DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

Quarterly Report
December 31, 2005

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since Inception June 30, 1993
DK Income Fund	**2.6%**	**21.0%**	**23.2%**	**24.5%**	**20.8%**	**16.4%**	**11.2%**	**11.8%**
SCM Universe Bond Index	0.7%	6.5%	6.8%	6.8%	7.3%	7.4%	7.7%	8.1%
ML CDN High Yield (hedged)	-1.9%	-2.4%	3.4%	10.4%	6.7%	3.7%		
ML USD High Yield (unhedged)	0.7%	2.7%	6.7%	13.4%	9.4%	8.4%	6.6%	7.2%

The portfolio paid an income distribution of 8.8% to unitholders in 2005. Furthermore, the capital value of the portfolio increased significantly, primarily from the appreciation in the value of the income trust holdings but also from capital gains from bonds which were called for redemption during the year. The result was a total portfolio return of 21% for the year.

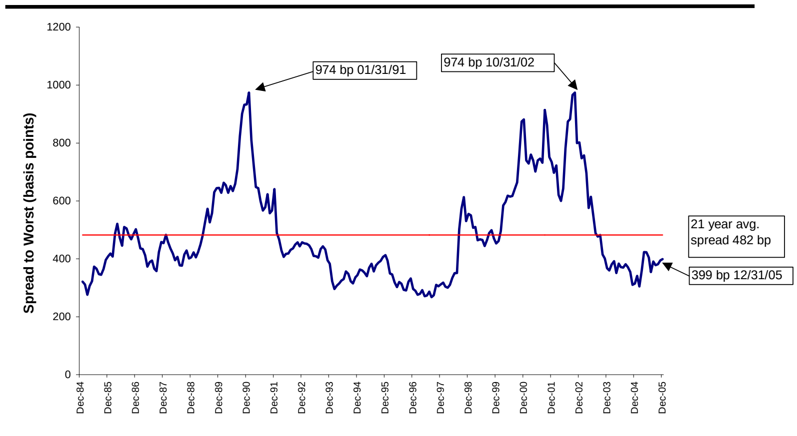
The price of **Harvest Energy Trust** increased 64% last year. Moreover, the increase in oil and gas prices resulted in increased cash flow and Harvest was able to increase the cash distribution to unitholders. At year-end, Harvest was still trading at an attractive 11% yield. **Vicwest Income Trust**, 10% of the portfolio at year-end, increased in value by 80% during the year. Vicwest began the year with a regular corporate share structure and converted to an income trust in July. Vicwest paid $1.40 in distribution in 6 months as a trust during 2005 (65¢ regular and 75¢ as a special distribution). The Company has announced a monthly distribution of 12¢ per unit for 2006, also providing a yield of 11%

A whopping 50% of the bonds held in the DK portfolio at the start of last year were called for redemption. For example, at the beginning of 2005, the DK portfolio held a 5% weight in **Anchor Lamina** $9^{7}/_{8}$% bonds due in 2008. The book cost in the portfolio was $65.75 and the bonds were valued at $80 at the start of the year. Anchor Lamina called the bonds in March 2005 at $101.64 which is a 27% capital return for 2005 and this alone contributed roughly 10% of the capital gains during 2005. In December S**herritt Intl.** called for redemption $9^{7}/_{8}$% bonds due 2010 at $109.875; this holding is 5.8% of the portfolio. We elected not to take cash and instead rolled into a new Sherritt $7^{7}/_{8}$% bond due 2012. For every $100 bond, we received $108.79 of new $7^{7}/_{8}$% notes. Sherritt produces nickel, coal, oil and gas and all business units are doing well. We believe the $7^{7}/_{8}$% coupon on Sherritt bonds provides a very attractive income return for such a high quality company.

[1] Returns longer than one year are annualized.

In our view interest rates are too low and credit quality spreads too narrow between government and corporate bonds as shown below. As a result, very few corporate bonds represent attractive investment opportunities today.

Credit Spread History
Merrill Lynch High Yield Master Index Less 10 year Treasury Yield



Source: Merrill Lynch high yield

As a consequence, in an effort to provide our clients with steady and reasonable income we have expanded our focus to include bridge loans. For example, in December we negotiated an 18-month Promissory Note with **Anvil Mining**. Anvil is an Australian-based public company with low cost copper production in the Congo. We know the company well as we have owned shares in Anvil for the past year and a half in our equity portfolios. The note pays a 2% commitment fee and an initial coupon of 8% which increases 2% each 6 months to 12%. As an additional incentive we receive 10 warrants per $100 Note to buy shares at $6.25; Anvil Mining's shares were $5.90 at year end. The income payments alone are attractive but the equity kicker provided by the warrants may be more attractive. We look for the Anvil share price to reach $8; in this event the warrants would add an additional $17.50 per $100 bond, more than doubling the return on this investment.

