March 31, 2013

DK EQUITY GROWTH FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Report
March 31, 2013

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs.	15 Yrs	20 Yrs	Since Inception March 31, 1993
DK Equity Growth Fund	**-4.5%**	**-8.2%**	**-13.3%**	**-2.0%**	**15.3%**	**0.5%**	**14.9%**	**12.4%**	**15.5%**	**15.5%**
S&P/TSX Composite Index	3.3%	6.1%	-2.1%	4.9%	13.1%	2.1%	10.0%	5.9%	8.9%	8.9%
S&P 500 (in U.S. Dollars)	10.6%	14.0%	11.2%	12.7%	21.0%	5.8%	8.5%	4.3%	8.5%	8.5%

With the daily business news now entirely focused on the new record highs being set by the U.S. Dow Jones Industrial Average and the S&P 500 Index, you might think that we would all be dancing in the streets. Not so. Yes, our prescient viewpoint on the global economy since the great recession/financial crisis of 2008/2009 turned out to be uncannily accurate. Readers of those quarterly missives over the past 4 years will recall our view and advice at the bottom of the global recession (mid 2009) and the ensuing 4 years. In spite of the ominous storm clouds that enveloped us all, our view was that the global economy would gradually heal, and that the remarkably low valuations on stocks and non-government bonds, would improve.

We did not need a crystal ball to anticipate a recovery. We just asked ourselves two simple questions… One, prior to the 2008/2009 recession, in the past 100 years, how many recessions had we experienced in North America. Answer: 21. Two, how many recoveries had there been. Answer: 21. So in the midst of the 22nd recession, what was the likelihood of a 22nd recovery? It was extremely likely, and it did occur.

That said, the recovery in the U.S., although it appears to be picking up a little momentum, has been somewhat anemic compared to most of the previous 21. To keep it going, it has required an enormous amount of monetary stimulus from the Federal Reserve. Moreover, the global economic recovery has been uneven, at best. Although there are a few bright spots in Europe, the EU as a whole has flopped back into recession. Even the pre-recession powerful economic growth of the BRIC's (Brazil, Russia, India, China) is not looking as robust.

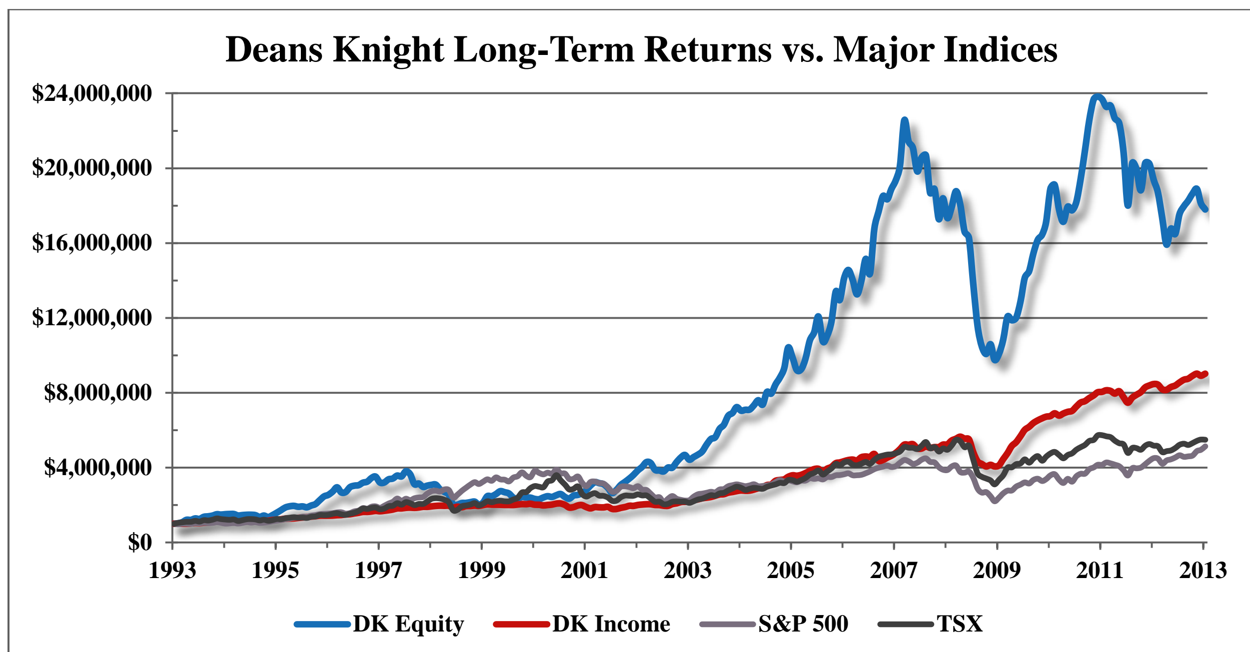
[1] Returns longer than one year are annualized gross of management fees.

