December 31, 2011

DK INCOME FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

DK INCOME FUND

Quarterly Report
December 31, 2011

Rates of Return[1]

	3 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs	10 Yrs	15 Yrs	Since June '93
DK Income Fund	**7.6%**	**4.1%**	**11.0%**	**25.5%**	**12.1%**	**12.8%**	**15.6%**	**11.2%**	**11.9%**
DEX Universe Bond Index	2.1%	9.7%	8.2%	7.3%	7.0%	6.4%	6.5%	6.7%	7.4%
ML CDN High Yield	3.7%	3.4%	8.4%	20.1%	3.8%	3.4%	5.3%		
ML USD High Yield	6.2%	4.4%	9.7%	23.7%	8.7%	7.3%	8.6%	6.9%	7.5%
S&P/TSX Composite Index	3.6%	-8.7%	3.6%	13.2%	-0.7%	1.3%	7.0%	7.0%	8.4%

We strive for a shared understanding of how we are investing our client's capital. Our investment strategy is different and, as a result, we have been successful in producing better returns than the S&P/TSX Composite Index since our inception nearly 20 years ago. We hope this report will give you, our valued client, a better understanding of our income strategy and what has made it successful over the years.

The objective of the DK Income Fund is to provide our investors with a stable stream of income, higher than what can be earned from government or investment grade corporate bonds, without taking on undue risk. We achieve this by investing predominantly in high yield corporate bonds while owning a handful of private debt financings and dividend paying equities. In fact, beginning in 1992, Deans Knight was the first investment management firm in Canada to focus exclusively on investing in higher yielding corporate debt securities.

High yield bonds are defined as non-investment grade debt or debt rated below BBB by rating agencies such as Moody's and S&P. It is very important to remember that the rating agencies often get it wrong. For proof, you need to look no further than Worldcom, Enron and Asset Backed Commercial Paper which were all A-rated or better before their highly publicized collapses. Deans Knight uses in-house credit knowledge of the outstanding corporate issues, the trust indentures, and experience in structuring new debt securities to evaluate opportunities regardless of their rating.

As a debtholder in a corporation, the most important consideration is the company's ability to meet its coupon payments and pay back our principal at maturity. A secondary consideration is whether or not we are being adequately compensated for the risk should they fail to meet these obligations. The majority of high yield bonds won't meet our criteria and deserve the title of "junk bonds". However, therein lies the opportunity. Since the general investing public views the entire high yield universe as

[1] Returns longer than one year are annualized gross of management fees.

junk, there is an opportunity for bonds to be mispriced, as good businesses are lumped in with the rest. We own a concentrated portfolio of corporate debt issues in businesses with tangible assets as collateral, strong cash flows and reasonable leverage.

The most common risk associated with high yield bonds is default risk. This is the risk of a company being unable to service debt and repay its principal obligations. It is important to note that when a company defaults on its bonds, it does not mean the bonds are worth nothing. It does mean that bondholders now control the process. Deans Knight's in-house credit experience enables us to invest in bonds that are less likely to default in the first place. However, in the rare case of a default, we have been able to extract value as the debt is supported by underlying asset value. The DK Income Fund has had 14 defaults in its 20 year history, with the average recovery being 100 percent of our original investment.

Credit analysis is obviously very important but if you can't access bonds, the expertise is irrelevant. The Canadian high yield market is comprised of 98 issues, with most companies issuing in US dollars. As a result, new issue bonds are offered by major US Investment banks, such as Goldman Sachs, JPMorgan etc… who have little-to-no interest in providing liquidity after the debt has been placed, rendering the Canadian High Yield market less liquid and inefficient. During our 20 year involvement in the Canadian High Yield market, Deans Knight has developed strong relationships with many small dealers in the United States and Canada who focus on providing liquidity to the high yield market.

As mentioned above, most Canadian issuers raise debt denominated in US dollars. We hedge any currency exposure back to Canadian dollars to minimize the impact currency fluctuations may have on the portfolio.

