September 30, 2017

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Report
September 30, 2017

Rates of Return[1]

	3 Mths	YTD	2 Yrs	4 Yrs	5 Yrs	15 Yrs	Since Inception March 31, 1993
DK Equity Growth Fund	**2.0%**	**3.9%**	**14.0%**	**11.0%**	**9.4%**	**14.1%**	**14.5%**
S&P/TSX Composite Index	3.7%	4.4%	11.7%	8.3%	8.1%	9.2%	8.7%
S&P 500 (in U.S. Dollars)	4.5%	14.2%	17.0%	13.0%	14.2%	10.0%	9.4%

The world has been a crazy place in the past 3 months. We have witnessed the August 17th Barcelona terrorist attacks where 13 people were killed and at least 130 injured . . . natural disasters including the late August Hurricane Harvey that pummeled Houston, Texas (America's 4th largest city), taking lives and causing an estimated $180 billion in damage (the costliest natural disaster in U.S. history) . . . Hurricane Irma's devastation in the Caribbean and Florida in early September with estimated damage of $100 billion . . . the Mexico city earthquake that killed more than 200 . . . and now the unspeakable carnage inflicted by a lone gunman in Las Vegas on October 2nd.

In our increasingly interconnected world, we are all touched by these events in some way . . . a Vancouver friend's father was killed in Barcelona, their mother seriously injured . . . at least 4 Canadians were murdered in the Las Vegas carnage . . . friends affected in Florida, Houston and Mexico City. In addition to the tragic loss of life, the storm damage in the U.S. alone will likely reduce U.S. GDP by at least 1% in the next 12 months.

That said, it is a testament to the strength and resilience of mankind as people fight back in the face of these tragic events. Lives will be rebuilt, structures will be repaired, and economies will recover.

[1] Returns are presented gross of management fees.

The objective of our quarterly reports are to always give you a perspective on the 'big issues'. We try to help you keep those so-called 'big issues' in a context that we can deal with, and to not overreact to them. Let's try to simplify things, and focus on what is important. Let's focus on what we do know rather than what we don't know, and then make investment decisions accordingly.

In your writer's experience over 50 years in the financial world, most of what appears important, most of what dominates in the media . . . is just noise and is not relevant to long-term investment success. In fact, focusing and reacting to the noise can be detrimental to long-term investment success. That is why the title of our 20th Anniversary book is "Don't Listen to Everyone with an Opinion". (If you haven't received a copy, or would like another for a friend, please let us know and we'd be happy to send you one).

Let me rewind the clock back roughly 2 years and let's look at some of those big issues that were the focus of the media . . .

- The Brexit vote. It was going to crater the U.K. and E.U. economies.
- The impending collapse of the Chinese economy.
- Slow global economic growth.
- The threat of a U.S. recession.
- The risk of rising interest rates.
- The war on terror.
- Weak commodity prices.
- The angst leading up-to-and following the U.S. election.

Now add the threat that Kim Jong-un will blow up the world.

All this stuff has provided fodder for the media and grist for the cocktail parties of the chattering class. But none of it was or is relevant to disciplined investment thinking, and none of it is important in determining long-term future investment returns. "To know what everybody else knows, is to know nothing".

Let's recall the environment in the recession of 2008/09. Just think about the 'noise' back then. It was off the decibel scale! If you had, in early 2009, listened to that noise, you would have sold everything. If you had ignored the noise, you would have bought everything.

All that noise about the big issues of the day turned out to be unimportant. If we had just recognized that global central banks were doing what their charters required them to do (i.e. flooding the banking system with liquidity when it was needed), we would have reduced our personal angst, and bought stocks.

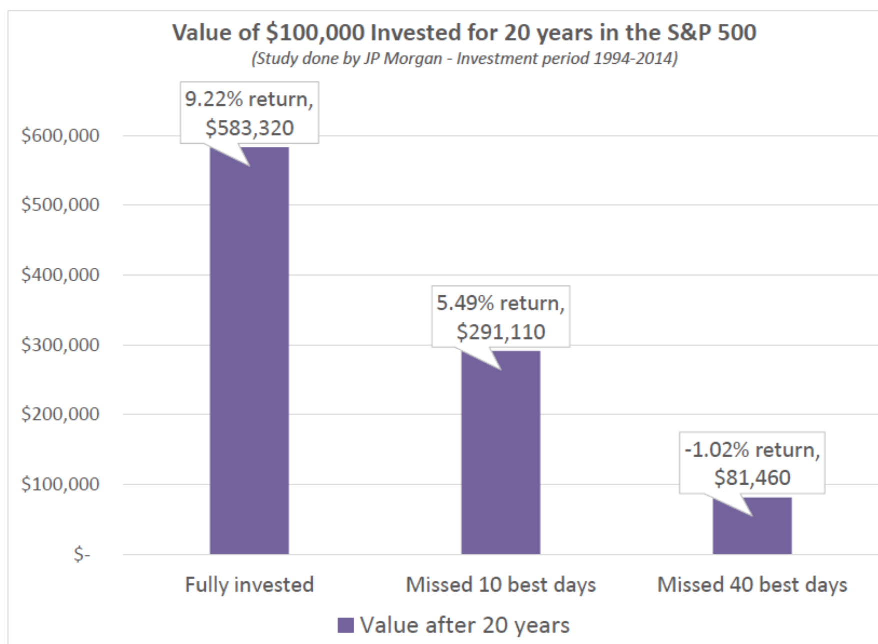
In response to 2008/09, the deepest recession since the Great Depression, we witnessed a massive, globally synchronized move to stimulative monetary and fiscal policies. These policies have been in place for almost a decade, and although global economic growth has not been

