March 31, 2011

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
March 31, 2011

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	Since June '93
DK Income Fund	**4.3%**	**19.1%**	**39.8%**	**15.4%**	**13.9%**	**13.1%**	**15.6%**	**12.2%**	**12.4%**
DEX Universe Bond Index	-0.3%	5.0%	5.1%	5.1%	5.2%	5.3%	6.1%	6.9%	7.1%
ML CDN High Yield	2.4%	10.0%	32.3%	6.6%	3.0%	4.5%	4.5%	n/a	n/a
ML USD High Yield	3.9%	14.2%	34.0%	12.7%	8.4%	9.0%	8.4%	7.5%	7.8%
S&P/TSX Composite Index	5.6%	20.4%	30.8%	5.0%	4.7%	6.0%	4.7%	7.7%	9.7%

There was certainly a lot to fret about during this past quarter. Unrest in the Middle East, rising oil prices, and American frustration with Federal energy policy. Sounds like a new crisis in the making. However, to those who are, as the French say, of a "certain age", it sounds like a replay of the 1973 Arab oil embargo, only less severe.

Someone once said *"the more things change, the more they stay the same"*. President Obama gave a speech on U.S. energy policy on March 31, 2011. He pledged to reduce America's reliance on foreign oil. However, every President since Jimmy Carter has given the same speech, almost verbatim. Yet America is more dependent on imported oil than ever before. The unrest in the Middle East . . . Egypt . . . Tunisia . . . Libya . . . Syria, what does it teach us? It teaches us that those dictators whose regimes economically benefit their cronies, while the populace struggles in abject poverty, will ultimately be shown the door. Moreover, when it happens in an oil rich region, it teaches us how reliant the world still is on oil as an energy source, and how less abundant it is becoming.

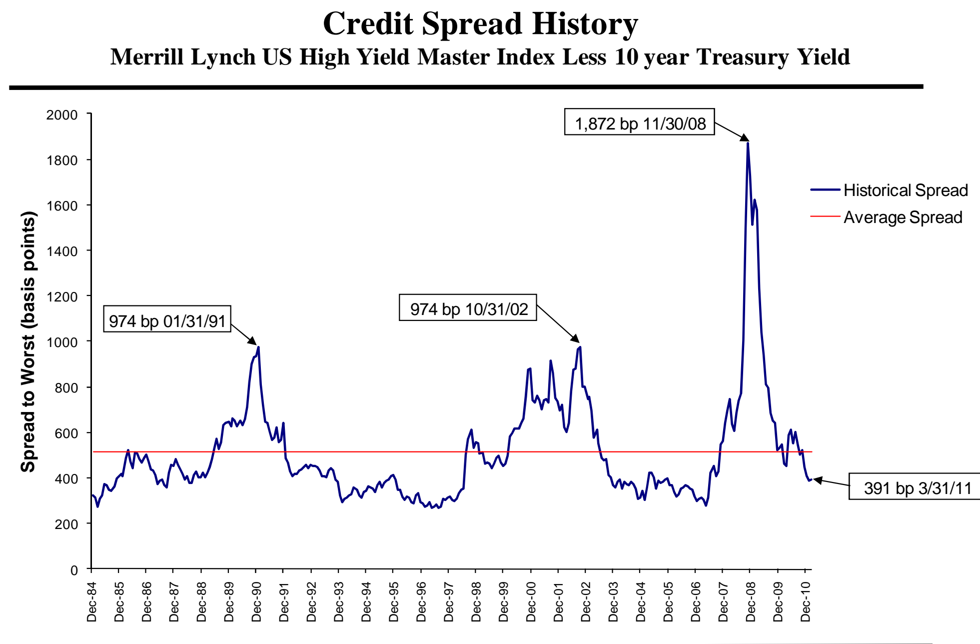
What will be the social and economic implications of what is happening in the Middle East? As George Jonas recounts in a recent column in the Canadian National Post . . . when the legendary Chou En Lai was asked in 1949 what he thought about the 1789 French Revolution, he replied *"too soon to tell"*.

The 9.0 earthquake and resulting tsunami in Japan on March 11, 2011 shocked the world. The massive death toll and devastation saddened us all, and roiled financial markets. The damage to nuclear power facilities and the media coverage of the efforts to contain the spread of radioactive material, has resulted in much debate about the future of nuclear power as an energy source. Will

[1] Returns longer than one year are annualized.

these events curtail or slow the growth of nuclear power plants? Perhaps, but we surely cannot be certain of that. A growing world, demanding increased prosperity, will require more energy. The power will need to come from somewhere. Nuclear is relatively abundant, clean, and affordable. The problem in Japan has reignited the debate about the safety of nuclear. This debate reminds us of a wise statement we read recently . . . *"a great many people think they are thinking, when are merely rearranging their prejudices"*. Perhaps the outcome may be a positive one . . . more efficient, safer nuclear power facilities.

Despite the events in the Middle East and Japan, spreads between U.S. 10-year Treasuries and high yield bonds continued to narrow during the quarter (see graph below).



Source: Merrill Lynch high yield

We have maintained for some time that investors seeking income should be buying shorter term corporate bonds with higher yields where you are being compensated for the risk. We have focused on debt instruments in businesses with strong management teams, tangible assets, strong cash flows and reasonable leverage, with restrictive covenants protecting our interests. This focus allowed us to navigate the recession unscathed. We have since benefited, as the Companies which met our criteria reacted to the challenging environment by reducing debt and cutting costs to improve their credit quality. Given the credit quality of our bond holdings, a 7.75% yield is attractive versus a basket of government and investment grade bonds[2] yielding 2.75%, which is simply too low to compensate investors for the risk of rising interest rates.

High yield debt is typically issued with maturities ranging between 5 and 10 years, which naturally keeps our maturity schedule short. Despite recent refinancing of shorter term bonds, our average maturity remains less than 5.5 years. By comparison, the basket of government and investment grade bonds has an average maturity of 7.6 years. The DK Income Fund will be less affected in a rising interest rate environment as our bonds mature at par allowing us to re-invest at higher interest rates.

[2] Merrill Lynch U.S. Corporate & Government Master Index

Given the higher yield, shorter maturity schedule and relative strength of the companies within the portfolio, the DK Income Fund provides an attractive yield to investors looking to generate an income stream without taking on excessive risks.