March 31, 2015

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
March 31, 2015

Rates of Return[1]

	3 Mths	1 Yr	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**4.2%**	**7.4%**	**4.6%**	**7.5%**	**10.4%**	**11.0%**	**10.9%**	**11.0%**
ML USD High Yield	2.5%	2.1%	7.5%	8.4%	8.0%	7.6%	7.8%	7.6%
ML CDN High Yield	1.8%	-0.9%	6.3%	7.0%	4.9%	4.4%		
FTSE TMX Canada	4.2%	10.3%	5.1%	6.0%	5.6%	6.3%	7.1%	7.0%

In our book “Don’t Listen to Everyone With An Opinion…20 Lessons over 20 Years of Investing”, Lesson #18 is “Bonds…It’s All About the Coupon.”

When we were strategizing the "bond" side of our business plan back in 1992, we had a critical look at the bond industry. We suspected traditional bond management was not adding any value. Yes, some managers outperformed others but none were really providing any value for the customer. When we looked back at the historical universe of returns pre ‘92 we discovered something. Returns over time (we used 10 years) were no different than the coupon returns the portfolio generated. So all the baloney about shifting up and down the yield curve, constructing barbell portfolios, was just that…baloney.

Now that we at Deans Knight have the benefit of 22 years of practice, how do our findings hold up today? Low and behold, looking in the rear view mirror, bond portfolio returns have been no different than the coupon generated in the high yield universe or the investment grade universe.

Annualized Returns June 1993 – March 2015

	Investment Grade Bond Index[2]	High Yield Bond Index[3]	**DK Income Fund**
Income Return (i.e. coupon)	5.7%	7.8%	**8.9%**
Total Return	5.8%	7.6%	**11.0%**
Difference	**0.1%**	**(0.2%)**	**2.1%**

[1] Returns longer than one year are annualized gross of management fees
[2] Bank of America/Merrill Lynch US Corporate and Government Index
[3] Bank of America/Merrill Lynch US High Yield Index

We wonder why bond investors continue to expect long-term returns that exceed the coupon on the bond? Why not seek to maximize the coupon, while minimizing risk?

In the table above, we included returns for the Deans Knight Income Fund to show two things:

1. We have generated a higher coupon/income return than both the investment grade and high yield bond indices.
2. Historically, we have been able to provide returns in excess of the income by investing in a concentrated portfolio of high yield bonds, dividend paying equities, and structuring unique debt financings with equity kickers.

With our "all about the coupon" mantra established, we determined the only way to maximize the yield/coupon while minimizing the risk of losing money was to invest in high yield debt. In 1993, this made us the first investment firm in Canada focused on the area (the reason we use a US High Yield Index is because a Canadian one did not exist until 1998).

Up until the mid-2000's, there were still only a few firms investing in Canadian high yield debt, which meant there were opportunities for us to capitalize on. As more competitors entered the market, yields were bid lower and covenants became weaker. With less opportunities in high yield bonds, we searched out and created other vehicles to maximize income for our clients.

Our experience in high yield debt and our extensive network led to the opportunity of lending directly to Companies. In 2000, we designed and executed our first two custom debt financings to Lionore Mining International, Ltd., a convertible debenture and a term loan with warrants. These investments provided an annualized return of 40% with high coupons, 10% and 12% respectively, and equity kickers where stock was eventually sold at more than 10x our exercise price.

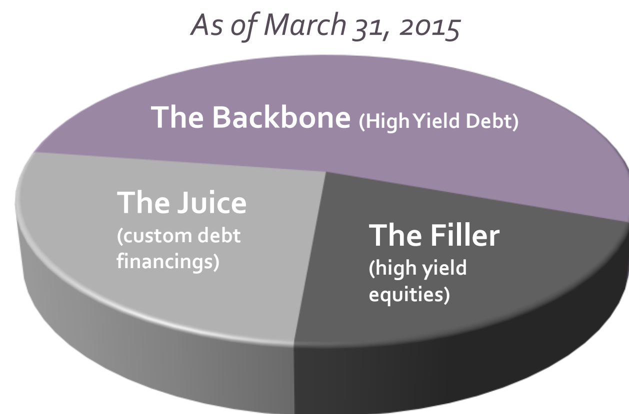
When evaluating custom debt financings, similar to our high yield investments, we look for companies with either hard assets, a cash flow stream or both, but which are too small to access public debt markets. Typical size financing is $5 – 25 million. We look to obtain security over the assets of the business, demand a high coupon (i.e. average above 10%) and a short maturity (i.e. loans outstanding on average 18 months). In most cases, we receive equity incentives which can provide capital growth in addition to our income. We have designed and participated in 40 of these financings over the past 15 years allocating over $350 million. These investments have provided an average annualized rate of return of 17%.

