March 31, 2009

DK INCOME FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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Quarterly Report
March 31, 2009

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**1.3%**	**-21.4%**	**-7.2%**	**-1.8%**	**3.5%**	**8.2%**	**7.5%**	**9.4%**
SCM Universe Bond Index	1.5%	5.0%	5.4%	5.4%	5.3%	5.2%	6.1%	7.4%
ML CDN High Yield	-2.1%	-30.8%	-19.8%	-10.8%	-7.8%	-5.4%	-1.6%	
ML USD High Yield	5.0%	-20.3%	-12.3%	-5.0%	-2.1%	-0.3%	2.4%	4.8%

As Warren Buffet succinctly put it during an appearance on CNBC on the morning of March 9th "*the U.S. economy fell off a cliff in September*". It is clear to us now, that following the bankruptcy of Lehman Brothers on September 15th, the already weakened global banking system was rendered dysfunctional. As a consequence, in the final quarter of 2008, U.S. real domestic product contracted at an annual rate of 6.3%. This was the worst decline since the recession of the early 1980's, when in the first quarter of 1982 U.S. real G.D.P. dropped 6.4%. Moreover, according to a March 19th forecast by the World Bank, we will witness in 2009 the first global recession in 60 years. The World Bank suggests that for the year 2009, world output will decline between .5% and 1%. Advanced economies will suffer a deeper contraction of 3% to 3.5%. This compares with global growth of 3.2% for 2008. Their projection for 2010 is a resumption of growth to a paltry 1.5% to 2.5%.

If you, the reader, are confused by the myriad policy responses to this downturn . . . join the club. However, let's simplify a confusing situation. The single most important objective of policy makers globally should be to restore confidence in, and restore the normal functioning of the global banking system. Without a functioning financial system, the economy as we know it will not function. It is not clear exactly how or when this will be accomplished, but the "big fix" led by the U.S. is well underway. Although there may be many critics of the actions taken by the U.S. Treasury and the Federal Reserve to date, much needed dramatic action has, and will continue to be taken, to "oil" the financial system and encourage it gradually back to reasonable health. With that accomplished, it will be the freedom and the entrepreneurial spirit of individuals that will lift the global economy out of recession.

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[1] Returns longer than one year are annualized.

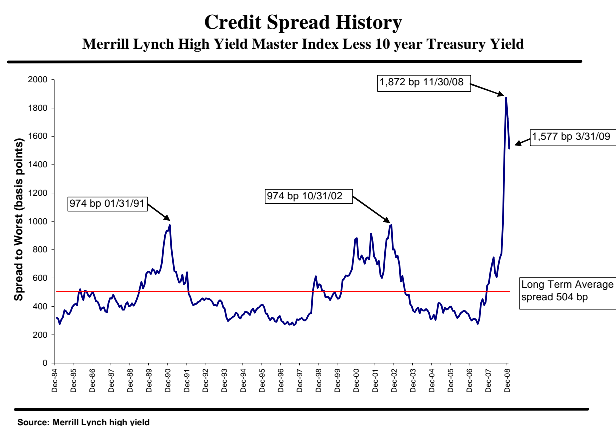
No question about it, this is a doozie of a recession. Also, make no mistake about it . . . the economic numbers will get worse before they get better. Unemployment for example, will continue to rise after the economy has bottomed and begun to recover. Unfortunately, this is part of the cleansing process that occurs in every recession. When the economy emerges from recession it will be leaner, more efficient, and more productive than before.

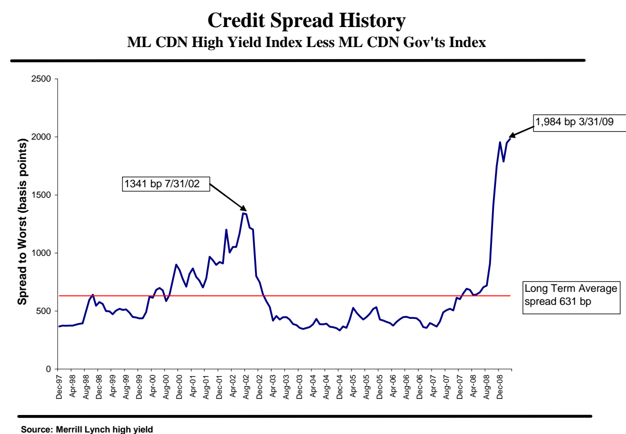
During a recession, corporate bond prices decline as investors become increasingly concerned about potential defaults. Using the Merrill Lynch U.S. High Yield Index as a proxy, the table below shows the peak to trough declines in previous slowdowns.

