September 30, 2017

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Quarterly Report
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Year-to-date our income earned is 4.9% (annualized 6.5%) and our bond prices have been flat. For context, the Canadian Bond Index had an income return of 2.2% (2.9% annualized); however, bond prices were down 1.9%, offsetting the already low coupon.

After 9 years of easing monetary policy, central banks have begun to raise interest rates and will continue to do so in the coming years. This is not a prediction, it is what central banks do. They provide extra liquidity when the economy needs it; when the economy is back on its feet and the party is in full swing, they ease the punch bowl away.

What does this mean for investors? It means that you are at great risk if you own long-dated, low coupon bonds. As central banks raise rates, bond prices will fall, offsetting the small amount of income you are generating. In addition to price declines, the low coupon will put investors' capital at risk of permanent loss as they are forced to sell investments to cover the income shortfall.

The low interest rates often compel investors to take more risk, and invest in equity markets ignoring the alternative of investing in shorter dated, high coupon debt. <u>Remember, when you need income you should own income generating investments.</u>

Table 1: Deans Knight Income Fund Historical Annual Returns:

Year	Income Earned**	Price Movement	Total Return
2017 YTD	4.9%	0.0%	4.9%
2016	7.1%	5.9%	13.0%
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%	-4.2%	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%	7.1%	15.6%
2006	9.0%	0.1%	9.1%
2005	9.3%	11.7%	21.0%
2004	9.7%	15.8%	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%	-3.7%	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%	-2.0%	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.
**Income Earned is gross of fees.

The graph below shows the 10 year cumulative return since September 2007, just before the credit crisis. It highlights that the DK Income Fund outperformed all asset classes, including the S&P 500 which has widely been touted as the big outperformer.

To show we aren't cherry picking a specific period, we looked at every 10 year return period over our 25 year history (175 data points) and compared them to the TSX and S&P 500. Results:

- DK Income outperformed the TSX Composite 99.4% of the time.
- DK Income outperformed the S&P 500 86.2% of the time.

Despite this evidence, many investors still believe high-yield debt is "too risky". To be clear, we do not view ourselves as high-yield managers but rather income focused bond managers. We understand why high-yield has gotten a bad name, as there are many bond issues which will not meet our credit quality. It is why we would never recommend the high-yield index, which consists of 2,000 bond issues, as a suitable investment.

The number of high-yield bonds which pass our credit test and pay a high enough coupon is quite small. For example, 75% of the high-yield bonds in North America currently have a yield of less than 6%. While there are many great companies in this group, very few offer an attractive coupon. The bonds offering the highest yields usually will not meet our credit criteria. Our expertise is finding 30 – 40 bond investments, out of 2,000 issues, which maximizes the coupon for our clients while protecting capital.

When you loan money, you don't participate in the business gains but you may share in the losses. To a debtholder, the most important consideration is the company's ability to meet its coupon payments and pay back our principal at maturity. We are constantly stress testing our businesses, to determine their ability to repay us, even in a severe downturn.

Some of the characteristics that we look for when lending to a business:

- Loan to a business we can understand
- Loan to a business run by a competent management team
- Loan to a business with competitive advantage that can endure the destructive forces of competition
- Loan to a business with barriers to entry
- Loan to a business with financial strength and flexibility to withstand adversity
- Loan to a business with cash flow to pay interest in all cycles
- Loan to a business with tangible assets providing security/collateral

When your best case scenario is earning a coupon and getting paid back, lenders need to ensure their capital is protected. If a company meets the above criteria, we use our credit knowledge to evaluate the trust indenture of their debt. A trust indenture is the legal contract between a company and its lenders. It outlines what the company must pay (the coupon), and when it must pay back the loan (the maturity). In addition, it details the lenders security/collateral and contains restrictions on what the company can and cannot do (the covenants). Each indenture is different. Our expertise is in examining these contracts to ensure bondholder's principal is protected.

Our strategy and credit research has generated a steady stream of high income, protected our clients' capital, and routinely outperformed equity indices over the past 25 years.

Currently, our portfolio of bonds is yielding 7% with an average maturity of 4 years. While at the lower end or our long term range (7 – 10%), it compares favourably to a portfolio of government and investment grade bonds which yield only 2.5% and protect investors requiring income against permanent loss of capital that a low coupon brings.

Portfolio Activity

During the quarter we had a small position in **Iron Mountain** (6.125% Aug 15, 2021) called at a premium to par of $103. We also received our final payment on **Shoes.com** which included 100% of our loaned principal plus interest owed. We used this cash to add to existing positions and purchased new issues of **Mattamy Group Corp** (6.5% Oct 1, 2024) and **Gibson Energy Inc**. (5.25%, Jul 15, 2024).

Mattamy Group is a Company that we have been following for several years. When they issued bonds this September we knew the business well and were able to assess and promptly reach an investment decision. Mattamy is the largest private homebuilder in North America and has been run for nearly 4 decades by its founder, Peter Gilgan. We have had previous success in lending to family-owned businesses such as Mattamy because they have high incentives to avoid the bondholders taking control.

We invested in Mattamy for several reasons. Management ownership is key, as is their excellent track record, such as 23 years of consecutive profitability (only 2 of 39 years were not profitable). Geographic diversity, a large and liquid inventory of land, history of steady cash flows, moderate leverage, and significant growth opportunities support several of our criteria for lending.

Mattamy has over $4.5B in assets on their balance sheet and $1.7B in debt. The book value of their inventory is $3.6B and the estimated fair value is $5.6B. Last year Mattamy generated over $3B in revenue and $500M in EBITDA which means leverage is 3.4x Debt/EBITDA. $3.7B of its $4B backlog is in Canada where their historic cancellation rates are under 2%. This provides reasonable clarity on the short term revenue forecast for Mattamy.

At quarter end, we initiated a position in Gibson Energy Inc. (5.25%, Jul 15, 2024). Gibson issued $250M in Senior Unsecured Notes and will use the proceeds to repay debt. After the repayment the Company is expected to have $1B in debt and 3.2x Debt/EBITDA. Gibson is a publicly traded company that owns and operates crude oil infrastructure assets (oil terminals, pipelines, disposal wells etc.) in Canada and the U.S. The majority of Alberta oil exports would go through one of Gibson’s 2 facilities, providing them high quality, stable cash flows. Over 50% of their infrastructure business is under long-term, fixed fee contracts. Gibson’s assets are difficult to replicate and their cash flows are stable which provide strong collateral for bondholders.