

June 30, 2006

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

**Quarterly Review
June 30, 2006**

Rates of Return¹

	<u>3 Mths</u>	<u>YTD</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>10 Yrs</u>	<u>Since Inception March 31, 1993</u>
DK Equity Growth Fund	-6.1%	12.4%	35.1%	34.5%	39.7%	32.9%	33.1%	17.4%	21.5%
Nesbitt Burns Small Cap Index (Unweighted)	-5.9%	6.0%	20.2%	15.2%	23.5%	16.5%	12.8%	7.3%	8.7%
S&P/TSX Composite Index	-3.5%	4.2%	19.6%	18.8%	20.7%	15.1%	10.5%	10.6%	11.3%
DJIA	0.9%	5.2%	11.1%	5.7%	9.9%	7.2%	3.4%	9.1%	11.6%
S&P 500	-1.4%	2.7%	8.6%	7.5%	11.2%	8.4%	2.5%	8.3%	10.1%

During the latter part of May and the first part of June there was a marked devaluation in the shares of oil, natural gas and metals producing companies. This was not a big surprise as valuations on the companies had been marching straight up for a few years and had begun to attract speculators.

In recent quarterly reports we reminded readers that it was time to be cautious when purchasing shares of resource based companies. With so much money made in this area over the past five years, it has attracted more attention, created more companies, and it pushed up some valuations to danger levels. In spite of this, there are still attractive investments in the resource areas and some of these have become even more attractive with the recent decline in valuations.

However we must now be prepared to take a long-term view. We must be prepared to hold temporarily out of favour situations that have attractive reserves in the ground . . . reserves that will be developed and produced later into a strong commodity price environment at great profit.

As a matter of interest we have attached to this report a copy of a presentation delivered by your author in May. The key point in the presentation is that this commodity boom, like all booms, does attract speculation. However it is not comparable to the technology bubble of the 1990's. This commodity bull market is the result of 20 years of underinvestment in these areas, and the resulting lack of capacity finally being overtaken by steadily rising global demand. This will not reverse quickly. Demand continues to grow, inventories are low, and most importantly, new capacity (be it oil, gas, or base metals) is not yet coming on quickly enough to satisfy demand.

¹ Returns longer than one year are annualized.

The pullback in share valuations in May/June has served the useful purpose of shaking out some of the hot money and creating more attractive valuations. It is worth noting that coincident with the speculators bailing out, the more serious long-term money, i.e. the industry operators, are making big long-term commitments in the resource area.

On May 8, Shell Canada Limited made an all cash \$24 per share offer (CDN \$2.4 billion) to acquire **Blackrock Ventures** (4.3% of the portfolio at the time). Shell wanted access to the long-term value represented by Blackrock's conventional heavy oil and oil sands resources in Western Canada. It is worth noting that Shell's bid was a 60% premium to the average Blackrock share price in the 30 trading days prior to the bid.

On June 23, Houston-based Anadarko Petroleum Corporation announced separate all cash bids totaling US \$21.1 billion to acquire Kerr-McGee Corporation and Western Gas Resources. The acquisition prices represent a 40% and 49% premium over the previous trading price, respectively. The acquisition gives Anadarko access to high impact, long-life reserves, and enhances their portfolio of unconventional natural gas resources. Anadarko is taking a long-term view as these combined acquisitions are heavily skewed toward natural gas, at a time when natural gas in the marketplace is decidedly out of favour.

In the base metals world, the fight for control of Falconbridge and Inco continued to play out over the past few months. Inco has bid for Falconbridge, Swiss-based Xstrata has bid for Falconbridge, Teck has bid for Inco, and Phoenix-based Phelps Dodge has bid for the combined Inco-Falconbridge. The bottom line . . . these players see more long-term value in gaining control of copper and nickel reserves than do portfolio investors.

This particular battle has important implications for our investment in **LionOre Mining International**. An obstacle to the combination of Inco and Falconbridge is the anti-competition concerns of the U.S. Department of Justice and also the European Commission. To satisfy the concerns of both authorities, on June 7 Falconbridge agreed to sell to LionOre, subject to the successful Inco acquisition of Falconbridge, their Nikkelverk refinery in Norway. As a consequence, on June 23, the Justice Department formally agreed to approve the Inco acquisition of Falconbridge. On July 4, the E.U. did the same and formally approved the transaction. If Inco is successful in acquiring Falconbridge, LionOre will acquire the Nikkelverk refinery. It will be a significantly accretive transaction to LionOre which would then become an integrated nickel producer from mine to finished metal. In our view the successful completion of this transaction alone would enhance the value of our company by as much as 50%. Not only would the earnings and cash flow increase dramatically, but LionOre would become an attractive strategic long-term asset for any company with a positive long-term view of nickel.

