

June 30, 2008

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

**Quarterly Report
June 30, 2008**

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	7.9%	10.9%	8.3%	13.6%	15.1%	18.9%	19.1%	11.2%	12.2%
SCM Universe Bond Index	-0.7%	2.2%	6.8%	5.8%	3.6%	5.6%	5.2%	6.0%	7.4%
ML CDN High Yield	2.7%	-2.5%	-4.2%	3.6%	1.8%	3.5%	4.4%	2.6%	
ML USD High Yield	1.8%	-1.3%	-2.1%	4.6%	4.6%	6.1%	6.9%	4.9%	6.8%

Our main objective is to ensure the income stream is high enough for the risk being taken. Over the past 5 years, we have had success generating income despite being in a low interest rate environment. In order to maintain our income stream to our clients, we shifted focus away from high yield bonds concentrating on investing in bridge/mezzanine financings and Income Trusts. This approach has allowed us to meet our income objective as well as grow our clients' capital.

The table below illustrates two points. First, how much income a \$1,000 investment, made on December 31, 2003 would have generated, to June 30, 2008. Second, how much the investment would be worth today in the DK Income Fund vs. various benchmarks, assuming income is paid out:

	<u>Income Paid</u>	<u>Value of \$1,000 Investment Today</u>
DK Income Fund	\$486.67	\$1,451.38
ML CDN High Yield Index	\$326.87	\$814.05
ML USD High Yield Index	\$353.41	\$896.68
ML CDN Corporate Index	\$240.84	\$961.37
ML CDN Gov't Index	\$223.25	\$1,029.37
S&P Income Trust Index	\$490.54	\$1,433.17

Going forward, we feel our strategy enables us to earn a high level of income, in excess of any other income producing investments, without taking on an unreasonable amount of risk. With 5-year Canadian government bonds at 3.5% and Canadian investment grade bonds averaging a 5.5% yield, investors are still not being compensated for the risk. Our income strategy

¹ Returns longer than one year are annualized.

investing in a concentrated portfolio of high yield bonds, bridge/mezzanine financings and Income Trusts currently yields roughly 10%.

The high yield bond market has seen a dramatic correction since the “Credit Crunch” began last summer with prices down on average 10% since June 30, 2007. Since we had shifted our focus to bridge/mezzanine financings and Income Trusts, only 22% of the portfolio was invested in high yield bonds shielding us from the full impact of the credit crunch. With the price correction, there is now an opportunity to invest in high yield debt at double digit yields.

In 2008, we added to our position in **Cott Beverages USA** 8% bonds due December 15, 2011 at an average cost of \$88.50 for a yield of 12%. Cott is North America’s dominant manufacturer of private label soft drinks with a very strong franchise in North America that has been built over the past 20 years. Although Cott’s margins have been shrinking, we are comfortable owning the bonds as we feel the breakup value is more than the \$400 million of debt on the balance sheet.

The current credit environment continues to provide us with opportunities to invest in short term private debt financings. During the quarter, the DK Income Fund lent \$1.5 million of a \$3 million secured promissory note to **North American Tungsten**. The Company has two assets in the Northwest Territories: the Cantung mine currently producing 4% of world’s Tungsten and the Mactung deposit awaiting feasibility. With 85% of the world’s Tungsten produced in China, North American Tungsten owns a strategic asset currently producing 33% of the world’s production outside of China. In addition, the Company’s Mactung deposit is the largest undeveloped tungsten resource in the world with the potential to produce twice the annual amount of Tungsten as Cantung.

North American Tungsten required a bridge to complete its feasibility study on its Mactung deposit in advance of a \$19.4 million equity financing from a branch of the Chinese government. The Note matures in one year, has a 10% coupon and 100 warrants per \$1,000 of debt to buy shares at \$1.30. The Company has a market cap of \$130 million with only our debt outstanding, which is secured by all the assets of the Company.

We mentioned in our last quarterly report, with yields on high yield debt rising, income trusts in general are becoming less attractive investments. That said there are still some opportunities paying attractive yields and trading at reasonable valuations. For example, we purchased **Daylight Energy Trust** during the quarter at a yield of 11%. Using \$9 gas and \$105 oil, we purchased Daylight at 3.7 times cash flow, well below the industry average of 6.2 times. In addition, Daylight has a conservative 40% payout ratio with excess cash flow to either fuel growth or increase distributions to further add value to unit holders.

On June 18, 2008 we took the decision to split the units of the DK Income Fund. In exchange for each unit held before the split, an investor subsequently received 100 units. The value of each new unit became 1/100th of the old units (i.e. \$7.3052 post-split vs. \$730.52 pre-split). The Canadian Income Tax act requires that a pooled fund has a minimum of 150 unitholders before the fund is eligible to invest in debt instruments of private companies. Why? . . . We do

not know. The Income Tax Act also states that above a \$100 unit price the minimum investment is 10 units and below a \$10 unit price the minimum investment is 100 units. In order for the Fund to be able to participate in an attractive upcoming private debt financing, we wanted to be able to quickly increase the number of unitholders from 70 to over 150. Prior to the split, the minimum investment was approximately \$7,300. At the post split unit price the minimum investment is approximately \$730. This lower unit value allowed us to quickly increase the number of unitholders, so we are in a position to participate in the attractive private debt financing.