June 30, 2006

DK INCOME FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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Quarterly Report
June 30, 2006

Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**0.8%**	**8.4%**	**18.1%**	**24.5%**	**23.5%**	**21.0%**	**18.4%**	**11.6%**	**12.0%**
SCM Universe Bond Index	-1.0%	-1.5%	-0.7%	5.5%	4.7%	6.3%	6.9%	7.3%	7.6%
ML CDN High Yield (hedged)	-1.7%	0.8%	-1.6%	3.5%	4.9%	9.3%	5.3%		
ML USD High Yield (unhedged)	0.2%	3.1%	4.7%	7.6%	8.5%	11.8%	8.3%	6.6%	7.2%

The objective of the DK Income Fund is to provide our investors with the maximum amount of income while preserving capital value. Five years ago, 100% of the Fund was invested in corporate bonds. Interest rates were higher then and, more importantly, corporate bond spreads were over double what they are today. Five years ago, the DK Income Fund had a 12% yield to maturity and we felt the Fund was compensated for the risk of investing in bonds. Over the next few years, the Fund benefited as interest rates fell and corporate bond spreads narrowed, (i.e. bond prices rose).

Interest rates are still near 50 year lows. As a consequence, bonds are not as attractive as they were five years ago and only 45% of the portfolio is currently invested in bonds. Moreover, corporate borrowers have taken advantage of low interest rates by exercising the option to call their outstanding debt. Normally the call price acts as a deterrent because companies must call outstanding bonds at prices well above $100. However, companies are willing to pay the premium when it allows them to replace high coupon debt with low cost longer term financing. In fact, in the past 18 months an astounding 70% of our bonds have been called. Although, the DK Income Fund has earned a significant premium over cost, we have been challenged to replace these attractive coupon payments with new bond investments. In fact, we have added only three new bond holdings to the portfolio since December 2004.

When we could no longer achieve our objective of maximizing income investing solely in high yield debt we began to think more creatively about generating income for our clients. The attached speech, delivered by Doug Knight in Montreal in May, discusses the attractive income opportunities we are finding including income trusts and short-term private debt financings.

[1] Returns longer than one year are annualized.

We are concerned about inflation. We do not believe the recent moderate increases in the Consumer Price Index as yet reflects underlying upward pressure on prices. The U.S. Federal Reserve obviously shares our view on inflation as Fed fund rates have quadrupled from 1% to 4¾% in the past two years in an attempt to suppress inflation. We have spoken at length about rising commodity prices in our equity quarterly reports. The substantial rise in price of oil, natural gas, nickel, copper and steel will increase the cost of many of the products we consume every day. For example, nearly everything we use in our daily lives is either made from oil, by machinery dependent on oil, and/or transported using oil. The attached table illustrates just how pervasive the impact of rising oil prices can ultimately be.

As we said earlier, we added three new bond holdings in the past year and a half. The biggest such position is **Jean Coutu Group** 8.5% August 1, 2014. Our holding has an average cost of $93.61, for a 9.6% yield, with the majority of our holding purchased in 2006 as the bond price weakened. Jean Coutu operates drugstores in the Eastern parts of Canada and the United States. Jean Coutu purchased 1,549 Eckerd drugstores from JC Penny in April 2004. JC Penny had devalued the Eckerd brand and the integration of Jean Coutu and Eckerd drugstores has been a difficult one. As a result, the bond price suffered and the Company was forced to amend the covenants on its senior secured credit facility. The cost of this amendment increased the Company's annual interest payment by a modest $2.7 million to $204 million. The amendment gives Jean Coutu the flexibility it needs to improve the performance of the Eckerd drugstores. The Company is making progress growing revenues and generating free cash flow after interest and CAPEX expenditures. Although we are not expecting strong growth in 2006, we are well compensated by the 9.6% yield.

We have continued to add to our holdings in income trusts as the portfolio's weight in income trusts has doubled from 20% at year-end to 40%. Although a portion of this growth has come from capital appreciation, the majority of the increase was the result of adding seven new income trusts to the portfolio and increasing our weight in two others.