A word about China. There appears to be a singular focus on China's growth, and by inference a focus on global growth and commodity prices. During our visit to China one year ago, our main takeaway was that economic growth in the coming few years would likely be in a hefty 7.5% - 8% range per year. If any softness did occur it would likely be in the first half of 2013, as a result of the transition to the new ruling group. As it turns out growth in Q1 2013 has come in at 7.7% and it has been treated by the media as a 'disastrous' number, and by inference, commodities are an outright sell. Makes little sense to us.

The U.S. stock market indices have rallied strongly since the lows of March 2009. The S&P 500 Index bottomed at 676.53 and touched a new high of 1,569.12 at the end of March. The Dow Industrials hit a low of 6,547.05 and at March 31 hit a new high of 14,578.54. On March 31, the TSX Composite, by comparison, still sat 15.4% below its prerecession high. After outperforming the U.S. indices for more than a decade, the Canadian market has lagged over the past two years.

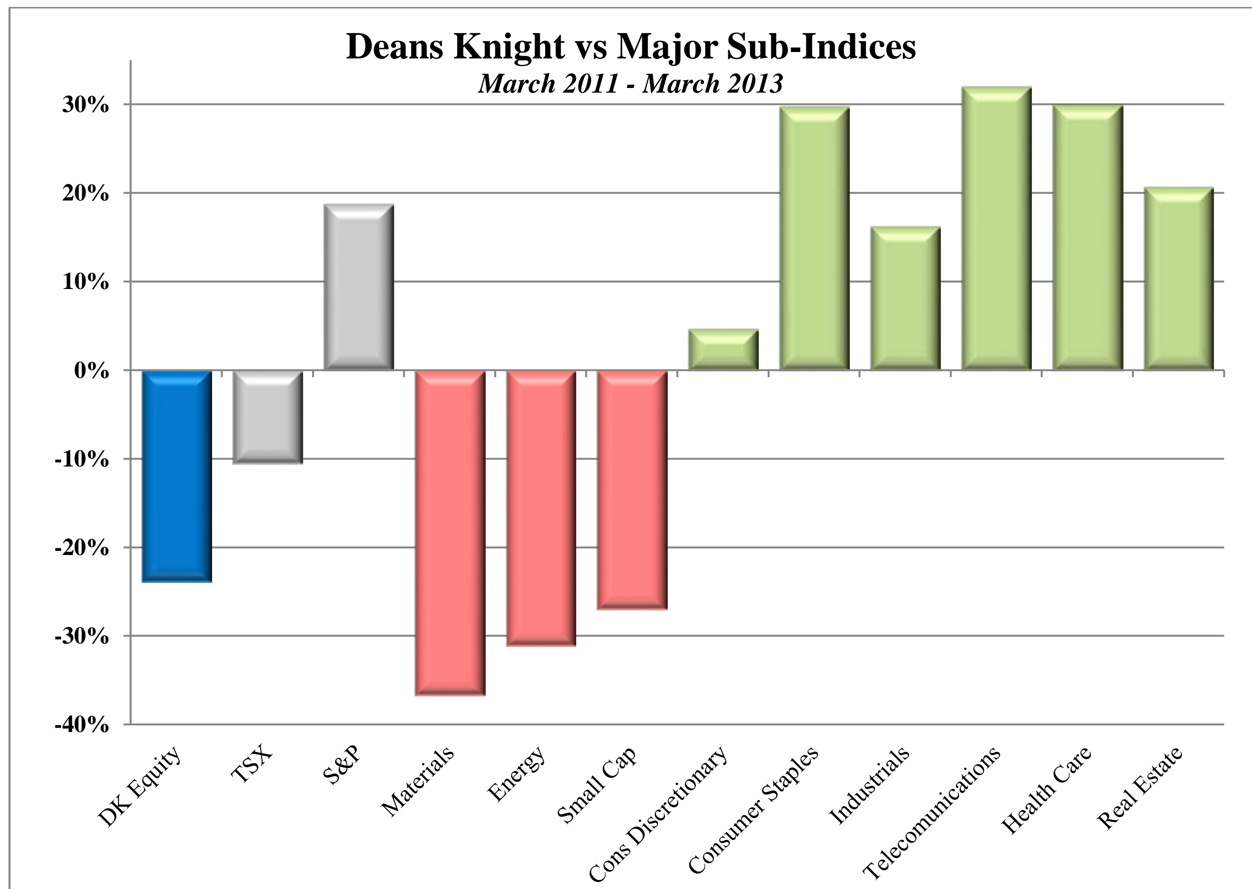
As for our Equity Strategy returns,…from the bottom of the North American markets in early 2009 and for the ensuing two years, our valuations outpaced the market indices. However for the past two years we have lagged. Why?

