December 31, 2013

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	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**1.0%**	**0.1%**	**5.4%**	**4.9%**	**8.1%**	**17.0%**	**12.9%**	**10.7%**	**11.1%**	**11.2%**
DEX Universe Bond Index	0.4%	-1.2%	1.2%	3.9%	4.6%	4.8%	5.2%	5.6%	6.5%	6.8%
ML CDN High Yield	3.0%	6.7%	10.9%	8.3%	9.6%	16.3%	5.4%	4.7%		
ML USD High Yield	3.5%	7.4%	11.4%	9.0%	10.5%	18.6%	8.5%	7.3%	7.8%	7.9%
S&P/TSX Composite Index	7.3%	13.0%	10.1%	3.4%	6.8%	11.9%	8.0%	7.5%	8.3%	8.6%

It is that time of year where pundits trot out predictions for the coming year including where interest rates will be in 12 months. As we have written for 20 years, predicting interest rates is futile. Simply put, lending your money long term (say 5 years or more) to governments or any organization at negative real interest rates, like today, is never a good idea . . . EVER. But people en masse are currently doing just that. In a yield starved world, you want to lend shorter, at positive real rates, against reasonable collateral. That is what we do.

The DK Income Fund is invested in a select number of corporate credits with a short duration, 2.8 years, and an average current portfolio yield of 7.1%. This makes more sense to us than investing in a portfolio of government and investment grade bonds that yield 2.7%, (similar to the DEX Universe). Real interest rates are interest rates adjusted for expected inflation. While we do not know what the inflation rate will be over the next 10 years, it has averaged roughly 2.5% in Canada over the last 30 years. This inflation rate is extremely low by historical standards and still real interest rates on government bonds are negative and only slightly positive if you include Investment grade corporate debt.

The DK Income return has exceeded government and investment grade returns this year, but returns have lagged the high yield indices. This is because we had two credit problems, Mirabela Nickel and Northlands Resources, which impacted our 2013 return. Credit problems are a normal part of working in debt markets. We have been involved in 18 companies that have defaulted since our inception over 20 years ago. Credit problems certainly have a negative impact on short term returns; however, it does not mean the company’s bonds are worth nothing. The historical average recovery on high yield corporate bonds in general is 30 – 40%. Because of our experience we are able to be

[1] Returns longer than one year are annualized gross of management fees.

pro-active, which has resulted in an average recovery of more than 75% for our investors. The actual impact on the portfolio was negligible when you consider the much higher interest we received while the bonds were in good standing.

Northlands Resources is a producer of a high grade iron ore concentrate from their Kaunisvaara project in Northern Sweden. In January 2013, Northlands announced a funding shortfall at its Kaunisvaara mine and the immediate need to raise approximately $400 million in additional capital. The unanticipated cost overruns destroyed confidence in management and fundraising efforts failed, as a result, the Company filed for reconstruction. We sold our entire position in April 2013 at $29 per $100 par value.

We continue to own Mirabela. Mirabela produces nickel from a sulphide deposit in Brazil, with the capability to produce 20,000 tonnes of nickel per annum. Mirabela also has a first-class processing plant. The Company had cash of $108 million USD on the balance sheet at June 30th; however, with low nickel prices, was producing negative cash flow after administrative and debt servicing costs. In late September, the Company provided a disappointing operational update outlining higher cash costs in July and August resulting in a reduction of cash on hand to $80 million USD. In addition, the Company received notification from one of its two customers, Votorantim Metals, of its intention to terminate their offtake agreement at the end of November. Mirabela recently secured bridge financing to allow them time to secure long term financing or to find a buyer of the asset. The ultimate recovery is still unknown at this point. We are currently pricing the bonds at $10 but we expect to realize a higher value over time.

In both cases, it highlights the importance of access to capital in the mining industry. Without it, companies struggle to survive. A painful lesson, but a lesson learned. The good news is that those issues are now behind us, and despite credit issues our return was flat for the year, which was higher than the DEX Universe Bond Index, a portfolio of Government and Investment Grade Bonds.

