**September 30, 2012**

# DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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## Quarterly Report
## September 30, 2012

## 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** | **4.8%** | **6.4%** | **14.5%** | **8.5%** | **12.4%** | **15.4%** | **11.2%** | **15.9%** | **10.7%** | **11.6%** |
| DEX Universe Bond Index | 1.2% | 3.3% | 5.5% | 6.1% | 6.5% | 7.4% | 6.9% | 6.2% | 6.4% | 7.3% |
| ML CDN High Yield | 4.9% | 12.3% | 16.5% | 9.4% | 11.6% | 9.6% | 5.6% | 8.3% | | |
| ML USD High Yield | 4.6% | 12.0% | 18.9% | 9.8% | 12.6% | 15.0% | 9.1% | 10.8% | 6.9% | 7.8% |
| S&P/TSX Composite Index | 7.0% | 5.4% | 9.2% | 2.6% | 5.5% | 4.2% | 0.2% | 9.8% | 6.1% | 8.4% |

The high yield corporate bond market has been volatile over the last five years. Depending on which way that volatility is moving, the media jumps on the story and bombards investors with news exacerbating the trend. Twelve months ago, the tone was decidedly bearish with growing concerns that U.S. economic recovery was slowing…that China's growth was slowing…and that Greek debt woes would wreak havoc with the Euro and European banks. Last year's worries caused investors to redeem high yield bond mutual funds in the third quarter of 2011, creating forced selling while bidding up government and investment grade bonds in a "Flight to Quality". Which, in the short term, is the exact opposite of what investors should have been doing, as can be seen from our one year return versus the Dex Universe Bond Index (an index consisting of government and investment grade bonds).

Does this mean you should pat us on the back for being smart? No. What you should thank us for is our patience. The reality is the concerns mentioned above are the same concerns the average investor has today. Twelve months ago we didn't know what was going to happen to high yield bond prices or what the catalyst to reverse the downward trend was going to be. What we did know, through experience, is as fast as prices fall, they can rise. The catalysts that reversed the trend were investors need for yield and the fact that businesses, despite the negative news, were actually improving.

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

So what does this mean going forward? Although we can't predict with certainty, bond portfolio returns are far more predictable than stock returns. Over the long run, the rate of return from investing in bonds should be its current yield to maturity. With government deficits continuing to grow and too little tax revenue/income to support the debt, we believe our income strategy of investing in high yield corporate debt is a better alternative. Companies, in general, are actually doing relatively well. Good management teams are using improving cash flows to de-lever their balance sheets putting them in a better position than they were five years ago.

As we have stated numerous times, as a debtholder in a corporation, the most important consideration is the company's ability to meet its coupon payments and pay back our principal at maturity. As investors, we cannot predict short term prices, the only thing we can control is the companies we choose to invest in and whether or not we are compensated for the risk that they fail to meet their obligations. The DK Income Fund, as of September 30$^{th}$, is yielding 8% which is attractive versus U.S. and Canadian government bonds providing yields of only 1 – 2%.

Over the long term, we will look to provide additional return from capital gains by identifying mispriced high yield bonds and structuring private debt financings with equity kickers.

Our investment in Paramount Resources is an example of debt that has provided a return above its coupon. Paramount is an oil and gas producer, predominantly natural gas, with assets in Alberta, Northwest Territories, and North Dakota. In addition to its producing assets, the company has a number of investments in other oil and gas companies (all of these companies were previously assets within Paramount that were spun out to form new companies). The ratings agencies have consistently rated Paramount's debt lower than we believe is appropriate, as they focus on production numbers and do not properly value Paramount's extensive land position or their investments in other oil and gas companies. We knew, if you looked beyond the "metrics", there was substantial asset coverage versus the level of debt outstanding.

Thanks to the low rating, Paramount has paid coupons on its debt between 7.875% – 8.875% since 2003. They've refinanced their debt twice in 9 years, each time having to call the bonds at a premium to par. This has resulted in a return of 11% to bondholders during this time period which exceeds the coupon.

We did not invest in any new private debt financings during the third quarter. However, one was repaid. In August 2011, the Deans Knight Income Fund participated in an $18 million CAD Secured Subordinate Revenue Note with RapidEye Canada Ltd. ($8.4 million initial investment in the Fund). 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.

At time of purchase, we believed RapidEye Canada could generate EBITDA margins of 25% on annual revenues of €13 million Euros and could improve revenues and margins over time as new management re-focused the business plan. Management exceeded our expectations, as they are on pace to reach revenues of at least €20 million Euros this year and have improved EBITDA margins to 40 – 50%. As a result of this quick turnaround, the Company was able to repay our Notes with cash and a new debt facility.

The Notes had a 3-year maturity with a coupon of 5% and were secured by the assets of the Company. In addition to the coupon, Noteholders were compensated by a royalty on net revenue which declined as debt was reduced. To September 30$^{th}$, the Fund earned interest and royalties of \$1.45 million CAD, providing a 17% income return on our initial investment. In addition, although the note has been repaid, Noteholders will continue to receive a royalty of 2.75% on the Company's net revenue for 9 more years.