The bottom line . . . the investment opportunities in the resource area are not yet exhausted. Our focus is on out of favour companies that are not well understood and are under-followed. In the oil and gas area this means gas weighted companies and companies with future resource growth potential. In our view oil and gas in the ground is going to represent more value going forward than current production. In metals it is again the smaller, less well followed companies of which LionOre is the best example . . . a top ten nickel producer with one of the largest disseminated nickel resources in the world.

As resource companies gradually become less of a focus for us, we continue to look at other areas. We are finding out of favour, well run, and attractively priced businesses in other industries. This is a gradual process and patience is important. It also requires some courage because these types of investments go against commonly held views and certainly go against the advice of the financial news services, both print and television. The headlines are currently screaming about the gutting of the Canadian manufacturing sector because of the 40% appreciation of the Canadian dollar. This information is essentially correct and it plays well to the anxieties of the investing public, causing them to sell or avoid investing in many of these companies.

However this is where we are likely to uncover real deep value situations . . . strong franchises whose margins have been squeezed by the rising dollar and increases in other input costs such as oil, gas, and metals. This is where we can buy companies at or below hard book values, companies that are generating positive cash flow, and have the potential to regain lost margins by putting through price increases and cutting costs. Some of these areas where we have made investments include **Velan Inc.** (valves), **Linamar Corporation** (automotive parts), **CAE Inc.** (flight simulators and training), **Menu Foods** (pet food) and **Emergis Inc.** (technology).

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

Presentation at Club X Family Office Investment Conference

Montreal May 10, 2006

Wayne Deans

Our panel has been asked to talk to you about commodities - resources and metals. We haven't seen commodity markets like this since the days of disco. I am even hearing words that I haven't heard for 30 years - tungsten, . . . molybdenum. Commodity stocks have supplanted the technology stocks of the late 1990's as the engine of stock market profits and as the subject of breathless daily reporting by the financial press. In our opinion, much of what gets reported is (as with the tech era) sensationalized, short term focused, and ill-informed. Each new record high price is reported breathlessly. Weekly U.S. oil and gas inventory numbers are analyzed ad nauseum as if they actually mean something. An endless stream of pundits is trotted out to debate whether this bull market is just another tech-like bubble, or an elongated super commodity cycle.

Firstly, let's have a look at what is creating all the fuss. Below is a table that shows the appreciation in various commodity prices from previous cyclical lows:

	<u>Cyclical Low</u> US\$	<u>Cyclical Low</u> Date	<u>Recent Price</u> US\$	<u>% Appreciation</u>
WTI Oil	\$10.83 per barrel	Dec. 11, 1998	\$69.94 per barrel	545.80%
N.A. Natural Gas	\$1.72 per mmbtu	Nov. 16, 2001	\$6.56 per mmbtu	281.40%
Nickel	\$1.75 per lb	Dec. 11, 1998	\$8.68 per lb	396.00%
Copper	\$0.61 per lb	Nov. 07, 2001	\$3.23 per lb	429.51%
Zinc	\$0.34 per lb	Nov. 07, 2001	\$1.46 per lb	329.41%
Gold	\$255.55 per oz	Apr. 02, 2001	\$667.00 per oz	161.00%

NICKEL



OIL



GOLD



NATURAL GAS



ZINC



COPPER



As a consequence of these moves, the market values of the producing companies have appreciated, in many cases, to an even greater extent than the underlying commodities.

I want to emphasize three points here today:

1. Regarding commodities . . . we are in a “bull” market not a “bubble” market.
2. The real easy money is already in the can.
3. One commodity . . . uranium . . . may be the key determinant of the future of the commodity bull market.

Bull Not Bubble

To suggest that the rally in commodity prices is akin to the tech bubble of the late 1990's is ludicrous. In the tech bubble, companies with little or no revenues at all were accorded valuations of hundreds of millions and in many cases billions of dollars. For example in March 2000 the combined market value for the tech darlings, Research in Motion and Ballard Power, was \$28.4 billion. The companies had combined revenues at that time of \$96 million, and no profits. By comparison, the 4 largest Canadian conglomerates: CP, Power Corp., Onex, and Edper Brascan (now Brookfield) had a market cap of only \$22 billion. However they had revenues of \$20 billion and profits of \$1.7 billion. Even more dramatic, Nortel had a market cap at that time of \$245 billion. For this amount you could have purchased the 4 Canadian conglomerates, plus the big 5 Canadian banks, and put \$150 billion in the til. It would have been a good trade. Nortel's current market cap is \$13.3 billion and the combined market cap of these same conglomerates and the banks is \$301.96 billion. End game 2006 . . . Nortel \$13.5 billion or 4 conglomerates, 5 banks, plus \$150 billion in cash, equals \$450 billion. Now that was a bubble.

