DK Equity Growth Fund
Quarterly Report
March 31, 1999

Rates of Return for the Period Ended March 31, 1999

	3 Mths	1 Yr.	3 Yrs.	4 Yrs.	5 Yrs.	6Yrs.
DK Equity Growth Fund	**-0.9%**	**-30.7%**	**-5.7%**	**7.7%**	**7.2%**	**13.5%**
NB Small Cap Index (Unweighted)	-0.2%	-26.1%	-2.8%	3.5%	0.6%	5.1%
TSE 300	2.1%	-11.3%	11.8%	13.3%	11.0%	12.9%

The underperformance of small cap stocks that we have written about consistently since the latter part of 1997 continued into the first quarter of 1999. This trend has been going on for so long in the U.S. and Canada that a recent article in the Wall Street Journal has called small cap stocks “Roach Motels” – shareholders can check in, but not out, except at huge losses.

You might think that small cap stock specialists such as ourselves would have thrown in the towel by now. As Charlie Baillie, the CEO of Toronto-Dominion Bank mused to a group of us at a dinner in Vancouver recently, “When your horse dies, it is wise to dismount”. He, of course, was responding to a question regarding the prospects of resurrecting the Canadian bank mergers, but you might think that with the death of small cap stocks the same advice should apply to small cap managers. However, as we have learned over our 30 years in the investment business, “when death is declared on Wall Street, it is always wise to seek a second opinion”.

Small companies are not dead, they are just being ignored. Although the magnitude of the spread in valuations and returns between big cap and small caps in the past 2 years may be unprecedented, diverging returns between big and small caps are nothing new. We have seen many periods in history where bigger company stocks have provided higher returns, but nevertheless small cap stocks have always recovered and generated higher long-term returns. Although at times like this we feel like “the hydrant rather than the dog”, we know from experience that things do change and this is not the time to abandon cheap stocks and buy expensive stocks.

We pointed out in our report to clients for December 1997 that the broad market indices in North America (TSE 300, Dow, S&P 500, NASDAQ) were being carried higher by price increases in a smaller and smaller number of larger companies. This trend has become even more dramatic in 1998 and into 1999. Jonathan Chevereau pointed out in a column in the National Post on April 3 that although the Dow has surpassed the 10,000 mark, "most people have missed the real news that 70% of all U.S. stocks have been in a bear market since last April".

Seldom, if ever, has such a strong stock market produced so little joy. We are not the only market mavens attempting to bring attention to the narrowness of the market. Greg Ip of the Wall Street Journal has been writing columns about it since last July. In an article in the Wall Street Journal on April 1, he pointed out that although in the first quarter of this year the Dow Jones rose an impressive 6.6% and the S&P 500 4.6%, the Value Line Index, which measures the average performance of 1700 major stocks, actually fell 3.7%. Moreover, the Russell 2000 Index of smaller capitalization companies declined 5.8%. In the S&P 500 index of 500 stocks, only 21 big stocks contributed all of the index advance. One third of the performance came from just two stocks, Microsoft and America Online.

Gretchen Morgenson wrote in a recent Sunday New York Times article that while the "Dow has soared, the rest of the market has snored". Fewer and fewer stocks have been rising and most stocks are well off their peaks. The article noted that recent Salomon Smith Barney research shows that 92% of NASDAQ stocks and 86% of NYSE stocks are below their 52-week high by 10% or more. Salomon also publishes a Laggards Indicator, which measures the percentage of U.S. common stocks that are lagging behind the S&P 500 Index by 15% or more. Currently, roughly 75% of stocks fall into that category. This is the highest percentage since the indicator began in 1971. The previous peak was 60% in the early part of the 1973/74 bear market.

As a result of all this, the recent returns provided by small cap managers versus large cap managers, and value managers versus growth managers, have been wildly divergent. An April 4th Mutual Funds Report in the New York Times compared the 12-month returns to March 31 for mutual fund categories. The median return for large cap growth funds was 27.8% whereas the median return for small cap value funds was –23.4%, an astonishing gap of 51.2%. What it means to us however is that the large cap growth funds are full of grossly overvalued stocks like Coca-Cola (7% annual growth, trading at 40 times earnings) and the small cap value funds are full of companies trading at multiples that are about 1/3 this level. At this stage it is our strong opinion that serious long-term investors should avoid the former and emphasize the latter.

A related matter of some discussion recently has been the better returns generated by the U.S. market vis a vis the Canadian market. We have refuted this for some time and have

argued that similar companies of similar size have performed in a similar manner, whether they are Canadian or U.S. stocks. We published and sent to clients a special report on July 31 of last year showing that the average TSE listed stock and the average NYSE stock of similar market capitalization had performed in a surprisingly similar manner. As Jeff Rubin of CIBC Wood Gundy clearly shows in a recent research report, the difference in performance between the Canadian market (TSE 300) and the U.S. market (S & P 500 and the Dow) has been simply the result of the recent preference for big capitalization stocks. Canada relative to the U.S. is a smaller capitalizaton market.

We have argued that the most attractive place to invest at this time is small cap stocks because of the relatively low valuations. We have also argued that the exceptionally attractive area is resource stocks (oil & gas, forest products, and metals). Rarely do we see an opportunity like late in 1998 and early 1999 to acquire top quality resource companies at such incredibly low valuations.