explosive, it has been mostly steady. However, it is now synchronized and it is accelerating. The OECD is predicting global growth of 3.5% for 2017 and 3.7% for 2018. Stimulative policy has been by far the most important driver of the global economy and stock markets over the past decade. The U.S. unemployment rate, for example, has trended down from 10% in 2009 to the current level of 4.4%. To put this into perspective, the unemployment rate averaged 5.8% from 1948 to 2017. Economists would call today's rate 'full employment'.

So here we are today. The annualized return for the S&P 500 has been 7.4% over the past 10 years. The TSX has underperformed at 4.1%.

The TSX has been lagging the S&P 500 because of the heavy weighting in resource-based companies (oil, gas, metals). From 2010, until a recent upturn, we have witnessed the longest metals bear market in history, combined with a steep drop in oil/gas prices between 2014 and 2016. On top of these woes, some sectors of the Canadian market are now being affected in a negative way because of U.S. protectionist rhetoric and the uncertainty surrounding the outcome of the NAFTA negotiations.

As mentioned, it has been 9 years since the last recession in the U.S. and Canada. If we use history as a guide, and look back 70 years to WWII, we have had 11 recessions in North America . . . on average every 7 years. Therefore, unless we have repealed the business cycle, and it is unlikely that we have, then the likelihood of a recession in the next few years is high. That is not a prediction. That is simple common sense. We do not know exactly when; how long it will last; how deep it will be; nor what will be the trigger that causes it. But don't forget Lesson No. 8 in the book: "Recessions and Bear Markets: Not Abnormal and Not All Bad". If our companies have a strong competitive position in their industry, are well-capitalized, and are run by good people, they will likely emerge from a recession as stronger companies. Moreover, the following graph which is based on a study by JP Morgan, which we have used before, should convince you that, when trying to time the market, the risk of being wrong is much greater than the reward of being right.



We believe we can apply some common sense to help guide us forward. Those of you who know us well, and those who have read our book, know what we think of financial predictions (all baloney). A reminder, Lesson No. 4 in our book, "If Your Financial Advisor Says He Knows What's Going to Happen Next Year, Get a New Financial Advisor". We mere mortals, however, are addicted to predictions.

The only macroeconomic prediction we are comfortable making is that the global economy will be larger 10 years from now than it is today. How much bigger, we simply do not know. Some things we will be doing 10 years from now will be different than what we do today, but on the other hand many of those things might be quite similar. However, we will collectively be doing more of those things. For example, we know that we humans will still be eating and nourishing our bodies . . . and as populations grow we collectively will be eating more food. What is not predictable are the trends/fads regarding what we eat or where we eat it.

We know we will be buying and selling more stuff. However, we might be doing it through different channels. For example, in 1990, we did not know much about the internet. Desktop computers were rare. Laptops a dream. Handheld computers farfetched. The emergence of technology has altered the way many things are bought and sold. Recent surveys in the U.S., for example, show that roughly half the population prefer online shopping. This is not earthshattering news. It is simply that new, more convenient, more efficient ways of doing things are emerging.

Looking forward, the most important guiding principle is 'You must know what you don't know'. Sounds simple, but most of us do not acknowledge, nor follow, the principle. Knowing what you don't know reduces the temptation to place bets on things we don't know i.e. baseless predictions.

It is a simple principle, but not easy to adhere to. For example, in today's world, compared to say 50 years ago, we are bombarded by news or sound bites from multiple sources. Some reliable. Some credible. But most are not. It is a busy world. Always, 24/7, some company, organization, individual is trying to grab your attention. Much of what we hear or see on a daily basis is 'fake news'. How often have you heard someone say to you "I saw an article the other day that claims . . ." Probably was bullshit, fake news.

