

June 30, 2007

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

**Quarterly Report
June 30, 2007**

Rates of Return¹

	<u>3 Mths</u>	<u>YTD</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>10 Yrs</u>	<u>Since June '93</u>
DK Income Fund	9.1%	18.5%	19.2%	18.6%	22.7%	21.9%	20.7%	11.5%	12.5%
SCM Universe Bond Index	-1.7%	-0.8%	4.8%	2.0%	5.2%	4.7%	6.0%	6.4%	7.4%
ML CDN High Yield	-0.5%	3.3%	12.0%	4.9%	6.2%	6.7%	9.8%		
ML USD High Yield	0.3%	3.1%	11.7%	8.2%	9.0%	9.3%	11.8%	6.3%	7.5%

The DK Income Fund had a return of 9.1% during the quarter with the takeovers of **LionOre Mining Intl.** and **KCP Income Fund** providing the majority of the capital appreciation.

We owned LionOre shares as the result of our investment in two private debt financings in 2000 and 2001. We were the lead investor and negotiated the terms on both financings which provided expansion capital when it was unwise for LionOre to issue equity. The first of these debt financings was a convertible and the second provided us with warrants. As a result, we acquired shares at an average cost of \$2.33. The annualized return on our 7 year investment in LionOre was over 40%.

LionOre became the most recent target in the wave of consolidation in the nickel industry amidst soaring global demand and a run up in nickel prices. On March 26th, Swiss-based Xstrata initiated a “friendly” cash bid of \$18.50 per share. The deal was termed “friendly” because it had the support of management, the directors, and a small group of shareholders, including ourselves. The group agreed to lock up their shares with Xstrata, but had the right to withdraw from the lock up if another bid was received that the LionOre Board of Directors deemed to be superior.

Subsequent to this initial bid, nickel prices continued to spike higher, eventually reaching \$22 per pound, causing LionOre’s cash flow to balloon. Bear in mind, we were invested in LionOre when nickel was trading as low as \$2 per pound in 2000.

On May 3rd Norilsk entered the picture with a cash bid of \$21.50 per share. Russian-based Norilsk is the world’s largest nickel producer. Xstrata countered on May 15th with \$25, and Norilsk came back at \$27.50 on May 23rd. To put the valuation in perspective here, just the increase in the market value of LionOre between the time of the initial Xstrata bid and the final

¹ Returns longer than one year are annualized.

Norilsk bid, a mere 58 days, was 1.5 times greater than LionOre's entire market cap one year ago.

The lock up proved to be a potent value creating strategy. It drew the first bid to the table and created the auction that we feel resulted in a very attractive price for the Company. The \$27.50 Norilsk bid was deemed superior to Xstrata's bid and our shares were released from the lock up.

Rather than wait and tender our shares to the Norilsk bid, we elected to sell in the market at a small discount, thereby avoiding the potential risk, albeit small in our view, of an unforeseen development that could have derailed the Norilsk bid. By the end of June, the LionOre stock had been turned into cash, which represented almost 10% of the portfolio. As a footnote, during the month of June the price of nickel declined by 25%.

As mentioned in our March quarterly report, **KCP Income Fund** received a \$10 cash bid from Caxton-Iseman Capital. Following the Government's decision to impose income taxes on trusts, KCP's units fell 25% allowing us to purchase units at an average cost of \$7.58. KCP is one of North America's largest and most diverse contract manufacturers of consumer products. KCP had experienced a very difficult operating environment in the last few years; however, we felt KCP was attractively valued, had a strong position in its industry and the potential for growing cash flows. In November, KCP announced they would look at strategic alternatives, including a possible sale. The outcome of this search was a \$10 cash bid for KCP at a 32% premium to our cost.