We have a tale of two markets over the past two years. Let's look at the two graphics below for an explanation. The first graph shows Deans Knight's long-term results (20 years), to March 31, 2013. The top blue line is the cumulative return for our DK Equity Strategy and the red line is that for the DK Income Strategy. The bottom two lines are the TSX Composite and the US S&P 500. Both DK Equity and DK Income have 20-year returns in excess of the two North American equity indices. However, it is certainly not true of each and every year. There have been periods of underperformance followed by periods of outperformance that more than made it up.



*Returns are gross of fees

The bar chart below looks specifically at the past two years, March 2011-2013, where our numbers have lagged.



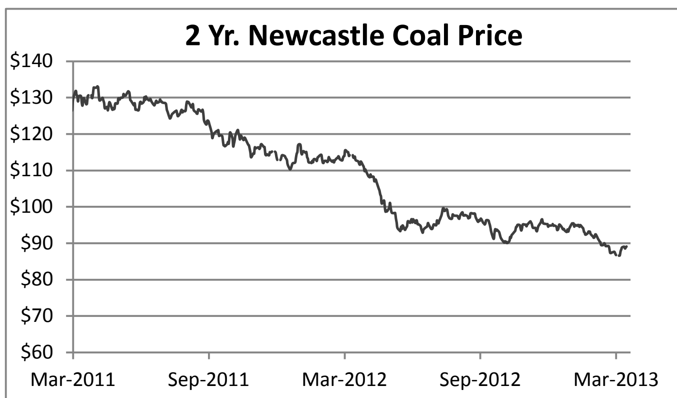
The blue bar shows the decline in our valuation over the period. As you move to the right we have the lesser decline of the TSX Composite and the rise of the US S&P 500. Our story is told in the next three bars…TSX Material…TSX Energy…and TSX Small Cap. The two worst performing sub-indices in the past two years have been materials (i.e. mining) and energy (oil and gas). This is where we have been over weighted. Moreover, small cap stocks have done poorly relative to the bigger caps. The next 6 bars represent the ‘other’ market. In a nutshell, the valuations on extraction type industries have been clobbered whereas consumer related and high dividend paying sectors have been rewarded. Based on our experience, we must not overreact by chasing returns. That would be capitulating to Mr. Market and selling good resource companies at deflated prices. Moreover, it would mean switching into areas that have already seen significant appreciation in values in the past two years.

