DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK BOND FUND
Quarterly Report

December 31, 2003

Rates of Return

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs
DK Bond Fund	**6.5%**	**27.2%**	**18.5%**	**12.0%**	**6.7%**	**6.4%**	**9.4%**
SCM Universe Bond Index	0.9%	6.7%	7.7%	7.8%	8.4%	6.4%	7.8%
ML CDN High Yield (hedged)	4.9%	25.8%	10.1%	3.9%	1.4%	3.2%	n/a
ML USD High Yield (unhedged)	5.9%	28.1%	12.1%	9.5%	5.7%	5.0%	7.0%

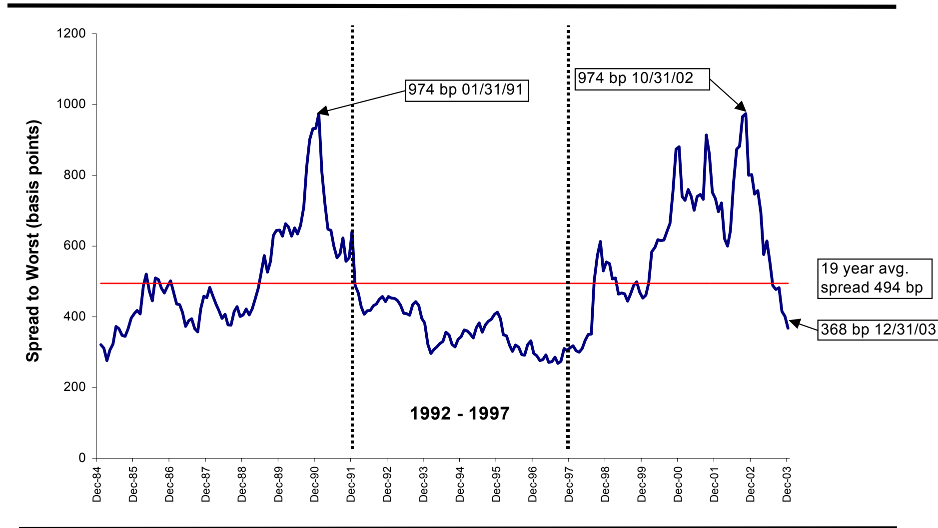
An exceptional year, it's not the norm.

Clear signs of global growth emerged during 2003. This helped credit markets go from apprehension 12 months ago to solid optimism. Over the course of the year this optimism led to significant price recovery in corporate bonds. The annual return in the DKBond portfolio was 27.1% versus 6.7% for the SCMU bond index (primarily Government bonds). Optimism is still evident in credit markets, leading to a return of 6.5% in the DKBond fund during the fourth quarter versus 0.9% for the SCMU bond index. Last year's substantial portfolio returns are very welcome, but they must be recognized as the exception. Unfortunately double digit high yield bond returns can not be expected to continue.

Breaking down last year's return, the income distributed from the DKBond fund during 2003 was equal to 10.1%[1]. This demonstrates corporate bonds provide a substantial return from interest income alone. Last year in addition to income, the recovery in bond prices from the cyclical bottom in 2002 added significantly to the DKBond fund annual return. Strong fundamentals continue to support corporate bond prices; solid U.S. GNP growth, rapidly improving corporate profits, strong commodity prices and a robust consumer. However, there is little prospect of further price improvement in corporate bonds during 2004. For example, the average bond price in the DKBond portfolio at the start of 2003 was roughly $91 and it was close to $102 at year end. Because bonds mature at $100, bond investors should expect future returns equal to portfolio income alone, or approximately 8.5% going forward for the DKBond fund.

