September 30, 2008

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	**-14.6%**	**-5.2%**	**-3.8%**	**2.7%**	**7.1%**	**12.0%**	**14.1%**	**9.7%**	**10.9%**
SCM Universe Bond Index	-0.4%	1.8%	4.6%	3.1%	3.4%	4.8%	4.8%	5.7%	7.2%
ML CDN High Yield	-7.3%	-9.6%	-9.1%	-2.4%	-0.6%	0.5%	2.4%	2.6%	n/a
ML USD High Yield	-9.5%	-10.6%	-11.7%	-2.4%	0.9%	2.3%	4.3%	4.3%	6.0%

The events that have unfolded in this most recent calendar quarter are unprecedented. The bursting of the U.S. housing bubble has essentially brought the global financial system to its knees and has resulted in the biggest restructuring of the U.S. financial system since the 1930's. (See Appendix A for a review of what has recently transpired, most of it in the month of September alone). As a result of the turmoil, credit markets globally have become dysfunctional, raising the risk of further financial dislocations and a global economic slowdown. Signaling the crisis of confidence, the LIBOR rate, the rate at which banks lend to each other, surged to an all time high on September 30th. Moreover, the TED spread, the difference between LIBOR and 3 month U.S. treasury bills, surpassed the previous record level it had reached on Black Monday (October 19, 1987).

A process of deleveraging is well underway. We are witnessing forced liquidation and panic selling of securities. Global stock markets have fallen further into bear market territory and credit spreads have been driven to record levels. None of us know when the forced liquidation will end. What we do know is that credit markets need to be gradually "unfrozen". In order for this to occur, cash is needed. In that regard, a mountain of cash (buying power) is piling upon the sidelines. In Canada alone, between August 2007 and August 2008 money market fund assets grew by $24.5 billion or 50.8%. In the U.S. over the same period, money market assets increased $744 billion, or 27%. Moreover, according to a recent report by J.P. Morgan, emerging economy central bank reserves rose $1.4 trillion over the past year; global savings accounts rose 65% over the past 4 years; more than 50% of equity managers have overweight cash positions; net credit balances in NYSE cash and margin accounts stand at roughly $150 billion; S & P 500 technology, healthcare, consumer and industrial companies cash balances are at 10-year highs; and short interest on the NYSE is at its highest level since 1976.

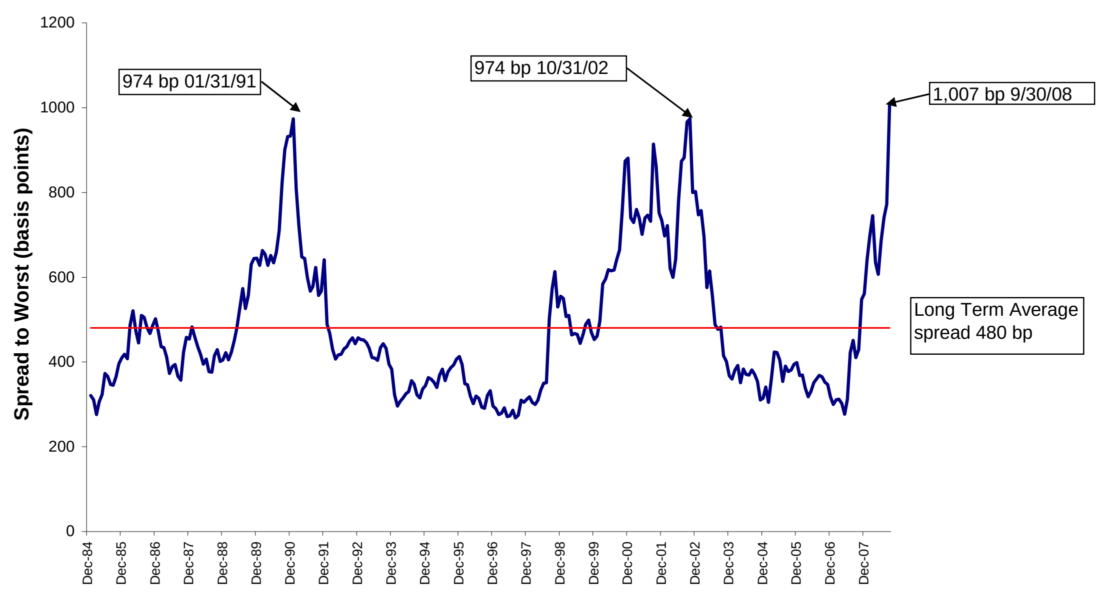
[1] Returns longer than one year are annualized.

As a learned client of ours wrote recently, although the financial collapse in the U.S. has been "breathtaking and frightening", it is part of the remarkably rapid adjustment process going on within the U.S. economic and financial systems. Furthermore, the U.S. Fed and the U.S. Treasury have reacted proactively, and although their plan may not be perfect, they are moving in the right direction.

