September 30, 2011

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
September 30, 2011

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	**-6.1%**	**-3.2%**	**2.9%**	**11.4%**	**15.7%**	**10.4%**	**10.3%**	**15.3%**	**11.0%**	**11.6%**
DEX Universe Bond Index	5.1%	7.4%	6.7%	7.0%	8.1%	7.2%	6.1%	6.5%	6.9%	7.4%
ML CDN High Yield	-2.6%	-0.3%	2.7%	9.2%	7.4%	3.0%	3.4%	5.4%		
ML USD High Yield	-6.3%	-1.7%	1.3%	9.6%	13.7%	6.7%	6.9%	8.6%	6.7%	7.2%
S&P/TSX Composite Index	-12.0%	-11.9%	-3.6%	3.7%	2.7%	-1.9%	2.6%	8.0%	7.6%	8.3%

We are now into our second "bear" stock market in Canada in two and a half years. A "bear" market is conventionally defined as a decline of 20% or more in the broad stock market indices. Like the equity markets, high yield bonds have also declined with the Merrill Lynch High Yield Index total return down 1.7% year to date.

We do not need to dwell on the reason for the decline in bond prices. We outlined them clearly in our June 30, 2011 report: "growing concern that the U.S. economic recovery is slowing . . . that China's growth is slowing . . . and that Greece's debt woes will wreak havoc in the European banks." Nothing much has changed. That's the problem. More worry about the same issues, but no leadership to clarify these issues and lead us to solutions. The problems the world faces are big ones and they are complex. But they are not intractable. True leadership entails taking complex issues and distilling them to simple issues upon which action can be taken. Leadership is lacking.

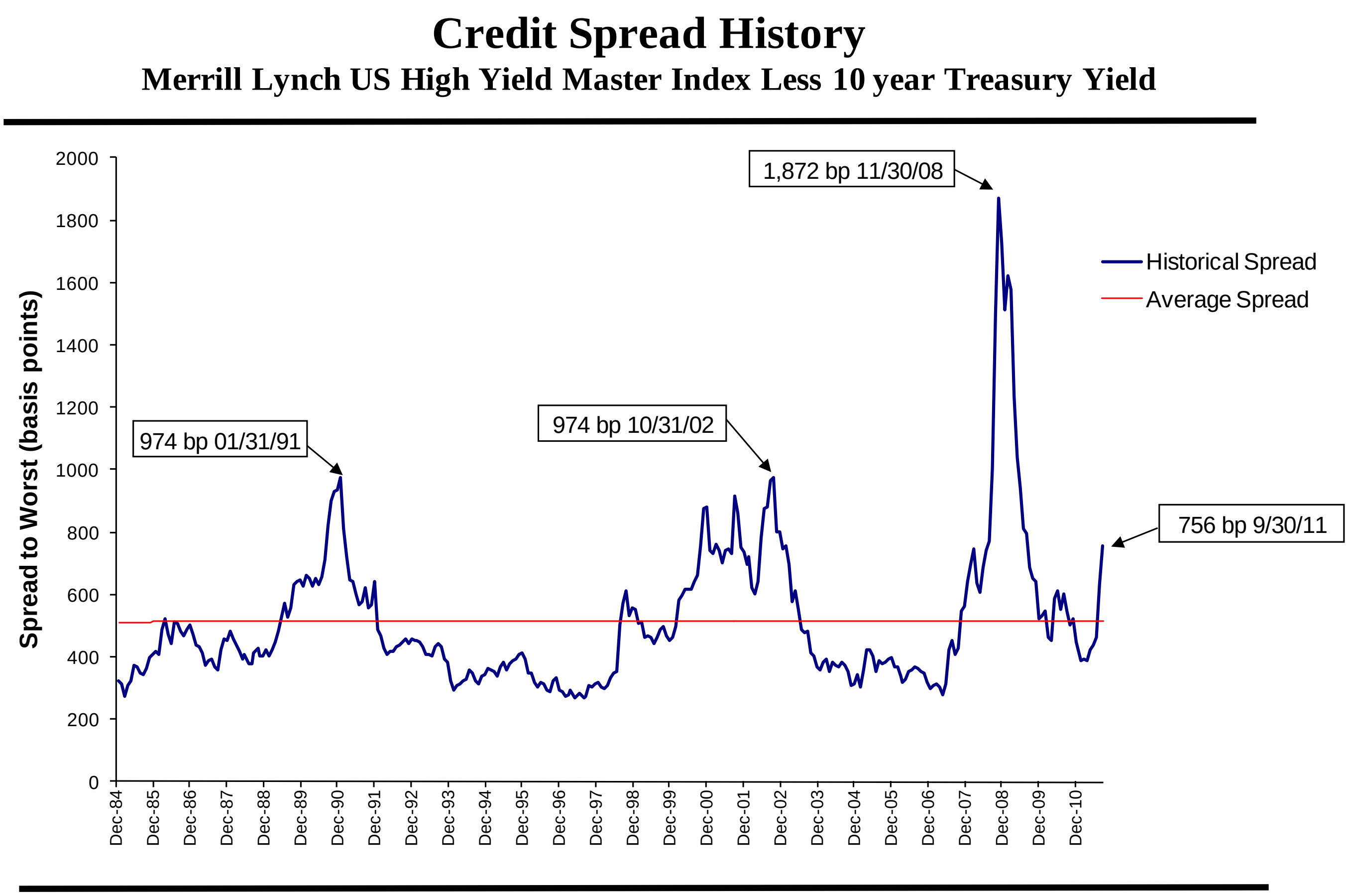
The good news . . . the mood today is excessively pessimistic, even more so than it was when we outlined the bearish sentiment in our June report. The wise writer Robert Heinlein once wrote . . . "does history record any case in which the majority was right?"

