

**DK EQUITY GROWTH FUND**  
**Quarterly Review**  
**December 31, 2002**

*Rates of Return*

	<u>3 Mths</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>7 Yrs</u>	<u>9 Yrs</u>	<u>Since Inception Mar 31/93</u>
<b>DK Equity Growth Fund</b>	<b>13.3%</b>	<b>32.7%</b>	<b>31.0%</b>	<b>21.0%</b>	<b>18.9%</b>	<b>6.4%</b>	<b>11.2%</b>	<b>13.0%</b>	<b>16.1%</b>
Nesbitt Burns Small Cap Index (Unweighted)	11.9%	-2.5%	0.8%	-1.0%	3.1%	-2.3%	2.2%	1.9%	4.4%
S&P/TSX Composite Index	7.5%	-12.4%	-12.5%	-6.3%	2.0%	1.3%	6.7%	6.7%	8.4%

All three broad U.S. stock market indices: the Dow, the S&P 500, and the NASDAQ showed negative returns for the third consecutive calendar year. This is the first time this has occurred since the early 1930's. The broad Canadian market index, the S&P/TSX, has declined by a similar margin overall in this bear market. It has shown negative returns for the past two years, the first time this has occurred since 1973/74.

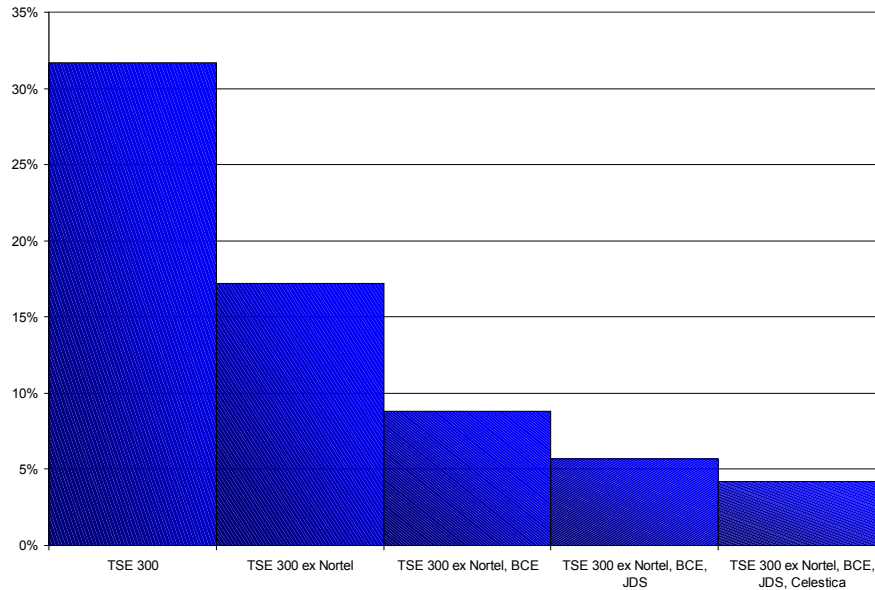
You would think by reading the popular press that the financial world is in dire straits. You would think the economy is in recession. You would think all stocks are going down. The press would also have you believe the frauds at WorldCom, Enron, Tyco, and Adelphia; the vaporizing of tech stocks; and the terrorist attacks on America are the reasons for the decline in stock prices. The reporting, as usual, is not balanced and it has perpetuated myths that are unsubstantiated by facts. It is time to debunk the myths.

The Canadian economy grew by roughly 3.4% in 2002, the strongest growth of any of the G7 countries. The U.S. economy grew by just under 3% ... not boom times, but respectable nonetheless. Remember, as well, that except for a brief interruption in 2001, the U.S. and Canadian economies have shown steady growth for the past 10 years. Not bad going at all.

Not all stocks have declined either. Looking at 2002, of the 1,577 stocks listed on the Toronto Stock Exchange at year-end, 51% were unchanged or higher for the year. The median return of all stocks was zero. Looking at the 3,323 stocks listed on the NYSE, 46% shown were flat or higher, and the median stock had a return of -1.6%. This has not exactly been a booming nor an easy equity market. However, it is certainly not worth jumping out a window over, as the press would suggest.