For example, we purchased **Data Group Income Fund** at an average cost of $9.95, providing an annual distribution of 11.6%. Data Group is a National full service provider of quality printed products and document management services. Data Group operates in a stable industry with reliable cash flows. Data Group has a modest payout ratio of 85% and the ability to grow the business internally with their substantial excess capacity. Data Group is currently trading below our cost and we will look for opportunities to add to our position.

We also purchased **First National Financial Income Fund** on its IPO at $10, providing an annual distribution of 9.5%. First National is the largest non-bank originator, underwriter and administer of mortgages. Their customers include Canada's largest Banks, Life Insurance, Trust, Pension and Mutual Fund Companies. The Company sources its single-family residential mortgages almost exclusively through independent mortgage brokers and its multi-unit residential and commercial mortgages in-house. Cash flows are driven directly by the value of its mortgages under administration, currently $20 billion. We feel the Company has the ability to continue to grow cash flows as mortgage brokers share of the market, currently 27%, continues to grow. By comparison, mortgage brokers in the U.S. handle over two-thirds of all residential mortgages.

We tripled our position in **Avenir Diversified Income Fund** during 2006. As we mentioned in our previous quarterly report, Avenir had three main divisions: oil & gas operations, energy services and financial services. On April 5th, Avenir announced they would spin out to unitholders a new oilfield services trust comprised of its energy services division, and on May 30th **Essential Energy Services Trust** began trading. The combined entity increased distributions at the time of the spinout by 4%, we believe both companies have the ability to grow cash flows to further increase distributions in the future.

We should note that although the extra income generated from income trusts has helped the portfolio, distributions are not guaranteed. Investors are fleeing low interest rate deposits and buying trust units in search of higher income. Many investors paid high valuations as their decision was based solely on yield. As companies over-promised and under-produced, investors wound up paying for cash flows that were not sustainable. We look for companies, like Data Group, First National and Avenir/Essential, that we can purchase at a reasonable price with the ability to increase sustainable cash flows, and ultimately distributions.

In an effort to provide our clients with steady and reasonable income we have expanded our focus to include bridge loans. In order to obtain deal flow, we informed all the companies we were invested in that we provide private debt financing on short notice and used our network to look for deals. As a result, we have participated in 13 private debt financings, 9 of which were to companies we were already invested in, lending over $75 million CAD since 2000, on behalf of our clients. Private debt financings typically have a short term to maturity and high coupon payments. In addition, over half the loans provided by Deans Knight have provided capital growth through “equity kickers” in the form of warrants or convertible debt.

Although the portfolio has not participated in any new private debt financings in 2006, we continue to benefit from past transactions. For example, we agreed to extend the maturity on our fully secured holding of **Imperial Metals 8% June 30, 2006**. Imperial Metals is a copper producer located in B.C. and a publicly traded company listed on the TSX. The Company has timing issues with some of their commodity hedges and wanted to extend the maturity six months. In exchange for us agreeing to the extension, we negotiated an increase in the coupon to 10%. In addition, as a sweetener for providing the company with a short term facility, the DK Income Fund received 13.35 warrants per $100 loan to purchase shares at $6.00. In February, we exercised the warrants and sold the shares at $6.98 meaning the warrants added over $13 of value per $100.

Conclusion

We employ our strategy with the goal of protecting capital while providing a high level of income. We do not think 10-year Government of Canada bond yields at 5.1% compensate investors fairly for the potential risks. A lot can happen in 10-years and we need to be flexible to invest in a variety of income generating investments.

Table 1

Products Made from Oil[2]

