June 30, 2013

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

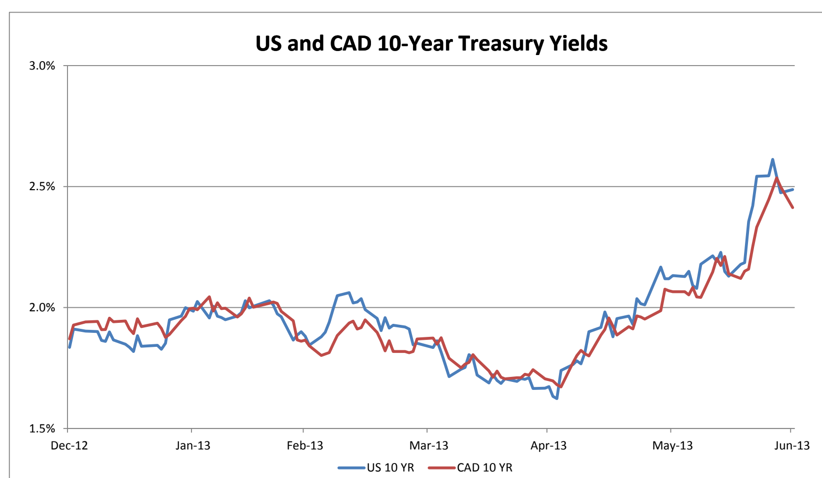
DK INCOME FUND

Quarterly Report
June 30, 2013

Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**-1.5%**	**-0.3%**	**8.9%**	**5.6%**	**8.8%**	**14.6%**	**9.5%**	**14.2%**	**10.6%**	**11.5%**	**11.5%**
DEX Universe Bond Index	-2.4%	-1.7%	-0.2%	4.6%	4.6%	5.2%	5.5%	5.3%	5.9%	6.9%	6.9%
ML CDN High Yield	-2.0%	0.7%	8.4%	8.2%	8.8%	13.2%	6.7%	5.5%	4.0%		
ML USD High Yield	-1.4%	1.5%	9.6%	8.0%	10.4%	14.5%	10.6%	8.7%	6.8%	7.8%	7.8%
S&P/TSX Composite Index	-4.1%	-0.9%	7.9%	-1.6%	5.4%	7.0%	-0.5%	8.4%	5.7%	8.1%	8.1%

A regular reader of our quarterly report will know that we have warned investors about rising interest rates and their impact on government bonds for years. We didn't know when it would happen, just that it would. Well, the long awaited rise began in May with the yield on 10-year US treasuries going from 1.6% on May 2nd to 2.5% at quarter end. Canadian treasuries had a similar result, going from 1.7% to 2.4%.



[1] Returns longer than one year are annualized gross of management fees.

We told you this would have a negative impact on government and investment grade bonds and it did. The DEX Universe Index, an investment grade bond index primarily comprised of Government bonds, was down 4% from its peak in May. In our view, this is just a preview of what is to come. Interest Rates in Canada have gone from 8.5% when Deans Knight was founded in 1993, to 2.4% today. As a result, since 1993, the DEX Universe provided a total annualized return of 6.9% from interest and capital gains, the latter a result of the significant decline in rates. As declining interest rates shift to rising rates, capital gains will turn into capital losses for government and investment grade bonds.

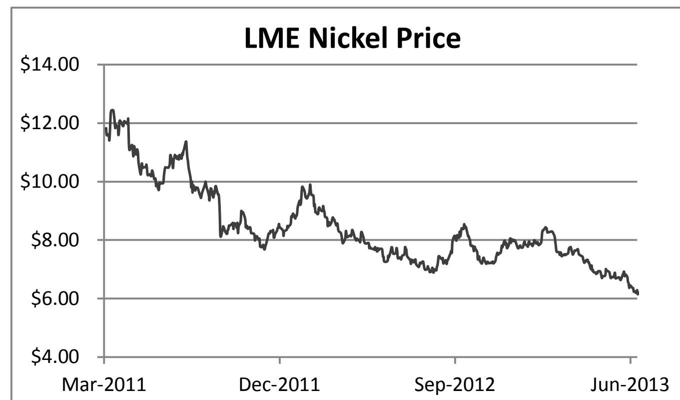
The difficulty for bonds last quarter was caused by Fed Chairman Bernanke's remarks that Quantitative Easing will likely come to an end this year. In our opinion, all Bernanke did was state the obvious. Of course QE will end, the Fed cannot continue to "print money" in the face of improving economic results. The economy is able to stand on its own feet and, as a result, it is standard practice for the Fed to 'remove the punchbowl once the party gets rolling!' Much improved recent employment figures in the US indicate we are returning to more normal business activity.

Nonetheless, the concern of rising interest rates finally caused investors to ask themselves the question 'what happens to my bonds if rates rise'? The simple answer is when interest rates rise, bond prices fall and the longer the term of the bond, the further the price will fall. As we've outlined above, this is certainly true on government and investment grade bonds. However, the high yield market is not impacted to the same extent by rising rates. As an example, the DK Income portfolio produced a -0.3% return year-to-date compared to the DEX Universe Index return of -1.7%.

Why? Firstly, the coupon on the securities in the DK Income Fund is significantly higher than the coupon in the DEX Universe. At June 30, 2013, the DK Income Fund provided a yield to maturity of 7.5%, versus the DEX Universe which yields 2.7%. Secondly, our portfolio has a shorter term to maturity of 4.5 years versus the DEX Universe Index at almost 10 years, meaning our portfolio is less sensitive to changes in interest rates. Thirdly, interest rates rise because economic conditions are improving, which is positive for corporate earnings and balance sheets, thus positive for high yield bonds. We are invested in sound businesses with quality assets. The securities we hold will mature at par within approximately 4.5 years, or earlier if they are called, and we anticipate reinvesting at higher rates.