As an example, one of our outstanding issues will mature this month. In April 2012, we structured a $35 million secured debt financing with **Petroamerica Oil Corp**., an oil producer with assets in Colombia. The proceeds from the debt financing, along with $20 million in cash on the balance sheet, were used to develop their assets growing production from 1,400 barrels of oil per day ("bopd") in 2012 to current production of 6,250 bopd. Their success will allow the Company to pay our debt back on April 30, 2015 (the maturity date) with cash on the balance sheet.

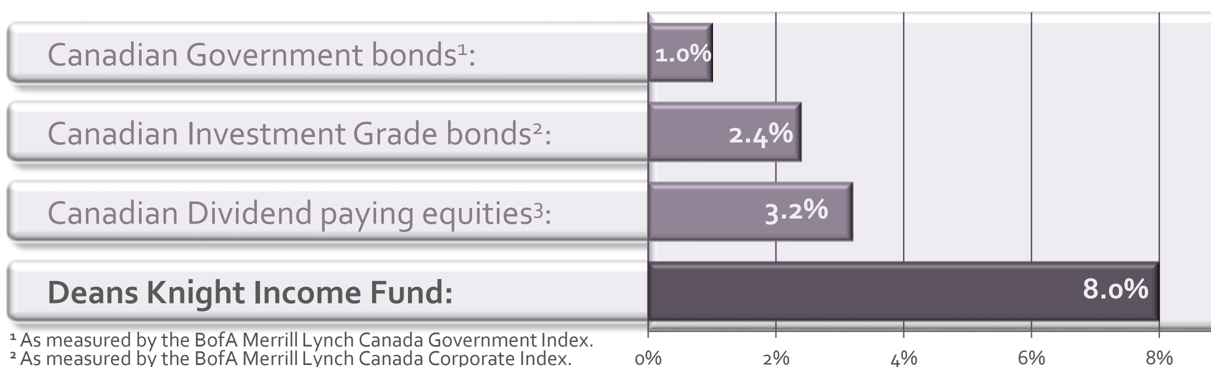
The investment provided an annualized total return of 16.5%, a combination of income earned and capital appreciation from warrants, which were sold early last year. We will continue to evaluate potential debt financings such as Petroamerica which can augment the income earned and provide capital gains to unitholders.

The remaining portion of the portfolio is invested in a handful of high yielding equities. Unlike interest payments, distributions/dividends are not guaranteed. We focus on analyzing the underlying business and the cash flow generated to determine the sustainability of the dividend and whether or not we are paying a fair price for the business. The amount allocated to dividend paying equities will fluctuate depending on opportunities in the debt markets.

The portfolio as of March 31st is invested as follows:



This current mixture of investments is providing a yield to investors of 8.0% which is over 2.5 times that of Investment Grade Bonds and dividend paying equities and 8 times that of Canadian Government Bonds.



While we don't focus on short term performance, our quarterly return of 4.2% bears some explanation. The income generated a predictable return of 1.9% (7.6% annualized) with the remaining return coming from capital appreciation. While our energy holdings, which rebounded from fourth quarter declines, provided some of this return, the major contributing factor was our holding in **Mirabela Nickel Ltd.**

Mirabela is a nickel producer with assets in Brazil which, in 2013 fell victim to a two year slump in the nickel market. We worked as part of a debtholder group to restructure the Company exchanging our debt for shares. As part of the debtholder group, we hired Maryse Belanger as CEO in June 2014. Maryse has held senior roles with large mining companies, most recently Goldcorp, and has experience working in Brazil. Subsequent to year end, Maryse and her team announced improved operations with a reduction in cash costs by over 30% and has communicated a clear plan for the operations going forward. The positive developments caused the stock price to go from $0.03 at year-end to $0.14 on March 31st.

We don't know how the stock price will trade over the next few quarters. If management can maintain operations and nickel prices improve, we strongly believe Mirabela will be worth more than it is valued at today.