The areas of the North American market that have done well in both New York and Toronto have been consumer discretionary and consumer staples, along with industrials, telcos, healthcare, real estate and basic manufacturing. Telcos and real estate (REITS) have been driven by the low interest rate environment that has resulted in the rush to these sectors in search of dividend yields. These types of companies also dominate the S&P 500 Index and the Dow. The TSX Index, by comparison, is dominated by resource based companies. Hence the outsize performance by the U.S. indices over the past two years.

Is the underperformance of our materials and energy companies justified over the past two years. Certainly in the materials area the answer is yes. For example, our nickel company, **Mirabela Nickel Ltd.**, has endured the very strong headwind of lower global nickel prices. The price of the metal is down 36%, to $7.54 per pound, over the past two years, see graph below.

Mirabela's management has responded by lowering operating costs to adjust to this difficult environment, making Mirabela one of the lowest cost producers. This is similar to what one of our other major investments, **West Fraser Timber Co. Ltd.**, did during the depths of the U.S. housing depression in 2008/09. West Fraser drove down costs, improved efficiencies, and then eventually began to enjoy the benefits of the beginnings of a housing recovery in the U.S. and consequent rising lumber prices.

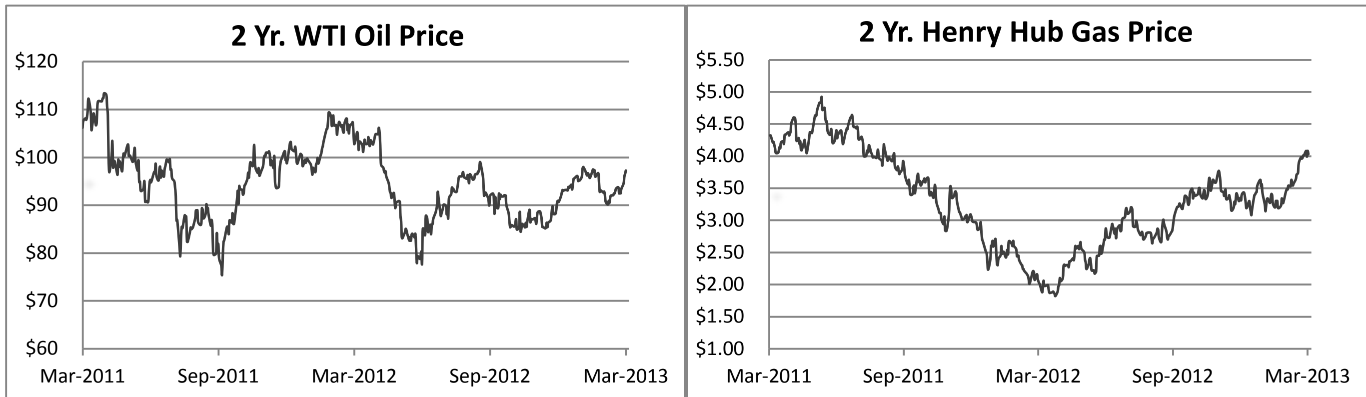
Our thermal coal business, **Coalspur Mines Ltd.**, is a similar story. With concerns about future global growth and lower North American natural gas prices, the price of thermal coal is down in the past two years by roughly 33%, as shown in the graph below.



Even though Coalspur's Vista project in Alberta is arguably the best, or at least one of the best, thermal coal development projects in the world today, putting together a package to finance Phase One of the mine construction in this environment is a difficult challenge. But as a well-known investor once said, "What is comfortable is rarely profitable."