The DK portfolio had a few holdings which negatively impacted the returns in the past quarter. Most notably, were the sale of **Northland Resources S.A.** bonds at a loss, and a decline in value of our holding in the bonds of **Mirabela Nickel Ltd**. We discussed Northland in detail last quarter. We believe Mirabela is different and presents an opportunity for future capital appreciation as the bonds currently trade in the $70's.

Mirabela produces nickel from a world class sulphide deposit and facility in Brazil. The nickel market is in a very deep slump. The graph below shows the steep decline in the commodity price since March 2011.



Source: Bloomberg

At today's nickel price, very few producers make any money, including Mirabela. That said, the company has a first class deposit and plant, strong shareholders, great management, they operate in a good jurisdiction (Brazil), and they have cash on hand to help them withstand low nickel prices for an estimated 18 months. Management has been working hard and has been effective in reducing mining costs. To be sure, we need a recovery in nickel prices for the Company to remain current on their interest payments. The point is that because of the low commodity price, there will be no new nickel mines. Moreover, we may begin to see production cuts or shutdowns from higher cost mining operations. Mirabela has a $50 million fully drawn bank facility and $395 million of high yield bonds which are currently marked in the low $70's. Assuming this price level, and ignoring cash on hand, the bonds are valuing the company at $325 million. The replacement value of the plant alone is roughly $1 billion.

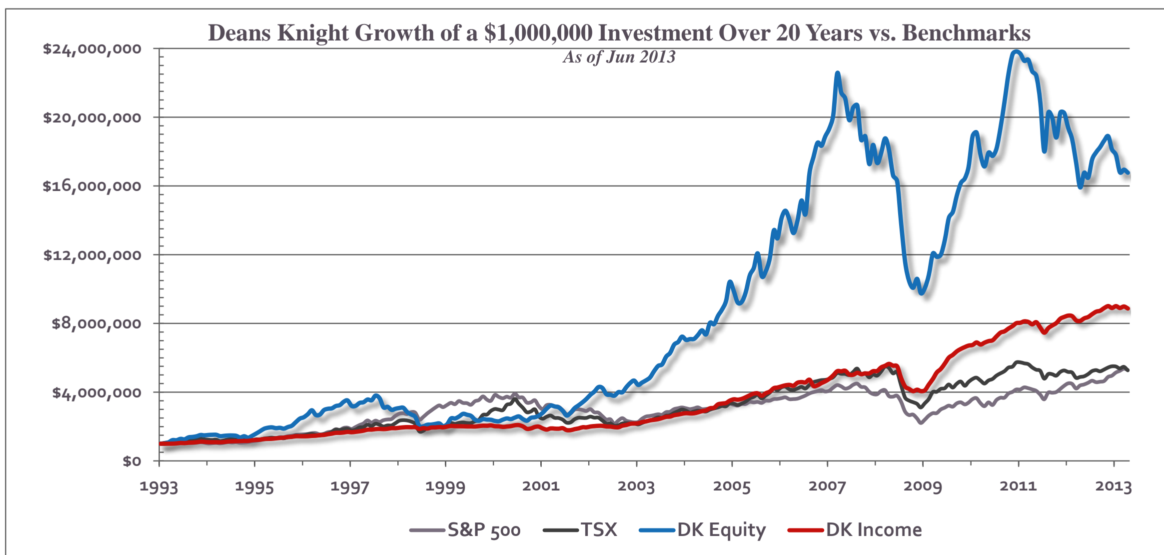
We also had some positive outcomes during the quarter, one example being **North American Energy Partners Inc**. In June, the Company announced the sale of their piling division for $210 million with an option to receive an additional $92.5 million if certain hurdles are met. Proceeds from the sale need to be either reinvested back into the business or be used to pay off the debt which currently totals $310 million. The Company retains their mining division, which management expects to generate $45 million over the next twelve months. In addition, the majority of their hard assets, roughly 80%, remain with company after the sale of the piling division. This was positive for the bonds, which have risen from a low of $86 to $103 at quarter end.

We have allowed cash to build in the portfolio over the past 12 months. Cash currently represents 14% of the portfolio. We did this because yields were declining and attractive opportunities became scarce. As rates rise, we expect to gradually deploy the cash when more attractive opportunities come our way.

During the quarter, we added to our position in two dividend paying corporations which we believe will provide attractive total returns going forward. Firstly, we purchased shares of **Vicwest Inc.**, a leader in grain storage/handling systems and building construction products. We purchased stock at a 5% dividend yield and believe, despite short term headwinds, the investment will provide capital appreciation as revenue grows and margins in their building products division improve.

We also added to **Bird Construction Inc.**, a general contractor operating throughout Canada. Their focus is in the industrial, mining and commercial sectors. Bird has a solid management team, which has shown a positive track record of making money even in difficult economic environments. This is evidenced in their ability to manage the risk of using fixed priced contacts even when margins compress during economic instability. Bird continues to pay a healthy dividend of 5.5%, and we will continue to add to our position as we feel Bird will benefit from improving economic conditions.

Our final point of focus…this year marks the 20th Anniversary of the founding of Deans Knight. We have had periods of great returns and periods of underperformance over the 20 years in both of our strategies…equity growth and income. In spite of the ups and downs, our long term track record has been very good. Both strategies have outperformed benchmarks by a wide margin.



To commemorate the Anniversary we have written a book... '*Don't Listen to Everyone with an Opinion, 20 Lessons over 20 Years of Investing*'. One may not agree with each of the 20 lessons, but we hope the book will provoke thought, and help provide an understanding of what we do, how we do it, and most importantly WHY WE DO WHAT WE DO…with passion.