In our equity commentary, we discuss bear markets of the last 100 years to show that financial booms and busts are not as abnormal as the media lead you to believe. Credit markets do not have the same historical data that the stock market has. What data we do have, shows credit spread premiums are higher than the previous peaks in 1991 and 2002, and currently offer yields and returns that have been historically sufficient to compensate for risk (see graph below).

Credit Spread History

Merrill Lynch High Yield Master Index Less 10 year Treasury Yield



Source: Merrill Lynch high yield

Similar to the stock market, a bear market in credit markets (i.e. rise in spreads) is immediately followed by a bull market (i.e. narrowing of credit spreads). Following the peaks in credit spread premiums in 1991 and 2002, annualized returns over the next 4 years in the high yield bond market were over 17% and 14%, respectively.

As Warren Buffet said to Charlie Rose in an hour conversation on October 1st, which can be seen on www.charlierose.com, "be fearful when others are greedy and greedy when others are fearful". Over the coming months we will see more opportunities to invest in the debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage which, because of the current credit environment, will provide equity like returns. We will take advantage of these opportunities using our current cash position of 7.5% and will raise proceeds by selling income trusts which, with yields on corporate debt rising, are becoming less attractive investments.

High yield bonds in our portfolio are down on average 10% during the quarter, regardless of the financial condition of the company. In addition, one of our private debt holdings, GBS gold, contributed to a large portion of the negative return this quarter as it entered creditor protection. We felt it was prudent to reduce the price to $25 per 100 par value. That said, the GBS debt is secured by all the assets of the Company and, over time, debtholders should realize a higher value as we are first in line on the capital structure. Deans Knight is leading the secured noteholder’s committee dealing directly with Ferrier Hodgson, the administrator appointed to deal with the disposition of assets and/or restructuring of the Company. We must approve any decision and will steer the process in order to maximize recovery from this investment.

Appendix A

In September, seven of the largest financial organizations in America failed . . . bankrupt, rescued by the government, or taken over by stronger partners. On September 7th, Fannie Mae (The Federal National Mortgage Association) and Freddie Mac (The Federal Home Loan Mortgage Corporation), were put under conservatorship, a.k.a ~ they were taken over by the U.S. Government. On September 14th, Merrill Lynch, the world's largest investment bank, was acquired by Bank of America. On September 15th, Lehman Brothers, the 4th largest U.S. investment bank, filed for bankruptcy in the largest corporate bankruptcy in history. On September 16th, the Federal Reserve announced that the U.S. Government would provide an $85 billion emergency loan to AIG, the world's largest insurance company, in exchange for a 79.9% equity stake in AIG. On September 25th, Washington Mutual, the largest savings and loan in the U.S., and the largest bank failure in U.S. history, was seized by U.S. bank regulators and then sold to J. P. Morgan. On September 29th, Citicorp made a bid to take over the weakened Wachovia Corporation, the fourth largest U.S. bank, only to be trumped by a higher bid from Wells Fargo on October 3rd. Furthermore, after much wrangling in the Senate and the House of Representatives, U.S. lawmakers, on October 3rd, passed a $700 billion package giving the U.S. Treasury the power to acquire troubled debt securities from financial institutions.

Following suit, in late September European governments jumped into the frey with measures to provide support to weakened financial institutions. The stumbling block in Europe is the lack of unison among governments in support of a pan-European program similar to that passed in the U.S. The governments of Ireland and Greece unilaterally announced that they will guarantee all bank deposits. In Great Britain, Lloyds Bank agreed to acquire the weakened Halifax Bank of Scotland (HBOS), and the government nationalized Bradford & Bingley, one of Britain's largest mortgage lenders. The German government proposed a state-led rescue program for the mammoth real estate lender Hypo Real Estate. Belgium's two largest banks, Dexia and Fortis, were rescued by government packages.

Furthermore, in the last week of September, the U.S. Federal Reserve granted a request from the country's last two major investment banks, Goldman Sachs and Morgan Stanley, to change their status to bank holding companies. Both companies had been under enormous pressure since the bankruptcy filing of Lehman Brothers. This now puts both directly under the regulatory supervision of the U.S. Central Bank. Morgan Stanley subsequently raised capital by selling a 21% interest to Mitsubishi Financial Group for $9 billion. Goldman announced that it had done a deal to sell $5 billion of 10% perpetual preferred stock to Warren Buffet's Berkshire Hathaway. In addition, Berkshire received warrants to purchase an additional $5 billion of common stock, exercisable for five years. Buffett followed up his Goldman deal with a similar $3 billion deal with General Electric, the largest non-bank financial company in the U.S. G.E.'s stock had been down 49% from this year's high, amid concerns about the health of its finance arm, G.E. Capital.