September 30, 2007

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	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**-3.8%**	**13.9%**	**9.8%**	**13.0%**	**17.9%**	**19.1%**	**20.7%**	**10.5%**	**12.0%**
SCM Universe Bond Index	1.7%	0.9%	1.6%	2.8%	4.9%	4.8%	5.5%	6.1%	7.3%
ML CDN High Yield	-2.0%	1.3%	5.2%	4.1%	4.0%	5.5%	11.1%		
ML USD High Yield	0.3%	3.4%	7.8%	7.9%	7.5%	8.7%	12.5%	5.9%	7.4%

The most recent quarter was dominated by headlines concerning the popping of the U.S. housing bubble, the resulting defaults in the subprime mortgage market, and the negative effects on global credit markets. A large portion of the portfolio, 37%, is invested in cash and short term investments as a result of a number of takeovers occurring in the last 4 months as discussed in our Q2 report. We have always purchased treasury bills as short term investments for our clients and we do not hold any Asset-Backed Commercial Paper (ABCP). However, given the amount of press dedicated to the liquidity issues faced by non-Bank sponsored Asset Backed Commercial Paper programs in Canada, we felt it was important to explain the issues.

Asset Backed Commercial Paper is a method whereby banks transfer assets (mortgages, consumer loans, credit card receivables) from the balance sheet of the bank to outside investors. This is an advantage to banks because they continue to manage the loans for investors earning sizable fees without taking any credit risk. Banks are able to support their ABCP programs as funding problems occur because they can put these assets back on their balance sheet. Investors held $72 billion in Canadian Bank sponsored ABCP, and received compensation of 5 basis points above Bankers Acceptance's.

The liquidity problem occurred in non-bank sponsored ABCP, where there is an additional $35 billion outstanding in Canada. Non-bank sponsored ABCP was introduced to Canada by Coventree Inc. In July, it became known that varying percentages of these notes were backed by questionable U.S. subprime mortgage loans. Holders of the asset back notes reacted by refusing to roll over the maturing notes and attempted to redeem their investments. The emergency bank lines of credit that were put in place to guarantee the highest R1 rating, could not be drawn down in this circumstance, and the notes could not be repaid.

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[1] Returns longer than one year are annualized.

The matter is a simple one. We have been writing for some time suggesting that risk was being priced too low in the credit markets. Spreads between "risk free" government treasury investments and corporate debt instruments have been too narrow. As a result, we have shied away from investing in corporate debt for some time. The subprime matter and the related problems in the commercial paper market is just one simple example of mispricing. This debt must now be repriced, and those that own it will lose money.

Given our large position in cash and treasury bills, the portfolio is in a great position to take advantage of attractive income opportunities. For example, we continued to add to our position in **Progress Energy Trust**, a Canadian natural gas producer, at a yield of 9.4%. The U.S. demand for Canadian natural gas has been weaker this year than in the past, causing Canadian gas prices to be weaker. As a result of the lower Canadian gas price environment, Canadian natural gas producers continue to reduce spending on exploration and development. It is our belief that with less capital being spent on drilling in Canada, overall supply will begin to decline which will ultimately begin to put upward pressure on prices. Progress has the financial flexibility to withstand lower gas prices, maintain production and will benefit as gas prices improve.

In addition to Progress, we bought **Vermilion Energy Trust** during the quarter. Vermilion has more than 12 years of successful operating results expanding their asset base in Canada, Western Europe and Australia through strategic acquisitions, farm-ins, asset optimization and exploration activities. Vermilion has over 60 core assets currently producing 33,000 BOE per day. Vermilion has a premier management team focused on maintaining the lowest payout ratio, currently 75% after maintenance CAPEX, while retaining financial flexibility to take advantage of potential opportunities. Although Vermilion trades at a 20% premium to NAV, we feel it is justified as they have a strong inventory of investment prospects, long RLI, and the ability to increase production and reserves from their current asset base.

In addition to their core assets, Vermilion owns 41.8% of the outstanding shares of Verenex, a publicly traded Canadian junior Oil & Gas producer with operations in Lybia and France. Verenex has drilled and tested three wells, all of which have tested light sweet crude oil at high rates. Vermilion's large stake gives them an option on the success of Verenex which is currently valued at $3/unit.

Last year, we purchased units in **Blackwatch Energy Services Trust**, an energy service company that was combining the operations of six private companies. Blackwatch has experienced severe downward pressure on utilization and pricing because of the reduction in capital spending by major energy producers. This has led to a significant reduction in cash flow and the elimination of its distribution. As a result, the Company is now in breach of its covenants.

The bank has agreed to alter the covenants if Blackwatch can reduce their bank debt exposure. Deans Knight, along with another major shareholder, is providing a short term $22.5 million senior subordinated debt facility to reduce bank debt and temporarily alter the covenants. This offering gives the Company's new CEO, Travis Robertson, a chance to work through their issues, improve cash flows and realize value for its unit holders.

The Blackwatch financing will close in October and the Fund is purchasing $2.5 million of the facility. As a Debt holder, the Fund will receive an attractive income return as well as 133 warrants per $1,000 of debt. Although we are subordinate to the banks, we feel the assets of the company are in excess of $40 million, thereby providing security on our debt investment.