325 million in capital. We target a return on investment between 12 – 15%; however, our average Internal Rate of Return has been approximately 18.5%.

Our approach to identifying the right opportunities is not unlike equity investing. We are looking for value in places that other investors or lenders have not yet realized. We look for businesses with a sustainable competitive advantage; reliable cash flows/tangible assets; strong balance sheets; and hidden value making our equity kickers more attractive. We invest with management teams we can trust who are financially committed to the company, as ultimately we are creating a partnership where increasing shareholder value enhances the return to debt investors. Security is vital and our preference is to be at the top of the capital structure; however, we have negotiated secured facilities subordinated to a limited bank facility. We currently have 12% invested in 5 private debt investments. While the low interest rate environment helped identify the opportunity, these financings have proven to be attractive regardless of opportunities in the high yield market, and will continue to be a key component of the Fund going forward.

In addition to private debt, the growth of the income trust market in the mid 2000's provided another opportunity which we wrote extensively on at the time. We cautioned investors, who were buying trust units focusing solely on yield, that unlike interest payments, distributions were not guaranteed. We focused on analyzing the underlying business and how much cash flow was being generated rather than just yield. Our focus on the business allowed us to escape the federal government's decision in 2006 to eliminate the income trust structure relatively unscathed. We identified a handful of opportunities and our weight in income trusts increased from zero in 2002 to 40% in early 2007. We gradually reduced our weight when the credit markets became more attractive as spreads widened to historical highs. In today's market, this opportunity comes in the form of high dividend paying companies.

Contrary to private debt, our exposure to dividend paying equity/income trusts fluctuates based on opportunities in the high yield market. With fewer corporate bonds representing attractive investment opportunities our investment in dividend paying equities has gradually increased over the past 12 months and currently sits at 20%. I have highlighted a number of our larger dividend paying equity investments and why we own them.

Vicwest Inc. is a leader in grain storage/handling systems and building construction products. We have owned shares in Vicwest since it was restructured in 2003. The Company has provided an attractive yield to investors paying cumulative dividends/distributions since July 2005 of over $12 per share. Vicwest operates in two cyclical businesses which historically led to short term volatility in the share price. The Company was faced with a number of headwinds and shares traded down 25% from year end. While we were disappointed in management's ability to manage these issues, we believe strong demand in agriculture storage along with an eventual improvement in North American construction should lead to an improved valuation in the long term.

Whitecap Resources Inc. is the fourth energy company Grant Fagerheim has built in his successful career. When Whitecap started 5 years ago, Deans Knight was a founding investor on behalf of our clients. The DK Income Fund owns shares from the conversion of a private debt financing that we designed and funded alongside the Company's initial equity raise. The company now produces more than 30,000 boepd and the stock is valued at more than 4x our exercise price of $2.88 per share. In addition, in 2013, Whitecap began paying a dividend, which has a current yield of 5.5%.

We have owned **Contrans Group Inc**. for almost 7 years. Contrans is Canada's third largest trucking company, based in Woodstock, Ontario. Contrans was founded in 1985 and built by Stan Dunford over the past 29 years. Stan owns 15% of the company. He runs it like an owner and the trucker that he is. Trucking is a tough business and you want to partner with tough guys like Stan. Stan has provided us with great shareholder value and he pays us a 3.8% dividend at today's share price. The industry is cyclical, but it does grow with the economy over time. With Stan at the helm, we expect Contrans to grow at a better clip than the industry.

Bird Construction Inc. is our window on commercial construction, primarily in Western Canada. Again, well-managed, Bird is 13% owned by the management team and employees of the company. Another cyclical business but again, better managed than most and with a heavy emphasis on the stronger, faster growing western part of Canada. Bird is paying a dividend yield of 5.5% to investors and we expect capital appreciation in the share price as the outlook continues to improve.