At December 31st, the portfolio has 55% in high yield bonds, 9% in private debt financings, 21% in dividend paying equities and 15% in cash. The large cash position is a result of six positions, totaling $26 million or 17% of the portfolio, that were called during the recent quarter. High yield bonds are structured to allow the borrower to repay debt early, or call their bonds, at a premium to par. In a low interest rate environment, companies are incented to refinance at lower rates despite paying a premium to par. Although the large cash position reduces income in the short term, with interest rates at current low levels, it pays to wait for the right opportunities to invest in order to maximize returns. Our objective is to acquire the debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage when deploying our excess cash. Investing in a concentrated portfolio has allowed us to provide a higher level of income than the index while preserving capital over the long term. To give you an idea of the types of companies we are invested in, we are including some brief comments on a few of our larger bond holdings.

Paramount Resources *8.25% due December 13, 2017*. Paramount is an Alberta based intermediate natural gas exploration and production Company with assets in Alberta, Northwest Territories, and North Dakota. The Company expects to more than double its production, from 21,000 boepd to over of 50,000 boepd in 2014, as their new gas plant in Musreau is commissioned and new production is brought on stream. The Company estimates the free cash flow, after CAPEX, from their Montney play alone will be $340 – $520 million. In addition to its producing assets, the Company has a number of investments in other, predominantly public, oil and gas companies that are worth over $750 million plus an extensive land position versus total debt of roughly $1.1 billion. Paramount has a current market cap of $3.8 billion, of which management owns 50%. Our bonds are currently yielding 7.3% to maturity and are well secured by the increasing cash flows and the extensive asset base of the Company.

Gateway Casinos *8.5% Second Lien Notes due November 26, 2020*. With operations in BC and Alberta, Gateway is the second largest gaming company in Canada and the largest in British Columbia. In November, management refinanced their existing credit facilities and our 8.875% senior secured notes were called at a premium to par of $106.656, resulting in an overall return to DK Income investors since 2010 of 10.8% annualized. We participated in the new senior secured notes because the Company has shown the ability to service debt and reduce principal with excess free cash flow. They are well supported by their equity sponsor and prior to this refinancing they had repaid approximately $90 million of their original $355 million term loans issued in 2010.

Due to the highly regulated nature of the business, Gateway's revenue is dependent on the number of slots and table games they are allocated by the provincial gaming board. This regulation creates a significant barrier to entry and helps to maintain a steady demand for existing operators such as Gateway- which can be seen in their consistent revenue and EBITDA of $255 million and $82 - 93 million, respectively. During 2013, Gateway hired a new, experienced CEO and a CFO who are focused on improving EBITDA through several cost saving and revenue optimization initiatives. The increase in EBITDA, which along with debt repayments funded by free cash flow, will allow the Company to de-lever their balance sheet, currently consists of $310 million term loan and $200 million second lien notes. Investors are receiving an attractive yield of 8.5% and we expect bonds to increase in value as the credit quality improves, similar to the previous bond.

Sherritt International Corp. *8.0% due November 15, 2018* and *7.5% due September 24, 2020*. Sherritt is a diversified natural resource company that produces nickel, cobalt, oil and gas and electricity. In December, Sherritt announced the sale of their coal business for $946 million. Post sale, the Company will have over $1 billion in cash with $1.2 billion in recourse debt. While they sold roughly 36% of their last twelve months EBITDA, their remaining assets generated $245 million in EBITDA. As per the indenture, proceeds from the sale must be used to reinvest back into the business or repay debt. Management has not specified its preference; however, they did state that any investment will be focused on base metal assets that are, or very near to, generating cash flow and possess long-life reserves. We believe the Company received an attractive price for their assets, given the environment, and the increased liquidity has improved the credit quality of the debt. Bonds traded up on the news of the sale and are currently yielding 8.3% and 8.8%, respectively.

An area of continued focus, and a potential use of our cash, is private debt financings. These investments are typically short term, high coupon, in some cases fully secured and, most importantly, provide capital growth through “equity kickers” in the form of warrants or convertible debt. Since 2000, Deans Knight has participated in 33 private debt financings providing over $320 million in capital. Our average internal rate of return on these investments is 18%.

Deans Knight provides an attractive alternative because inefficiencies in the banking system and lack of flexibility from alternative lenders create obstacles for businesses looking for an alternative to issuing equity. Banks are typically slow to provide financing and less willing to negotiate on terms which are too restrictive for a Company's needs. Some alternative lenders require high returns, via fees and coupon, and have a loan to own mentality, which can put short term pressure on a business. Deans Knight takes a collaborative approach with each Company to find a less dilutive financing structure that compliments their business while maintaining our security requirements and target return. Our mindset is to develop a partnership, as increasing shareholder value enhances our return via our equity kickers.

