December 31, 2006

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**-3.7%**	**9.1%**	**14.9%**	**18.3%**	**20.5%**	**18.4%**	**10.4%**	**11.6%**
SCM Universe Bond Index	0.7%	4.1%	5.3%	5.9%	6.1%	6.6%	6.9%	7.8%
ML CDN High Yield (hedged)	3.9%	9.2%	3.2%	5.3%	10.1%	7.2%		
ML USD High Yield (unhedged)	4.2%	11.8%	7.2%	8.4%	13.0%	9.9%	6.6%	7.5%

The objective of the DK Income Fund is to provide our investors with the maximum amount of income while preserving capital value. In 2006, the Fund provided unitholders with an income return of 8.8%, more than double 5-year government bond yields at 4%, while the unit value rose slightly. The rate of return for the fourth quarter was negative, primarily because of the Government's decision to impose income taxes on trusts, which resulted in a reduction in the valuation on most trusts. Furthermore, our largest portfolio holding, **Vicwest Income Fund**, had a disappointing third quarter and the unit value declined by roughly 40%. The portfolio held 35% in income trusts on average throughout the year. We used the decline in value as an opportunity to add to our income trust holdings.

We do not want to spend an excessive amount of time on the trust taxation issue as it has been adequately hashed out in the media for the past two months. That said however, we have two major issues with what has transpired.

Firstly, the Conservative Government had clearly stated in January they would not tax the trusts. Canadian companies and individual Canadian investors made decisions and organized their affairs accordingly. The consequence . . . roughly $30 billion of individual savings has been rubbed out.

Secondly, the Government stated that the primary reason for the decision was to stop the tax "leakage". However, the Government has not released documentation to support the claim that there is any tax leakage. On the other hand, there is enough anecdotal evidence to suggest that the opposite is the case. Personal and corporate tax receipts have been stronger than forecasted.

[1] Returns longer than one year are annualized.

In our opinion the outcome of this decision may produce a classic inducement of the "law of unintended consequences". Government income tax revenues may decline and the Conservatives may be thrown out of office.

Our job as professional investors is to take advantage of any given set of circumstances. Trusts are still just businesses, albeit businesses that now trade at lower and potentially attractive valuations. Since October 31st we have added one new income trust holding and increased our position in two others.

Following the Government's announcement and the disappointing Q3 results we doubled our position in **Vicwest Income Fund**. In our opinion, the market has overreacted. Vicwest generated cash flow of $10.5 million in the 3rd quarter of 2006 versus $17 million last year. The volume of sales was similar to last year but the margins were lower. Vicwest should generate free cash flow of $37 million for the full year in 2006, substantially above the $30 million needed to maintain the current $1.56 annual distribution. Vicwest carries very little debt, trades at 5 times cash flow, and provides a yield of 15%. On December 7th, Vicwest made an acquisition that should add $2 million to cash flow next year and, on December 19th, announced their intention to buy back up to 900,000 units over the next 12 months, representing approximately 4.6% of the outstanding units.

We also doubled our holding in **Data Group Income Fund** at an average cost of $8.90, providing an annual distribution of 13%. Data Group is Canada's largest provider of document outsourcing solutions, including printed products. During the third quarter, Data Group purchased Relizon Canada, the Company's largest competitor in the document management services industry. We expect Data Group to generate $1.45 per unit in distributable cash flow once Relizon has been fully integrated assuming no growth in sales.

We purchased a new position in **KCP Income Fund**. KCP operates in two business segments. They are North America's largest private-label bleach manufacturer and one of the largest contract manufacturers of consumer products in North America. Like many export-oriented Canadian manufacturers, KCP has experienced a very difficult operating environment in the last few years because of the significant appreciation of the Canadian dollar versus the U.S. dollar and also because of increased input costs, including most metals and petroleum based packaging materials. To offset increasing costs, KCP negotiated three price increases on their private-label bleach which significantly improved margins in 2006.

In 2005, KCP acquired two contract manufacturing businesses, APG Group and the custom division of CCL Industries. KCP is now one of North America's largest and most diverse contract manufacturer of consumer products. Many Fortune 500 consumer product companies, like Proctor & Gamble and Johnson & Johnson, have outsourced more of the product manufacturing to reduce their costs.

Margins in the contract manufacturing industry are currently low, but there are some signs this is improving and that KCP may be able to increase pricing. A small increase in the total cost to the consumer has a huge impact on KCP's margin and their bottom line. We feel KCP is attractively valued, has a strong position in its industry and the potential for growing cash flows.

During the 4th quarter Deans Knight was instrumental in structuring a $30 million bridge financing for **Jinshan Gold Mines Inc**. Jinshan is a $200 million publicly traded Canadian company with a 2.5 million ounce gold deposit in China. The purpose of the loan is to finish building the mine and to have it in production by early 2007. Ivanhoe Mines, a major copper and gold company, controls 49% of the Company. Ivanhoe itself is developing a large copper/gold project in Mongolia in a partnership with BHP.

The Company has a strong Board and management team, many of whom we know well and have dealt with in the past. The portfolio holds $3.5 million of the Jinshan note with a term of 3 years and paying interest of 12%. In addition, each $100 of debt receives 20 warrants to purchase Jinshan shares at $1.60 for 2 years ($1.53 at year end). When the mine is in full production midway through 2007 at an annual rate of 120,000 ounces, given the expected cash costs of $253 and using a gold price of $500 per ounce, Jinshan will generate a projected cash flow of $30 million per year. We expect the loan to be paid down out of cash flow or an equity issue within 2 years. In the interim, the fund receives a cash yield of 12% on the note. Furthermore, if the shares rise to $3 and the loan is repaid in 2 years, the potential total annualized return is 25%.

We hold four common equity positions received from our participation in debt investments with equity incentives attached. The most significant position is **LionOre Mining International**. We participated in two private debt financings in 2000 and 2001 which allowed us to purchase shares at an average cost of $2.33. Investors have been so intently focused on Falconbridge and Inco during the dramatic takeover battles for these companies, we felt they failed to evaluate LionOre correctly. With Falconbridge absorbed by Swiss-based Xstrata and Inco by Brazilian CVRD, LionOre became the largest publicly traded pure nickel producer in the world. This, combined with record nickel prices of over $15 per pound in late 2006, led to a significant increase in LionOre's valuation which closed at over $13 at year end. Our two investments in LionOre provided a total annualized return of 30%.

Our largest bond holding is **Jean Coutu Group 8.5%** August 1, 2014. We own bonds at an average cost of $93.50, a yield of almost 10%. In August, Jean Coutu announced the sale of their US pharmacy operations to Rite Aid. As part of the sale, it is intended that Rite Aid will assume the obligations of the 8.5% subordinated bonds from Jean Coutu. As a result, the Company has asked the Trustee to remove Jean Coutu and their very profitable Canadian assets as guarantor of the Notes. We, along with the majority of the bondholders, have challenged this and the matter is now before the courts. At year-end, bonds were valued at 100.