In addition, our largest bond holding, **Jean Coutu Group 8.5%**, was called at \$108. Jean Coutu operates drugstores in the Eastern parts of Canada and the United States. In 2004, Jean Coutu purchased 1,549 Eckerd drugstores from JC Penny. JC Penny had devalued the Eckerd brand and the integration of Jean Coutu and Eckerd drugstores had been a difficult one. As a result, the bond price suffered and we were able to purchase bonds in the first half of 2006 at an average cost of \$93.50, a yield of 9.5%. We felt the Company was making progress growing revenues and generating free cash flow after interest and CAPEX expenditures. We were not expecting a quick solution; however, in August 2006, Jean Coutu announced the sale of their U.S. pharmacy operations to Rite Aid and our bonds were called at \$108 during the second quarter. Our annualized return on our investment in Jean Coutu was approximately 20%.

Two additional investments announced takeovers with both transactions closing in the third quarter. Earlier this year we began purchasing **CanWest MediaWorks Income Fund**, the largest publisher of newspapers in Canada, acquiring a 4% weight at an average cost of \$8.49. CanWest units had an attractive yield of 11% and we felt **CanWest Global Communications**, who owned 74% of the Fund, would eventually purchase the 26% interest held by the public at a premium to our cost. On May 25th, sooner than we expected, CanWest Global announced their intention to acquire the remaining 26% interest for \$9.00 in cash and privatize it. The transaction will close in mid July.

In August 2006, we purchased a participation in a Bank Term Loan of **Paramount Resources** with a coupon of 10%. Paramount develops and produces oil & gas property, and held a 36% interest in North American Oil Sands Corporation (“NAOSC”) against which the \$150 million Loan Facility was secured. Paramount sold their interest in NAOSC for \$682 million and, as per the credit agreement the Loan was redeemed on July 3rd at \$102. The Loan was outstanding for 10 months with an annualized return on investment of over 12%.

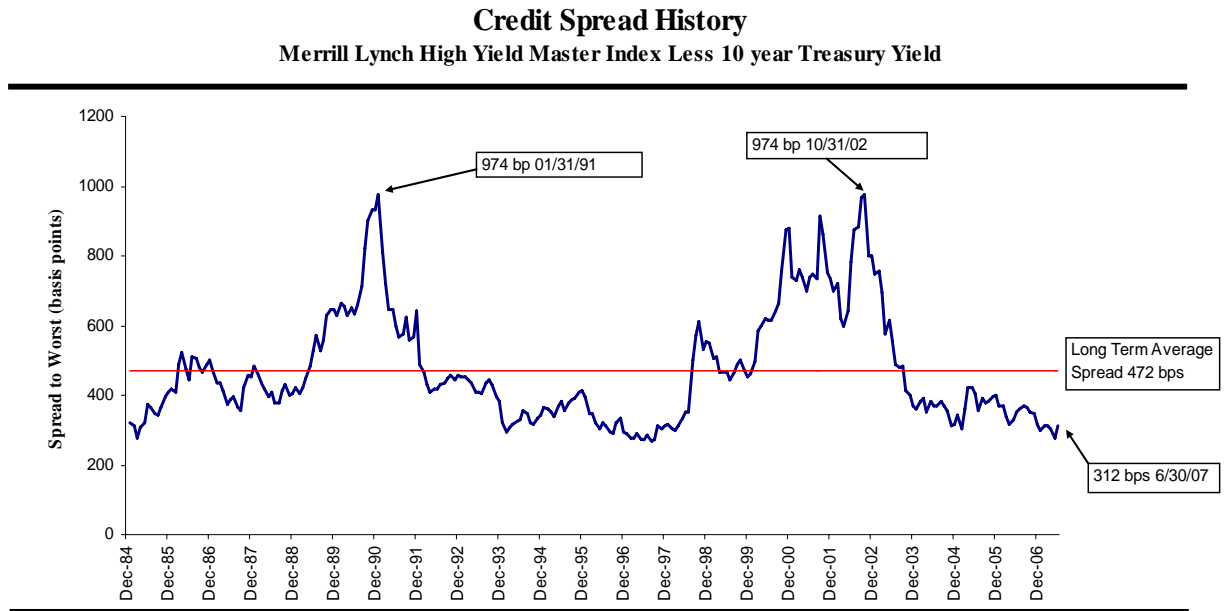
As a result of the recent takeovers, the portfolio currently has 22% invested in treasury bills. This cash is now available for other opportunities that may emerge.