Merrill Lynch US High Yield Master II Index

Peak to Trough Period	Total Return
May 08 – Dec. 08	-34.7%
May 02 – Oct. 02	-14.0%
Sep. 00 – Dec. 00	-8.9%
Aug. 90 – Nov. 90	-12.0%
Dec. 79 – Mar. 80[2]	-13.8%

This is the most troublesome economic morass we have seen in 60 years and it could take some time to right the listing economic ship. That said, bonds have a contractual obligation to pay a coupon and, barring a default, investors are "paid to wait". When credit markets improve and spreads return to more normal levels (see graphs below), the high yield bond market has historically provided equity like returns (see table below):





[2] The Merrill Lynch US High Yield Master index has an inception date of December 1987. We used the Merrill Lynch U.S. High Yield 100 Index for periods prior to this which had an inception of December 1979.

Rebounds from Cyclical Lows

	June 30, 1982*	Jan. 31, 1991**	Oct. 31, 2002**	Mar. 31, 2009**
Average Price	$60.95	$72.03	$77.15	$62.23
Average Coupon	$10.32	$12.77	$8.43	$8.17
Cash on Cash Yield	16.9%	17.7%	10.9%	13.1%
Yield to Maturity	17.4%	18.1%	13.7%	18.7%
1 Year Total Return from the date above	**47.81%**	**40.99%**	**33.10%**	
Annualized 5 Year Total Return from the date above	**19.59%**	**17.76%**	**12.83%**	

*Based on High Yield 100 Index (H100)
**Based on High Yield Master II Index (H0A0)

Source: Merrill Lynch & Co.

The big risk is that investors succumb to the constant barrage of negative information spun by the media. The objective of the media is to sell advertising, not sensible investment advice. You sell more advertising if you have more viewers or more readers. You get more viewers and more readers if you deliver more entertainment value.

In a bull market you get more entertainment value by "feeding the bull". Conversely, in a bear market the media delivers more entertainment value by feeding the readers and viewers more negative news. Scare the crap out of them, and they will tune in again tomorrow to see how much worse the news has become. Rarely do we see any sensible or reasonable investment advice delivered through the media.

For example, over the past few months, there have been numerous articles written on opportunities in the bond market. Most of the "advice" pointed out the great opportunity in investment grade bonds trading at spreads not seen since the great depression but warned against high yield, or "junk bonds", citing historically high defaults with low recovery rates. We agree with the views on spreads and expected default/recovery rates and we wrote about it in our last quarterly report. Where we disagree is on the media's assessment of risk and the way they discard the entire high yield sector as too risky.

Default rates will be higher in this recession than in past recessions. During the good times of plentiful and cheap credit, companies borrowed money at historically low levels, leveraging up their businesses to unsustainable levels. In 2000, a business with leverage of 5x EBITDA would have been considered highly levered. At the peak of the credit frenzy in 2007, private equity firms were buying businesses with 5x bank debt and issuing high yield debt taking total leverage up to 7 – 10x EBITDA. As you can imagine this was not sustainable and many of these businesses will go bankrupt with the recovery on the high yield tranche being nominal at best. It is not difficult to identify these companies and to avoid them.

We are investing in the debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage. These businesses have been painted with the same brush as those over-levered LBOs and their bonds are yielding on average 15 – 17%, priced at levels that, even in the event of a default, we feel we will make money. The media ignores these opportunities choosing to dub the entire high yield sector as too risky.

For the investment grade sector, the media chooses to fall back on credit ratings ignoring any risk of downgrades. It is unwise to rely solely on the credit rating when making an investment decision as the rating agencies do not consider the price you pay when assessing risk which is the most important determinant of long term value creation. We believe the risk of default is priced into the high yield market. However, yields on investment grade bonds are not adequately compensating investors for downgrade risk. When a bond is downgraded to high yield from investment grade, typically there are investors who, due to mandate reasons or perceived risks, must sell. This can drive down the price significantly making it just as painful, or more, as a high yield bond defaulting especially given current prices.

