September 30, 2009

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

Quarterly Report
September 30, 2009

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	**16.8%**	**48.1%**	**24.6%**	**9.5%**	**9.6%**	**11.2%**	**14.4%**	**11.6%**	**11.7%**
SCM Universe Bond Index	2.7%	5.6%	10.3%	7.4%	5.5%	5.1%	5.9%	6.6%	7.4%
ML CDN High Yield	14.4%	40.0%	4.0%	-2.8%	-0.3%	0.5%	1.2%	1.9%	
ML USD High Yield	14.8%	48.5%	22.4%	4.0%	5.2%	5.9%	6.0%	6.0%	6.9%
S&P/TSX Composite Index	10.6%	30.0%	0.5%	-7.2%	1.9%	3.7%	8.3%	7.3%	9.5%

One year ago, September 15th to be exact, Lehman Brothers, the United States' 4th largest investment bank filed for Chapter 11 bankruptcy protection. With roughly $660 billion of assets, this was the largest bankruptcy in global economic history.

Lehman was the biggest casualty when the largest credit and housing bubble in economic history finally popped. When Lehman went down, it unleashed a cavalcade of events that brought the world financial system to the brink of collapse and it brought on the most severe global recession and biggest bear market since the 1930's.

The origins of the U.S housing bubble can be traced back to the Clinton administration. New legislation was enacted at that time, that not just encouraged mortgage lenders to make home loans to less credit worthy borrowers, but punished them for not doing so. Overnight it was everybody's right to own a home, regardless of one's ability to service or repay the debt. Hence began the emergence of NINJA mortgages . . . no income, no job, no assets. The abandonment of traditional standards of credit worthiness and the explosive growth in mortgage lending, combined with the low interest rate and easy money policy of the U.S. Federal Reserve, resulted in the U.S. real estate market being pumped up like an athlete on steroids.

Mortgage lenders, also known as shadow banks, through a network of mortgage brokers, began originating mortgages at record rates in 2001. These mortgages were purchased by the Wall Street investment banks who in turn packaged them into collateralized debt obligations (CDO's). Using risk models that we now know were flawed, Moodys and Standard and Poors granted the CDO's an AAA rating. However, these instruments were really AAA investment

[1] Returns longer than one year are annualized.

grade bonds backed by American trailer trash. They were then sold to banks, hedge funds, and other investors domestically and globally. In fact, CDO's became America's biggest export. The investment banks that created the CDO's reaped huge fees by doing so. Furthermore, they kept billions of dollars worth on their own balance sheets and financed them profitably because of the Fed's easy money policy and the positive carry trade. They could finance the CDO's by borrowing cheaply in the 30-day commercial paper market, or from a commercial bank at 3%, and hold the CDO's that paid 6%.

Underpinning the bubble was the belief that U.S. housing prices, which had never declined by more than 5% in any one year since the 1930's, would continue to appreciate. The financial models on which the CDO's were designed, and on which the rating agencies granted them AAA status, were based on this premise. What the quants failed to realize is that you cannot model human behavior.

The air began to seep out of the bubble in 2006, when the first signs of a stall in U.S. home demand and home prices became apparent. Many subprime borrowers had been able to borrow the entire purchase price of the home and in some cases more than the purchase price. Many of the subprime borrowers were enticed by step-up mortgages. These mortgages had extremely low interest rates for the first few years, then the rates reset much higher in ensuing years. When faced with this step-up and a decline in home values, borrowers began to default in record numbers. This pushed housing prices even lower, mortgage lenders (shadow banks) began to file for bankruptcy, and ultimately the banks themselves in the U.S. and Europe, which were caught holding the devalued CDO's, began to teeter and had to be rescued by government funding and forced mergers.

The G20 governments subsequently unleashed coordinated stimulus packages targeted at lubricating a locked financial system, and stimulating global demand for goods and services. At this point it looks like the patient has stopped hemorrhaging and has been stabilized. Armageddon has been called off.

As we have pointed out in recent reports to our clients, the economy will recover. Prior to this current recession, since 1900, there have been 21 recessions in the U.S. and there have been 21 recoveries. It is unlikely that it will be different this time. What we do not know is what the recovery will look like, and how long it will take to get back to or exceed the level of economic output we were at before the recession began in the fourth quarter of 2007.

Our best guess is that this recovery will be a bit of a struggle. Roughly 50% of the economic growth in the U.S. between 2002 and 2007 was illusionary. It was not real growth in economic output, rather it was a bubble created by excessive and cheap money. It created a false sense of economic well being and massive consumer spending. This will not return anytime soon, nor should we want it to. The consumer must pay down debt and increase savings. In the interim the economy is being held aloft by a transfer of the leverage to governments as they spend to stimulate economic activity. The current level of government stimulus cannot be sustained. The private sector will ultimately determine the level of future growth and the private sector will take some time to heal.

That said, there are some signs for optimism. The Merrill Lynch investment grade and high yield indices lost roughly 6.8% and 26.4% of their respective values in 2008. However, in 2009 these indices have rallied up 18.3% and 48.5%, respectively. In addition, all the major stock market indices have also shown remarkably strong rallies and are currently trading roughly 45% - 50% above their lows. As a consequence, U.S. household net worth has stabilized and is beginning to show some small increases. Housing starts, auto sales, housing prices have bottomed and have shown tentative signs of recovery. The financial system is showing signs of life again. In the past 6 months, the global high yield bond market has issued more than $100 billion of bonds, almost double what was issued in 2008.