As investors we must comb through the detritus . . . root out the fake news, and identify the facts. I will never forget L.A. Detective Joe Friday's immortal words from the 1950's TV show, Dragnet: "Just the facts, Ma'am".

How does this apply to where we are today in our DK Equity portfolio. Let's look at some of our companies in the portfolio, why they are there, what they have been up to and what the future might look like for them based on what we know today. Let's cut through the noise and the fake news and deal with the "facts Ma'am".

We've owned **Transat A.T. Inc.** for 4 years and our patience has begun to pay off. During the quarter Transat struck a deal to sell its 35% stake in its hotel joint-venture to its JV partner for a sum of $190 million CAD ($5.15/share) which is nearly double the book value. For context, Transat traded as low as $5.15 per share just a few months prior to this sale; an example of how wrong the market can be in 'valuing' a business. The Company now has $9.50 per share in free cash and the stock trades for $10, essentially giving no value to the tour business or future growth plans. Management estimates a stronger Canadian Dollar could boost this winter's cash flow by as much as $55 million ($1.50 per share). The Company intends to deploy its cash into purchasing (and operating) hotels. Our calculations show in the next 5 years the Company could deploy $450 million of its own cash (cash on hand plus free cash flow) to build a hotel business capable for adding $75 million of annual cash flow to its current base of $80 million.

During the quarter, our lumber producer, **West Fraser Timber Co. Ltd.**, made a material acquisition of Gilman Companies which owned 6 saw-mills in the U.S. South (Florida and Georgia) for $540 million CAD. West Fraser's prudent approach to capital spending makes large acquisitions such as this infrequent. Management had watched Gilman for over 15 years waiting for the opportune time to buy. The acquisition adds $85 million of cash flow to its base of roughly $900 million. More importantly, it further diversifies its production base away from BC's deteriorating operating conditions. The Company now produces 65% of its lumber outside of BC and 45% in the US. In their opinion, they are sufficiently insulated from any potential bad outcome for the much publicized Softwood Lumber Dispute between Canada and the U.S.

Cott Corp. reached an agreement to sell its legacy carbonated soft drink business to Refresco Group N.V. for a sum of $1.25 billion USD. They can now focus their attention on growing their home and office coffee & water delivery (HOD) business. They are the largest provider of this service in the U.S., Canada and Europe. The deal is scheduled to close later this year. We'll report more on this story as it concludes.

One important development that occurred just after quarter end involved our largest holding aerospace manufacturer **Héroux-Devtek Inc.** On Monday, October 2 Héroux announced a major acquisition. They are purchasing Madrid-based CESA, a subsidiary of Airbus, which produces landing gear, actuation and hydraulic systems. Héroux had been working on the complex deal for 2 years. This is a transformational acquisition, boosting Héroux's revenues by 30%; further diversifying their client base; adding new product offering; and adding valuable intellectual property.

Our 5 oil & gas producers represent 20% of the portfolio assets. We would argue that they have already been through their own industry recession . . . oil prices were down from a high of just over $100 per barrel in 2014 to a low of $24 in 2016 and gas from over $5 per mcf to under $2. Today oil is back to roughly $50 per barrel and gas at $3 per mcf. Our oil and gas producers have more production, stronger balance sheets (less or no debt), stronger profit margins, more free cash flow, and management that is that much more experienced than in 2014. With increased free cash flow, one company is currently paying a dividend and three of the five are buying back

stock in the market. All five are better companies today by any measure than they were in 2014, yet they all trade at lower prices, some substantially lower.

The media has gone from ‘peak oil’ a decade ago, to ‘peak pessimism’ today. The media is replete with stories (largely fake news) about the demise of oil. The facts do not support these stories. Global oil demand continues to grow. In fact oil consumption is growing even faster than the most bullish forecasts. With synchronized global growth and lower prices, why would we not expect increased consumption? The International Energy Agency (“IEA”) recently announced that in Q2 of 2017, global oil consumption grew by a whopping 2.3 million barrels per day over the same period last year. OPEC recently revised upwards their expectations for global demand in 2017 and also 2018.

The media touts that China will join the ranks of countries that will ban fossil fuel vehicles furthering the narrative that the age of oil is near its end. But China and other developing nations are a long way from reining in oil consumption growth. Moreover, if global demand continues to grow it will begin to “butt up” against supply constraints. With the sudden drop in oil prices to the lows in early 2016, the exploration and capital spending budgets of oil producers were slashed in draconian fashion. For the past 2 years, the level of new oil reserves have been at record lows. Add to this the rising levels of decline rates on existing and new wells and it sets the stage for better product pricing ahead and even better free cash flows for our companies.