In addition to downgrades, there is also a risk of rising interest rates as the economy improves. A rising interest rate environment is negative for investment grade bonds as a 1 – 2% rise in interest rates would significantly reduce the spread unless prices on investment grade bonds fall accordingly. In contrast, a rising interest rate environment for high yield bonds is actually positive. High yield bond spreads are determined by credit quality. Interest rates won't rise until the economy shows signs of recovery which means credit markets are easing and the risks associated with high yield bonds are diminishing. Therefore, a rise in interest rates would be more than offset by the improving credit environment. In addition, the average term on high yield bonds is lower than investment grade bonds, 6.6 years versus 9.9 years, as investors are willing to lend money to higher rated credits for longer periods (Note: the average term on our bonds is 5 years). As interest rates rise the average price of investment grade bonds should fall by almost 50% more than high yield bonds, all else being equal.[3] The graph on the following page provides a comparison of the DK Income Fund returns versus returns of the DEX Universe Bond Index[4] during quarters where interest rates have risen.

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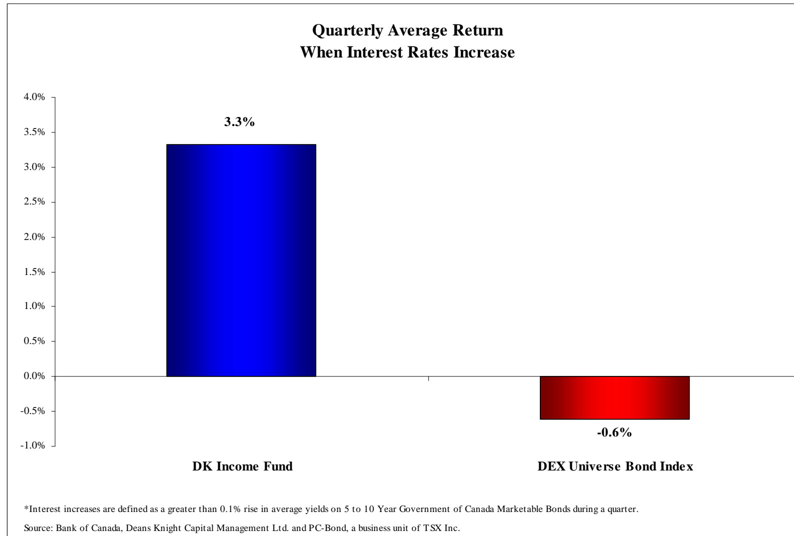
[3] Calculated using duration of the ML US Corporate Index (5.7) and the ML US High Yield Index (3.9). Duration can be defined as the percentage change in a bond's price function with respect to interest rates.

[4] The DEX Universe Bond Index was designed to be a broad measure of the Canadian investment grade fixed income market



We try constantly to urge our clients to keep a balanced perspective about financial matters. As shown in the graphs on page 2, yield spreads are 50% higher than previous peaks. Although we are expecting a significant rise in defaults, with yields between 15 - 20%, the rewards outweigh the risk. Would you be inclined to sell high yield bonds today?

DK Income Corporation

We obviously feel there is a very good investment opportunity in high yield bonds today. As evidence, on Wednesday March 18, 2009, Deans Knight completed a $100 million investment transaction to invest exclusively in a diversified portfolio of high yield corporate bonds. Although this vehicle will have similar investments to our pooled fund, it was designed as a short term vehicle (5-year life). Both vehicles are set to benefit from the unprecedented credits spreads. The DK Income pooled fund is fully invested and designed to generate high income returns beyond the life of the Deans Knight Income Corporation. We are currently in the process of investing the funds raised in the DK Income Corp., which is listed and traded on the Toronto Stock Exchange (ticker symbol DNC).

Bernie Madoff

The Ponzi scheme perpetuated by Bernie Madoff has shocked many investors. Some investors are concerned that it could happen to them. It is important to highlight the significant differences in the way Deans Knight (and other companies like ours) is structured compared to Madoff. First, Deans Knight uses an internationally recognized accounting firm (PricewaterhouseCoopers LLP) to audit the firm. Madoff used a small accounting practice with a local focus. Second, firms such as Deans Knight hold all securities purchased on behalf of its clients with a reputable independent third party, such as RBC Dexia (a division of Royal Bank of Canada). Madoff held his clients' assets in-house, thus making it easy to hide or sell securities without anyone noticing. With an independent auditor and custodian, firms in our industry will not likely be able to perpetuate a Ponzi scheme.