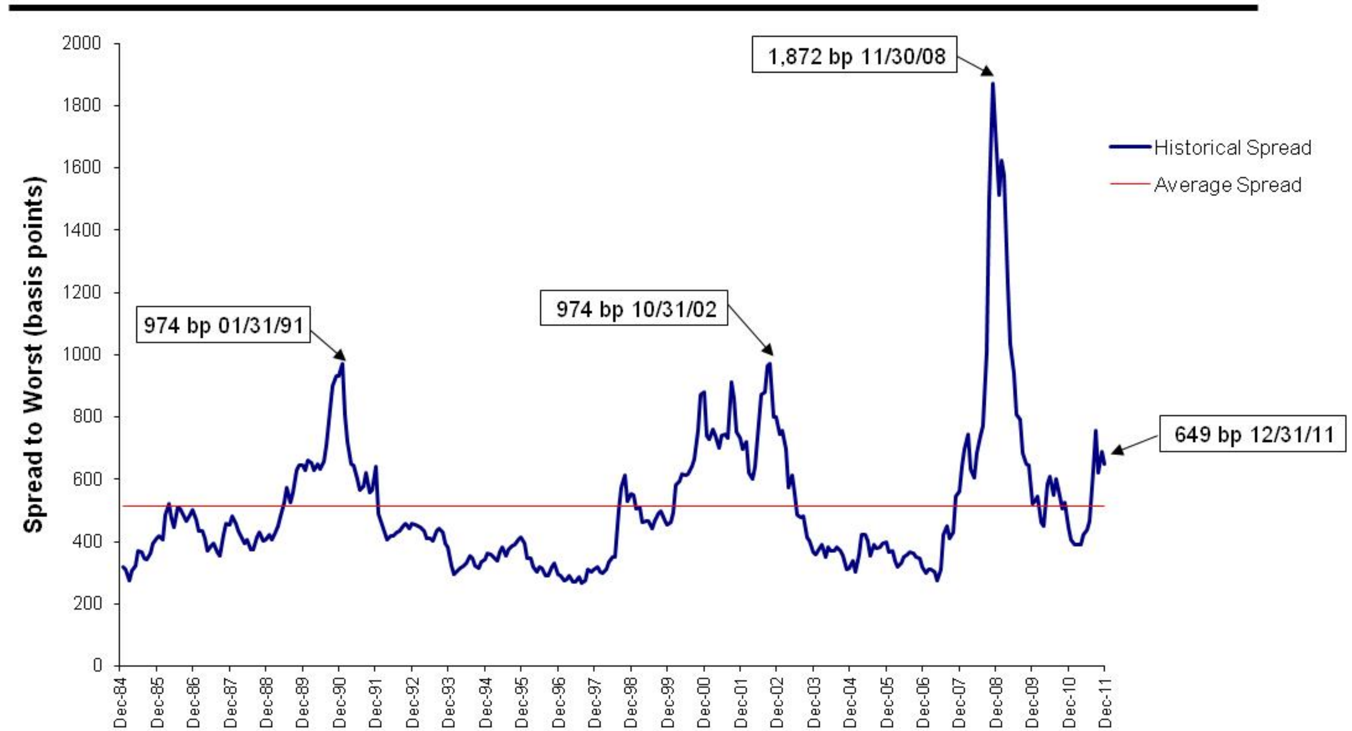
In addition to our high yield bond investments we negotiate private debt financings, unique to Deans Knight, such as bridge, mezzanine and short-term secured loans. These financings are typically short term, high coupon, in some cases fully secured and, most importantly, provide capital growth through "equity kickers" in the form of warrants or convertible debt. Historically, we have achieved annualized rates of return of 20% on these investments.

We continue to complement high yield and private debt financings with investments in a select number of high dividend paying corporations. Unlike interest payments, dividends/distributions are not guaranteed. In analyzing these investments, we focus on the underlying business and how much cash flow is being generated, rather than just yield, to determine whether or not we are paying a fair price for the business.

For almost 20 years, the Fund has generated consistent annual income, in the range of 7.5% to 10%. Historically, we have provided additional return from capital gains by identifying attractive high yield bonds trading at a discount and structuring private debt financings with equity kickers. In fact, as the return table above shows, not only has the DK Income Fund outperformed the high yield benchmark we have also outperformed the S&P/TSX Composite while taking on less risk.

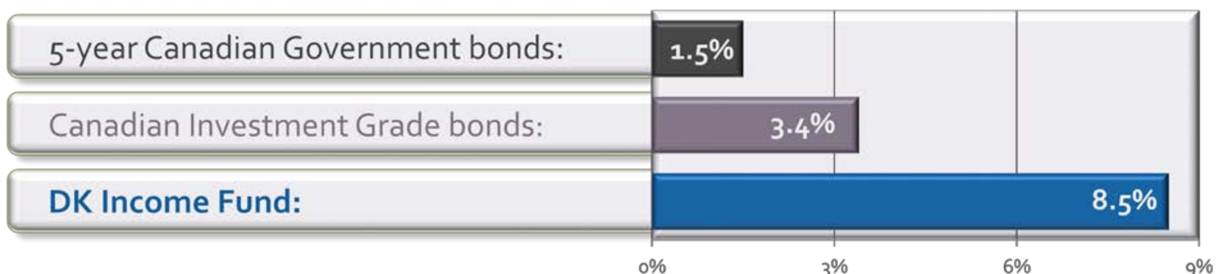
Deans Knight has the expertise and access to the inefficient Canadian high yield market, as well as a broad network providing attractive private debt opportunities. This has enabled us to earn a high level of income, in excess of other income producing investments, without taking on an unreasonable amount of risk.

As we mentioned in our last quarterly report, the businesses in which we own the debt are in good shape. In many cases they are in better shape than they were two years ago. As you will see from the graph below, although spreads have come off since September 30th, they are still above the long term average.



Source: Merrill Lynch high yield

At December 31st, the DK Income portfolio is providing a yield to maturity of 8.5%, see graph below. We believe this offers a strong incentive for investors to move out of treasury securities and investment grade bonds and into higher yielding corporate bonds.



During the quarter, the DK Income Fund designed and participated in a $12 million Secured Note with Conifex Timber Inc. ($3.5 million or 2.4% of the portfolio). The proceeds from the note will be used for general corporate purposes. Conifex is a lumber producer with sawmills in the northern interior of BC. The Company owns sawmills in two locations, Fort St. James and Mackenzie, with a combined capacity of approximately 745 million fbm. Conifex holds forest licences with average allowable cut of 1.573 million m^3 of timber in the Prince George and Mackenzie Timber Supply Areas, providing the Company with ample supply of sawlogs.

In the last three years, the Company has invested $80 million into their sawmills and current operations are generating positive EBITDA despite depressed lumber prices. A recent sale of assets in BC by Tembec for $60 million provides further evidence that the debt of the Company is secured by the assets. Conifex has almost double the capacity and 50% more allowable cut which would value the assets at approximately $100 million. Including our facility, Conifex can have up to $24.5 million in debt.

The Notes mature on December 31st, 2012 and bear interest of 10% for the first six months and 12% for the remaining term of the loan. In addition to the coupon, Noteholders received a commitment fee of 2% and warrants to purchase 325,000 common shares at a price of $9.50 per share, which mature on December 31, 2014. At year end, the common stock closed at $7.25.