December 31, 2012

# DK INCOME FUND

DEANS KNIGHT

CAPITAL MANAGEMENT LTD

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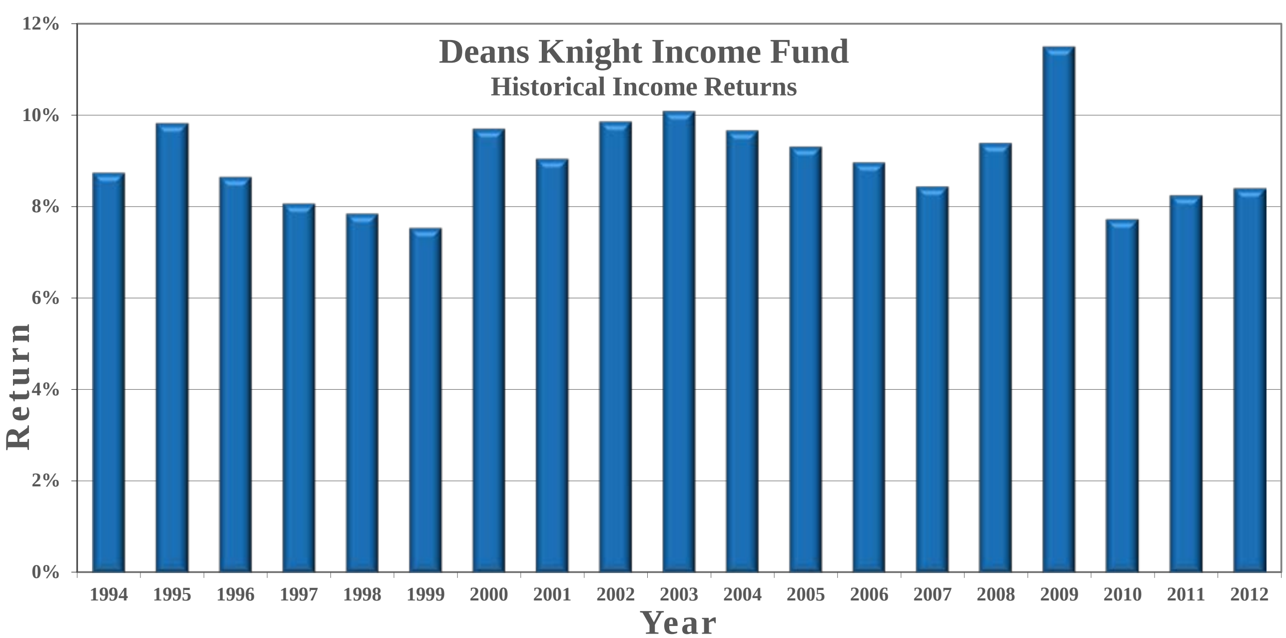
## Quarterly Report
## December 31, 2012

### 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** | **4.2%** | **10.9%** | **7.4%** | **10.9%** | **21.7%** | **11.8%** | **15.6%** | **11.0%** | **11.8%** |
| DEX Universe Bond Index | 0.3% | 3.6% | 6.6% | 6.6% | 6.3% | 6.3% | 6.0% | 6.3% | 7.2% |
| ML CDN High Yield | 2.5% | 15.1% | 9.1% | 10.6% | 18.8% | 6.0% | 7.2% | 4.2% | |
| ML USD High Yield | 3.2% | 15.6% | 9.8% | 11.6% | 21.6% | 10.0% | 10.4% | 7.0% | 7.9% |
| S&P/TSX Composite Index | 1.7% | 7.2% | -1.1% | 4.8% | 11.7% | 0.8% | 9.2% | 6.5% | 8.4% |

The main objective of the DK Income Fund is to provide our investors with an attractive level of income, regardless of the environment, without taking on undue risk. Over our twenty year history, we have demonstrated an ability to generate stable income returns of 7.5% to 10% and 2012 was no exception; the portfolio generated an income distribution of 8.4% for unit holders (see graph below). Our actual returns are higher than this income level due to capital appreciation on our investments.




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

When interest rates are low, like they have been over the past few years, providing an attractive income return can be difficult. An investment in a portfolio of US Investment Grade Corporate and Government bonds would have provided an income return of 3.3% in 2012[2]. The secret to our success has been our credit research, concentration and creativity.

Our income strategy has focused exclusively on investing in higher yielding income opportunities since our inception in 1992. Over this time period, we have continued to develop in-house credit knowledge of outstanding corporate issues and trust indentures, and used our experience in structuring debt securities and to evaluate income investments. This history allows us to identify and monitor the risks of any high yield debt issue, regardless of credit rating, and determine whether or not we are being compensated for the risk.

As a debtholder, the most important consideration is the company's ability to meet its coupon payments and pay back our principal at maturity. The risk of a company not servicing its debt is known as default risk. As we've noted in the past, when a company defaults, it does not mean the bonds are worth nothing. Although the historical average recovery on high yield bonds is roughly 30 – 40% this is on the entire universe. The DK Income Fund has had 15 defaults in its 20 year history, with the average recovery being 100 percent of our original investment. The reality is the majority of high yield bonds won't meet our criteria. We own 26 high yield bonds versus the high yield market which has over 2,000 issues. Investing in a concentrated portfolio of the best opportunities allows us to provide an attractive level of income while preserving capital over the long term.

It is important to note that prices do fluctuate. In 2012, for example, prices were down 2.75% for the first 6 months of the year but were up 5% in the second half. We have no control over short term price movements; however, the fund's annualized return of 11.8% since inception, versus an average annual income return of 9.0%, shows that we have provided additional return through capital growth over the long term. The capital appreciation has come from our ability to identify mispriced high yield bonds and our creatively structured private debt financings, unique to Deans Knight. The private debt financings are typically short term in nature; pay a high coupon; in some cases fully secured; and, provide the aforementioned capital growth through "equity kickers" in the form of warrants or convertible debt. On average, we have achieved annualized rates of return of 20% on these investments.

As an example, in April 2012, we structured a secured debt financing with Petroamerica Oil Corp. for $35 million ($6.0 million was allocated to the DK Income portfolio). The Debentures mature on April 19, 2015 and bear interest of 11.5%. In addition to the coupon, our clients received a commitment fee of 1.5% and warrants to purchase 100 common shares per $100 of debt at a price of $0.20 per share, which mature on April 19, 2015.

Petroamerica is an oil producer with assets in Colombia. They started 2012 producing 200 barrels of oil equivalent per day ("boepd") with proceeds from the debt financing to be used to develop and appraise their assets. They drilled 5 wells on their Las Maracas property which, at year end, were producing 4,000 boepd net to Petroamerica. In addition to the Las Maracas asset, Petroamerica

[2] Source: BofA ML US Corporate & Government Index

announced a new discovery at La Casona in November with one well testing at 480 boepd net to Petroamerica.  With this success, Petroamerica's stock is trading at $0.38 almost double our exercise price.

At December 31st, the DK Income portfolio is providing a yield to maturity of 7.6%, despite 13.3% of the portfolio invested in cash, which is 2.5 times investment grade bonds and almost 5 times five year government bonds, see graph below.  With government debt levels continuing to grow and too little tax revenue being generated, to support this debt, we believe our income strategy offers a better alternative.