Adhesives	Cream Denture Adhesives	Lip Balm	Saccharine
Air-Conditioners	Deodorant	Lipstick	Seals
Ammonia	Detergents	Loudspeakers	Shoe Polish
Anti-Histamines	Dice	Mascara	Shoes
Antiseptics	Dishwashing Liquid	Medicines	Shower Curtains
Artificial Turn	Dryers	Mops	Solvents
Asphalt	Electric Blankets	Motor Oil	Spectacles
Aspirin	Electrician's Tape	Motorcycle Helmets	Stereos
Balloons	Non-Natural Fabrics	Movie Film	Sweaters
Bandages	Fertilizers	Nail Polish	Table Tennis Balls
Boats	Fishing Lures	Oil Filters	Tape Recorders
Bottles	Fishing Rods	Paddles	Telephones
Bras	Floor Wax	Paint Brushes	Tennis Rackets
Bubblegum	Footballs	Paints	Thermos
Butane	Glycerin	Parachutes	Tires
Cameras	Golf Balls	Paraffin	TV Cabinets
Candles	Guitar Strings	Pens	Computer Ribbons
Car Batteries	Hair Coloring	Perfumes	Umbrellas
Car Bodies	Hearing Aids	Petroleum Jelly	Upholstery
Carpet	Heart Valves	Plastic Furniture	Vaporizers
Cassette Tapes	Heating Oil	Plastic Wrap	Vitamin Capsules
Caulking	House Paint	Plastics	Volley Balls
CDs	Ice Chests	Refrigerators	Water Pipes
Chewing Gum	Ink	Roller-Skate Wheels	Water Skis
Combs/Brushes	Insect Repellent	Roofing Paper	Wax
Computers	Insulation	Rubber Bands	Wax Paper
Contact Lenses	Jet Fuel	Rubber Boots	etc…
Cortisone	Life Jackets	Rubber Cement	etc…
Crayons	Linoleum	Running Shoes	etc…

[2] Obtained from "The Energy Crisis Has Arrived" presentation given as part of the Energy Conversation Series to the Department of Defense in Alexandria, VA on June 20, 2006 by Matthew R. Simmons, Chairman of Simmons & Company International.

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

Presentation at Club X Family Office Investment Conference

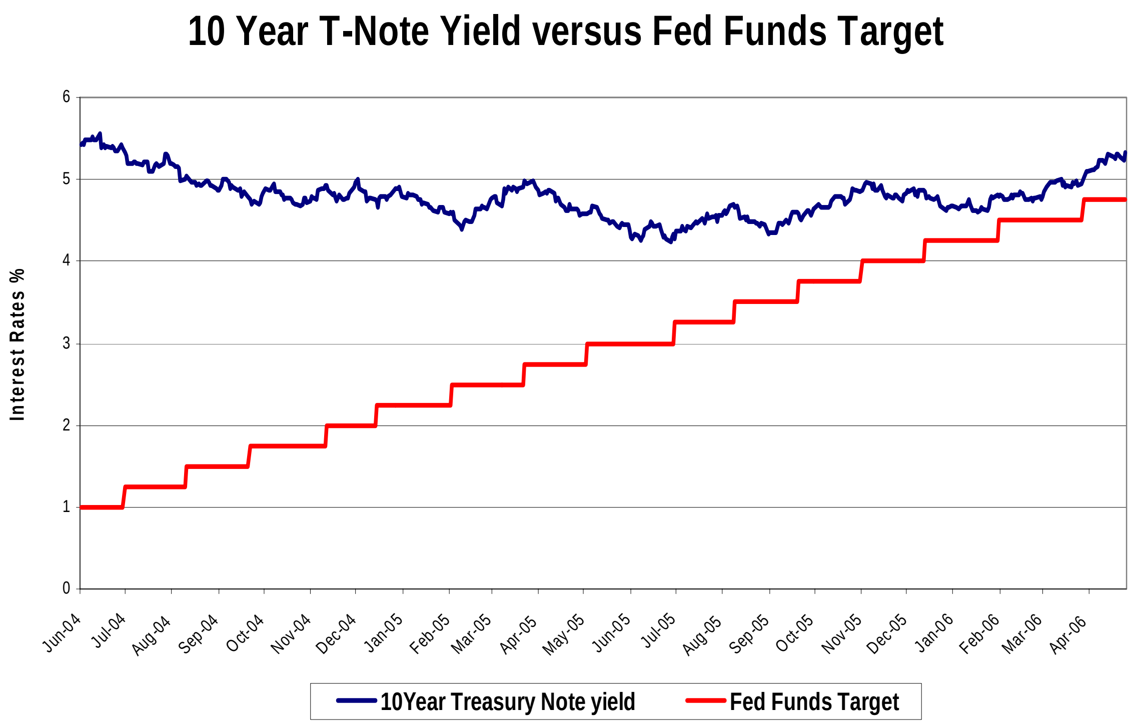
Montreal May 10, 2006

Are there attractive Income opportunities left? YES.

