December 31, 2016

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

Quarterly Report
December 31, 2016

The DK Income Fund provided an income return of 7.1% in 2016 and a total return of 13.0%. The income earned was at the lower end of our long-term range (7 – 10%) for two reasons. Firstly, bond interest rates were the lowest ever recognized for the 2016 year. Secondly, we began the year with a cash position of 25%, the result of 6 bond issues repaid in the latter part of 2015. Both these factors acted as a temporary drag on income. We invested all our cash through the first four months of the year and interest rates began to rise in the second half of the year. The portfolio is now earning a yield of 7.3%.

Table 1: Deans Knight Income Fund Historical Annual Returns:

Year	Income Earned	Price Movement	Total Return
2016	7.1%	5.9%	13.0%
2015	8.4%	-8.1%	0.3%
2014	7.9%	-3.8%	4.1%
2013	7.2%	-7.1%	0.1%
2012	8.2%	2.7%	10.9%
2011	8.3%	-4.1%	4.1%
2010	7.7%	10.6%	18.3%
2009	11.5%	49.1%	60.6%
2008	9.4%	-29.7%	-20.3%
2007	8.5%	7.2%	15.6%
2006	9.0%	0.1%	9.1%
2005	9.3%	11.6%	21.0%
2004	9.7%	15.9%	25.5%
2003	10.1%	17.1%	27.2%
2002	9.9%	0.6%	10.5%
2001	9.1%	-8.9%	0.2%
2000	9.7%	-17.5%	-7.8%
1999	7.5%	-2.2%	5.3%
1998	7.9%	-3.6%	4.2%
1997	8.1%	6.4%	14.5%
1996	8.7%	7.7%	16.4%
1995	9.8%	11.1%	20.9%
1994	8.7%	-2.1%	6.7%
1993*	4.0%	4.5%	8.5%
Annualized Since Inception	**8.8%**	**1.7%**	**10.5%**

* Fund Inception was June 30, 1993. 6 month annualized income earned is 8%.

The Fund experienced positive price movements, largely the result of a recovery in energy and metal producer bond prices throughout 2016.

Government and investment grade bond prices did not fare as well as high yield bonds in 2016. For example, interest rates on 10-year U.S. Treasury bonds increased from 1.5% to 2.5% in the later part of the year, causing a price decline of 7.6%. This recent price decline equals four years of coupon interest.

By contrast, over the same period, our high yield portfolio generated a positive 3.5% return. We have a higher coupon (7.3%) and a much shorter average term to maturity (3.8 years) meaning our bond prices are less impacted by rising interest rates. Income investors should look forward to higher interest rates and we expect to continue to benefit from rising interest rates with 8% in cash and 16% of our portfolio maturing in the next twelve months.

Our DK Income strategy has provided a high level of income between 7 – 10% for over 20 years. If you reinvest the income, the earning power of your investment will obviously grow over time. Our Chairman Emeritus and co-Founder, Doug Knight, highlights the miracle of compound interest in a recent note, included below.

I was married 40 years ago. We chose a Church wedding and were required to meet with the Minister to get his approval. He asked my occupation and I answered "bond trader". He settled back in his chair, smiled and said, "Ah yes, the miracle of Compound Interest". This, of course, is something the Church fully understands. If Christ had invested just one penny at 3%, due to compounding (and no tax) his Church would have investments worth 2.8 Trillion times the total of all U.S. corporate, personal and Government assets.

Over my investment career I have enjoyed a more modest but similar experience. I co-founded Deans Knight Capital Management Ltd., in 1993. I invested my entire RRSP of $141,899 to become the initial investor in our newly created DK Income Fund. I have never made another contribution to my RRSP because my accountant instructed me to make future annual contributions to my wife's RRSP and pay all fees outside the RRSP for tax efficiency. As a result, the only cash inflow my RRSP has received is interest income, which I automatically reinvested into more units each month in order to compound tax free. Now retired, the value of my RRSP is $1,466,616, meaning I achieved a cumulative growth of 900% over 23 years. This equals an average annual return of 10.5% per annum but more importantly the 2016 interest distribution of roughly $95,000 is now equal to 65% of my original deposit amount. Not a miracle but an excellent result!

For comparison, over the same time period below are other market indicators:

June 1993-Dec 2016	*Cumulative Growth*	*Annualized return*
TSX/S&P Stock index	*555.8%*	*8.3%*
BofA/ML Cda Broad Bond Index	*336.9%*	*6.5%*
Berkshire/A	*1485.2%*	*12.5%*

The bottom line, buy high yield bonds and leave them alone. It is not easy because markets go up and down and business news constantly bombards us with the latest market threat du jour. Don't let your anxieties affect your investment decision making. There is always volatility. Over the last 23 years, we have watched the tech bubble grow and burst, Y2K, 911, Al-Qaeda, Iraq, Syria/ ISIS and now Donald Trump in the White House. Does volatility mean anything to my investment? No. Looking back, I should be happy with 900% cumulative growth!

