DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND
Quarterly Review
September 30, 2004

Rates of Return

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs
DK Equity Growth Fund	**9.7%**	**18.8%**	**43.1%**	**45.5%**	**45.0%**	**32.8%**	**25.2%**	**18.4%**
Nesbitt Burns Small Cap Index (Unweighted)	0.4%	2.7%	19.3%	29.7%	21.0%	6.6%	8.5%	6.5%
S&P/TSX Composite Index	1.9%	6.8%	18.9%	20.6%	10.2%	-2.7%	6.2%	9.0%
DJIA	-2.9%	-2.1%	11.0%	17.8%	6.7%	0.6%	1.4%	12.3%
S&P 500	-1.9%	1.5%	13.9%	19.0%	4.0%	-4.7%	-1.3%	11.1%

If we could single out one investment that has contributed to the increase in value of your investment portfolio over the past year it would be **Algoma Steel**. In fact Algoma has been one of the best value creating investments in our 12 year history at Deans Knight. We began investing in Algoma shares in April of 2002. At the time we were attracted by the value parameters of the company. A mere fifteen months ago the shares traded as low as $1. The entire company, which at the time had $1.2 billion in sales, could be purchased for $30 million and the book value per share was roughly $12.

The restructured company had come out of CCAA (bankruptcy protection) in 2002 with a lower cost structure and a new CEO, Denis Turcotte. When we began purchasing the shares, Algoma carried a heavy debt load, but the company was beginning to generate significant cash flow. Denis and his team stated they were positioning the company to generate positive cash flow even at the bottom of the steel cycle. Over the past two years, Algoma's improving cost structure, combined with a dramatic improvement in the market for steel have produced a startling improvement in the financial performance of the company and its value. A company that traded at $1 per share a short 15 months ago will now generate roughly $10 per share in cash flow in the year ended 2004. Moreover the equity value of the business has grown from $30 million to roughly $800 million.

Over the past few weeks we have sold roughly 50% of the Algoma shares in your portfolio at prices ranging from $17 to $22 per share. Although we do not feel that the valuation is wildly excessive at this time, we would argue strongly that the company is certainly not as attractively valued as it was when we initially purchased the shares.

The continued rise in the price of oil has been the most topical issue in the investment markets as of late. At the outset of 2004 it would have been very difficult to find an oil analyst that predicted

continued strong pricing. Our clients know that for the last 5 years we have been in the lonely position of being positive on oil prices. One of the very best times in history to buy oil companies was in 1999 when the Economist magazine published a cover story predicting $5 oil. Continued rising global demand, powered by China and other developing nations, combined with maturing and even declining production from the world's major producing basins, have pushed the price per barrel to roughly $50.

Our guess is that the global oil market is currently operating at capacity. As a consequence, oil will decline only if the price is high enough to destroy demand. Is $50 high enough? We don't know, but we are certainly getting closer to a level where demand will be negatively impacted. The only prediction we have been prepared to make is that the average price for oil in the next five years will be higher than the last five.

We have done well investing in oil and gas producers over the past 5 years. Five years ago we could buy the best Canadian junior and intermediate exploration companies for 2 - 3 times cash flow. Today these companies generally trade at more than double that multiple. It is time to be careful about what we own. $50 oil can cover a multitude of sins. It is important to continue to search for value in the oil patch. It would be a dangerous time to simply "buy the oils". In fact, although we still have a large part of your portfolio invested in oil and gas, we have spent the last two years selling producers that have matured and become over valued. We have used these proceeds to purchase earlier stage companies that we believe are more favourably valued.

As some of our clients are aware, one way that we are attempting to profit from this robust oil and gas environment, while avoiding higher valuations, is by investing in private, early stage companies, with strong management teams. To this end we launched the $20 million DK Energy Fund Limited Partnership one year ago. This fund has invested roughly 80% of its initial capital in 13 companies. The balance of the fund will be invested primarily in additional financings of the same companies.

We expect to see a continued flow of good opportunities in this area and as a consequence we are launching DK Energy Fund II this year. The goal is to do a fund of roughly the same size as last year, with a closing on November 15. Two important differences from last year's fund . . . this version will be RSP eligible and the mandate is expanded to include energy producers outside of oil and gas such as uranium.

During the first quarter of this year we purchased **E3 Energy Inc.** for the portfolio at a price of $1.50 per share. On October 4th, 2004 E3 announced that it was merging with Starpoint Energy. Once the merger is completed in January 2005, the new company will convert itself into an income trust, and also spin out a new exploration company to shareholders. Our estimated value of this transaction to E3 shareholders is $2.25 to $2.50 per share. We will continue to hold these shares and re-evaluate our position after the restructuring has been completed.

More about indexing and benchmarking. We have written critically in the past about the perils of index funds and benchmarking portfolios to capitalization-weighted major market indices. Our contention has been that index-like investing results in a tendency to buy high and sell low . . . the opposite of what an intelligent investor should be doing. A recent study by Research Affiliates, an asset management and research firm in California, comes to a similar conclusion. It points out

that roughly $1 trillion dollars in the U.S. is invested in a manner that tracks the S&P 500 Index, which weight component companies by market capitalization or the current market value of their shares. The higher the market cap or share price, the higher the weight. The research concludes that this practice leads more money to flow to shares with higher valuations and less to those with lower valuations. Doesn't sound like the right thing to do. As Research Affiliates points out "market-cap weighting assures you'll overweight overvalued stocks and underweight undervalued stocks".

The research went on to look at alternative ways of weighting the companies and the results were startling.

1962 – 2003

	S&P 500 cap-weighted	Book value weighted	Income weighted	Revenue weighted
Annualized Return	10.52%	11.71%	12.31%	12.49%
Value of 1$ Invested	$66.79	$104.80	$131.49	$140.24

Weighting the companies by any other measure than capitalization, introduces an element of value investing to the equation and produces higher returns. It is still passive investing in the same companies but tends to eliminate the momentum bias of cap weighting. For example, using revenue weighting, Algoma would have been a holding in a Canadian index fund in 2002. Using capitalization weighting it would not have been purchased because its market cap did not even put it in the index. Conversely, by market cap, Nortel was 35% of the TSE index in 2000; by revenue its weight would not have gotten it much beyond 5%. The moral of the story is not that indexing or benchmarking are so bad, it is the index or benchmark that is utilized that is flawed.

As of September 30th the portfolio breakdown by industry group stood as follows:

Energy	38.1%
Industrials	22.6%
Base Metals & Minerals	13.6%
Consumer Discretionary	10.9%
Other Materials	6.1%
Healthcare	3.3%
Paper & Forest Products	2.6%
Precious Metals	0.8%
Utilities	0.6%
Cash & Miscellaneous	1.4%
	100%

As of September 30th the 10 largest equity holdings were:

Company	%	Sector
Transat A.T. Inc.	7.7%	Tour Operator
LionOre Mining International	6.9%	Nickel Mining
Paramount Resource Ltd.	5.2%	Oil & Gas
Bonterra Energy	4.8%	Oil & Gas
Mustang Resources Inc.	4.7%	Oil & Gas
Linamar Corporation	4.2%	Auto Parts
Ketch Resources Ltd.	3.9%	Oil & Gas
Algoma Steel Inc.	3.9%	Steel Manufacturer
First Quantum Minerals	3.8%	Copper Mining
E3 Energy Inc.	3.7%	Oil & Gas
	48.8%	