

**December 31, 2010**

**DK INCOME FUND**

**DEANS KNIGHT**  
CAPITAL MANAGEMENT LTD

**DK INCOME FUND**

**Quarterly Report  
December 31, 2010**

**Rates of Return<sup>1</sup>**

	<u>3 Mths</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>10 Yrs</u>	<u>15 Yrs</u>	<u>Since June '93</u>
<b>DK Income Fund</b>	<b>6.3%</b>	<b>18.3%</b>	<b>37.8%</b>	<b>14.9%</b>	<b>15.0%</b>	<b>13.8%</b>	<b>15.1%</b>	<b>12.0%</b>	<b>12.4%</b>
DEX Universe Bond Index	-0.7%	6.7%	6.1%	6.2%	5.6%	5.3%	6.3%	6.9%	7.3%
ML CDN High Yield	2.9%	13.5%	29.4%	4.0%	3.3%	4.5%	4.1%		
ML USD High Yield	3.1%	15.2%	34.7%	10.1%	8.1%	8.8%	8.6%	7.3%	7.7%
S&P/TSX Composite Index	9.4%	17.6%	26.0%	2.1%	4.0%	6.5%	6.6%	9.5%	9.5%

Since its inception in 1993, the DK Income Fund has provided income to its unitholders ranging between 7.5 – 10% per annum. We have added additional value, by opportunistically investing in bonds that have appreciated in value and private debt financings with equity incentives that provided additional capital appreciation.

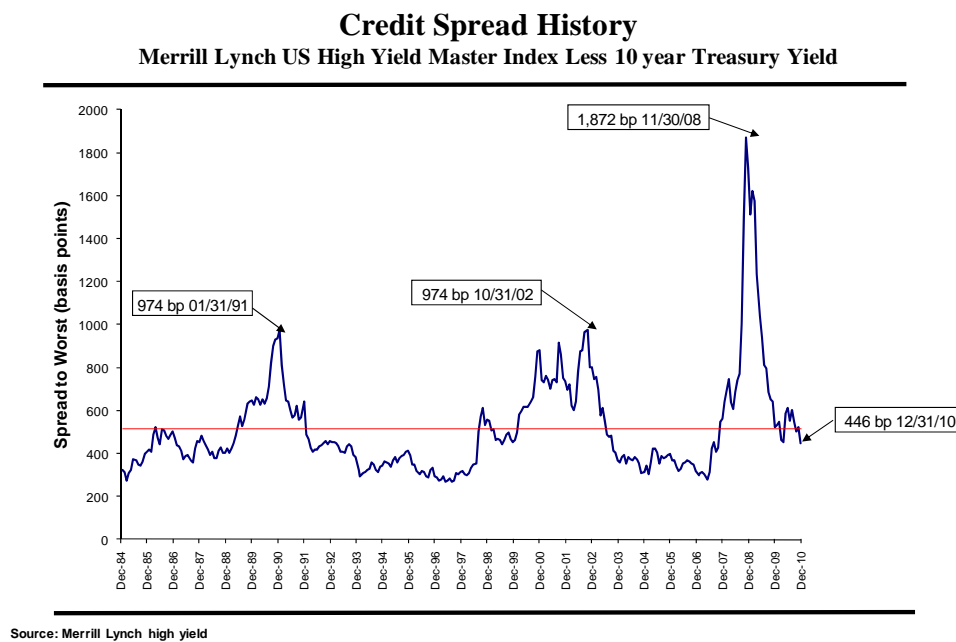
We participated in two such private financings over the past year. In August 2009, Deans Knight structured a \$10 million, 8% convertible debenture for **Whitecap Resources** (3.7% of the portfolio). Whitecap is a junior Calgary-based oil and gas producer. We are very familiar and have great confidence in the management team, and have invested successfully with them in previous initiatives. Whitecap grew production from 850 barrels of oil equivalent per day (“boepd”) to 2,900 boepd, 60% of which is oil. Our convertible debenture had an exercise price of \$2.88. On December 8<sup>th</sup>, we converted our bonds into equity and subsequently sold a portion of our holding at \$6.16. Whitecap is still a 3.7% weight in the fund, as we feel the Company can grow production per share and create additional value for shareholders going forward.

In the past three months, Deans Knight Income Fund designed and participated in a \$20 million secured subordinated note with **Sure Energy** (2.0% of the portfolio), another junior oil and gas producer, where again we have been very close to the principals for many years. Sure is currently producing 1,250 boepd, 46% of which is oil & liquids. Sure is undergoing a transition to a higher growth oil producer, with a significant position in the emerging Viking light oil resource at Redwater, an extensive inventory of low risk oil development (45 locations) and additional oil inventory (74 locations). The purpose of the facility is to develop the Viking asset and provide infrastructure to increase production.

<sup>1</sup> Returns longer than one year are annualized.

On December 21, 2010, Sure Energy drew down \$10 million of the facility. Additional draws on the Secured Note Facility may be made at the Company's discretion in minimum tranches of \$2.5 million. The drawn portion of the Secured Note Facility bears interest at 6.25 percent per annum. The undrawn portion bears a standby fee of 0.25 percent. The facility matures on January 21, 2014. Warrants to purchase 2.5 million common shares at a price of \$1.80 per share were issued as additional consideration and mature on December 21, 2013. As of December 31<sup>st</sup>, the common stock closed at \$1.75.

Although private debt financings have had a positive impact on returns in the last 10 years; 75% of the Fund continues to be invested in traditional high yield bonds. Even though the current spread in yields between U.S. 10-year Treasuries and high yield bonds has narrowed to the long term average (see graph below) we are still uncovering attractive opportunities within the high yield universe.



Our unique strengths are our experience in evaluating businesses, and also our ability to evaluate the protective covenants in the bond indentures. We focus on the debt instrument in businesses with tangible assets as collateral, strong cash flows and reasonable leverage, with covenants which limit the issuance of additional debt that would rank ahead of us.

We have stated for some time that higher yielding shorter term corporate bonds are a much safer and more attractive investment than government or high grade corporate bonds. Government and corporate investment grade yields are simply too low to compensate investors for the risk of rising interest rates. By contrast, the shorter maturity schedule and relative strength of the companies within the Deans Knight Income Fund provide an attractive income stream where investors are being compensated for the risk.

In addition to our bond holdings and private debt transactions, we are invested in a few high dividend paying equities. For example, during the quarter we started building a position in **Bird Construction**. Bird is one of the top national general contractors in Canada with an excellent management team and a strong balance sheet with net working capital of \$140 million on a market capitalization of \$500 million. Margins in 2010 were squeezed as projects were competitively bid, a trend which management expects to continue into 2011. Despite decreased margins, Bird is continuing to earn its monthly dividend of \$0.15 providing an annual yield at our cost of 5.6%. As demand for Bird's services increase and margins improve to more normal levels, their valuation should rise.