March 31, 2007

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**8.6%**	**10.1%**	**15.4%**	**19.9%**	**21.6%**	**19.0%**	**11.1%**	**12.0%**
SCM Universe Bond Index	0.9%	5.5%	5.2%	5.1%	6.5%	7.0%	7.0%	7.7%
ML CDN High Yield (hedged)	3.8%	10.6%	6.1%	5.7%	9.0%	7.7%		
ML USD High Yield (unhedged)	2.7%	11.6%	9.4%	8.6%	11.8%	10.1%	6.8%	7.6%

There were important developments this quarter in two key holdings in the portfolio. Firstly, on March 26th, LionOre received a friendly all cash bid of $18.50 per share from Swiss-based Xstrata. We own **LionOre Mining International** common shares, currently 7% of the portfolio, as a result of our participation in two private debt financings in 2000 and 2001. We were the lead investor in both financings which provided expansion capital when it was unwise to issue equity. These debt financings were convertible or provided warrants allowing us to acquire shares at an average cost of $2.33. The annualized return on our 7 year investment in LionOre is over 35%.

Xstrata is a major diversified mining group involved in the production of alloys, aluminum, coal, copper, nickel, and zinc. The Company is listed on the London and Swiss stock exchanges and has a market capitalization of Cdn $60 billion. Xstrata acquired Falconbridge Ltd. in a $24.8 billion Cdn deal in 2006. The LionOre deal is valued at Cdn $4.6 billion. In our opinion it is a fair deal and we support LionOre's Board of Directors and its management in their recommendation that shareholders accept the bid.

Deans Knight has had a long relationship with LionOre, its founders, and its management group. The Company was founded in 1996 and has grown into an important international nickel concentrate producer with operations in Western Australia, South Africa, and Botswana. The Company also owns the Thunderbox Gold Mine in Western Australia. The nickel production also throws off significant by-product credits in the form of copper, cobalt, platinum group metals, and gold.

In our opinion, for most of the last 10 years, LionOre has been an under followed, underappreciated, and undervalued mining asset. It was not until the takeover of Falconbridge and Inco last year, that LionOre began to attract a following. Only in the early part of 2007, with record high nickel prices, has it begun to trade at levels that reflect its true value.

[1] Returns longer than one year are annualized.

It is our view that this is the proper time to accept what we believe is a fair price for the business. The management and board have built a very successful nickel company. In the current environment of record nickel prices ($20 per pound) we are susceptible to looking at the future through rose coloured glasses. However, we remember very clearly in the days of 1998, following the Asian "meltdown", when nickel was $1.75 per pound. With the benefit of hindsight, we were wise to have been a buyer in those dark days of low nickel prices and the shareholders may be wise to tender to a bid in this environment of record high prices.

Between the day the bid was announced and April 5, 100 million shares of LionOre have traded at prices 50¢ to $1 above Xtrata's offer. This represents more than 40% of the outstanding shares. Xstrata needs to attract $66^{2/3}$% of the outstanding shares to consummate the deal. The shares that have traded have gone to investors that believe either that another bidder will appear and pay a higher price, or that they can force Xstrata to pay a higher price. We shall see.

It is worth clearing up one point here. At the time the takeover bid was announced, the Canadian media made much of the fact that another Canadian mining company was being gobbled up by a foreign giant. Well, unlike Inco and Falconbridge, LionOre mines nothing in Canada. LionOre is a Canadian registered company simply because Canada is the centre of global mining finance. Roughly 2/3's of the public capital raised for global mining is done through the auspices of the Toronto Stock Exchange. The Company has one employee in Canada. It is run by non-Canadians, from its main office in London, and its operators are in Australia and Africa. Canada is losing no jobs, but it is gaining more prominence as the centre of global mining finance which will attract more international companies to come here to finance their expansion, as LionOre did 10 years ago.

Secondly, our largest bond holding, **Jean Coutu Group 8.5% (**5.7% of the portfolio), is being called. We purchased the majority of the bonds in the first half of 2006 at an average cost of $93.50. In August, Jean Coutu announced the sale of their U.S. pharmacy operations to Rite Aid. As part of the sale, it was intended that Rite Aid assume the obligations of the 8.5% bonds from Jean Coutu. Because Rite Aid is a weaker credit than Jean Coutu we, along with the majority of the bondholders, challenged this intention. On March 30th, Jean Coutu and the bondholders agreed to a settlement whereby Jean Coutu will tender for the bonds at $109 and pay all legal fees. This holding provided an annualized return for the portfolio of over 20%.