For example, in December only one of Canada's 30 publicly traded forest products companies traded above book value (Donahue). Almost an entire industry was being valued as if it was going out of business. Many good quality small and mid sized mining and oil and gas companies are trading at 10 – 20% of their peak 1997 valuations. Moreover, most of these companies are better companies today (i.e. higher production, more reserves, and lower cost structures).

As a result of our views on where the values lie in the market, we have stuck to our guns. We may be one of the few remaining small cap managers in Canada. We have also maintained significant investments in resources stocks and we are now beginning to see early signs of a revival in small cap stocks and resource stocks.

At March 31 our portfolio had approximately 40% of the assets invested in resource areas (26.6% oil & gas, including oil service stocks, 5.4% in forest products, and 8.3% in metals). The balance is in consumer and industrial products stocks that all trade at discounts to the average TSE 300 multiple.

One of the classic early signs that your stocks are undervalued and coming back into favour is takeovers. As big cap versus small cap valuation premiums develop, it becomes cheaper for big companies to buy rather than to develop or build additional business. This is clear in the energy sector in Canada right now. It is now cheaper to drill for oil on Bay Street than it is in Alberta. AEC took over (we should say stole) our **Amber Energy** last October at $7.50 per share. At the time, **Amber's** netback on the Pelican Lake heavy oil production was about $11 per barrel. Today that production is netting closer to $20 per barrel.

AEC is now trying to pull off a double play by bidding to take over **Pacalta Resources** at .235 AEC shares per **Pacalta** share (at the time of writing this equates to $9.50 per **Pacalta** share). We and some of the key shareholders (including management) hold enough stock that we can make it tougher for AEC to steal this one. The bid is set to expire on April 21 and we feel that if this company is sold, it will be at a price much higher than $9.50 per share. Our biggest concern at this time is that we may lose some very good companies to takeover bids at valuations that do not adequately reflect their exceptionally good longer- term prospects.

In the non-resource area, focus on **OSF Industries** as an example of the market ignoring reality and forcing down valuations to a ridiculous level. **OSF** is North America's largest store fixture manufacturer. In spite of a record year in 1998 (sales up 50% to $290 million, EPS of 89¢ per share versus 7¢ in 1997) the market drove the share price down from $11 to a low of $5 (down 60%) and the trailing 12 month P/E ratio to a ridiculous 6 times. The company generated EBITDA of $41 million in 1998 and yet had a market capitalization as low as $100 million.

One notable sale during the first quarter was the balance of our **Cinram** position at $17. We had earlier sold a portion of the holding at much higher prices. This is a stock that we had first purchased in late 1994 at a split-adjusted price of $4 per share. We eliminated the position for 3 reasons: 1) the growth in the market capitalization took it over our notional $1 billion market cap maximum.; 2) the valuation had increased from a P/E ratio of 10x when we bought it to a high of 36x; 3) the threat that competing technology may reduce the company's growth potential.

We wrote to you about our holding in **International Wallcoverings (IWL)** in January 1999. We, along with three other shareholders, had become concerned about the poor performance of the company in late 1997 and through 1998, and with the lack of action to identify and rectify the problems. We took a position on the Board of Directors late in 1998. We subsequently discovered that the U.K. operations, which were purchased in 1996, were draining a sound North American business. We took immediate steps to seek protection from creditors and put a transition CEO in place. The company will emerge from CCAA in May. At the time of writing, a proposal has been made to merge **IWL** with the private and very profitable Blue Mountain Wallcoverings. The combined companies would be the second largest North American wallpaper manufacturer with strong management from Blue Mountain and strong financial backing. We are disappointed with our investment in **IWL**, but feel that by taking action last fall we were able to avoid bankruptcy; we were able to preserve some shareholder value, and save a viable business and hundreds of jobs.

As of March 31 the ten largest holdings in the portfolio were:

Pacalta	6.1%
Merit Energy	3.4%
Aber Resources	3.4%
Winpak	3.4%
UCAR Intl.	3.0%
UniCan Security Systems	3.0%
Tritech	3.0%
Intertape Polymer	2.7%
Western Star Trucks	2.7%
GST Tel	2.7%
	33.4%

Six of the top ten holdings were the same at December 31, 1998 – **Merit Energy, Aber Resources, Winpak, Unican Security Systems, Tritech,** and **Intertape Polymer**. We still hold the four December 31 top ten holdings that have dropped from the list – **Premdor**, the world's largest door manufacturer, **SNC-Lavalin**, the world's 5th largest engineering company, **Velan**, a world class valve manufacturer, and, **Ontario Store Fixtures (OSF)** a world leading retail store fixtures manufacturer that trades at 7 times trailing earnings. At December 31, we also held the four new additions to the March 31 top ten list. **Pacalta Resources** joins the top ten based on price appreciation due to the AEC takeover bid. **Western Star Trucks** joins the top ten as we added to our position early in the year. As we wrote to you in December, if you take away the loss in their Orion Bus Division, (which we believe is now profitable) **Western Star** could earn $3 per share in the current year. **GST Telecommunications** joined the list based on price appreciation as it participated in the strength in tech stocks. **GST** provides telecommunications services to business customers in the western United States. **UCAR International** manufactures graphite and carbon electrodes used in the production of steel. **UCAR's** share price has appreciated as the market has broadened into undervalued manufacturing stocks.