

September 30, 2007

DK EQUITY GROWTH FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK EQUITY GROWTH FUND

Quarterly Review

September 30, 2007

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	-4.1%	11.1%	43.1%	30.5%	36.8%	38.3%	40.2%	18.4%	23.2%
S&P/TSX Composite Index	2.0%	11.2%	22.8%	15.8%	20.2%	19.8%	20.4%	9.1%	12.0%
DJIA	4.2%	13.3%	21.7%	17.3%	13.9%	13.1%	15.4%	7.9%	12.5%
S&P 500	2.0%	9.1%	16.4%	13.6%	13.1%	13.3%	15.5%	6.6%	10.8%

The most recent quarter was dominated by headlines concerning the popping of the U.S. housing bubble, the resulting defaults in the subprime mortgage market, and the negative effects on global credit markets. Stock market indices reacted negatively. The TSX Composite Index declined from a peak of 14,625 on July 19 to a low point of 12,850 by August 16 (-12%). Similarly, the Dow Jones Industrial Average declined by 8% over a similar period. Central banks responded to the credit market problems by pumping additional liquidity into the system to cushion the negative effects. If you followed the financial press or watched BNN or CNBC over this period, you might have concluded that the world as we know it had come to an end and that the only sensible course of action was to sell all the businesses that you owned.

As always, during these times of high anxiety, we humans seek comfort in the words of the learned experts. The financial news media responds by trotting out an endless parade of prognosticators, to educate us as to the best way to protect ourselves from the perils that loom.

How often have we seen this movie before? Even though it has been proven time and time again that none of these mere mortals can predict the future, we refuse to acknowledge it, and take false comfort in what they say. We have written about this many times before in these pages.

From March 2003:

“Your author was recently asked to be a pundit on Report on Business T.V. (Webster’s defines pundit as “any learned man”). What was significant about the interview was the reporter’s singular focus on the War in Iraq and what impact this would have on the future direction of the stock market. In fact, the War has become the main focus of almost all market forecasters since it

¹ Returns longer than one year are annualized.

began officially on March 20th. For obvious reasons, we can understand the interest in the war. However, what we cannot understand is the attempt to use the war as a tool to value a business. That makes no sense whatsoever to us.”

Also from March 2003:

“Back to market predictions for a moment. There was an interesting piece on this subject that was reported recently by Investech, a U.S. market newsletter. The writer looked at the predictions made by 22 well-known U.S. market experts who appeared on the popular television program Wall Street Week in early 2001 and again in early 2002. They were asked for their predictions on where the Dow Jones Industrial Average and the NASDAQ would finish in each year. In both years, for both indices, every one of the forecasters was too high. We have analyzed and summarized the results below:

	2001		2002	
	<u>DJIA</u>	<u>NASDAQ</u>	<u>DJIA</u>	<u>NASDAQ</u>
<i>Actual Close</i>	10,021	1,950	8,342	1,336
<i>Range of 22 Predictions</i>	11,400 to 13,170	2,250 to 4,600	10,235 to 13,750	1,700 to 2,810
<i>Median of 22 Predictions</i>	12,100	3,010	11,150	2,250
<i>% Median Prediction Above Actual</i>	21%	54%	34%	68%

What lessons are to be learned from this?

- 1) Don't get your investment advice from T.V. or newspapers.*
- 2) There are no pundits (learned men) when it comes to market forecasts.*
- 3) Only optimists are invited to appear and reappear on T.V. shows and in the popular press.*
- 4) Conventional wisdom always prevails on popular T.V. shows and in the popular press. No serious investment thinking is presented.”*

As Nassim Taleb postulates in his remarkable new book, “The Black Swan” (a must-read for all serious investors), we fool ourselves into thinking we know more than we actually do. We restrict our thinking to the irrelevant and inconsequential, while large events, “the black swans”, continue to surprise us and shape our world. Taleb defines a black swan a highly improbable event with three principal characteristics: it is unpredictable; it carries a massive impact; and after the fact, we concoct an explanation that makes it appear less random, and more predictable than it was. Google was a black swan, as was 9/11.

Taleb deals extensively with what he calls the “scandal of prediction” . . . that we are demonstrably arrogant about what we think we know . . . arrogant enough to get us into serious trouble. He deals head on with the question of why on earth we predict so much . . . and more interestingly, why we don't deal with our dismal record in predicting and why we almost always miss the big events. In the words of an unnamed famous philosopher, “when everybody knows that something is so, nobody knows nothin'.”