Subsequent to quarter end, on April 2nd, **KCP Income Fund** announced it had received a $10 cash bid from Caxton-Iseman Capital, a US private equity investment firm. Following the Government's decision to impose income taxes on trusts we purchased units in KCP at an average cost of $7.58, a 7% weight in the portfolio. KCP is one of North America's largest and most diverse contract manufacturers of consumer products. KCP has experienced a very difficult operating environment in the last few years; however, we felt KCP was attractively valued, had a strong position in its industry and the potential for growing cash flows. In November, KCP announced they would look at strategic alternatives, including a possible sale. The outcome of this search was a $10 cash bid for KCP at a 32% premium to our cost.

Following the Halloween decision to tax trusts, unit prices for all trusts declined presenting buying opportunities. For example, we added to Progress Energy Trust, a Canadian natural gas producer. The warmer than normal year in the U.S. in 2006, coupled with worries about a U.S. recession, contributed to the decline in natural gas prices from a high of $15.39/mcf in late 2005 to a low of $3.63/mcf in September 2006. Valuations on gas weighted companies have similarly declined. We were able to purchase Progress at net asset value.

In our view we are setting up for a recovery in natural gas prices late in 2007. Although gas drilling in the U.S. is continuing at record levels, production is flat as decline rates on existing wells is offsetting new production. Furthermore, because of lower prices, drilling for new gas has slowed in Canada and production is declining. A normal weather pattern combined with rising demand for natural gas for cogeneration facilities will lead to declining inventory levels and rising natural gas prices.

The reduction in capital spending by major producers caused the energy services sector to experience severe downward pressure on utilization and pricing. As a result, cash flows in 2007 will be significantly lower than the record levels of 2006. We hold **Blackwatch Energy Services Trust** and **Peak Energy Services Trust** and both experienced a significant decline from our cost. We believe cash flows in the services sector along with energy prices will improve in time. We intend to increase our position in energy services trusts. Blackwatch is trading at below liquidation value and Peak is trading at a significant discount to book value.

As mentioned in earlier reports, we have been focusing more attention on originating and structuring private bridge financings. These financings are short term, high coupon, in some cases fully secured and, most importantly, provide capital growth through "equity kickers" in the form of warrants or convertible debt. The companies are typically looking for a bridge to an equity financing or to finance capital expenditures which will provide immediate cash flows to the business. We provide a debt plus warrant structure that is less dilutive than issuing equity. In addition, our ability to react quickly and work with the company provides more flexibility than a bank can offer.

Although private financings currently represent only 15% of the portfolio, they have been an important source of income and the capital appreciation has had a meaningful impact on returns. For example, in December 2005, we negotiated an 18-month Promissory Note with **Anvil Mining Ltd.** (copper). Anvil is a $940 million market cap Australian-based public company with low cost copper production in the Congo.

We negotiated a 2% commitment fee, an initial coupon of 8% escalating 2% each 6 months to a maximum of 12% and 10 warrants per $100 to buy shares at $6.25. After four months, Anvil repaid our $1 million Note with proceeds from a $150 million equity offering. Our income return was 4.3% over 3.5 months (15.5% annualized). However, the shares have appreciated to $16.38 at quarter end and the 100,000 warrants are worth $1,013,000 at quarter end. Our return to date, including the "equity kicker" is over 100%.

During the 1st quarter, Deans Knight clients were the lead investor extending $20 million of a fully secured $46 million bridge financing to **GBS Gold International Inc,** of which

DKIncome lent $3.0 million. GBS is a publicly traded Canadian company with a $350 million market cap. The Company has gold assets in Australia producing 150,000 ounces annually. The purpose of this loan is to finance two acquisitions and growth capital expenditures. GBS will be acquiring Australian gold assets near their current operations and over 10% of a Canadian company whose main asset is a 30% Joint Venture interest in a Tanzanian gold asset (the 70% shareholder is Barrick Gold, who operates the mine). We are familiar with the Company and its management. On behalf of our clients, Deans Knight is a large shareholder and we also provided a loan to GBS in 2005 which enabled the Company to close two acquisitions forming the foundation of the Company.

The bridge financing is fully secured and pays a 12% coupon for a term of 2 years. In addition, each $100 of debt receives 13.5 warrants to purchase GBS shares at $3.75 for 18 months ($3.11 at quarter end). The Company's plan is to grow production from 150,000 oz to 500,000 oz by 2009 with 150,000 oz of growth coming from the two acquisitions. GBS expects to generate $175 million in operating cash flow in 2009. Although this estimate is at today's gold price, even at $500/oz GBS will generate cash flow in excess of $60 million. We expect our loan to be paid down out of cash flow or an equity issue within 18 months. The DK fund receives a cash yield of 12% on the note. If GBS shares rise to $5 and the loan is repaid in 18 months, the potential total annualized return is 25%, which is very attractive in addition to being well secured.