With the headlines regarding the NAFTA negotiations, one would think the end is near for Canada’s exporters. Let’s not forget that Canada successfully and profitably traded with the U.S. long before trade agreements were in place. In all likelihood, changes will be made to NAFTA, and not all will be bad. The share prices of at least two of our export-oriented companies (Winpak and Héroux-Devtek) have trended down with the ‘buy America’ position of the new administration and since the NAFTA negotiations began. Both are very well-run companies. They are very competitive in key industries that are difficult to disrupt. They are financially strong.

Another of the ‘news narratives’ that is overblown is the emphasis that internet shopping will be the death of ‘traditional’ retail. As a consequence, the shares of retailers in Canada and the U.S. have been trashed. In our opinion it is not the increased popularity of shopping online and the threat posed by behemoths like Amazon that has led to weak performance of the retail group. Retailers are suffering because of poor execution. Great execution in retail is having the right merchandise available for the right market, at the right price, at the right time. The success of our 4 retailers . . . **Auto Canada Inc.**, **Aritzia Inc.**, **Sleep Country Canada Holdings Inc.**, and **New Look Vision Group Inc.** will ultimately be determined by how well they execute, not by online shopping. To date they all have been doing a very good job.

On the personnel front, Jon Muller joined us on schedule in mid-June. As we had expected, Jon’s transition to Deans Knight and our style and culture has so far been seamless.

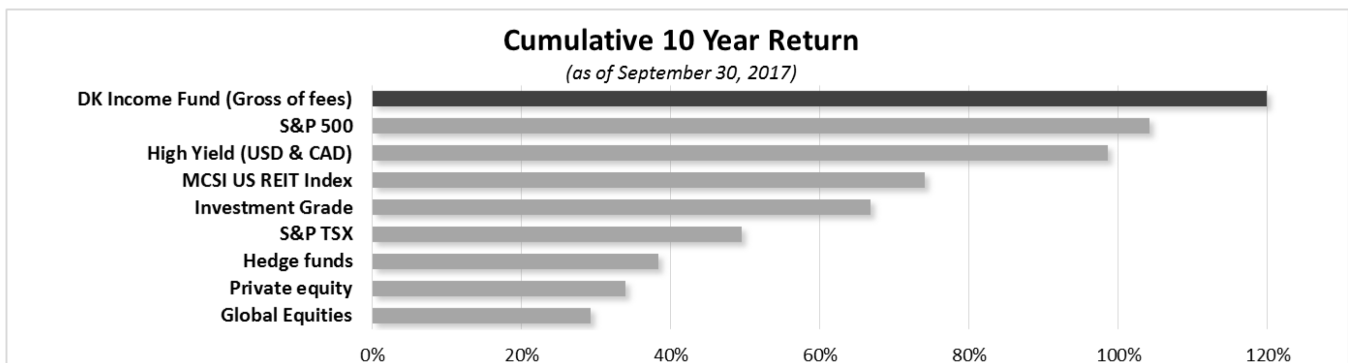
Ken deRegt joined us late last year, and who you may recall is the retired Global Head of Fixed Income for Morgan Stanley. Ken splits his time between New York and Vancouver. His knowledge, experience and global perspective has been very helpful to all of us at the firm especially to Dillon Cameron, our Senior Income partner.

Your author just celebrated his 71st birthday a week ago. As I age, I am often asked about succession at Deans Knight. Let me address the matter now. The legendary Warren Buffett, at 87, is asked about succession more than anybody. He addressed the matter recently when he spoke in New York at a dinner honouring the 100th anniversary of Forbes Magazine. He pointed out that there are 53,000 Americans alive today that are over 100 years old (8,000 in Canada). Moreover, the "centenarians" are the fastest growing age group in North America. However, within the category, women outnumber men 5 to 1. So perhaps we should stop talking about succession, and talk about a sex change operation. In case that doesn't happen, we have a very capable, experienced team at Deans Knight that has been together a very long time.

We will make one final low risk prediction. After 9 years of easy monetary policy central banks have begun to raise interest rates and will continue to do so in the coming years. This is not crystal balling, it is just what central banks do. They provide extra liquidity when the economy needs it, then when the economy is back on its feet and the party is in full swing, they ease the punch bowl away.

What does this mean for investors? It means that you are at great risk if you own long-dated, low coupon bonds . . . or real estate with low cap rates. You are better off in shorter dated, high coupon debt. This sounds like a commercial for our high-yield bond strategy, and it is. For 25 years this DK strategy has provided investors with steady cash yields far in excess of government and investment grade bonds, while protecting capital. Moreover, with all the hype surrounding the great bull market in stocks since 2009, the media has forgotten the high-yield asset class. The following graphs say it all.

High-Yield Bonds: Best performing asset class



Best Risk Reward Tradeoff