Furthermore, the dramatic rise in stock prices that was trumpeted in the press in the late 1990's was nothing more than a very large bubble, that became increasingly reliant on a shrinking number of extraordinarily overpriced companies. At the end of 1999, the height of the so-called bull market, we included the following information in our report to clients.

#### One-Year Return to December 31, 1999



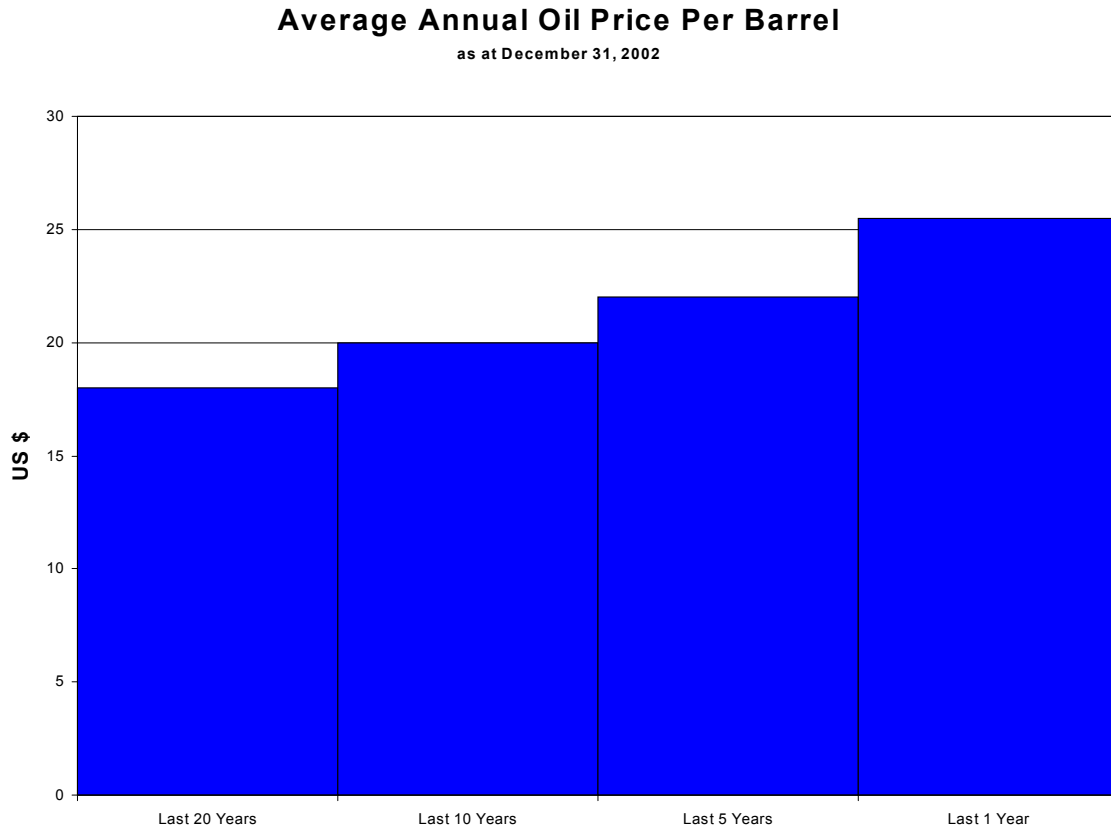
The TSE index of 300 stocks was up almost 32% in 1999. However excluding just 4 stocks, it was up only 4%. The bull market really wasn't a bull market in all stocks, just as the bear market is not a bear market in all stocks. The reason investors feel so much pain is so many individuals and so many investment funds bought into these few wildly overvalued stocks in an attempt to get in on the ride. It is these same stocks that were so widely owned, that have taken the biggest drops in value. As a wise investor once said: *"It is when the tide goes out that we find out who has been swimming naked"*. (Warren Buffett)

The frauds, the terrorism, and the problems in tech and telecom, are not pleasant things. However, these events are not the cause of the stock index declines since 2000. They occurred before the market indices began to decline. The declines are simply the bursting of just another bubble. Full stop.

