September 30, 2014

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	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**1.8%**	**8.3%**	**9.3%**	**8.9%**	**9.9%**	**12.2%**	**11.0%**	**11.3%**	**11.2%**
FTSE TMX Canada	1.1%	5.9%	6.3%	3.4%	4.9%	5.4%	6.0%	7.0%	6.8%
ML CDN High Yield	-0.9%	5.9%	9.0%	10.5%	10.0%	5.5%	4.6%		
ML USD High Yield	-1.9%	3.6%	7.2%	11.0%	10.4%	8.2%	7.5%	8.0%	7.7%

Investors seeking income need to WAKE UP to the reality of today's environment. While High Yield bonds have become low yield, averaging less than 7%, they are still more attractive than government and investment grade bonds that are providing virtually NO yield. Five-year Government of Canada bonds yield 1.6%, a negative real rate of return when adjusted for current inflation, at 2.1%. Meaning, you are paying the Canadian government to keep your money "safe"….NEVER a good idea. Investment grade corporate bonds don't offer much more at yields of only 2.8% on an average maturity of almost 9 years[2]!

Investors are expressing concern over today's low yields and we agree. If interest rates rise, government bond prices will decline in value and provide negative returns. Investors that require income must find ways to lend shorter, at positive real rates, against reasonable collateral and look for income opportunities which may fall outside of traditional debt investments. This is what Deans Knight does. Since our inception in 1993, we have opportunistically invested our client's capital providing a long term return of 11.2%.

When Doug and Wayne founded Deans Knight, they wanted to offer clients something different. This led us down the path of investing in high yield debt, making Deans Knight the first investment manager in Canada to focus on the Canadian High Yield market. Our credit knowledge and experience has led us to invest in private debt financings; something we have done since 2000. Our network enables us to source ideas and then properly structure the investments. We have invested in 34 private debt financings, which have provided average returns in excess of 17%. We believe private debt opportunities offer attractive equity like returns without taking equity risk.

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[1] Returns longer than one year are annualized gross of management fees.
[2] Source: BofA Merrill Lynch Canada Corporate Index

In the mid 2000's, with interest rates at then historically low levels, we identified another opportunity beyond the increasingly less attractive high yield market when we began investing in what were then called income trusts and that are now high dividend paying stocks. Unlike interest payments, dividends/distributions are not guaranteed. In analyzing these investments, we focus on the underlying business and how much cash flow is being generated, rather than just yield, to ensure that the dividend was sustainable and has the potential to grow over time.

Our flexible income approach has made it difficult for some investors to put our strategy in a box. Our philosophy has always been, why would we want to be put in a box? Our goal is to earn a higher level of income than government and investment grade bonds without taking on undue risk. In English, that means we are trying to make YOU, our client, money. Ten years ago Government & Investment grade bonds were roughly 4% (high yield bonds were yielding less than 8%); whereas we were able to provide an annualized return of 12.2%!

Similar to ten years ago, most debt instruments are not attractive today. This is why our portfolio weight in High Yield bonds has declined, while investments in equity and private debt have increased. At September 30th, we are invested in a select number of high yield credits, 60% of the portfolio, with a short duration, 3.2 years, and an average current portfolio yield of 7.3%. The remainder of the portfolio is invested in private debt financings (16%), and dividend paying equities (24%).

The big banks are not very effective in the short term private debt business. This has presented us with a big opportunity. To be effective, it requires a large network to source the right deals and the experience to properly structure each deal. These financings offer investors good security, they are short term (i.e. 18 months on average), pay a higher coupon and, most importantly, provide capital growth through "equity kickers" in the form of warrants, convertible features, or royalties.

We are currently in advanced talks with a couple of potential new private debt opportunities. In addition, on September 30th, the remaining amount on the $8 million facility with **BuildDirect Technologies** was drawn ($1.75 million to the DK Income portfolio for a total investment of $3.5 million). BuildDirect pays a 9% coupon and issued additional warrants, giving the fund a total of 328,126 warrants with an exercise price of $2.15 per share. Subsequent to quarter end, the Company raised $29.7 million of equity capital at a price of $6 per share valuing the Company at $320 million. We had negotiated our warrants when we originally structured the deal in April 2013, which is why our warrants are at a significant discount to the recent equity raise.

Our equity investments are either a result of the equity kickers received from our private Debt Financings (**BuildDirect**, **Conifex Timber** and **Whitecap Resources**) or the direct purchase of common shares of Companies paying a dividend (**American Hotels**, **Bird Construction**, **Contrans Group**, **Prairie Sky**, **Range Royalty**, **Vicwest** and **Wajax**). I am going to focus on the four dividend paying names we have owned for over 4 years to illustrate our philosophy.

We first purchased Bird Construction in 2010 as our window on commercial construction, primarily in Western Canada. Bird is a well-managed cyclical business whose margins had compressed; however, at under $11 per share, we were buying it at an attractive valuation. The Company was yielding 5.5% and we felt the dividend could grow as margins improved. Our thesis is slowly playing out and the Company has grown monthly dividends by 25% since our original purchase. At September 30th, Bird was priced at $13.36 and, with the higher dividend, was still yielding 5.5%. We continue to own Bird as we believe the company will continue to win business and improve margins.

In July, we received a $15 all cash takeover bid for Contrans, our trucking company, from Canada's largest trucking company, TransForce Inc. We were not surprised. We have been involved as a shareholder of Contrans since 2007, adding to our position during the "great recession" in 2009. The experience has been a very good one for us. We received a steady stream of dividends along the way, $4.83 in total, with a 70% growth in share price over our cost of $8.74. We voted your shares in favour of the transaction, which was originally open until September 17, but has been extended until the end of October. Contrans represents 2.7% of your portfolio, which, if the transaction goes ahead as envisioned, will generate cash for the portfolio to put to work in other situations.

Vicwest has been an investment with us for 15 years. Vicwest is a leader in grain storage/handling systems and building construction products. We had originally owned the debt. However, in 2001 the Company filed for CCAA protection as Vicwest, operating in two cyclical businesses, was facing a number of headwinds that impacted its short term cash flows. We liked the business and felt the issues were temporary. We got heavily involved in the restructuring process and our bonds were exchanged for equity that began paying a dividend in July 2005. To date the dividends we have received total roughly $12 per share. In addition, the Company has grown in value from our original cost base of $4.13 to $10.25 per share.

Our investment in Whitecap Resources is a result of structuring a $10 million secured convertible debenture in 2009; the proceeds of which were used to help found the Company. Our converts had an exercise price of $2.88 per share and within 15 months were converted into equity, as the share price was trading above $6.00 per share. In 2013, Whitecap began paying a dividend, currently $0.75 per share, which despite the recent fall in the price of oil, is sustainable given the Company's growth profile and extensive hedging strategy. Whitecap yields 5% on today's stock price of $14.75.

We understand that it is a difficult environment for investors seeking income. That is why we selectively invest in high yield bonds and look for creative income opportunities to meet our client's income needs despite the poor rate environment.