June 30, 2015

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Rates of Return[1]

	3 Mths	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**1.2%**	**5.5%**	**3.3%**	**6.3%**	**7.3%**	**10.2%**	**11.2%**	**10.7%**	**10.9%**
ML USD High Yield	0.0%	2.5%	-0.5%	6.8%	8.4%	7.8%	7.5%	7.4%	7.5%
ML CDN High Yield	1.7%	3.5%	-2.2%	6.3%	7.3%	4.9%	4.7%		
Inv. Grade Bonds[2]	-1.7%	2.4%	6.3%	3.8%	5.1%	5.0%	6.1%	6.7%	6.8%

Year to date, the DK Income Fund returns exceeded all three indices. Over the last five years, the Fund's returns have exceeded the investment grade bond index and are roughly in line with the high yield bond index benchmarks.

As of June 30th, cash as a percentage of the portfolio stood at 20%, up from 6% at March 31st. This increase is the result of two loans being repaid (**Paramount Resources Ltd. and Petroamerica Oil Corp.**) and a take-over bid on one of our dividend paying equity positions (**Vicwest Corp.**).

Paramount Resources was one of our companies that called bonds, at $102.875, and then refinanced this debt during the quarter. We have owned Paramount debt since their first high yield issue in 2003. As a result, we know and understand the people and the business very well. By refinancing, Paramount was able to lower the coupon to 6.875% versus 8.25%, and extend the maturity from 2.5 years to 8 years.

This is the third time Paramount has refinanced our debt. We have earned an average coupon of 8.35% and a total annualized return of 10.5%. The significant difference of 2.15% per year in return is the extra value provided by the call premiums we have received. The Company continues to grow production and cash flow with more than enough assets to support our debt. We elected to participate in the new issue, albeit at a smaller commitment than it has been historically, due to a slightly lower yield and the longer maturity.

[1]Returns longer than one year are annualized gross of management fees.
[2] FTSE TMX Canada Universe, an index of Canadian investment grade bonds.

In April 2012, we structured a $35 million secured debt financing, which included warrants for **Petroamerica Oil**, 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 allowed the Company to pay our debt back at maturity from cash on the balance sheet. This investment provided an annualized total return of 16.5%, a combination of coupon income earned of 12% and capital appreciation from warrants issued with the debt.

The purchase of shares in **Vicwest Corp.**, by competitors Kingspan and Ag Growth, was settled during the quarter culminating our very profitable long-term investment relationship with the Company. We had originally owned the debt in Vicwest. In 2001 the Company filed for CCAA protection. We provided short-term financing and put our representative on the Board to protect our interests and guide the Company through the restructuring process. The debt was exchanged for 100% of the equity, at a valuation of $4 per share, and the Company began paying dividends in July 2005. Since then, Vicwest has provided us with dividend income of roughly 8% per annum and was sold at $12.70, over three times our cost.

With interest rates at historical lows, companies are refinancing debt at lower coupon rates and extending their maturity schedules. In the past two years, 45% of our bond investments have been refinanced at lower interest rates. The majority of these bonds have been called at a premium to par, a common requirement when refinancing bonds early.

To replace the refinanced debt we have invested in 12 new opportunities over the last two years. The investments range across a variety of industries and provide average coupons in excess of 8%, with maturities of less than five years. They are all backed by tangible assets and strong cash flows. The covenant packages are solid. These investments are performing as we would expect and, on average, are trading above our cost base.

As an example, in the most recent quarter we purchased **Cott Beverages Inc.** 5.375% Senior Notes due July 1, 2022. Cott is the largest private label soft drink producer in the world. In December 2014, Cott acquired DS Services, one of America's largest direct-to-office and home suppliers of water, coffee and other products. Cott leveraged the balance sheet, issuing these notes, to make the acquisition. On the growth side of Deans Knight we have owned shares in Cott for many years. We understand the business and have a very good relationship with the CEO, Jerry Fowden. We are very impressed by the progress Jerry has made shifting the focus of the business toward alternative beverage manufacturing, co-packing for other branded products, and of course with the transformational acquisition of DS Services.

We were interested in purchasing the Cott debt issue but felt the yield should be higher. In March, 3 months after the deal closed, the bonds traded down from their $100 issue price and we started a position at $95, a yield of 6.3% versus the issue price yield of 5.375%. The bonds have since traded up to $97.25. We continue to hold and we will look to add to our position on further weakness.

The buoyant equity market of the past few years has worked in our favour, enabling many of our investee companies to raise equity, strengthen their balance sheets, and enhance the value of our debt.

In June, **Canadian International Oil Corp.**, a private oil and gas company, raised over $200 million with the majority coming from a $30 billion energy focused U.S. private equity firm who now owns more than 40% of the equity and likely going higher. The Company is now well funded with the drilling opportunities to grow production which, along with a strong equity partner, further increases the security on our $75 million Senior Secured 11% 2nd lien notes due May 2016.

Shoes.com, a Canadian based online retailer, raised $46 million equity capital in May. The cash will be used to support growth which will benefit our $10 million secured convertible debenture we provided in December 2014. Our debentures pay us a 10% coupon and are convertible into equity at $3.50 per share, well below the $9.80 price at which the recent equity was raised.

Syncordia Technologies is a medical billing company growing by acquisitions in a fragmented industry. They raised $10 million in equity at $3 CAD per share in June. Proceeds from the transaction will be used to make acquisitions which will further secure the $12.5 million 11% secured note we structured in November 2014. Following the capital raise, the Company closed a reverse take-over transaction and now trades on the TSX venture exchange under the symbol SYN. This improves the Company's access to capital through the public markets, which will allow further growth through acquisitions. The shares trade in the $2.75 range, roughly in line with the conversion price of the warrants we have attached to the secured note.

On March 12th, **Perpetual Energy Inc.** announced the sale of roughly 25% of their producing assets in exchange for $250 million in shares of Tourmaline Oil Corp., the second largest gas producer in Canada. Then, on April 13th, Perpetual raised $21 million cash through a land sale as they continue to monetize assets to reduce debt and fund development projects. In the last 18 months they have raised $190 million cash, in addition to the Tourmaline transaction. The recent asset sales have greatly improved the credit profile of the Company. Moreover, the shares that they now hold in Tourmaline cover 80% of the debt outstanding.

We are frequently asked by clients about the impact of rising interest rates. We have been in a "bull market" for bonds since 1981. The 10-year Government of Canada bond yield has declined from 17% in 1981 to 1.65% today. With current inflation rate at 1.5%, Government of Canada bonds are producing close to a net zero rate of return. We can't predict interest rate movements. However, when interest rates do increase, bondholders will sustain a loss of capital. The loss will vary depending on the term of the bond and the coupon level. The longer the term and the lower the coupon, the greater would be the capital loss. For example, should the yield on the 10-year Government of Canada bond increase by only 1%, the price of the bond will decline by 8%.

Because we are lending for shorter terms and much higher coupons the impact on our portfolio is muted. If the yield on our portfolio increases by 1%, the price of our bonds would decline by 2.5%. Our current average term to maturity on our bonds is roughly 3.5 years and the average

coupon is 7.5%. Moreover, our shorter term and our 20% cash position puts us in a position to take advantage of more attractively priced bonds should we see a higher interest rate environment.