Doug Knight

Our panel has been asked to comment on income strategies. Even though bond yields are close to 50 year lows and corporate credit spreads are tight, we are still finding attractive income opportunities. We have a bottom up investment approach and we have been able to find income opportunities in private debt investments, bridge loans, certain income trusts, and out of favour special situations. Portfolio holdings in these areas have driven most of the returns for our income clients in recent years.

U.S. bond yields remain low despite a quadrupling in U.S. short rates, shown in the chart below. The fact is that 10-year U.S. bond yields are no higher today than 2 years ago even though the Federal Reserve has increased the Fed funds rate steadily from 1% to 4-¾%. We don't speculate on the direction of bond yields but it is obvious bond yields have no room to decline given the floor that high short term rates create. The result is, floating rate and shorter term debt is more attractive than long term debt.



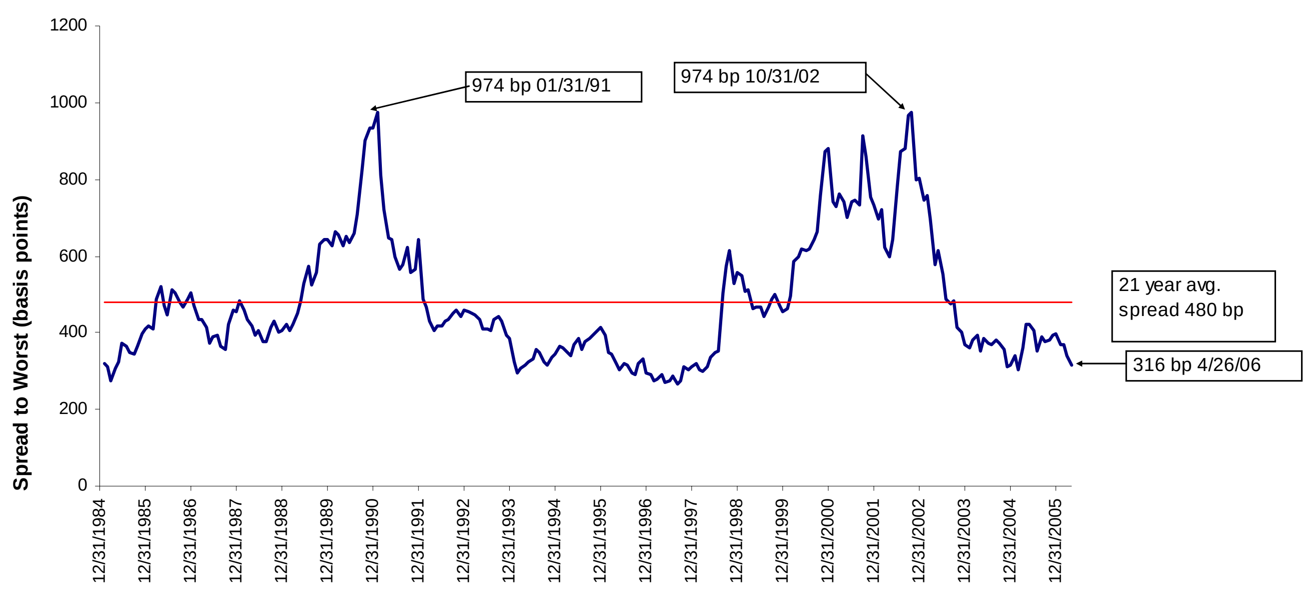
While U.S. interest rates are low, they are still among the highest in the world. Looking at 10-year bond yields in the G8 countries plus Europe (a total of 19 countries) only one country has higher bond yields than the U.S. Normally, a country with a weak currency, like the U.S., is forced to increase interest rates in order to attract support for the exchange rate from foreign lenders. The U.S. dollar is different, as the world's reserve currency, the U.S. does not have to be concerned about the level of the U.S. dollar. The opposite is true; a weak U.S. dollar is forcing other countries to maintain lower interest rates. In Canada, for example, the strong Canadian dollar means the Bank of Canada is pretty well forced to keep interest rate levels below the U.S. in order to stop the Canadian dollar from appreciating even further. Through this mechanism current low rates in the U.S. are being translated throughout the world to even lower interest rates in most other countries, contributing to even greater global liquidity. The owners of this growing global pool of investment assets are pushing up prices for a wide variety of risky assets, in search of returns. Higher prices mean potential returns are declining and risks are rising.

