

**DK BOND FUND**  
**Quarterly Report**  
**June 30, 2003**

*Rates of Return*

	<u>3 Mths</u>	<u>YTD</u>	<u>1 Yr</u>	<u>2 Yrs</u>	<u>3 Yrs</u>	<u>4 Yrs</u>	<u>5 Yrs</u>	<u>10 Yrs</u>
<b>DK Bond Fund</b>	<b>7.9%</b>	<b>12.9%</b>	<b>15.7%</b>	<b>12.1%</b>	<b>5.6%</b>	<b>4.0%</b>	<b>3.8%</b>	<b>9.0%</b>
SCM Universe Bond Index	5.1%	4.4%	11.3%	10.2%	8.8%	7.6%	6.9%	8.5%
ML CDN High Yield (hedged)	8.6%	17.3%	23.3%	5.8%	1.6%	0.7%	0.9%	
ML USD High Yield (unhedged)	10.0%	17.9%	22.2%	8.1%	5.0%	3.5%	3.0%	6.8%

We celebrated a milestone on June 30, 2003 when the DKBond fund reached its 10<sup>th</sup> anniversary. We appreciate the support we have received from our clients over the past 10 years. Having specialized in corporate bonds for a decade, we continue to follow a simple philosophy, articulated in our first DKBond quarterly comment in 1993. *“We concentrate on maximizing portfolio income, we do not attempt to predict interest rates.”* While bond market valuations fluctuate, our focus on income has provided value-added returns over time.

**Quarterly Comment**

During the second quarter corporate bond prices increased further, driven by continuing strong demand for income generating assets. The DKBond fund earned 7.9% for the quarter and 12.9% year-to-date. This compares to the SCMU bond index (primarily Government bonds) that earned 5.1% for the quarter and 4.4% year-to-date. A more positive economic environment in the past year helped the DKBond fund earn a one-year return of 15.7% versus 11.3% for the SCMU bond index.

**A fight for yield . . . not a flight to quality**

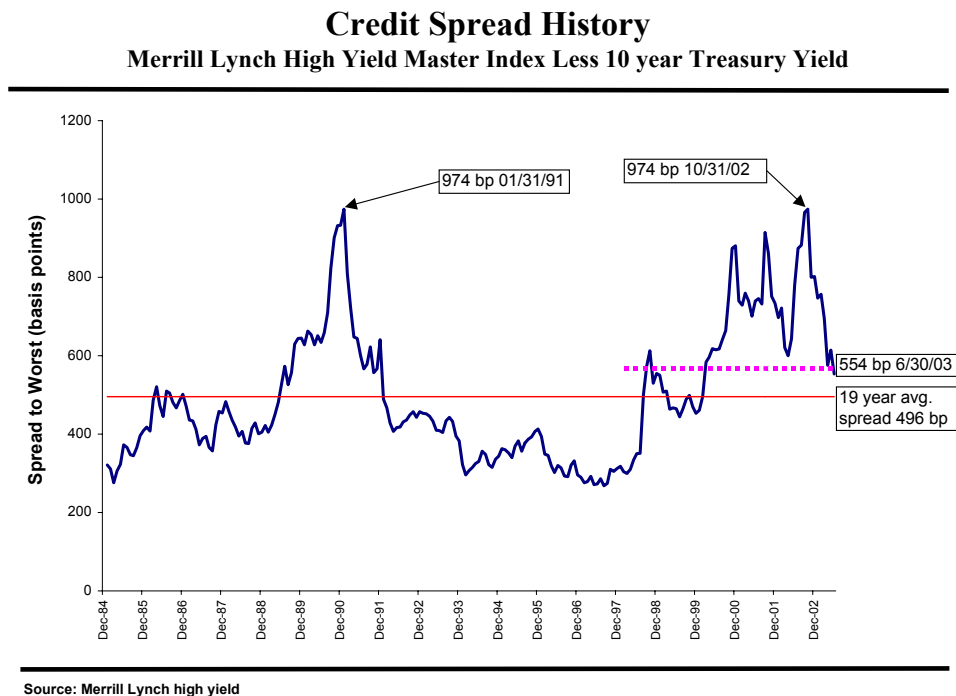
Long-dated Government of Canada bonds rose \$8.00 during the quarter. Normally such a large price increase is associated with a *flight to quality* response by investors. It has been uncommon for both Government and corporate bonds to have large price increases at the same time. This rise in corporate and Government bond prices together indicates investors are primarily looking for a steady return. Government bond interest rate levels are at 40-year lows and this is leading investors to reach for yield

by purchasing corporate bonds. As investors *fight for yield*, and with the economy on the mend, investors appear very comfortable with corporate credit quality.

