

# DEANS KNIGHT

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INCOME CORPORATION

## **INTERIM MANAGEMENT REPORT**

### **OF FUND PERFORMANCE**

For the period from

January 1, 2011 to June 30, 2011

This interim management report of fund performance (the "Report") contains financial highlights of Deans Knight Income Corporation (the "Company"). This Report should be read in conjunction with the interim financial statements of the Company for the six month period ending June 30, 2011 (the "Financial Statements"), which, if not included with this Report, can be obtained at your request, at no cost by emailing [info@dkincomecorp.com](mailto:info@dkincomecorp.com), visiting our website at [www.dkincomecorp.com](http://www.dkincomecorp.com) for contact details or on SEDAR at [www.sedar.com](http://www.sedar.com). Shareholders may also contact us to request a free copy of the Company's proxy voting policies and procedures, proxy voting disclosure record or quarterly portfolio disclosure.

### **A Note on Forward-Looking Statements**

This Report contains certain forward-looking statements. These statements relate to future events or future performance, including the Company's targeted dividend payout, investment strategy, behaviour of financial markets and reflect the Company's expectations regarding the growth, results of operations, performance and business prospects and opportunities of the Company and its investments. Such forward-looking statements reflect the Company's current beliefs and are based on information currently available to the Company. In some cases, forward-looking statements can be identified by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue" or the negative of these terms or other comparable terminology. With respect to such forward-looking statements, the Company has made assumptions regarding, among other things, what type of debt securities will be included in its investment portfolio. A number of factors could cause actual events or results to differ materially from the results discussed in the forward-looking statements. In evaluating these statements, prospective investors should specifically consider various factors, including the risks outlined under "Risk Factors" in the AIF (as defined herein), which may cause actual results to differ materially from any forward-looking statement. Although the forward-looking statements contained in the AIF are based upon what the Company believes to be reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward-looking statements. Forward-looking statements are made as of the date of this Report and, other than as required by applicable law, the Company assumes no obligation to update or revise them to reflect new events or circumstances.

This Report also contains certain financial and operational information obtained from public sources in respect of certain companies included in the Company's investment portfolio. While management believes this data to be reliable, such information is subject to variations and cannot be verified due to limits on the availability and reliability of data inputs, the nature of the data gathering process and other limitations and uncertainties inherent in such information. Accordingly, the accuracy, currency and completeness of this information cannot be guaranteed. The Company has not independently verified any of the data from third party sources referred to in this Report or ascertained the underlying assumptions relied upon by such sources.

## **Investment Objective and Strategies**

The Company is a closed-end, non-redeemable investment company focused on investing in corporate debt securities. The Company's assets are actively managed by Deans Knight Capital Management Ltd. ("**Deans Knight**"), a respected British Columbia-based investment firm focused on managing high income and growth mandates for high net worth individuals. Deans Knight, formed in 1992, has an experienced management team and a long history of successful investing in corporate debt securities.

The Company's investment objectives are to: (i) maximize the total return for Shareholders, consisting of dividend income and capital appreciation; and (ii) provide Shareholders (as defined herein) with monthly dividends, which have, to date, been set at \$0.0583 per month. The Company intends to achieve these objectives by investing primarily in corporate debt securities rated BBB or below by Standard & Poor's Rating Services ("**S&P**") or an equivalent rating by another nationally recognized statistical rating organization. The Company may also invest in investment grade debt securities rated above BBB and non-rated debt securities from time to time.

The Company believes there are attractive investment opportunities today in owning corporate debt of businesses with tangible assets, strong cash flows and reasonable leverage.

When evaluating bonds to purchase for the Company, Deans Knight focuses on the following:

- amount of security or collateral within a business to offset the value of the bonds;
- the position of the debt in the capital structure;
- covenants;
- liquidity;
- the business's ability to reduce or refinance the debt; and
- the overall term of the debt and yield to bondholders.

Deans Knight employs the above credit-based analysis to identify corporate debt for inclusion in the Company's investment portfolio with attractive valuations in order to maintain its targeted dividend payment.

## **Risk**

The overall risks of the Company are as described in its annual information form dated March 15, 2011 (the "AIF"). The Company does not believe there have been any changes over the financial period that has affected the overall level of risk associated with an investment in the Company.

Prior to the reorganization and change in business, as discussed in the notes of the Financial Statements, the Company had generated significant tax losses and other tax attributes as a result of its prior businesses and research activities. The Company has recorded, as a tax asset, the full amount of the potential tax benefit of such items to the extent of its projected taxable income. There is no guarantee that the tax authorities will allow the Company to

deduct some or all of the tax losses and other attributes. Should the Company be denied the deductions, the recorded amount of the tax assets, as well as such amounts claimed to date, would be recorded as a charge to income. The total tax assets recognized and tax losses and other attributes claimed to date, which are subject to uncertainty, amount to \$21,247,000, representing \$2.02 per common share at June 30, 2011.

