September 30, 2013

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
September 30, 2013

Rates of Return[1]

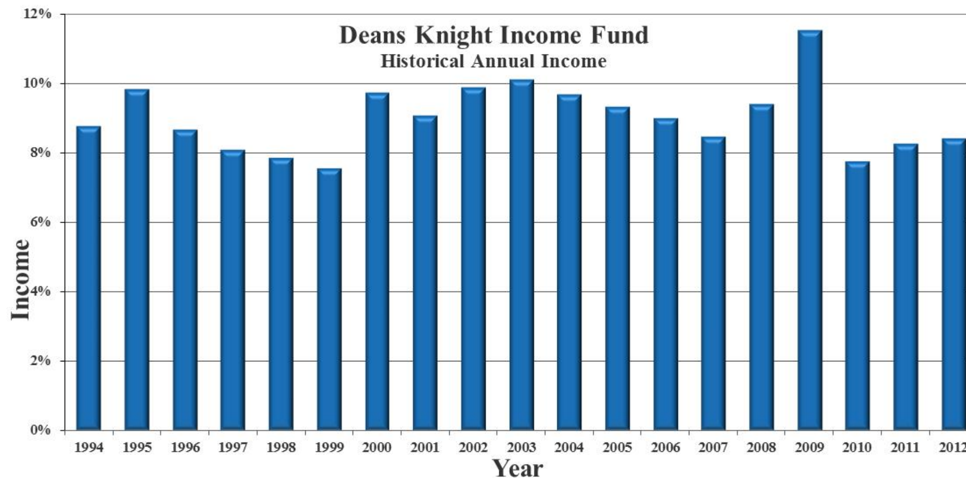
	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**-0.6%**	**-0.9%**	**3.3%**	**8.7%**	**6.7%**	**10.1%**	**12.8%**	**13.5%**	**10.7%**	**11.3%**	**11.3%**
DEX Universe Bond Index	0.1%	-1.6%	-1.3%	2.0%	3.6%	4.5%	5.6%	5.2%	5.7%	6.7%	6.8%
ML CDN High Yield	2.9%	3.7%	6.3%	11.3%	8.3%	10.2%	9.0%	5.6%	4.7%		
ML USD High Yield	2.3%	3.8%	7.1%	12.9%	8.9%	11.2%	13.4%	8.7%	7.2%	7.8%	7.8%
S&P/TSX Composite Index	6.2%	5.3%	7.1%	8.1%	4.1%	5.9%	4.8%	8.4%	8.1%	8.4%	8.3%

As we highlighted in our last quarterly report, Deans Knight recently celebrated our 20th anniversary. For 20 years we have specialized in two strategies, focusing on growth (equity) and income (bonds). On the income side, we were the first in Canada to specialize in utilizing high yield corporate bonds. We have developed considerable expertise in this area in ensuing years. Our income philosophy was articulated in our first quarterly commentary in 1993. "*We concentrate on maximizing portfolio income, we do not attempt to predict interest rates*."

We learned in the early days of Deans Knight that some of our clients were less interested in growth and had a greater need for current income. As a consequence, the goal in the income strategy became one of maximizing the current cash income generated by the underlying investments. The bar chart below shows that we have generated annual cash income ranging between 7.5% - 10% each year since inception, averaging 8.8% over this period.

Our total return (as distinct from total annual generated income) since inception of 11.3% is higher than this income level due to capital appreciation on our investments. We have achieved capital appreciation by buying bonds at a discount, investing in private debt financings with equity kickers and through credit improvement resulting in bonds trading above par or being called early at a premium.

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



In a low interest rate environment, like the one we are in today, achieving attractive income levels is challenging. At September 30th, portfolio income is in the lower end of historical returns. In addition to the effect of lower interest rates, we held cash of between 12 – 15% throughout the year. This also had the effect of lowering the portfolio yield. We were not in a rush to deploy cash earlier this year, as there were simply not enough attractive opportunities. However, since quarter end we have made some new investments and our cash position will be less than 5% by the end of October.

