September 30, 2015

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	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	Since Inception June 1993
DK Income Fund	**-2.9%**	**2.4%**	**-1.5%**	**3.6%**	**5.6%**	**9.2%**	**10.7%**	**10.3%**	**10.6%**
ML USD High Yield	-4.9%	-2.5%	-3.6%	3.5%	5.9%	7.1%	7.1%	7.0%	7.2%
ML CDN High Yield	-9.4%	-6.3%	-10.7%	1.2%	4.4%	3.9%	3.8%		
Inv. Grade Bonds[2]	0.1%	2.5%	5.3%	3.4%	4.4%	5.0%	5.9%	6.6%	6.7%

The DK Income Fund has a positive year to date return of 2.4%. However, during this past quarter the majority of equity and bond markets around the world experienced negative returns. The TSX and the S&P 500 have declined more than 10% from their peaks, the US High Yield Bond Index was down 4.9% and the Canadian High Yield Index was down 9.4%. The Deans Knight Income Fund was down 2.9% in the quarter.

The DK Income Fund fared better than most this quarter due to our high cash position of approximately 20% throughout the quarter.

As you may recall, in the second quarter a number of our positions were repaid, creating the elevated cash position. We chose NOT to reinvest this cash right away because we felt bond prices were too high. Patience has been the right approach to date.

Throughout 2015 there has been growing concern about the health of the Chinese economy, the threat of rising interest rates in the United States, and an oversupplied oil market. These fears have increased in the third quarter, resulting in bond prices starting to decline. That means bond yields are rising. For the DK Income Fund, the rising bond yields is a good thing because we can now begin to deploy our 20% cash position into more attractive, well-priced opportunities.

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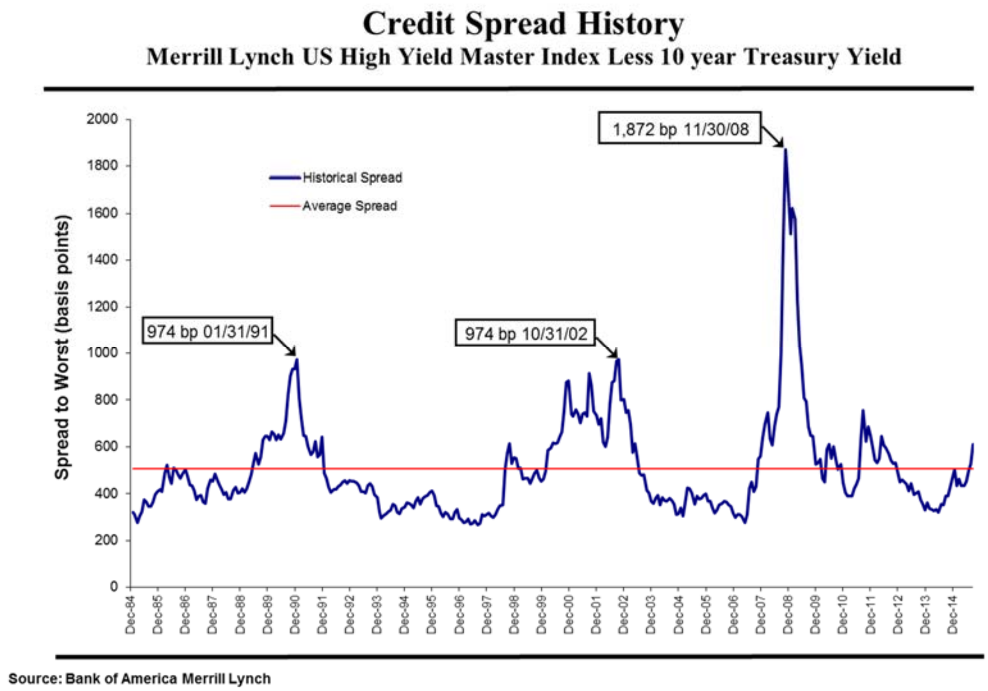
[1] Returns longer than one year are annualized gross of management fees.
[2] FTSE TMX Canada Universe, an index of Canadian investment grade bonds.

The graph below shows the historical spreads of high yield bonds over 10 year government bond yields. In other words, how much more high yield bond owners are being paid than government bond owners.



There are a couple takeaways from the above graph. One, volatility in yields is normal (i.e. bond prices fluctuate). Two, regardless of how severe the fears (or greed), bond prices will revert back to their mean. When yields are low (bond prices high) as they were from 2011 to 2014, investors need to exercise caution. When yields are above the historical mean, such as they are now, investors can then begin to take advantage of the higher yielding opportunities that present themselves. It is easy to say this, but a lot harder to implement. This is because when yields are the most attractive, the fear in the market place is usually at its highest.