Given the type of investments made by the Company, an investment in the Company may be considered to be speculative. An investment in the Company is generally suitable for investors who are looking to receive income, yet who are willing to tolerate volatility in the value of their investment.

## Results of Operations

As per the financial statements, the net assets of the Company at June 30, 2011 were \$143,428,658, or \$13.61 per common share, compared to \$143,343,361, or \$13.60 per common share at December 31, 2010. The net assets of the Company consisted of the following components:

	<b>June 30, 2011</b>		
	\$	Per common share <sup>(1)</sup>	%
Investments <sup>(2)</sup>	133,558,796	12.67	93.1
Cash and short-term deposits	2,618,721	0.25	1.8
Accrued income	1,888,705	0.18	1.3
Prepaid expenses	158,159	0.02	0.0
Future income tax asset <sup>(3)</sup>	5,870,000	0.56	4.1
Accounts payable and accrued liabilities	(665,723)	(0.07)	(0.3)
	<u>143,428,658</u>	<u>13.61</u>	<u>100.0</u>

<sup>(1)</sup> Based on 10,537,263 common shares, including 10,191,592 voting common shares and 345,671 non-voting common shares, as outlined in the notes to the Financial Statements.

<sup>(2)</sup> The details of the investments are outlined in the Summary of Investment Portfolio below.

<sup>(3)</sup> Refer to the Taxation note to the Financial Statements for more detail.

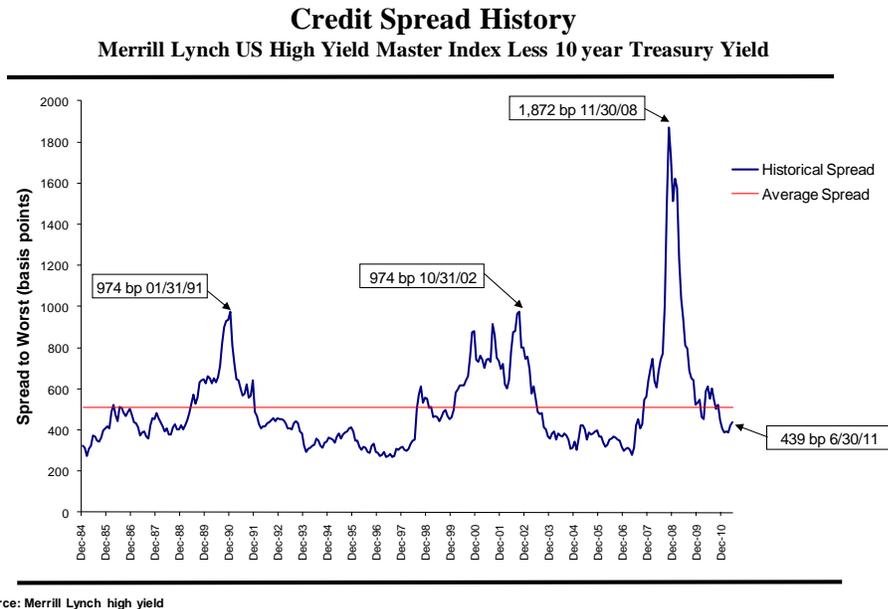
	<b>December 31, 2010</b>		
	\$	Per common share <sup>(1)</sup>	%
Investments <sup>(2)</sup>	128,449,450	12.19	89.6
Cash and short-term deposits	7,137,967	0.68	5.0
Accrued income	1,808,756	0.17	1.2
Prepaid expenses	89,662	0.01	0.1
Future income tax asset <sup>(3)</sup>	6,550,000	0.62	4.6
Accounts payable and accrued liabilities	(692,474)	(0.07)	(0.5)
	<u>143,343,361</u>	<u>13.60</u>	<u>100.0</u>

<sup>(1)</sup> Based on 10,537,263 common shares, including 10,191,592 voting common shares and 345,671 non-voting common shares, as outlined in the notes to the Financial Statements.

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In early 2009, in the midst of the global recession and financial panic, non-investment grade corporate bond prices collapsed. The spread between high yield bonds and government bonds widened to unprecedented levels not seen before (see graph below).



At that time, the Investment Manager felt strongly that the market was overreacting because of fear. It saw many opportunities where they believed that bonds were backed by solid assets, and in the unlikely case of default, full recovery of investments was reasonably assumed.