For example, in August 2011, the Deans Knight Income Fund participated in an $18 million CAD Secured Subordinate Revenue Note with **RapidEye Canada Ltd.** The proceeds from the financing were used to acquire assets from the bankruptcy of RapidEye AG, a global provider of high-resolution imagery and geospatial solutions. RapidEye was able to obtain DK Investor financing in less than 30 days, near impossible with traditional lenders, and thus secured their purchase offer by the court deadline. We structured our notes with a modest coupon, 5%, and a royalty on the Company's net revenue allowing the Company flexibility and time to improve operations. Management exceeded expectations and repaid the Notes within 1 year of funding providing an earned income return of 17% including royalty. Noteholders continue to receive a royalty of 2.75% until December 2021.

Our approach to evaluating private debt is not unlike how we view high yield debt or equity investments; we are looking for value in places that other investors or lenders have not yet realized. We look for businesses with a sustainable competitive advantage, reliable cash flows/tangible assets, strong balance sheets and hidden value. We invest with management teams we can trust and who are financially committed to the company. Investor protection and security is vital and our preference is to be at the top of the capital structure or negotiate secured facilities subordinate only to a limited bank facility. Two recent examples are **Conifex Timber Inc.** and **Petroamerica Oil Corp**.

In late 2011, we provided $12 million in Secured Notes to Conifex to fund working capital. The Notes paid a 12% coupon and were secured by the assets of the Company, including sawmills in northern BC, in which they have already invested $80 million. In addition to the coupon, Noteholders received a commitment fee of 2% and warrants to purchase 325,000 common shares. Since 2011, management has improved efficiencies and are now enjoying the benefits from the beginning of a housing industry recovery in the U.S. and consequent rising lumber prices. As a result of the improved outlook, Conifex secured a $25 million ABL facility with Royal Bank of Canada and repaid our $12 million Secured Notes on April 3, 2013. The annualized return on our investment, including commitment fees, was 14.5% which excludes the potential further upside from the warrants. The stock is currently trading at roughly $8.70 which is just below our exercise price of $9.33.

Petroamerica is an oil producer with assets in Colombia. In April 2012, we structured a secured debt financing with Petroamerica for $35 million. The Debentures mature on April 19, 2015 and bear interest of 11.5%. In addition to the coupon, our clients received a commitment fee of 1.5% and warrants to purchase 100 common shares per $100 of debt at a price of $0.20 per share, which mature on April 19, 2015.

They started 2012 producing 200 barrels of oil equivalent per day ("boepd"). With proceeds from the debt financing, Petroamerica was able to meet CAPEX goals to develop and appraise their assets. Since closing, the Company has increased production from 6,200 boepd, should cash flow close to $100 million in 2013 and, as of September 30th, has $65 million in cash on the balance sheet. Their success has been reflected in the stock price which is currently trading at $0.34, 70% above our exercise price.

A natural assumption is that we are taking on greater risk than the high yield market which is why the returns on our private debt financings are so much higher. This is not accurate. In many cases our private debt is secured. We obtain higher rates because the debt is illiquid. Since we only invest in a handful of opportunities, we are able to select only the one's which meet our strict criteria. Of the 33 private debt financings we have invested in since 2000 only one, GBS Gold, has experienced credit problems and in that case we recovered roughly our original investment.

We believe private debt opportunities offer attractive equity like returns with debt like risk. While they will only represent a small component of the overall portfolio, with historical returns of 18%, you can see how even a small weight can add significant value to DK Income Fund unitholders. We are encouraged with the continued deal flow and expect these financings to remain an important part of our portfolio going forward.

Finally, we complement high yield and private debt financings with investments in a select number of high dividend paying corporations. 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 determine whether or not we are paying a fair price for the business.

For example, we recently bought a position in American Hotel Income Properties REIT ("AHIP") which we believe will provide an attractive total return going forward. AHIP owns 37 smaller hotels in secondary U.S. markets within close proximity to railways, airports and highway interchanges. They focus on over-looked properties at attractive cap rates with room to improve cash flows through efficiencies and increased occupancy. Management has a strategy to have a majority of their rooms, currently 60%, contracted with railway operators to provide minimum occupancy rates and stability to their cash flows. The REIT has a strong board and management team with a track record of creating shareholder value and whom we have invested with in the past. The REIT currently provides a yield of 8.4% and we believe can grow shareholder value over time through acquisitions.