December 31, 2008

DK INCOME FUND

DEANS KNIGHT
CAPITAL MANAGEMENT LTD

DK INCOME FUND

Quarterly Report
December 31, 2008

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	Since June '93
DK Income Fund	**-15.9%**	**-20.3%**	**-4.0%**	**0.2%**	**5.0%**	**8.8%**	**7.6%**	**9.4%**
SCM Universe Bond Index	4.5%	6.4%	5.0%	4.7%	5.1%	5.5%	6.0%	7.4%
ML CDN High Yield	-25.7%	-32.8%	-17.4%	-9.4%	-7.7%	-4.5%	-0.7%	n/a
ML USD High Yield	-17.6%	-26.4%	-13.3%	-5.6%	-3.6%	-0.9%	2.0%	4.6%

The current equity bear market has resulted in the most dramatic destruction in value since 1929/32. No areas of the investment markets were immune. The U.S. S&P 500 index declined from a peak on September 10, 2007 to a low on November 20, 2008 by 52%. The S&P/TSX arrived at a similar point in 2008 but took a slightly different path. Held up temporarily by the continued bull market in most commodities, the TSX peaked on June 18, 2008, and declined by 49% to its low on November 20, a breathtakingly quick catch-up.

Corporate bond valuations held up well until September when a series of dramatic financial system failures rendered the credit markets dysfunctional. Lehman Brothers filed for bankruptcy, the largest in U.S. history. Fannie Mae (The Federal National Mortgage Association) and Freddie Mac (The Federal Home Loan Mortgage Corporation), were put under conservatorship. A weakened Merrill Lynch was acquired by Bank of America. The U.S. Government provided an $85 billion emergency loan to AIG, the world's largest insurance company, in exchange for a 79.9% equity stake in the Company. Washington Mutual was sold to J. P. Morgan. Wells Fargo took over the failing Wachovia Corporation, the fourth largest U.S. bank.

The cause of these failures is rooted in the misplaced complacent belief that U.S. home prices could never go down, and the increasingly sloppy lending practices that fueled the U.S. housing boom. When housing prices did begin to trend down, the world learned just how ridiculous mortgage lending practices had become, and how imbedded these shaky loans had become in the portfolios of financial institutions worldwide. Despite unprecedented government and central bank intervention, credit markets remain dysfunctional, with massive deleveraging all but eliminating any liquidity and credit capacity, as we enter a fierce global recession.

[1] Returns longer than one year are annualized.

The National Bureau of Economic Statistics declared recently that a recession officially began in the U.S. at the end of 2007. Most European economies are now also in recession. The global engines of growth, the BRIC's (Brazil, Russia, Indian, and China), are slowing dramatically. The current economic picture isn't pretty, and the die is cast . . . the economic numbers will get much worse before they get better. Based on the indicators already available, U.S. real domestic product (the broadest measure of economic activity) will likely show a steep contraction in the 4th quarter. We already know that auto sales have been annualizing 10 million units in recent months, the lowest levels since the early 1980's, and far below the 16 million units that were sold on an annual basis each year from 1999 to 2007. U.S. consumer confidence has declined to an all time low. U.S. housing starts have dropped to the lowest level since the recession in the early 1980's. U.S. retail sales are down sharply, and this past holiday shopping season will undoubtedly go down as one of the worst on record.

U.S. consumers have finally hit the wall and have begun the necessary deleveraging process, and they have begun with a vengeance. The portion of the corporate sector that was leveraged up, because of the private equity craze, is also going through the same process. As the economic contraction accelerates, all the weaknesses and cracks become more obvious. The result will eventually lead to a rise in bankruptcies and restructurings.

With the problems associated with the global financial industry becoming more evident in September, and with the global economy sliding deeper into recession, corporate bond prices declined sharply in the last four months of the year. As a consequence, the Merrill Lynch High Yield Index recorded its biggest annual decline in its history.

Merrill Lynch US High Yield Master II Index

Worst Years	Total Return
2008	-26.4%
2000	-5.1%
1990	-4.4%
2002	-1.9%
1980[2]	-1.3%

So what are we to do from an investment perspective today in the face of troubled times and pervasive pessimism? Sell corporate bonds and put our money in treasury securities?