There was a very interesting article related to this topic published in Time magazine in December of last year entitled “Why we worry about the things we shouldn’t . . . and ignore the things we should”. We agonized over Y2K . . . nothing happened . . . we agonized over avian flu . . . not a life was lost in North America . . . In ancient times threats and danger to humankind came in the form of an attacking mastodon. They now often come in the form of rumours or news broadcasts, giving us way too much time to over think the problem . . . time to screw it up.

This summer, the number one financial question is . . . will the trouble in the U.S. housing market and its impact on credit markets cause the U.S. economy to go into a recession? The financial press would have you believe that a U.S. recession is something as rare and as devastating to humankind as the “black death”. U.S. recessions are not unusual and they are not devastating to humankind. Moreover, they are, in most cases, the necessary antidote to a speculative excess, to rebalance the economy, and position it for further expansion. Furthermore, the timing and severity of a recession is unpredictable. As the old saying goes . . . “economists have predicted 10 of the past 6 recessions”.

In fact, since your author began a career in finance in 1970, there have been 6 recessions in the U.S.:

Start	End	Duration
January 1970	November 1970	11 months
November 1973	March 1975	16 months
January 1980	July 1980	6 months
July 1981	November 1982	16 months
July 1990	March 1991	8 months
March 2001	November 2001	8 months
Average Duration		11.5 months

Is it possible then to have another U.S. recession? It is indeed possible. Would it be a surprise? No. It has been 6 years since the last recession. Is it predictable? No. Is it worth worrying about? Not really. Do stock market indices go down in a recession? Yes, in all 6 of the past recessions they have. If the indices go down, do all stocks go down? No. In fact, in the last recessionary period which occurred after the tech bubble burst, more stocks actually went up than down. The indices went down because they are predominantly capitalization weighted, and thus biased toward those stocks that previously went up the most and are those that are likely to be the most overvalued companies. Do all businesses suffer because of recessions? No. Some businesses find recessions advantageous as competitors fail or can be acquired at bargain prices. Recessions enable some companies to reduce their cost structures and ultimately to widen profit margins as they regain pricing power.

It has happened more than once over the years that a client, who is also a business owner/operator, has asked us if we were going to sell stocks because of the threat of a recession. Our answer is always to ask him or her if they plan to sell their business because of that same threat. The reaction is always the same . . . “of course not, we are cutting costs . . . we are taking advantage of cheap

capital goods and/or labour to boost productivity and profits for the future”. Typically these same types of people would more likely sell their business in boom times, when the price they can fetch is far superior. Why do so many investment managers do the opposite? For one main reason . . . they believe they can predict the future and consistently outfox other investors. In the immortal words of Yogi Berra, “it is tough to make predictions, especially about the future”.

Given the amount of press dedicated to the liquidity issues faced by the Non-Bank Asset Backed Commercial Paper in Canada, it is useful to attempt to explain the issues and the implications.

Asset Backed Commercial Paper is a method whereby banks transfer assets (mortgages, consumer loans, credit card receivables) from the balance sheet of the bank to outside investors. This is an advantage to banks because they continue to manage the loans for investors earning sizable fees without taking any credit risk. Banks are able to support their ABCP programs as funding problems occur because they can put these assets back on their balance sheet. Investors held \$72 billion in Canadian Bank sponsored ABCP, and received compensation of 5 basis points above Banker Acceptances.

The liquidity problem occurred in non-bank sponsored ABCP, where there is an additional \$35 billion outstanding in Canada. Non-bank sponsored ABCP was introduced to Canada by Coventree Inc. In July, it became known that varying percentages of these notes were backed by questionable U.S. subprime mortgage loans. Holders of the asset back notes reacted by refusing to roll over the maturing notes and attempted to redeem their investments. The emergency bank lines of credit that were put in place to guarantee the highest R1 rating, could not be drawn down in this circumstance, and the notes could not be repaid.

The matter is a simple one. We have been writing for some time, suggesting that risk was being priced too low in the credit markets. Spreads between “risk free” government treasury investments and corporate debt instruments have been too narrow. As a result, we have shied away from investing in corporate debt for some time. The subprime matter and the related problems in the commercial paper market is just one simple example of mispricing. This debt must now be repriced, and those that own it will lose money.