DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK BOND FUND
Quarterly Report
December 31, 2002

Rates of Return

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	7 Yrs	9 Yrs
DK Bond Fund	**6.6%**	**10.5%**	**5.2%**	**0.6%**	**1.8%**	**2.3%**	**5.9%**	**7.5%**
SCM Universe Bond Index	2.3%	8.7%	8.4%	9.0%	6.4%	6.9%	8.1%	7.9%
ML CDN High Yield (hedged)	13.9%	-3.6%	-5.6%	-5.6%	-1.8%			
ML USD High Yield[1] (unhedged)	6.9%	-1.9%	1.2%	-0.9%	-0.1%	0.5%	3.7%	4.9%

It Was A Good Year

The 4th quarter provided a strong finish to a good year for the DKBond portfolio. The quarterly return in the DKBond portfolio was 6.6% versus 2.3% for the SCMU bond index, which is primarily made up of Government bonds. For one year the DKBond portfolio earned 10.5% versus 8.7% for the SCMU bond index. Income distributed in 2002 from the DKBond portfolio was equal to 10% based on the unit value at the beginning of the year, which represents 96% of the annual total return. This illustrates our point - the primary driver of bond return is the level of portfolio income.

2002 in Review

The portfolio benefited from a number of positive decisions that offset the impact of a general weakening in corporate credit prices.

First, one third of the portfolio is invested in "old economy" businesses such as Chemicals (***Nova & Methanex***), Energy (***Baytex & Denbury***), Forest Products (***Scott Paper***) and Mining/Steel (***Stelco & Lionore***). These businesses are attractive in today's environment since the growth in demand for their product is outpacing the growth in supply (in some cases supply is diminishing), creating a positive pricing environment. How has this happened? During the technology boom of the late 1990's, these businesses were denied access to capital markets thus very little money was being spent to maintain production and supply levels. In addition, we are now entering a stage where the economy is improving with Canada's economy growing by approximately 3.4% in 2002 and the United States by approximately 3%. This economic growth will help increase demand for basic materials such as steel, lumber, nickel, oil and gas at a time when supply is at a minimum.

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[1] The Merrill Lynch USD High Yield bond index (unhedged) is indicative of US high yield bond market returns.

Secondly, we identified specific bond opportunities which provided very good returns last year. For example, last quarter we provided the rationale for purchasing **Telus/BC Tel.** Telus bonds declined significantly in value following a credit rating downgrade by Moody's. We recognized Telus had a strong wireline franchise in Western Canada generating significant cash flow and we were able to take advantage of the price volatility to initiate a position. Telus became our largest portfolio holding, and increased by over 20% in value during the 4th quarter. Also during the quarter **Sparkling Springs**, the bottled water company, was purchased by ***Danone*** a large International bottled water company famous for the ***Evian*** brand. The bonds will most likely be redeemed at the call price of $105.75 (cost $92.68) when the deal closes in the new year.

Finally, during the 3rd quarter we were required to convert **LionOre** convertible debentures into shares, and we held most of these shares at year-end. The year-end share price of LionOre was $4.94 and this equates to over $200 per original $100 bond. LionOre shares have added significant value to the portfolio and we intend to reduce this share position gradually in order to maximize value.

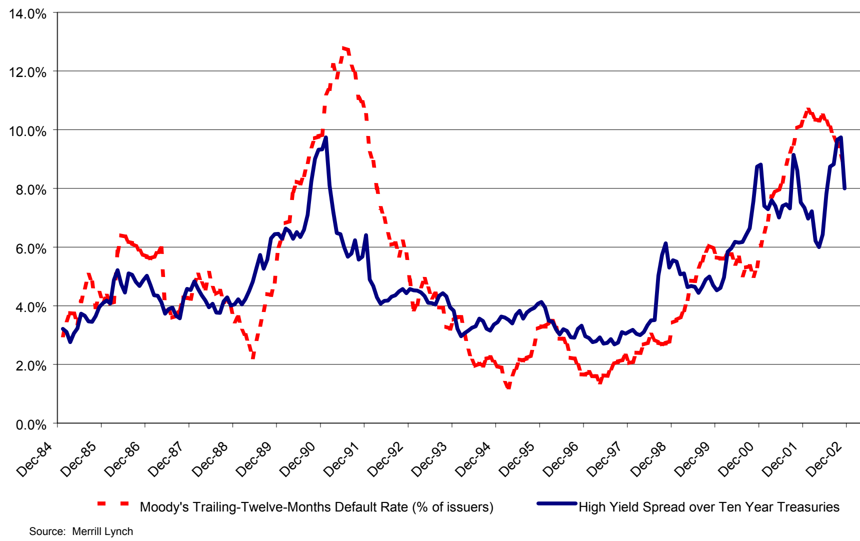
What lies ahead in 2003?

Government of Canada 10-year bonds ended the year at a 4.8% yield to maturity, the lowest interest rate in forty years. You have to ask yourself, why would investors want to lend money to the Government for 10 years at less than 5%? Our answer; we wouldn't. We would rather lend money to a select number of companies with an average interest payment of 10%, and earn the additional 5% interest each year for the next 10 years. Over the long run, the rate of return from investing in bonds is equal to the coupon interest. The DKBond portfolio currently provides interest distributions close to 10% - about double Government bonds.

It may be hard to be a confident investor given the high probability of a U.S. led attack on Iraq early in the year and the danger this poses to the Global economy. However, we continue to argue valuations for high yield corporate bonds already discount these problems. The Merrill Lynch U.S. High Yield bond index has a yield to maturity of roughly 12% at year-end, while the yield on 5-year U.S. Treasury bonds is less than 3%. The 900 basis point differential is close to the widest credit spread in history. We reiterate that following the previous peak in credit spreads during 1991, high yield bonds out earned Treasury bonds by 10% per annum for the next 4-years. Corporate bonds are again in a position to out-earn treasury bonds simply due to the substantial interest rate differential.

Confidence in Credit is Improving

Moody's trailing-12-month default rate, an indicator of corporate distress, is improving. This index is highly correlated with credit spreads, as shown in the graph below. When Moody's trailing-12-month default rate *(dashed line)* rises or falls, so do credit spreads *(solid line)*. During the last cycle, in 1991, credit spreads began to decline rapidly before confirmation from a substantial decline in the Moody's trailing-12-month default rate. This cycle, Moody's trailing-12-month default rate has declined each month since February; yet, credit spreads are higher today than they were in February. With a clear trend to lower default rates, credit spreads this cycle appear to us to be overly generous for the current level of uncertainty. Confirming this, Moody's is forecasting a further decline of 1.5% for 2003, in the trailing-12-month default rate.



Conclusion

While the popular press would have us believe stock price declines mean the economy is in dire straits, the fact is the economy has continued to grow, albeit at a moderate pace, despite a 3-year decline in U.S. stock market indexes. On the positive side most industrialized countries are already following extremely stimulative monetary and fiscal policies that should lead to rapid economic recovery once uncertainty is reduced. While it would be easy to be very bullish about the prospects for corporate bonds if uncertainty was behind us, in our opinion, current valuations already provide a substantial cushion.