These signs of a recovery tempered investors' fears of rising defaults and bond prices have risen accordingly. Although the timing of the recovery was difficult to predict, the outcome was not. In our March 2009 report, we argued "when credit markets improve and spreads return to more normal levels, the high yield bond market has historically provided equity like returns." We provided a table to prove our point, see below. Although the one year return is unknown, in the six months since March 31st, the US high yield index is up 41.4%. The DK Income Fund return over the same time period was 48.1%!

HY Index Rebounds from Cyclical Lows

	June 30, 1982*	Jan. 31, 1991**	Oct. 31, 2002**	Mar. 31, 2009**
Average Price	$60.95	$72.03	$77.15	$62.23
Average Coupon	$10.32	$12.77	$8.43	$8.17
Cash on Cash Yield	16.9%	17.7%	10.9%	13.1%
Yield to Maturity	17.4%	18.1%	13.7%	18.7%
1 Year Total Return from the date above	**47.81%**	**40.99%**	**33.10%**	**41.40%*** **
Annualized 5 Year Total Return from the date above	**19.59%**	**17.76%**	**12.83%**	

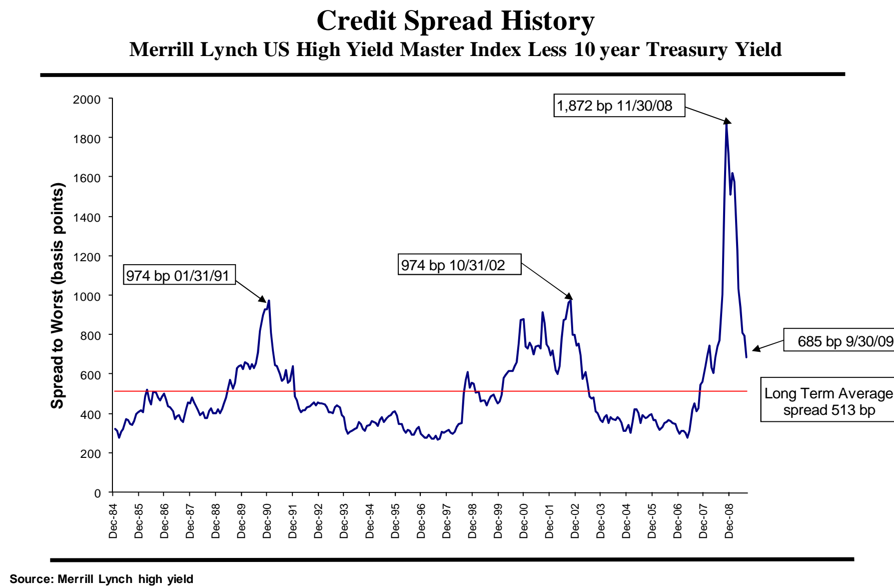
*Based on High Yield 100 Index (H100)
**Based on High Yield Master II Index (H0A0)
***Return for 6 months ended September 30, 2009

Source: Merrill Lynch & Co.

High yield strategies have performed well over the past six months which has attracted a large inflow of new capital. According to AMG data services, U.S. high yield mutual funds alone have raised $27 billion this year, which represents over 30% of the sectors assets at December 31, 2008. Near zero short term rates virtually force managers to invest this influx of capital quickly to reduce the risk of "underperformance" which increased prices further on all bonds regardless of credit quality. Deans Knight has been fully invested throughout this credit crunch focusing on debt instruments of businesses with tangible assets as collateral, strong cash flows and reasonable leverage that we felt would weather a prolonged downturn. When credit markets improved, the portfolio was able to take full advantage of the rise in prices. We

did not have to "chase" returns by being forced to invest in Companies with poor credit quality.

Despite the rise in prices, with 5-year Canadian government bonds at 2.5% and Canadian investment grade bonds averaging a 4.0% yield, we feel our strategy, currently offering cash on cash yields of 8.5%, is the best option for investors to earn a high level of income. The graph below shows credit spreads between high yield bonds and government bonds which have narrowed significantly from the record levels of late last year; however, they are still 33% higher than the 25 year average.



In addition to our high yield bond investments, we are also structuring and investing in private debt financings, such as bridge, mezzanine and short-term secured loans offering high coupons and equity incentives to enhance returns. These financings are typically short term, high coupon, in some cases fully secured and, most importantly, provide capital growth through "equity kickers" in the form of warrants or convertible debt. Historically, we have achieved annualized rates of return of 18% in these investments.

During the quarter, we structured a $10 million subordinated secured convertible debenture to Whitecap Resources Inc., a private oil and gas producer. Proceeds were used, along with a $36 million equity issue, to acquire a 50% stake in a Montney oil asset with a total purchase price of $115 million. The assets acquired are currently producing 1,800 boe/d of production (50% oil) have a long reserve life of 15+ years with the potential to significantly increase reserves using waterflood development. Whitecap has a strong management team with a history of creating value for its shareholders through both exploration, development and acquisitions. The DK Income Fund purchased $2.5 million of the debentures which have a coupon of 8%, mature on September 30, 2012 and a conversion price of $2.40, a 20% premium to their concurrent equity raise.