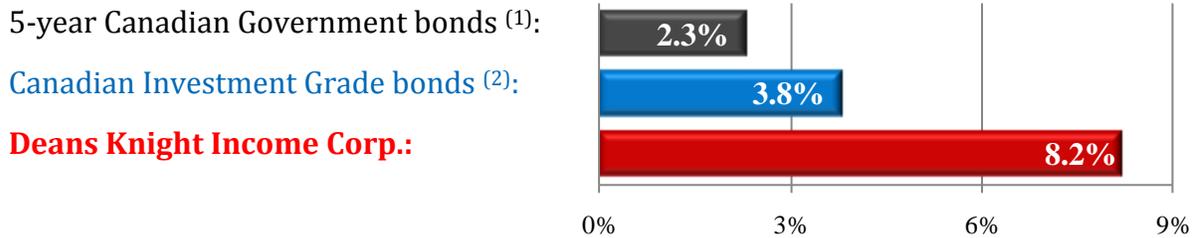
To take advantage of these opportunities, the Company raised \$94,100,000 (net of offering costs of \$6,268,900) by way of an initial public offering (“IPO”) that closed on March 18, 2009. Although the recovery has been disappointing in some respects, unemployment remains stubbornly high and real estate continues to be a soft spot, confidence has gradually been restored. Non-investment grade bond prices have recovered and yield spreads have returned to normal levels.

The Company’s net asset value has risen 36% since the IPO, excluding the \$0.70 per share annual dividend we have maintained since June 30, 2009.

As we move through 2011, the U.S. economic recovery is slowing; China’s growth is slowing; and Greece’s debt woes have called the stability of the Eurozone into question. Nevertheless, the fundamentals of many companies, including the portfolio’s investments, are stronger now than prior to the recession. Moreover, the average yield on the Company’s bond holdings is still very attractive....double that of investment grade bonds and three times that of government bonds.

## Yield to Maturity

As of June 30, 2011



(1) Source: Bloomberg

(2) Source: Merrill Lynch Canadian Corporate Index

Given the solid credit quality of the Company's holdings, the current 8.2% yield is very attractive compared to either government or investment grade bonds. The yields provided by government and investment grade bonds are far too low to compensate investors for the risk of rising interest rates. Further to this, the average duration of the Company's portfolio at June 30, 2011 is 4.2 years, compared to 4.7 years for 5-year Canadian Government Bonds' and 5.6 years for Canadian Investment Grade bonds.

The Company also attempts to add additional value, by opportunistically investing in private debt financings with equity incentives. In August 2009, the Company purchased a portion of a \$10 million, 8% convertible debenture for Whitecap. The Whitecap Debenture had an exercise price of \$2.88 and on December 8, 2010, the Company converted the Whitecap Debenture into equity. On June 30, 2011 Whitecap's share price closed at \$6.27 per share. Whitecap has grown production from 850 barrels of oil equivalent per day ("boepd") to 6,000 boepd, 60% of which is oil, and the Company believes management can continue to grow production per share and create additional value for shareholders going forward. Deans Knight Income Corp. sold 52% of its holding in Whitecap at \$6.16, but still holds 1,254,167 shares (5.5% of the Company's net asset value).

## Recent Developments

### *Comparison of net asset value and net assets*

National Instrument 81-106 ("NI 81-106") permits investment companies to have two different net asset values: (i) one for financial statements, which will be prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") including Section 3855 (and referred to as "net assets", previously disclosed as "GAAP Net Assets"); and (ii) another for all other purposes, including unit pricing for investor transactions (referred to as "net asset value", previously referred to as "Pricing NAV"). The main difference in calculating net assets and net asset value is that GAAP requires bid price to be used in valuing securities traded in an active market where quoted prices are readily and

regularly available, rather than the use of a price between the bid and the ask price currently used for determining net asset value. This difference results in a difference of approximately \$0.02 per common share at June 30, 2011, as outlined in the notes to the Financial Statements.

### *International Financial Reporting Standards*

The Company is required to adopt international financial reporting standards ("IFRS"). The Canadian Accounting Standards Board (AcSB) previously announced January 1, 2011 as the date international financial reporting standards (IFRS) will replace current Canadian standards and interpretations as GAAP for publicly accountable enterprises, which include investment companies.

However, on January 12, 2011, the AcSB issued a decision to defer adoption of IFRS for investment companies until years beginning on or after January 1, 2013. This is a further delay from the previously issued exposure draft of proposed accounting standard to defer IFRS for investment companies currently applying Accounting Guideline 18 - Investment Companies until years beginning on or after January 1, 2012.