I would argue that the strength that we are seeing in all commodity markets today is the direct result of an economic imbalance caused by years of underinvestment in new productive capacity. Specifically using oil and gas as an example, I don't know if \$70 is the correct price right now. Maybe it should be \$50 or \$100. But we do know why the price is higher than the \$10.83 low in December 11, 1998 . . . and it is not because of wild speculation. It is a simple matter. Demand has grown faster than productive capacity. In the early 1980's we estimate that excess capacity represented as much as 30% of daily demand. Surprise . . . oil prices fell for 20 years. Now, for the first time in the past 35 years we have reached a point where there is very little excess capacity in the system today. Some in fact would argue there is none. Because supply is now constrained, the price must rise to a level where demand is then rationed. Although it is too early to say definitively, there is no evidence yet that demand is being destroyed by current pricing.

The surging price of oil in the past 7 years has rekindled the great debate regarding "peak oil". The concept was first brought to prominence by the late American geophysicist, Marion King Hubbert, in a paper that was presented to the American Petroleum Institute in 1956. In that paper, Hubbert predicted that oil production in the continental U.S. would peak between 1965 and 1970, and worldwide by 2000. United States production peaked in 1971 and has been declining ever since. The fact that Hubbert's prediction of a peak in global production by 2000 has come and gone has led to much criticism of the theory. Proponents of the theory take the position that the OPEC oil embargos of 1973 and 1979 drove up prices and reduced demand, thereby delaying the inevitable production peak.

I am not a geophysicist. Any qualified geophysicist could likely put me away in a debate about the peak oil hypothesis. I am simply an investor trying to take best advantage of the cards that are dealt. Debating whether the peak is at hand is not a particularly efficient use of time. Even though Hubbert's theory does make a lot of sense to a layman like me, it is easier to make investment decisions with facts not theories. Fact - when oil production began in the mid 19th Century, the large oil fields recovered 50 barrels for every barrel used in the extraction, transportation, and refining processes. This ratio has become less efficient over time. It is estimated that between 1 and 5 barrels of oil are recovered for each barrel used in the recovery process. To me this implies simply that oil becomes harder to extract (more costly) as an oil field is depleted . . . the price therefore must be higher.

The Easy Money is in the Can

The commodity story . . . oil, gold, base metals . . . is not a bubble and it is not yet history. The chronic lack of investment in productive capacity over the last 20 years has collided head-on with continued demand growth - particularly from developing nations.

Zinc is a classic example. With years of low prices, the result has been a lack of investment in new mines. We are now at a point where a number of major mines are nearing the end of their useful lives and will gradually shut down over the next five years. Teck Cominco estimates that we will lose 1.4 million tonnes of existing production because of closures by 2011 (roughly 20% of current production). This cannot be made up with new production from known deposits. If demand grows by 1.5% per annum over the next five years, it will

result in a supply gap of 3 million tonnes per annum. With some variations, the picture is similar for nickel and copper as well.

That said, I have been in the investment business long enough to know one thing . . . the big profit is made investing in areas that are clearly out of favour. We have made really big money from investments we made in oil and gas exploration and production companies, copper, zinc, and nickel producers in the late 1990's and early this decade. This was a time where tech stocks were in fashion and "old economy" stuff like oil and metals were bland, boring, and nearly worthless. It was a time when oil, according to the Economist Magazine, was headed to \$5 per barrel and we could purchase the best junior oil and gas companies for 2 ½ to 3 times cash flow and \$20,000 per flowing barrel. These same companies today are trading at 8 times cash flow and \$100,000 per flowing barrel. Not bubble values, but not bargain basement either.

Bull markets also bring out the greed factor in the investment banking business. The demand for resource investments increases and the banks help create a slew of new vehicles to sop up demand. Unremarkable management teams with unremarkable projects, get capital too cheaply, or get capital they should not get at all.

