September 30, 2006

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

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Rates of Return[1]

	3 Mths	YTD	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**4.4%**	**13.3%**	**16.2%**	**22.1%**	**22.4%**	**23.6%**	**20.6%**	**11.4%**	**12.1%**
SCM Universe Bond Index	4.9%	3.3%	4.0%	6.5%	5.9%	6.5%	6.9%	7.3%	7.9%
ML CDN High Yield (hedged)	4.4%	5.2%	3.1%	3.5%	5.7%	12.7%	7.5%		
ML USD High Yield (unhedged)	4.1%	7.2%	8.0%	7.3%	9.0%	13.7%	10.2%	6.6%	7.3%

Our objective is to acquire undervalued income generating opportunities that will provide our investors with attractive income payments and preserve capital value.

We hold 15% of the DK portfolio in energy and energy services trusts. Popular thinking is now focused on the possibility of a U.S. recession due to a decline in the housing market, thus leading to a global economic slowdown, with the potential for a further decline in commodity prices. Recent declines in energy prices are leading to sharp declines in cash flow for most energy and energy service trusts, particularly those focused on North American natural gas production. Lower cash flows are putting pressure on energy trusts to cut distributions, reduce CAPEX, or both, which in turn has led to a decline in unit prices.

We do not know what will happen to the U.S. economy in the coming quarters or years…and for a fact, nobody else knows either. We are comfortable with the energy holdings in our portfolio, because we know that we are in a supply constrained oil & gas environment that will require persistently high prices to restrain consumption and also to encourage the development of increasingly expensive marginal barrels of production. As the valuation of energy trusts falls along with their distributions, we will look to add to oversold positions because we believe energy prices will recover.

Short-term cash reserves grew to 17% of the portfolio during the quarter primarily because three more bond holdings were redeemed. We originally purchased **Gerdau Ameristeel 6.5%** bonds at $75 in 2002 when it was still called Co-Steel, a Canadian company. Gerdau, a large and well capitalized Brazilian steel company, purchased Co-Steel's seven North American mini mills and assumed the debt in its US subsidiary. Gerdau specializes in mini mills and wanted Co-Steels assets as well as their public company TSX listing. The Gerdau bonds produced an annualized return from 2002 of more than 15%. We first purchased **Petrobank Energy 9%** bonds in 2001 at an average cost of roughly $88. Petrobank issued additional 9% bonds in 2003 to fund ongoing capital expenditures, with equity warrants included in order to

[1] Returns longer than one year are annualized.

sweeten the deal. The bonds were redeemed in July and the equity warrants significantly enhanced the return contributing to a total annualized return on the Petrobank investment of approximately 15%. In May 2005, we participated in a fully secured private debt financing with **Imperial Metals**, a copper producer located in B.C. and a publicly traded company listed on the TSX. In addition to the 8% coupon, we received 13.35 warrants per $100 loan. The warrants were exercised and sold in February and the debt financing was repaid this August resulting in an annualized rate of return of 19% on this investment.

We continue to uncover attractive opportunities. During the quarter, we participated in a Bank Term Loan of **Paramount Resources** with a yield of 9.75%. Paramount develops and produces oil & gas property, and holds a 36% interest in North American Oil Sands Corporation ("NAOSC") and a 16.4% interest in Trilogy Energy Trust. As Paramount's producing areas reach a certain critical mass the Company dividends the assets to shareholders as an income trust (Paramount has spun out Paramount Energy Trust and Trilogy Energy Trust). The strategy to spin out operating assets and hold developing assets makes Paramount appear to have a low Reserve Life Index and high Finding, Development, Acquisition & Operating costs. As a result, Paramount gets a lower credit rating on its debt leading to a higher coupon payment. The $150 million Loan Facility is secured by a pledge of Paramount's holding in NAOSC, recently valued at $400 million, as well as a general guarantee by the Company. With ample security and a floating rate coupon of 9.75%, we feel investors are being well compensated for the risk.

We purchased **Blackwatch Energy Services Trust** on its Initial Public Offering at $10, providing an annual distribution of 11%. Blackwatch holds an interest in five private energy services companies that have substantial future growth prospects. The shareholders of the private companies will retain roughly 70% of the outstanding units. Blackwatch has spent $21 million of capital in the past 18 months to ramp-up its fleet which will be put in to use in the latter half of 2006. This increased fleet will add to the cash flows of the business year over year. We purchased Blackwatch at an attractive multiple of 4.5x annualized first quarter EBITDA[2] and prior to the expansion of their fleet. The Company will target to have a low payout ratio of 65-75% in order to facilitate future growth.

Blackwatch's IPO brings up an interesting point in the new issue income trust market. A number of Income Trusts tout potential growth when marketing their IPO. Given some of the recent valuations, it seems as though Investors are willing to pay for the expected growth in cash flows. This encourages management to over-promise. When the Company fails to meet expectations the price falls below the IPO price. We focus on analyzing the underlying business' ability to generate and sustain cash flow. We look for opportunities, like Blackwatch, where the business is being priced at an attractive valuation to current cash flows with the possibility that future growth should lead to an increase in the unit value.

We also added to our holding in **Data Group Income Fund**. The Company issued units and convertible debentures to acquire Relizon Canada for $141 million during the quarter. We participated in the unit offering at a cost of $9.50 that provides an annual distribution of 12%.

[2] Q1 annualized, assumes an annual EBITDA contribution of 33%

We feel Relizon Canada is a good fit for Data Group's current operations. Relizon is a provider of document outsourcing solutions to a broad group of Canadian market leaders, including Canada Post, Manulife, Bell Canada and certain Canadian chartered banks. By purchasing Relizon, Data Group doubles revenues and eliminates their biggest competitor in the document management services industry. We expect Data Group to generate $1.45 per unit in distributable cash flow once Relizon has been fully integrated assuming no growth in sales.

We have spoken in our last few quarterlies about our investment in **Jean Coutu Group 8.5%** August 1, 2014. In August, Jean Coutu announced the sale of their US operations to Rite Aid. As part of the sale, Rite Aid announced it will assume the obligations of the 8.5% subordinated bonds from Jean Coutu. We believe this is wrong as, in our opinion, the credit quality of the bonds will be lower under Rite Aid. Therefore, the Companies should need bondholder approval in order to undertake this transaction. We, along with the majority of the bondholders, have commenced proceedings to challenge Jean Coutu's assertion that Rite Aid is able to assume the subordinated bonds. Our bond holding has an average cost of $93.53 and the current bid is roughly $96. If we are correct, Jean Coutu will be required to call/redeem the bonds at a price in excess of $100.

Conclusion

We continue to look for attractive income opportunities. We will be patient even though high cash reserves reduce the amount of income the portfolio generates in the short term. The portfolio is well positioned to take advantage of new income opportunities that will benefit portfolio returns in the long term.