We are seeing attractive investment opportunities in energy service trusts. We stated our intention to increase our position in energy services trusts in our March quarterly report. With the reduction in capital spending by major producers, the energy services sector is experiencing severe downward pressure on utilization and pricing. As a result, cash flows in 2007 will be significantly lower than the record levels of 2006. The time to add to services trusts is during a down cycle when valuations are below book and not a reflection of a full cycle’s earnings. When cash flows improve along with energy prices so to will valuations.

We are adding to our position in **Peak Energy Services** which is trading at a 60% discount to its high of \$13.50 in May 2006. The majority of Peak’s revenue is derived from rental equipment for drilling services. The rental equipment business is characterized by high operating leverage meaning when utilization is at lower levels, as it is today, cash flows tend to be understated. Conversely, cash flows are augmented when utilization is high as it was in 2005 and the early part of 2006. In our opinion, Peak’s unit price is trading off of depressed near-term cash flows and does not reflect Peak’s ability to generate cash flows long term. Peak has an experienced management team with the ability to weather downturns through cost reduction and emerge as a stronger company. Peak units are currently trading at book value, offer a yield of 14% and stand to benefit as capital spending increases and utilization improves. We will continue to add to our position in Peak over the summer.

In addition to Peak, we bought **Phoenix Technology Income Fund** during the quarter. Phoenix provides horizontal and directional drilling services and technology in Canada (15% of the market) and an expanding presence in the U.S (2% of the market). Horizontal and directional drilling has been steadily increasing since 2003 as producers are finding horizontal wells can be more productive than a conventional vertical well, depending on the reservoir type. Phoenix has an impressive management team and board with a significant equity stake in the Company. The Company has a sustainable distribution, paying out only 80% of net earnings, and no debt. The Company is focused on growing organically, expanding its fleet with excess cash flows and increasing market share in the U.S.

As we have written repeatedly over the past 4 years, high yield corporate bonds are not attractive investments at this time. Interest rates are too low and, as the graph below depicts, spreads between government and corporate bonds are too narrow.



Source: Merrill Lynch high yield

In the December report we expressed our opposition to the government's announcement to begin taxing income trusts in 2011. An unforeseen and unintended consequence of this legislation has been a wave of takeovers of the trusts following the decline in valuations in the past 6 months. Since the announcement a total of 26 income trusts, representing a total value of \$8 billion, have been taken over. These transactions will result in job losses and reduced tax revenue to the government. Furthermore, 50% of these transactions were done by foreign groups, resulting in potential further tax leakage.

BCE's potential conversion to a trust last fall was one of the major factors in the government's decision to tax trusts citing losses in tax revenue and a lack of reinvestment of capital. On July 2nd, Ontario Teachers, along with two U.S. based private equity funds, successfully bid to take BCE private financed largely with debt. Since interest is tax deductible, BCE will pay little to no tax and Ottawa stands to lose more than \$1 billion in annual tax revenue. In addition, the large interest payments will restrict the amount of capital BCE can invest back in to the Company. BCE as a private company is worse for Canada than BCE would have been as a trust.

None of this should have happened. In our view the government was not losing tax dollars to the trust structure. The trust structure gave these businesses a relative competitive advantage, made them stronger, and it resulted in larger personal income tax revenues to the government. Rather than imposing a tax on the trust, a better course of action would have been to stop meddling, allow more corporations to convert to trusts, or even better, eliminate corporate income taxes entirely, which are a punitive and unnecessary form of double taxation of individual Canadians.