[1] Based on the DKBond unit value at the start of the year

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

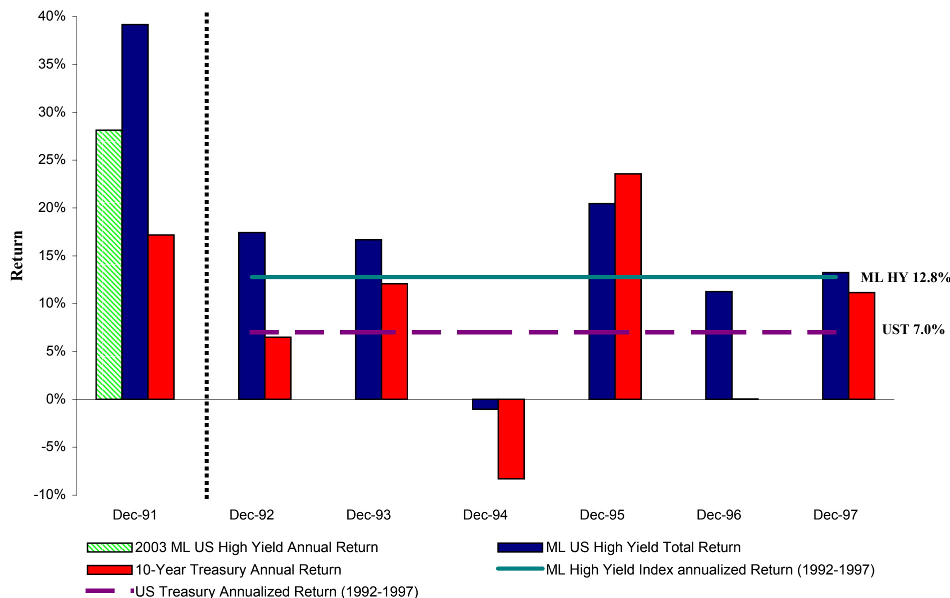


Source: Merrill Lynch high yield

Looking ahead

Credit spreads normalized during 2003 as shown in the chart above. In the last cycle the credit spread decline in 1991 was followed by 6 years of relative calm where credit spreads remained quite stable. During this 6 year period (1992 to 1997) the return of the ML High Yield bond index averaged 12.8% per annum. This return is similar to the start of period yield to maturity on the ML index in 1992 of 13%. We expect to see a similar pattern of stable credit spreads develop in 2004 and beyond as the economy continues to expand. Currently, the start of period yield to maturity of the ML High Yield index is 8.0% at year end, and we expect that this will be close to the high yield market return over the next 5 years.

Annual Returns following Previous Cyclical Bottom in Corporate Bond Prices



The economy, globally, has only recently entered the growth stage of the business cycle. Corporate profits are up, default rates are declining, and credit quality is still improving; all conditions that should continue for some time. Looking at the pattern of the last credit cycle in the chart above, the recovery in corporate bond prices occurred during 1991 in a similar fashion as in 2003. Following 1991 corporate bonds provided stable returns in 5 out of 6 years. Historically corporate bonds provide higher returns than Government bonds when the economy is expanding. In the last cycle (1992-1997) corporate bonds provided substantially more return at 12.8% than Government bonds at 7.0%.

Very low Government bond interest rates this cycle means institutional investors are stretching for yield and increasing corporate bond holdings. For example, GM's Pension Plan, a substantial high yield bond investor for the past 15 years, has announced they will be increasing the allocation to high yield bonds. GM's management said increasing the allocation to asset classes such as high yield bonds will enable the pension fund to achieve its 9% total return target and at the same time reduce the volatility in annual performance. We note that a 9% target return strikes us as a very tall order even for high yield but GM's decision illustrates the need or demand for yield and other so-called "alternative asset classes".

U.S. Treasury 10-year bond yields one year ago were 4%, the lowest level in 40 years. (At year end 2003 10-year Treasuries were 4.4 %.) One year ago we asked why investors would accept locking in for 10 years to earn just 4%. The DKBond fund earned an interest return in 2003 of 10.1%. In our opinion, low U.S. Treasury yields indicate to us that we are in a multi-year low return environment and this will encourage investors to seek better alternatives. In this environment high yield corporate bonds, while not as attractive as last year, still provide twice the yield of 10-year Treasury bonds. Solid evidence that the economy is expanding means the risk in corporate credit quality is significantly less compared to last year. As a result, return versus risk in high yield corporate bonds still remains attractive.

Bonds are for income

The DKBond fund began on June 30th 1993, 10½ years ago with an initial unit value of $500. The unit value today is $511.24. Over 10½ years the DKBond unit value has not grown. However, the DKBond portfolio has consistently provided a high level of interest income. Each unit has received $511.51 in distributions since inception, equal to the entire unit value today. Income alone has provided a 9.73% annualized return, and this illustrates a simple fact. Investors looking for growth should own equity. Investors looking for income should own bonds. We do not expect the DKBond unit value to grow but we do expect the DKBond portfolio to provide interest income of 8.5% in 2004 and this is roughly double the yield on Government bonds.