Yes, the U.S. economy and the global economy, are struggling to regain traction after the deep recession in 2008/09. That recession was caused by the massive U.S. housing boom (or bubble) that popped and brought the banking system to its knees. Today, that part of the U.S. economy which is not dependent on the housing industry is doing well.

The businesses that we own the debt of are in good shape. In many cases they are in better shape than they were two years ago. But that doesn't seem to matter right now. The investors who were seeking yield over the past two years are now panicking and want out. We have seen this movie before. Investors redeem higher yielding mutual funds creating forced selling while bidding up government and investment grade bonds in a "Flight to Quality". The result is widening spreads,

[1] Returns longer than one year are annualized gross of management fees.

which creates opportunity for rational investors. As you will see from the graph below, spreads are above the long term average and approaching previous peak levels seen in 1991 and 2002.



Source: Merrill Lynch high yield

Will high yield bonds continue to get cheaper, with prices falling to levels seen during the financial crisis of 2008/09? The honest answer is we don't know. What we do know is as fast as spreads widen, they can contract. The catalyst that will reverse the downward trend in prices is unknown and won't become evident until the opportunity is behind us.

As a bondholder, the most important consideration is the Company's ability to meet its coupon payments and pay us back our principal at maturity. A secondary consideration is whether or not we are being compensated for the risk that they fail to meet these obligations. We own corporate debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage. There are currently no defaults in our portfolio and all of our holdings are servicing their debt while, in most cases, continuing to reduce leverage. Although bonds could get cheaper, we believe current prices offer investors attractive returns; especially given their position on the capital structure.

At September 30th, the DK Income portfolio is generating 8.6% per annum in income and provides a yield to maturity of 10.1%. We believe this offers a strong incentive for investors to move out of treasury securities, currently yielding 1.1%[2], and into higher yielding corporate bonds.

[2] Merrill Lynch U.S. Treasury Master Index

In addition to corporate bonds, we will also opportunistically invest in private debt financings with equity incentives that provide equity-like returns.

During the quarter, the Deans Knight Income Fund designed and participated in an $18 million Secured Subordinate Revenue Note with RapidEye Canada Ltd. ($8.4 million or 6.2% of the portfolio). The proceeds from the financing were used to acquire assets from the bankruptcy of RapidEye AG, a global provider of high-resolution imagery and geospatial solutions. Following the transaction, RapidEye Canada became an affiliate of Iunctus Geomatics Corp., the leading supplier of optical satellite imagery in Canada. The acquisition combines one of the world's largest commercial archives of satellite imagery with Iunctus' already extensive distribution channels for satellite data and value-added solutions.

RapidEye Canada effectively owns five earth observation satellites with the technology to process high-resolution, large image data on a daily basis. The RapidEye system is able to collect an unprecedented 4 million square kilometers of data per day and has amassed over 2 billion square kilometers in its archive in just over two years of commercial operations. These data images cater to government and commercial clients ranging in applications from agriculture and energy to infrastructure and security. We believe RapidEye Canada can generate EBITDA margins of 25% immediately and, with a more focused management team, can improve those margins to a more industry standard of 40-50%.

The Notes have a 3-year maturity with a coupon of 5% and are secured by the assets of the Company with a guarantee from Iunctus. In addition to the coupon, Noteholders will receive a royalty on net revenue for a period of 10-years. Full details of the royalty cannot be publicly disclosed at the request of the Company.