In terms of overall return, Government and investment grade bond indices have provided negative returns this year because interest rates have increased. For example, 10 year US Treasury bond yields have gone from 1.8% at the end of 2012 to 2.6% at September 30th. As a result, the DEX Universe Bond Index return is negative 1.6% year to date. The high yield market is less impacted from rising interest rates and trades largely on credit worthiness; which is why the high yield indices have provided small positive returns this year by comparison. That said, our portfolio return has been slightly negative, reduced by about 4% due to events that lowered prices of two of our holdings this year: **Northlands Resources**, which was discussed in March and has since been sold, and **Mirabela Nickel Ltd**.

In our June report, we wrote about our position in Mirabela bonds which we originally purchased when issued in April 2011. We owned the bonds as Mirabela has a world class nickel sulphide deposit in Brazil; produces roughly 20,000 tonnes of nickel per annum with relatively low production costs; a solid management team; and a first-class processing plant. The Company had cash of $108 million USD on the balance sheet at June 30th and, although cash flow negative after administrative costs and debt servicing costs, had minimized cash burn at the mine site during the second quarter. Mirabela's large cash position on the balance sheet as well as the low cash burn operationally gave us comfort that, despite slumping nickel prices, our bonds were covered and we were being compensated for the risk with a 16% yield at June 30th.

In late September, the Company provided a disappointing operational update outlining higher cash costs in July and August resulting in a reduction of cash on hand to $80 million USD. In addition, the Company received notification from one of its two customers, Votorantim Metals, of its intention to terminate their sale agreement at the end of November which may constitute an event of default

under their bank facility. As a result, the Company is exploring opportunities for new strategic financing and off-take alternatives in a very challenging environment and bonds have gone from $76.50 at June 30th to current bids at roughly $30. It remains to be seen what the outcome and value realization will be.

We've been involved in 16 defaults or workouts in our twenty year history. It is a normal part of working in credit markets. As we've noted in the past, when a company defaults, it does not mean the bonds are worth nothing. The historical average recovery on high yield bonds in general is 30 – 40%. However, recoveries do vary. Like the high yield market, our returns have varied on these 16 investments; however, we are able to take a more pro-active role which has allowed us to recuperate more value for our investors in a default scenario. This is one of the reasons why we've outperformed the high yield benchmarks over the long term. The jury is still out as to what solution Mirabela and bondholders can come to and what the ultimate recovery will be. We have been in contact with management and continue to evaluate our options.

As mentioned above, we have deployed some of our cash recently. For example, we continue to invest in private debt financings providing attractive coupons with equity upside. In our March quarterly we announced that we had designed and originated an $8 million Secured Note facility with **BuildDirect.com Technologies Inc.** The facility was available in increments of $2 million and on July 29th the Company drew down $4 million. The commitment from the DK Income Fund was $1.75 million. The Notes are secured obligations of the Company bearing interest at 9% per annum on the drawn portion. The undrawn portion bears a standby fee of 0.5%. Additional warrants were issued upon draw down of the facility giving the DK Income Fund a total of 175,000 warrants at an exercise price of $2.15 per share. During the quarter, the Company raised $8 million in equity, via a private placement, at $3.50 putting our warrants in the money.

Subsequent to quarter end, we participated in the new issue of **Crew Energy Inc.** 8.375% bonds due October 21, 2020. Crew is an oil & gas company that is focused in Western Canada. We have longstanding relationships with Crew's President & CEO, as well as their Chairman, and we have successfully invested with them in the past through debt as well as equity. Crew has a diverse production base that is spread out over four core operating areas and their production is evenly split between natural gas and liquids. Management has done a great job prudently building an asset base over the last 10 years that we feel is worth significantly more than the debt outstanding. Bonds were issued below par to yield 8.48% which is attractive given strength of management and the asset base.