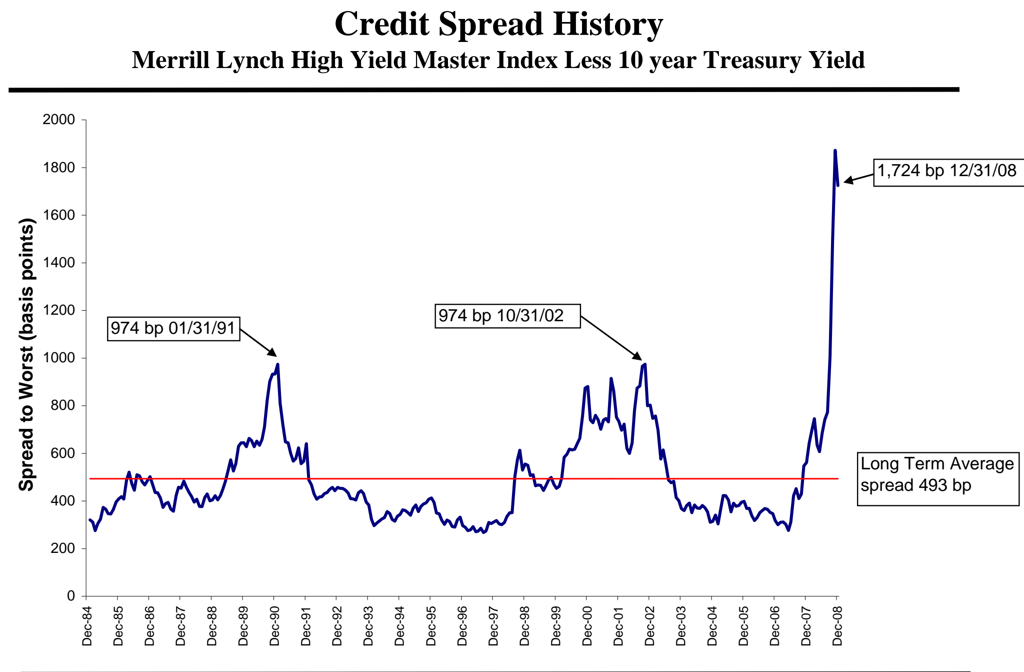
Every signal suggests the opposite.

[2] The Merrill Lynch US High Yield Master index has an inception date of December 1987. We used the Merrill Lynch U.S. High Yield 100 Index for periods prior to this which had an inception of December 1979.

We have already seen massive amounts of selling. We have seen huge redemptions of mutual fund and hedge fund assets, large amounts of forced liquidation due to margin calls and unprecedented year end tax loss selling. As a result of all this selling, Bloomberg estimates there is roughly $8.5 trillion of cash on the sidelines, mostly invested in low yielding treasury securities, a massive amount of buying power that represents over 2.5 times total U.S corporate debt outstanding.

Interest rates in many countries are at generational lows. Governments are printing money at unprecedented rates to spur the economy. Nervous investors are gobbling up treasury paper for little or no return. A consultant at Watson Wyatt calls this overconcentration on cash "reckless conservationism". There is a very strong incentive to move out of treasury securities and into corporate bonds.

Spreads on investment grade corporate bonds haven't been this wide since the Great Depression and high yield bonds are trading at almost double the recent peaks in 1991 and 2002 (see graph below). Although we are expecting a significant rise in defaults, with yields at almost 20%, the rewards outweigh the default risk. JP Morgan suggests, based on trading levels in December, the market is pricing in a cumulative default rate of almost 25% in 2009 and 2010.



History shows, following periods of widening spreads, the high yield bond market has provided equity like rates of return over the next five years. The table below outlines returns achieved following previous peaks in credit spread premiums in 1982, 1991 and 2002.

Rebounds from Cyclical Lows

	June 30, 1982*	Jan. 31, 1991**	Oct. 31, 2002**	Dec. 31, 2008**
Average Price	$ 60.95	$ 72.03	$ 77.15	$ 61.15
Average Coupon	$ 10.32	$ 12.77	$ 8.43	$ 8.14
Cash on Cash Yield	16.93%	17.72%	10.93%	13.31%
Yield to Maturity	17.43%	18.11%	13.66%	19.57%
Total Return				
next 12 months	47.81%	40.99%	33.10%	???
next 3 years	23.07%	24.04%	15.76%	???
next 5 years	19.59%	17.76%	12.83%	???
Price Return				
next 12 months	29.07%	26.45%	21.89%	???
next 3 years	7.94%	12.06%	6.65%	???
next 5 years	5.19%	6.74%	4.09%	???
By Comparison…				
S&P 500 Total Return				
next 12 months	61.18%	22.65%	20.79%	???
next 3 years	26.29%	15.22%	12.82%	???
next 5 years	27.87%	16.34%	13.46%	???

*Based on High Yield 100 Index (H100)
**Based on High Yield Master II Index (H0A0)

Source: Merrill Lynch & Co.

We would argue the most attractive investment opportunity today is to own corporate debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage which, because of the current credit environment, are providing equity like returns.