An example of this is credit spreads: in every credit rating category spreads are once again at cycle lows. Shown below are credit spreads for U.S. high yield bonds, which demonstrate the most dramatic cyclical changes. Given the strong economy and low interest rates we do not see credit spreads changing much in the near term; remaining low, similar to the period 1992 through 1998. However, two points of caution:

1. In our opinion credit spreads are not attractive and may be too low, on average, to compensate for real credit risk.
2. Credit spreads will move to higher levels at some point, we just don't know when.

Credit Spread History

Merrill Lynch High Yield Master Index Less 10 year Treasury Yield



Source: Merrill Lynch high yield

Despite this tepid outlook we are finding income opportunities. For example in Private Debt we negotiated an 18-month Promissory Note with Anvil Mining last year. We know the company well because we have owned shares in Anvil for the past year and a half in our equity portfolios. The Note paid a 2% commitment fee, a coupon of 8% and we got an additional incentive of 10 warrants per $100 Note to buy shares at $6.25. In March Anvil raised $150 million through an equity offering using a portion to repay our note. Our return to date, including the "equity kicker" is over 20%.

We also provided a fully secured private loan to GBS Gold International Inc., another company where we know management well. The loan allowed the company to complete a transaction that eventually lead to an equity IPO. We were paid interest of 8% and a large commitment fee on the amount drawn. In February, GBS raised $67 million through an equity offering with a portion of the proceeds used to repay our note. Together with early redemption fees, this Note provided a total return of over 13% in 4 months.

A special situation we purchased is **Jean Coutu Group** 8.5% bonds due August 1, 2014 at an average cost of $92.32 for a 9.9% yield. Jean Coutu's operations consist of 322 franchised drugstores in Eastern Canada and 1,853 drugstores operating under the Brooks and Eckerd banners in the Eastern United States. The price on Jean Coutu 8.5% subordinated bonds has fallen 10% in the last 7 months as delays in the integration of Eckerd drugstores forced the Company to amend the covenants on its senior secured credit facility. The cost of this amendment will increase the Company's annual interest payment by only $2.7 million to $204 million, which is a modest price to pay for the increased flexibility to improve the performance of the Eckerd drugstores. Jean Coutu generated $515 million in EBITDA in the last twelve months. After capital expenditures and interest paid, the Company is generating significant free cash flow to reduce the $2.48 billion in debt outstanding. Although we are not expecting strong growth in 2006, we feel investors in Jean Coutu 8.5% subordinated bonds are well compensated by the 9.9% yield.

As an alternative to corporate bonds, we have been increasing our investment in income trusts. For example, our largest holding is **Vicwest Income Fund** which has increased in price by 25% this year. Vicwest has no debt (unusual for a trust) and currently pays a distribution of $1.44 per annum, implying an annual distribution yield of 8.5%. We forecast Vicwest will generate higher distributable cash in 2006 of roughly $2.30 per unit. We expect Vicwest to pay out 80% of cash generated and we believe this will provide a distribution yield of 11% for investors in 2006.

We should insert a note of caution regarding income trusts. Investors are fleeing low interest rate deposits and buying trust units in order to earn higher income. Unlike interest payments, distributions from a trust are not guaranteed. During the past three years, there have been 83 new business trusts issued in Canada. Half of these business trusts are trading below issue price today and 11 have either reduced or suspended distributions all together. Ultimately, trust distributions can be no greater than the cash flow generated by the underlying business. We believe the specific focus on yield by investors encourages some trust management teams to over-promise, particularly at the time of the initial public offering, which leads to problems. Investors must focus on analyzing the underlying business and how much cash flow is being generated rather than just yield.

The point is, in the current environment we are still finding a small number of attractive opportunities. In our view, the worst way to participate in income markets today would be to own a diversified index or basket of over-priced credits or income trusts in an attempt to earn higher yield. The only way to win is to be selective focusing on the best priced income opportunities. With interest rates at 50-year lows and tight credit spreads, low returns offered by many income investments simply do not justify taking the risk in our opinion.

We wonder how any investor could think that a 5% yield on US Treasury bonds due in 30 years represents an attractive long term investment?

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