## What happens next?

Following a sizable rise in Government and corporate bond prices, and a decline in credit spreads that have provided 2 years of double-digit returns, investors should expect to earn primarily the coupon income over the next 3 to 5 years. For Canada bonds the yield to maturity is just shy of 4% at June 30. In contrast the DKBond fund provides an income distribution that is more than double Canada bonds at 9.5%.<sup>1</sup> Coupon income (or distribution) is the only dependable portion of future bond return, and this return is significantly below the portfolio rate of return achieved over the past 2 years.

## Credit spreads are near fair value



Credit spreads have improved dramatically and are well below the peak levels reached during the fourth quarter of 2002, shown above. However, current spread levels are still above the average historical spread. Corporate bond yields are now fairly valued when compared to Government bond yields. With the benefit of hindsight, it is not the best time to invest in corporate bonds - that was November 2002; however, it is also not the worst time (i.e. 1997-98). Corporate credit spreads, near their historical average, indicate that investors should not expect much in the way of further positive price changes. As an example, the average bond price in the DKBond fund is close to \$100. In other words, DKBond investors should expect a portfolio return primarily made of income distributions of roughly 9% over the next 3 – 5 years.

<sup>1</sup> Using annualized monthly distributions for the second quarter.

## Strong demand for income

The flow of capital into U.S. High Yield Bond mutual funds has been very strong. So far this year investors have put \$21.3 billion USD into high yield bond mutual funds, increasing total assets by over 20% from the January 1 level. The demand for income products has been so great that the largest High Yield corporate bond mutual fund in the U.S. (Vanguard at \$9.1 billion) and in Canada (AIM Advantage at \$1.4 billion) are now closed to new investors. The reason; these large funds can not find enough high yield opportunities to invest in. As a small fund manager we have not experienced a problem finding interesting opportunities and the DKBond fund is almost fully invested at quarter-end.

## Portfolio activity

We have been able to purchase a number of attractive new holdings during the quarter. For example, we added senior unsecured debt of **Saskatchewan Wheat Pool (1.6%)**. Due to drought and poor grain volumes the Company violated their bank debt covenants in late 2002. In response, the Company proposed to Banks and bondholders a refinancing plan that would reduce the overall level of debt and help the Company avoid bankruptcy. The approval of the plan in February 2003 allowed the Company to refinance former debt holders with a combination of a small amount of new debt and a majority of the equity. This allowed the Company to continue to operate with a healthier and less debt leveraged balance sheet. The debt we purchased this quarter, at less than \$75, is part of the new debt recapitalization plan for Sask Wheat Pool. Sask Wheat Pool earns revenues from handling grain volumes and they are not exposed to grain price fluctuations. The problem has been 2 years of drought that reduced grain volumes for the 2003 crop year just ending to 25% of normal levels. With better growing conditions forecast for 2004, and a stronger balance sheet, we believe Sask Wheat Pool bonds provide a very attractive investment opportunity.

We also added significantly to **Royal Group Technologies (3.1%)**. This company has high quality assets; however, earnings have suffered because new capacity has been added at a much greater rate than sales. Most important for a bondholder is the assets generate significant positive free cash flow, after debt interest payments. At a portfolio average cost of \$86, the bonds provide a very attractive 9.7% yield to maturity.

**Baytex Energy (4.4%)**, one of the largest portfolio holdings, made the decision to convert to an income trust during the 2<sup>nd</sup> quarter. In order to complete this transaction Baytex needed bondholders' consent to amend the bond trust indenture. To secure this consent, Baytex had to provide bondholders with an offer we couldn't refuse. We didn't refuse. Bondholders receive \$120 of new bonds for each \$100 original bond, and this additional \$20 USD provided a significant gain for the portfolio during the quarter.