Under the above noted decision, the Company's first set of financial statements to be reported on under IFRS will be for the semi-annual period ending June 30, 2013. These statements will include corresponding comparative financial information for 2012, including an opening statement of net assets as at January 1, 2012.

The Company has established a transition plan to ensure that it is able to meet its reporting requirements. The plan consists of three main elements, which include:

- Identifying differences between the current accounting policies of the Company, which reflect current Canadian GAAP, and those expected to apply under IFRS and the likely financial statement impact resulting from the adoption of IFRS;
- Analyzing the impact of the adoption of IFRS on business and reporting processes;
- Disclosing the qualitative impact in the December 31, 2009 management report of fund performance and disclosing the quantitative impact, if any, in the December 31, 2012 management report of fund performance.

Based on the Company's analysis of current accounting policies and presentation under GAAP against IFRS the adoption of IFRS is not expected to have a material effect on the Company's net assets or net assets per share. The primary impact will be in the areas of presentation and note disclosure. Further, the Company does not believe that the changeover to IFRS will materially affect the Company's existing business arrangements.

However, it should be noted that there are additional changes to IFRS expected during 2011 and 2012. This potential for change creates some uncertainty regarding the expected accounting standards that will be applicable upon the Company adopting IFRS. As such, the Company cannot conclusively determine the impact that the adoption of IFRS will have.

Throughout the remainder of 2011 and 2012, the Company will continue to monitor new standards and recommendations as they are issued by both the International Accounting Standards Board, who is responsible for the development and publication of IFRS, and the AcSB, to update its analysis as appropriate. By the fourth quarter of the year predating the required adoption, the Company expects to complete its analysis, determine overall financial statement presentation, and complete its assessment. Any changes required with respect to its business arrangements will then be adopted.

### **Related Party Transactions**

The officers, and certain directors, of the Company are also employees of the Investment Advisor, Deans Knight Capital Management Ltd. These officers, and directors, are not paid by the Company. Deans Knight provides investment management services to the Company, as well as administration, financial reporting and other ancillary services required by a publicly listed company. Management fees, for the services outlined above, are computed and paid quarterly, at an annual rate of 1.5% of the net asset value plus applicable taxes, and adjusted for certain non-investment related assets.

For the six month period ended June 30, 2011, management fees totaled \$1,165,607 (2010 - \$980,755). In calculating the amount, the net asset value was reduced by the value of the future income tax asset included in the statement of net assets.

A director of the Company is a partner at a law firm that provides legal services to the Corporation. During the six month period ended June 30, 2011, the Corporation incurred \$17,895 (2010 - \$17,409) in legal services and disbursements received from this related party. At June 30, 2011, accounts payable and accrued liabilities include \$1,532 (December 31, 2010 - \$1,355) to the law firm for legal fees and disbursements, which have not been billed.

### **Financial Highlights**

The following tables show selected key financial information about the Company and are intended to help you understand the Company's financial performance since it began operating its new business of investing in corporate debt in March 2009.

*The Company's Net Assets per Common Share <sup>(1)</sup>*

	<b>Six months ended June 30, 2011 \$</b>	<b>Year ended December 31, 2010 \$</b>	<b>2009 \$</b>
Net assets, beginning of period <sup>(2)</sup>	13.60	12.21	9.12
Increase (decrease) from operations			
Total revenue	0.52	0.95	0.62
Total expenses	(0.14)	(0.25)	(0.20)
Realized gains (losses) for the period	0.41	1.82	1.25
Unrealized (losses) gains for the period	(0.37)	(0.27)	1.21
Recovery of future income taxes	(0.06)	(0.16)	0.62
<b>Total increase from operations</b>	<b>0.36</b>	<b>2.09</b>	<b>3.50</b>
Dividends from income <sup>(3)</sup>	(0.35)	(0.70)	(0.41)
Net assets at end of period <sup>(4)</sup>	13.61	13.60	12.21

<sup>(1)</sup> The information is derived from the Company's audited annual and unaudited interim financial statements. Common shares outstanding are 10,537,263, including 10,191,592 voting common shares and 345,671 non-voting common shares.

<sup>(2)</sup> Net assets and dividends are based on the actual number of shares outstanding at the relevant time. The increase/decrease from operations is based on the weighted average number of shares outstanding over the period from the date the Company began operating its new business to December 31, 2009.

<sup>(3)</sup> Dividends were paid in cash.

<sup>(4)</sup> The net assets per share presented in the financial statements differs from the net asset value per share calculated for fund pricing purposes due to the provisions of CICA Handbook Section 3855. An explanation of the differences can be found in the notes to the financial statements.