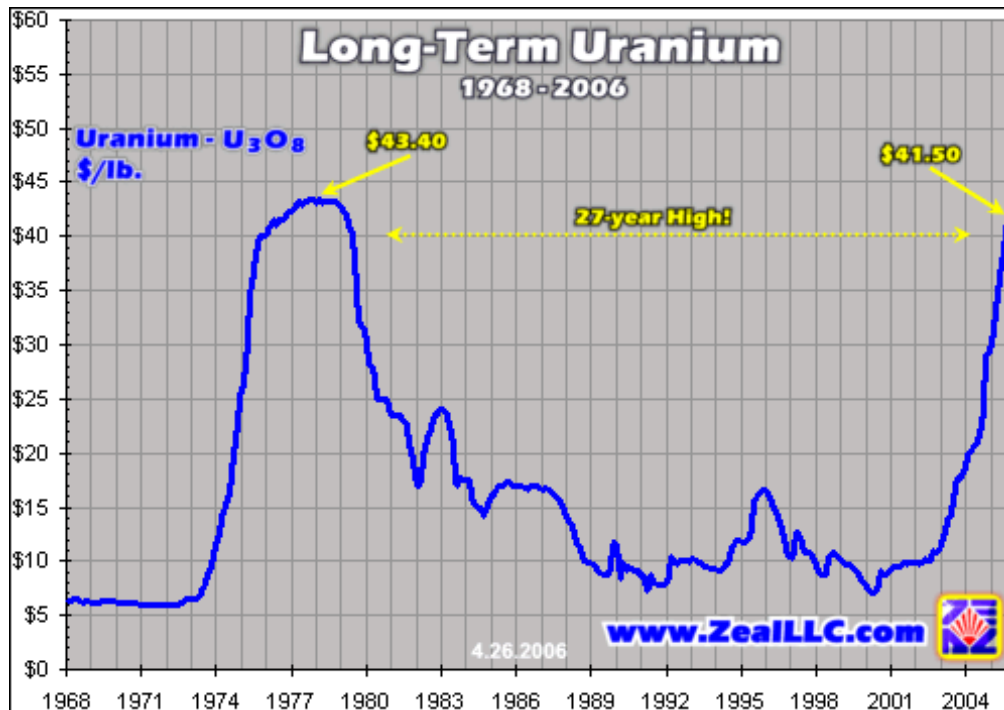
It is not time to pile in. It is time to exercise discipline. Look for the temporarily out of favour resource companies. They are out there.

Uranium - the Key?

If global growth is to continue, particularly among the emerging countries, the commodity most needed to enable this is energy. If you can't turn the lights on in the new plant, or fire up the equipment, there will be no growth. Shortages of energy, and the rising cost of energy, could become the achilles heel of global expansion. In today's world, 80% of all global energy is derived from fossil fuels. It does not make much sense in a supply constrained environment to keep burning fossil fuels to generate electricity. Alternative sources of energy must be deployed.

Nuclear ultimately is the path the world must take in order to procure the energy needs of the future. Nuclear energy is quickly becoming the acceptable alternative to fossil fuels that power the world today. Uranium is the commodity that makes it happen.

If you look at the historical price chart for uranium over the past 35 years, it looks just like oil . . . a big ramp up in the 1970's, peaking at the end of the decade, and then a steady decline for 20 years, and back up over the past 3 years.



Like many other commodities, uranium is in a major economic imbalance as mine production has fallen behind soaring demand. It hasn't been a big problem until now. Few new reactors have been built in the past 25 years and the demand deficit has been satisfied by eroding the huge global stockpiles that were built up during the cold war.

Today there are 441 nuclear power reactors in the world, providing roughly 16% of the world's electricity. There are currently 27 plants under construction and another 151 in the planning stages.

Observing press reports in recent years, it is becoming increasingly clear that the world is beginning to forget the Chernobyls and Three Mile Islands of the past and embrace nuclear fuel as the future. Nuclear plants have become safer, cheaper, and easier to construct.

I would like to draw your attention to an article that was published in the Washington Post April 16, 2006. This may be the tipping point of public opinion. It was written by Patrick Moore, who helped found Greenpeace in the early 1970's. He opens with the statement that at that time he believed that nuclear energy was synonymous with nuclear holocaust. Thirty years later his views have changed . . . "*nuclear energy is the only large-scale, cost effective energy source that can reduce emissions while continuing to satisfy a growing demand for power. And these days do it safely.*"

It is clear that the potential bottleneck to future global prosperity is the cost and shortage of energy. It is also clear that although wind and solar power have their niches they cannot replace big baseload plants. Hydro has been pretty much built to capacity and the price and future supply of fossil fuels is too uncertain.

What does this mean for uranium? Higher pricing will be necessary to encourage the development of future supplies. It requires enormous amount of capital to explore for uranium and the lead times for the development of projects is lengthening because of government red tape. We suspect that today's price of \$40 per pound may look cheap a few years down the road.