We need to look beyond the fears, which are no more than predictions of what might happen, and understand that we can't predict the future. Instead, we need to focus on the facts. Today, the US economy is growing. Canada, after negative growth in the first half of this year (severe winter and lower oil prices) has shown positive growth in July. The global economy is also growing at a rate of 2.5% to 3%. While spreads can continue to rise due to nervousness, there are a lot of positives in the economy today, creating a good business environment for the companies we have lent capital to.

During the most recent quarter, we added to a number of existing positions, including **Gateway Casinos** and **Paramount Resources**. These purchases were offset by a loan being paid down (**North American Energy Partners)** and a sale of assets which led to the prepayment of our **RapidEye royalty stream** (keeping our cash balance around 20%). We will continue to deploy the cash balance as higher yielding opportunities present themselves. As the cash is invested, our overall portfolio yield will rise, and thus increase our current income stream to investors.

During the quarter we visited senior management of **Gateway Casinos & Entertainment Limited** (3.8% of the portfolio) at their largest location - the Grand Villa Casino in Burnaby, BC. Gateway is the largest Casino operator in Canada with the majority of their assets in BC. We have followed Gateway's business for over 10 years back when it was an income trust. Gateway is a great business to lend to as they have high barriers to entry, hard assets, and a predictable income stream to service interest and gradually reduce debt.

Management walked us through the facility and their plans to organically grow the cash flows of each casino, through both gambling operations and improving the restaurant/accommodation options. Although still in their early stages, we are already seeing improvements to both Revenue and their bottom line. The meeting also provided important insight into the Ontario Lottery and Gaming Corporation's plans to gradually outsource day-to-day operations to service providers. While Gateway did not win the first of seven bundles to be awarded, we believe they are a compelling partner. Any contract wins would further strengthen our balance sheet. Our bonds pay an 8.5% coupon and mature in November 2020.

As we detailed in our last quarterly report, we participated in **Paramount Resources** new high yield debt issue this past June, which yielded 6.875% and matures in 2023. At the time, while we like the credit quality of the Company, we elected to invest a smaller amount of capital, and wait for an opportunity to add should the price fall, providing us with a more attractive yield. We didn't have to wait long. With oil prices remaining low, Paramount bonds traded down 10% and we took advantage by adding to our position, at a yield of 9.0%. Our weight in Paramount bonds is currently 5.2%.

We have been invested in the equity and debt of Paramount for twelve years, and have followed the company even longer. From our perspective, the company has a strong management team, has one of the lowest cost structures in the energy industry, and ample assets to provide security on our debt. In particular, we believe their newly completed natural gas processing facility and related infrastructure could be sold for the value of the bank debt on the balance sheet. The company provides us additional security with their current 60,000 boepd of production, which will be scaled to 70,000 boepd by year end. At these production levels and current pricing environment, the company can generate over $200 million in free cash flow, which is more than enough for the company to service and ultimately repay their debt.

Despite a difficult environment for energy service businesses, **North American Energy Partners** (1.0% of the portfolio as of September 30, 2015) continued to reduce debt paying down $38 million of their 9.125% notes due 2017 (only $20 million of the original $225 million in Principal remains). We have owned bonds since they were issued in 2010. The Company had to pay a high coupon as it appeared to be a low margin business with too many business segments. We dug deeper and found a business with hard assets backing the debt which, if re-focused, could improve margins and reduce debt. In 2013, the Company sold their pipeline and piling divisions for $235 million and retained their mining division where 80% of their hard assets resided. Management has continued to improve efficiencies ridding themselves of low margin business and disposing of assets, reducing debt along the way. With only $20 million outstanding, the Company could repay our debt through asset sales, cash flow or refinancing with bank debt. Until that time, we are being paid a coupon of 9.125%.

In September, **RapidEye** announced the sale of its constellation of satellites to Planet Labs, a San Francisco based Company who design, build and operate a network of Earth-imaging satellites. This concluded our investment in one of our top five most profitable investments in Deans Knight Income Fund's history. This was possible because of the very unique interest plus royalty structure we created; whereby investors continued to receive a royalty after the debt was repaid in exactly 12 months. We continued to receive royalties for 3 more years until the recent sale triggered a change of control which led to a prepayment of future royalties. Our $8.4 million investment received principal, interest and royalties of $13.5 million.