September 30, 2010

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	Since June '93
DK Income Fund	**5.4%**	**11.3%**	**20.7%**	**22.6%**	**13.1%**	**12.2%**	**13.0%**	**13.3%**	**11.9%**	**12.2%**
DEX Universe Bond Index	3.1%	7.5%	7.3%	8.8%	7.4%	5.9%	5.5%	6.7%	7.3%	7.4%
ML CDN High Yield	4.3%	10.2%	16.1%	9.9%	3.2%	3.6%	3.5%	3.5%		
ML USD High Yield	6.7%	11.8%	18.5%	20.4%	8.6%	8.4%	8.3%	7.7%	7.3%	7.6%
S&P/TSX Composite Index	10.3%	7.5%	11.6%	5.9%	-1.3%	4.2%	5.2%	4.1%	9.1%	9.6%

Since the Inception of the DK Income Fund in 1993, it has provided income to its unitholders ranging between 7.5 – 10% per annum. Over the long term, we have added additional value, by opportunistically investing in bonds trading at a discount and private debt financings with equity incentives. Our strategy has allowed us to provide our investors with an attractive alternative to other income strategies and have exceeded equity benchmarks, such as the S&P/TSX, while taking on less risk.

We don't understand how a basket of government and investment grade bonds at historically low yields of 2.2%[2] constitutes an attractive investment. There has been much debate over the status of the economy, with the majority of economists offering bearish predictions and promoting the purchase of Government and investment grade bonds. Their view is to invest in these bonds as a hedge against the risk of deflation and falling interest rates. We do not know exactly how the global economy will react to all the government stimuli and we certainly don't know the impact it will have on interest rates. What we do know is by investing in Government and investment grade bonds today you are either making a short-term bet on interest rates, or locking in at historically low returns, if held to maturity. In our opinion, government and investment grade bonds at these low yields are not compensating investors for the risk.

There is an inverse relationship between prices and yields/interest rates. Investing in 10-year U.S. Treasuries at the start of 2010 would have been a great investment, as the yield fell from 3.8% to 2.5% on September 30th, resulting in a price return of 11.5% year-to-date. If yields continue to fall, prices will rise, and owning long term U.S. Treasuries will continue to be a

[1] Returns longer than one year are annualized.
[2] Merrill Lynch U.S. Corporate & Government Master Index

good trade. However, if yields remain relatively flat, investors will only earn a small income return of 2.5%. This return could quickly turn negative if interest rates rise, causing prices to fall. The point being, buying Government or investment grade bonds today is a speculative trade on interest rates, not a sound long-term investment.

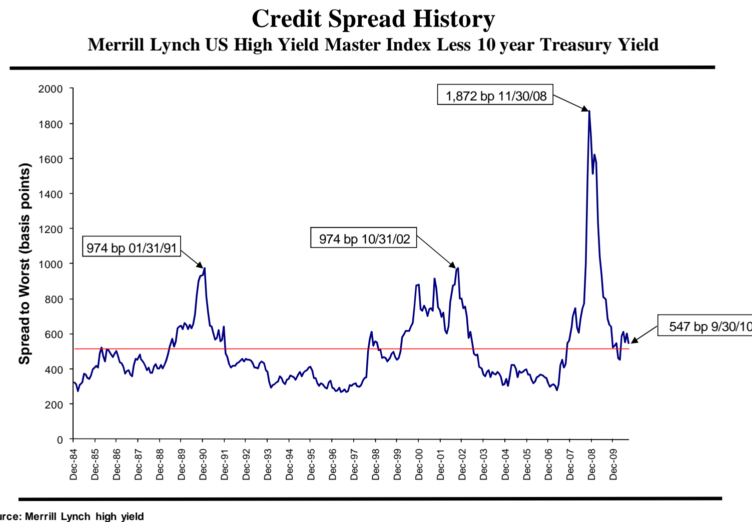
For those buying Government and investment grade bonds as a long-term investment, consider that we've just gone through a 30-year period where, for the most part, interest rates on bonds have steadily declined. As a result, bonds have provided attractive annualized returns over the last 29 years since the bottom of the bond market, roughly September 30, 1981; when you consider the risk.

Index	**Annualized Returns** Since 9/30/81
Government Bonds[3]	9.0%
Investment Grade Bonds[4]	10.2%
High Yield Bonds[5]	10.9%
Dow Jones Industrial Average	12.5%

The result of these returns is higher bond prices and significantly lower yields. On September 30, 1981, 10-year U.S. Treasuries were yielding almost 16%! Currently, U.S. 10-year treasuries are yielding 2.5% and the average yield on U.S. investment grade corporate bonds was only 3.7%, with an average maturity of 10 years[6]. Given the past returns and current interest rates being as low as they are, isn't it more likely that we are in a "bond bubble"? For long term investors, Government and investment grade bonds are the place to HAVE BEEN, not the place to BE.

We believe investors seeking income should be buying shorter term corporate bonds with higher yields where you are being compensated for the risk. The current spread in yields between U.S. 10-year Treasuries and high yield bonds is roughly at the long term average, see graph below.

[3] Merrill Lynch U.S. Treasury Master Index
[4] Merrill Lynch U.S. Corporate Master Index
[5] Merrill Lynch U.S. High Yield 100 Index
[6] Merrill Lynch U.S. Corporate Master Index



High yield bond issuers typically issue debt for seven – ten years (our average maturity is 5.4 years) and therefore are less affected by rising interest rates. If interest rates rise, our bonds will mature at Par and we can re-invest at higher interest rates. If you are invested in long term bonds you will be locked in at low yields or will need to sell at a lower price.

In addition, Corporate Balance Sheets have improved since the beginning of the recession, as good management teams have reacted to the challenging environment by reducing debt and getting costs back in order. If you compare this to Government agencies which are moving in the opposite direction with rising debt levels and increasing "costs" it begs the question, what's the attraction to Government bonds? We feel given the credit quality of our holdings, a 7.9% yield is very attractive versus a basket of government and investment grade bonds with an average yield of 2.2%[7].

Our expected long term return should be close to the current yield to maturity. Using our extensive network of contacts, we are uncovering very attractive opportunities to invest in private debt financings which will add to the return of the DK Income Fund. These private debt financings are typically short term, high coupon, in some cases fully secured and, as mentioned above, provide capital growth through equity incentives in the form of warrants or convertible debt.

[7] Merrill Lynch U.S. Corporate & Government Master Index