We sold off our investment in **Northland Resources** (iron ore) in January. Northland produces high grade iron ore concentrate from their Kaunisvaara project in Northern Sweden. That said, unanticipated cost overruns when ramping up production shook our confidence in management. We had been talking to management on a regular basis throughout the ramp up in production. There had been no hint of cost difficulties. When we did finally learn of the issues, we took the decision to exit the position.

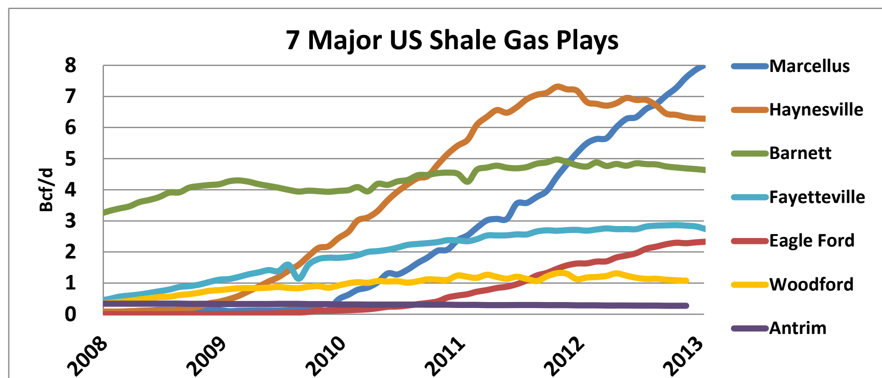
As far as the energy sector goes, it is much more difficult to understand and to justify the sharply lower sector valuations. The price of crude oil (WTI and Brent) has held reasonably steady over the past two years, whereas the price of North American natural gas has recovered smartly from its low point of roughly $2 mcf to $4 (see below).



Part of the explanation may be the negative atmosphere surrounding Canadian energy valuations caused by the debate over the Keystone pipeline and the well-publicized transport bottlenecks. The bottlenecks have resulted in price discounts for heavier grades of Canadian oil. These differential prices are temporary as alternative transportation systems will and are being put in place to move the oil to where it is needed.

Perhaps the notion that our biggest customer for Canadian oil and gas is currently 'awash' in both oil and gas is also affecting our valuations. Although we have witnessed surprising increases in U.S. oil and gas production in the past few years, it is not at all a foregone conclusion that this is sustainable. Many industry practitioners and experienced consultants have expressed caution to us about the future of this burst in oil and gas production. It has been pointed out that the industry does not have enough historical data on all these new shale and tight reservoirs to understand what the ultimate full cycle costs actually will turn out to be. Many argue that the costs may be much higher than expected.

The CEO of one of Canada's most successful intermediate gas producers reminded us that of the 7 major shale gas plays in the U.S., 6 of them are now showing that total production has declined, or has at least flattened out. The only one that has not is the Marcellus shale in the Northeastern U.S., which is the youngest of the 7 shale plays. It too is expected to have production roll over in time.



In our view, Canadian oil and natural gas will get to markets …either to the U.S.; to other parts of Canada; or to other parts of the world… and at a price that is profitable for the producers. The natural forces of the market are already making the adjustments to make this happen.

One more reason for the downward pressure on materials and oil and gas stocks…capitulation. We have seen it before. It works like this…resource mutual funds, resource hedge funds, and individual resource stocks have underperformed for long enough that investors give up hope. They cannot see a positive future because the past has been so disappointing. All the news is bad. Any good news is either not reported or dismissed as ill-informed at best. Investors begin to abandon or reduce their exposure to these areas. It results in forced liquidation into a market of weak bids. On the valuation front it results in dramatic reductions in valuations, whether warranted by fundamentals, or not.

It has been our experience that to capitulate to Mr. Market, where he is in a depressive phase, is unwise and costly. Always the better strategy is to be patient, even better to commit more capital to the downtrodden areas.