June 30, 2016

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
June 30, 2016

During the first half of the year we made a number of investments, reducing our cash position from 25% at the start of the year to 6% as of June 30th. As a result, our portfolio cash yield has risen to 7.5%, which will increase our income earned for the second half of this year.

As we can see from the adjacent table:

- Income earned generates almost 90% of the long-term return.
- The annual income earned has been relatively stable in a range of 7 -10% per year.
- Bond prices can be volatile as they trade in the market prior to maturity, but they trend back to par value as their maturity dates approach. Bond price movements account for a small part of total long-term return.

Like Chapter 18 in our anniversary book says, "It's all about the Coupon".

Table 1: Deans Knight Income Fund Historical Annual Returns:

Year	Income Earned	Price Movement	Total Return
2016 YTD	3.1%	2.0%	5.1%
2015	8.4%	-8.1%	0.3%
2014	7.9%	-3.8%	4.1%
2013	7.2%	-7.1%	0.1%
2012	8.2%	2.7%	10.9%
2011	8.3%	-4.1%	4.1%
2010	7.7%	10.6%	18.3%
2009	11.5%	49.1%	60.6%
2008	9.4%	-29.7%	-20.3%
2007	8.5%	7.2%	15.6%
2006	9.0%	0.1%	9.1%
2005	9.3%	11.6%	21.0%
2004	9.7%	15.9%	25.5%
2003	10.1%	17.1%	27.2%
2002	9.9%	0.6%	10.5%
2001	9.1%	-8.9%	0.2%
2000	9.7%	-17.5%	-7.8%
1999	7.5%	-2.2%	5.3%
1998	7.9%	-3.6%	4.2%
1997	8.1%	6.4%	14.5%
1996	8.7%	7.7%	16.4%
1995	9.8%	11.1%	20.9%
1994	8.7%	-2.1%	6.7%
1993*	4.0%	4.5%	8.5%
Annualized Since Inception	**8.8%**	**1.6%**	**10.4%**

* Fund Inception was June 30, 1993. Not a full year of return data.

We had 6 of our holdings repaid from April to October last year. During that time, cash yields for most high-yield bonds were historically low. Rather than investing our cash and locking in these lower yields, we elected to be patient, and wait for higher income opportunities.

From November 2015 to February 2016, bond prices in North America declined 11.5%, largely a result of investor fears of lower oil prices, sluggish global growth, and the threat of rising interest rates. The average cash yield in the high-yield market[1] increased to 7.9% in February (up from 6.75% in April 2015, when our first bond was repaid), which provided us an opportunity to put our 25% cash position to work.

Below is a list of the bonds we bought throughout the first half of this year, along with the cash yield (annual income) associated with each bond at the time of purchase.

Holding	Cash Yield
Cascades	5.7%
DirectCash	8.1%
Garda World	8.8%
Gateway Casinos	9.1%
HRG Group	7.8%
Imperial Metals	7.8%
Iron Mountain	5.9%
Ivy Funding	12.8%
Just Energy	6.0%
Lundin Mining	7.9%
Newalta Corp	8.2%
Paramount Resources	8.8%
Russell Metals	6.1%
Teck Resources	5.6%
Videotron	6.1%
Wajax Corp.	6.3%
Western Energy	9.0%

Two new names to the portfolio in 2016 were **Newalta Corporation** and **HRG Group, Inc**.

We accumulated a position in the bonds of **Newalta** between January and June of this year, at an average price of $77.75 (average cash yield of 8.2%). Newalta is the 3rd largest waste management provider to the energy sector in Canada, with a 15% market share. They provide an

[1] Based on the BofA/Merrill Lynch High-Yield index

essential service to the energy industry. Energy companies generate a lot of waste fluids while producing and drilling for oil and natural gas, which is required to be disposed of properly. Waste fluids generally contain drilling fluids, water, oil, and other material. Newalta is paid to remove the waste fluids from producers sites, and using their processing facilities they extract the valuable assets such as oil (usually given back to the producers to sell), and dispose of the remaining materials as required.

Low oil prices have impacted demand for Newalta's services as producers have shut in production and reduced drilling activities. This has reduced Newalta's EBITDA from $140 million in 2014 to our estimate of $25 – 30 million in 2016, providing an opportunity to buy bonds earlier this year at prices well below par value.

We are attracted to Newalta's debt for the following reasons:

- Provides us with a cash yield of 8.2%
- Our debt is backed by Newalta's assets with a book value of roughly 1.75 times the debt outstanding.
- The Company raised $50 million in equity in March 2016 giving them financial flexibility to withstand lower oil prices and wait until activity returns.
- It's an essential service to the energy industry with high barriers to entry. This limits future competition, and helps maintain the value of the company's assets.

In addition to Newalta, we bought bonds of **HRG Group** at a 7.8% cash yield. HRG is a holding company with 2 core public company investments – a 57% ownership in Spectrum Brands (household consumer products) and an 80% ownership in Fidelity & Guarantee Life (insurance company). HRG's ownership is valued at $4.9 billion ($3.9 billion in Spectrum and $1 billion in Fidelity) versus $1.5 billion in net debt outstanding.

Spectrum Brands is a global consumer products supplier of household goods including batteries, hardware, personal care products, small appliances, pet supplies, lawn and auto care products. Brands include Rayovac, Weiser, Black + Decker, Armor All and IAMS just to name a few. In 5 years, Spectrum has doubled EBITDA and is expected to generate over $500 million in excess free cash flow in 2016. This cash can been used to reduce debt or invest in the business to continue to grow its EBITDA.

HRG Group's other major holding is Fidelity & Guaranty Life which offers life insurance and annuity products. Fidelity & Guaranty has no net debt and recently went through a competitive sales process agreeing to a sale to Anbang Insurance Group valuing HRG's equity stake at over $1 billion. The sales process has stalled as they seek multiple regulatory approvals; however, both parties have stated their desire to close the merger as expeditiously as possible.

We expect proceeds from the sale to be used to pay down HRG's secured notes. This would leave HRG with over $300 million in cash, $890 million in debt and an investment in Spectrum Brands currently valued at $3.9 billion.

The most significant event for the portfolio happened on July 6. **Paramount Resources Ltd.**, our largest holding (7.2% of the portfolio), sold 310 sections of land in the Deep Basin producing 30,000 boepd of natural gas and associated liquids for $1.9 billion to Seven Generations (the largest Montney gas producer in that area of Alberta).

The $1.9 billion proceeds are made up of $475 million in cash, 33.5 million shares of Seven Generations (publicly traded) worth approximately $900 million as of July 7, and the assumption of Paramount's $450 million USD debt, due 2023 (which we own in the portfolio). Due to Seven Generations' strong balance sheet, these bonds have traded above par post transaction (we bought these bonds earlier this year at an average price of $73.75).

Post the sale of assets, Paramount has no net debt. They have $475 million of cash on hand, along with $1 billion of equity in publicly traded energy companies ($900 million of which is Seven Generations). This liquidity is offset by debt totalling $450 million, due in 2019 (we also own these bonds). Paramount has announced they will offer to purchase $300 million of these bonds, at a price of $103.81. Subsequent to the transaction, these bonds are now trading at approximately $103 (we purchased these bonds earlier in the year at an average price of $77.50).

Income earned is the driver of our future return, but it's worth noting that the average bond price in the portfolio today is $93.50 with an average maturity of 4.25 years. As bonds get closer to maturity we would expect bond prices to approach par.