Which areas are doing well and which are not? Businesses operating in industries that were denied access to the capital markets during the market bubble are faring well. Conversely, companies operating in industries that were allocated too much capital, namely telecommunications and technology, still struggle from the resulting excess capacity. These conditions will persist for some time to come.

An industry allocated very little capital in recent years is oil and gas. As a result, there has not been sufficient drilling to replace production. The world consumes roughly 1 billion barrels of non-OPEC oil every 23 days. This means, just to keep non-OPEC reserves from shrinking, we need 16 new 1 billion barrel discoveries each year. Not likely.

In the short term oil prices can be volatile. In the longer run however, they are determined by trends in supply and demand. Over the past 20 years, consumption of oil has grown steadily and the reserve life index and excess capacity has declined. What has happened to the price? The graph below shows a distinct uptrend.



At year end 2002, oil was trading at roughly \$31 per barrel, up from \$20 one year ago. The press suggests the strikes in Venezuela and the threat of war with Iraq are the main reasons for higher prices. This is only partly true. Most observers are missing the more important underlying reason for higher oil prices - i.e. the eroding level of excess capacity in the world oil market. Let's ask ourselves the question – why, if there is a lot of excess capacity in the oil market, would prices be higher because of a strike in Venezuela? Why not just make up this lost production elsewhere? It is not that easy. There isn't much excess capacity. There will be continued volatility in oil prices, but we expect prices over the next 5 years will likely on average be higher than the last 5 years.

The fundamentals for North American natural gas are similar to world oil. At year end 2002 natural gas was trading at roughly \$4.75 per mcf, up from \$2.55 one year ago. The decline rates for existing wells are rising and drilling activity has not been buoyant enough to offset them. As a result, U.S. natural gas production has declined for the last 6 consecutive quarters. We expect gas prices to remain buoyant, encouraging increased drilling to turn production around.

What is true for oil and gas is also true for metals – precious and non-precious. The price of gold has risen from a low of \$255 an ounce in 2001 to roughly \$345 an ounce at the end of 2002. Why? Consumption of gold has outstripped production for the past 10 years. For many years the deficit has been made up by sales by central banks. Central bank selling has now dried up.

Furthermore, because of the lack of capital committed to exploration in the past 5 years, global gold production will trend lower over the next 5 years, as consumption continues to rise.

The outlook for base metals, nickel in particular, looks similar. There is no new significant nickel production scheduled to come on stream over the next 3 years, yet demand continues to grow. Inco recently surprised the market by announcing that its Goro project, scheduled to be brought into production by late 2004 (54,000 metric tons per year), has been postponed due to much higher than anticipated capital costs.

In looking at the outlook for oil, gas, and basic materials the popular press places too much emphasis on what is happening in the U.S. economy and the economies of developed nations in general. In our opinion, not enough emphasis is placed on developing economies such as China, India, and Latin America. Yes, the economies of developed nations are an important source of ongoing consumption of energy and basic materials. However it is the developing nations that are having the greatest influence on the growth in consumption. For example, China's economy is growing at double-digit rates. The middle class in India is now larger than the entire population of the United States. India has now surpassed Japan as the second largest consumer of diamonds in the world, after the United States. Brazil, the 5<sup>th</sup> largest nation in the world, has made great strides in getting its act together over the past decade. Just think of the impact on demand for basic materials as these countries, whose populations dwarf North America and Western Europe, strive to build infrastructure. Think, as well, about the lack of capacity to meet the demand and what the potential impact could be on prices.

As December 31<sup>st</sup> the portfolio breakdown by industry group stood as follows:

Oil & Gas	30.4%
Metals & Minerals	22.2%
Industrial Products	21.4%
Consumer Products	13.9%
Merchandising	4.7%
Transportation	3.0%
Financial Services	1.4%
Cash & Short Term	3.0%
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	100%