A Note on Income Trusts and Taxation

On September 8, 2005, the Department of Finance released a consultation paper suggesting income trusts may create tax leakage of up to $300 million per annum. The Department of Finance paper raised the possibility of some form of tax on income trust distributions. For clarity, an income trust is a financial security used to distribute cash flow generated by a business to its owners (unitholders) on a pretax basis. By contrast, corporations with ordinary share structures are taxed on income before they are able to distribute any income as a dividend. Also, dividends paid are taxed again in shareholders' hands, creating double taxation.

In response to the Government consultation paper the overwhelming consensus of submissions was against any tax on trust distributions. Instead, it was suggested that the Government reduce the double taxation on corporate income in order to level the playing field. On November 23, Finance Minister Goodale announced there would be no new taxes on income trust distributions and he would reduce the tax on dividends.

The consultation process brought some clarity to a number of the Government's concerns over tax leakage.

1. The Department of Finance suggested that trusts cause tax leakage of up to $300 million per annum. Even if this was correct, it represents less than ¼ of 1% of total Federal tax revenues.

2. The Department of Finance calculation below, which was released with the consultation package, shows their interpretation of the tax leakage on $100 of income.

		Income Trusts	Public Corporations
1.	Business Income	**$100**	**$100**
2.	Effective corporate income tax rates		
	Federal		22.0%
	Provincial		13.0%
	Total		35.0%
3.	Amount distributed to individual		$65
4.	Effective personal income tax rates		
	Federal	25.0%	14.6%
	Provincial	13.0%	7.9%
	Total	38.0%	22.5%
5.	Personal income tax	$38.00	$14.63
6.	**Total Tax Collected**	**$38.00**	**$49.63**
7.	Combined corporate-personal income tax rate	38.0%	49.63%

Source: Department of Finance

The Government's analysis shows that they are potentially losing $11.63 of tax revenue per $100 of corporate income because of trusts.

We believe the Department of Finance is using the wrong starting point for trust income. Income trusts pay distributions with cash flow and cash flow is higher than ordinary business income. This is because income trusts add back non cash charges like depreciation and amortization to ordinary business income which are deducted by corporations for tax purposes and pay out income plus these non cash items as distribution. How much difference does this make? BMO Nesbitt Burns calculates that in their coverage universe (excluding REITS) income trust distributions are 1.8 times greater than taxable business income for corporations. On average, income trust distributions are 74% taxable (26% was counted as return of capital). Using BMO Nesbitt Burns' calculation below, when you adjust for higher distribution payouts by trusts, Federal tax revenues from income trusts are comparable to ordinary corporations.

		Income Trust
1.	Net Income	**$100**
2.	Cash Distributed as % of Earnings	**1.8x**
		$180
3.	% Taxable	74.0%
4.	Taxable Amount	**$133**
5.	Effective income tax rates	38.0%
6.	**Total Tax Collected**	**$50.62**

Source: BMO Nesbitt Burns

3. We believe much of the tax leakage worry by the Government is the revenue loss from income trust holdings in RRSPs, Pensions Funds, and other tax deferred entities. The Government estimates 39% of all flow through securities are held by tax exempt accounts, largely RRSPs. However, dollars going to RRSPs and Pension Funds are not lost, the tax is just deferred into the future. Within 10 years, baby boomers which represent the largest proportion of the population, will be turning 71 and will pay tax when they are required to begin removing funds from their registered plans. They are also well-informed voters. If the Government does not worry about tax loss from interest on bonds, dividends, and capital gains held in tax deferred accounts then they should not worry about income trust distributions. Many submissions recommended a simple solution of capping trust holdings for tax deferred accounts.

4. There is also an issue with foreign holders of income trusts who in many cases pay less tax than Canadian holders. Foreign investors hold sizable positions in many income trusts. Here the Government must be careful not to scare away much needed foreign capital, but this can be addressed separately without affecting Canadian income trust unitholders.

The bottom line is we think a tax on income trust distributions is now off the table.

Portfolio Holdings

As of December 31st, the 10 largest holdings were:

	% of Portfolio	
Vicwest Income Fund (Income Trust)	10.4%	Building & Construction
Sherritt Intl. Corp. (Bond)	6.1%	Natural Resources
Rhodia SA (Bond)	4.8%	Chemicals
GBS Gold (Bridge Loan)	4.5%	Gold Mining
Paramount Resources (Bond)	4.1%	Oil & Gas
Imperial Metals (Bond & Bridge Loan)	3.9%	Copper Mining
Royal Group Tech Mtn. (Bond)	3.5%	Plastic Building Materials
Baytex Energy Ltd. (Bond)	3.3%	Oil & Gas
Saskatchewan Wheat (Bond)	3.3%	Agricultural Operations
Harvest Energy Trust (Income Trust)	3.2%	Oil & Gas
Total	47.1%	