You may think it was easy for me because the interest rate on a Government of Canada 10 year bond was 7.34% in 1993 and it is now 1.7%. When interest rates decline, bond prices rise so maybe a large part of my return is from the capital gain on bond prices? You would be wrong. Bond prices only change in the short term. Essentially, you buy bonds at $100, receive the coupon income and when repaid you get your $100 back. In my case 92% of the 900% return was simply the result of the coupon income plus the compounding of that coupon income over time. Bond price changes, up or down, are misleading and unimportant over the long term. You should expect bond prices to change, but the reasons you invest in bonds should not. Whether you seek to compound or to spend the coupon income, bond investors should always wish for higher interest rates!

PORTFOLIO ACTIVITY:

We had three bonds repaid during the last quarter of 2016: **Paramount Resources Ltd.** (7.625% of 2019), **Just Energy Group Inc.** (6% of 2017) and **Conifex Timber Inc.** (7% of 2016).

Paramount bonds had traded down at December 31, 2015 to 75.50, a cash yield of 10.1%, as energy prices declined. While Paramount's debt levels had increased to fund its capital programs over the past two years, the Company had options to raise cash, including the sale of assets, and we added to our holding at an average price of $77.50 in 2016. Since then, Paramount sold assets in two separate transactions leaving them with more cash than debt. As a result, the bonds were called in December 2016 at $102.542.

Just Energy redeemed 70% of its 6% convertible bonds due June 2017 during the quarter using proceeds from a new convertible bond issuance and cash on hand. Just Energy is a natural gas and electricity retailer supplying households in Canada and the U.S. We originally purchased bonds in 2013 at an average price of $77.50, a 13% yield to maturity.

In 2013, Just Energy's stock price came under pressure over concerns of the true earning potential of the business and its growth prospects. The stock price was trading well below the conversion price of the bonds which caused them to trade in the $70's. Our analysis showed the bonds were covered more than two times by the current contracts with its customers and growth concerns were largely an equity holder's issue. At 13% yield to maturity, bondholders were being well compensated for the risk. Since 2013, Just Energy has gradually grown its cash flows and sold assets which allowed them to issue new convertible bonds in September and repay the majority of our bonds at Par. The remainder of our bonds will be repaid on June 30, 2017 or earlier.

Conifex Timber bonds matured in December. The Company repaid the debt with cash from the balance sheet.

We reinvested a portion of the cash by adding to some existing holdings listed below along with the cash yield (annual income) at time of purchase.

Holding	Cash Yield
Black Press	10.0%
Crew Energy	8.2%
Garda World	7.6%
Gateway Casinos	8.9%
Imperial Metals	7.4%
Newalta Corp	7.1%
Western Energy	8.4%

On December 13th, **Gateway Casinos & Entertainment Ltd.** announced that Ontario Lottery and Gaming had selected them as the service provider for both North and Southwest Gaming bundles as Ontario looks to modernize its gaming industry. Gateway's expansion into Ontario will bring nine existing properties and two planned new builds to add to its existing 18 properties in BC and Alberta. The new properties will further strengthen our debt position and bonds have traded up from our recent purchases at $95 to Par.

On December 15th, **GardaWorld Corporation** reported its most recent quarterly results. Garda is one of the world's largest security companies providing security services at airports, sporting events, office buildings etc . . . and the North American leader in armored transportation of cash. In 2015, Garda acquired Aegis Group and cash flows initially were impacted by integration costs. Going through the financials, we determined these costs were largely behind them and cash flows would increase in the latter half of 2016. The recent quarterly release shows continued improvement in cash generation and bonds have traded up from $86 at December 31, 2015 to $94.25 currently. We have added to our position throughout the year at an average cost of $89.50.

On December 30th, **Imperial Metals Corporation** closed an equity raise of up to $65 million. Imperial is a copper/gold producer with 2 open pit mines in British Columbia. The Red Chris mine, which is targeting production of 95 million pounds of copper and 65,000 ounces of gold with a 30 year mine life and Mount Polley which produces 27 million pounds of copper and 48,000 ounces of gold. Imperial had been burning cash as Red Chris was ramping up to commercial production and needed an equity injection to improve its working capital. With both mines in full production, Imperial will generate cash flow in excess of $100 million which can be used to reinvest in its operations or reduce debt.

The three energy bonds we added to (**Crew Energy Inc.**, **Newalta Corporation** and **Western Energy Services Corp.**) are benefiting from the improvement in oil and gas prices in 2016. All three Companies have solid assets and minimal debt ahead of our high yield bonds which. Like

Paramount, they had been penalized because of the weak commodity price environment earlier in the year. Crew Energy bonds have already recovered, and are now trading above par.

Energy Service companies, Newalta and Western Energy, experienced reduced cash flows earlier in the year as exploration and production companies decreased their drilling activity. With the subsequent improvement in oil and gas prices, budgets have since increased. With the improvement in activity, we would expect bonds of Newalta and Western Energy, which are currently trading at $85 and $93 respectively, to revert back to par. In the meantime, we will continue to add to our position.