*Ratios and Supplemental Data*

	<b>Six months ended June 30, 2011 \$</b>	<b>Year ended December 31, 2010 \$</b>	<b>2009 \$</b>
Net asset value (000's)	143,343	143,880	128,930
Number of common shares outstanding (000's)	10,537	10,537	10,537
Management expense ratio <sup>(1)(2)</sup>	1.56%	1.91%	5.51%
Portfolio turnover rate <sup>(3)</sup>	26.7%	86.60%	36.69%
Trading expense ratio <sup>(4)</sup>	0.00%	0.01%	0.01%
Net asset value per common share	\$13.63	\$13.65	\$12.23
Closing market price – common share	\$12.61	\$12.54	\$11.40

<sup>(1)</sup> Management expense ratio is based on total expenses for the period and is expressed as an percentage of weekly average net asset values over the period. For 2009, this ratio is calculated from the date the Company began operating its business as an investment fund, on March 17, 2009, to December 31, 2009.

<sup>(2)</sup> The Management expense ratio for 2009 includes offering costs for the IPO of \$6,268,800 less the offsetting related future tax benefit of \$1,692,500.

<sup>(3)</sup> The Company's portfolio turnover rate indicates how actively the Company manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Company buying and selling all of the securities in its portfolio once in the course of the year. The higher a portfolio turnover-rate in a year, the greater the trading costs payable by the Company in the year. There is not necessarily a relationship between a high turnover rate and the performance of the investment portfolio.

<sup>(4)</sup> The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net asset value during the period. As the purchasing and selling of bonds do not attract a commission from the buying or selling party.

## Management Fees

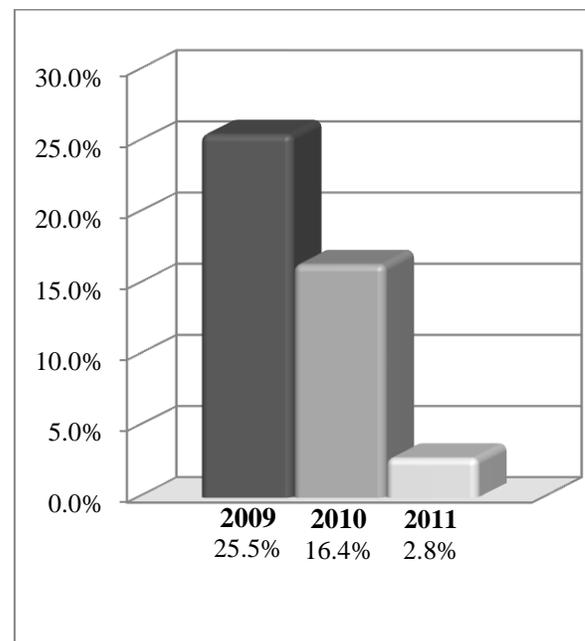
Deans Knight provides investment management services to the Company, as well as administration, financial reporting and other ancillary services required by a publicly listed company. Management fees are computed and paid quarterly, at an annual rate of 1.5% of the net asset value plus applicable taxes, and adjusted for certain non-investment related assets.

## Past Performance

This section shows the Company's past performance, since it began operating its business as an investment fund. The past performance information includes changes in net asset value and assumes the reinvestment of all dividends paid to common shareholders. It is important to note that the past performance will not necessarily indicate what performance in the future will be.

### *Year-by-year returns*

The accompanying bar chart shows the Company's performance for the periods shown and illustrates how the Company's performance has changed from period to period. The bar chart shows, in percentage terms, how much an investment made when it began its operation as an investment fund, March 17, 2009 to December 31, 2009, how much an investment made for the year ended December 31, 2010, and how much an investment made for the six month period ending June 30, 2011.



## Summary of Investment Portfolio

<b>Top 25 Investments</b>				<b>% of Net Asset Value</b>	<b>Portfolio Composition</b>		<b>% of Net Asset Value</b>
Paramount Resources Ltd.	8.250%	13-Dec-17		6.6			
North American Energy	9.125%	7-Apr-17		6.1	<b>Equity and Warrants</b>		5.7
Stone Energy Corp.	8.625%	1-Feb-17		6.0			
Whitecap Resources Inc.	N/A	N/A		5.5	<b>Fixed Income</b>		
CCS Inc.	11.000%	15-Nov-15		5.4	Canadian denominated in CAD		40.2
Calfrac Holdings LP	7.500%	1-Dec-20		4.1	Canadian denominated in USD		24.8
Southern Pacific Resource Corp.	10.750%	7-Jan-16		4.1	United States denominated in USD		17.6
Mirabella Nickel Inc.	8.750%	15-Apr-18		4.0			<u>82.6</u>
Perpetual Energy Inc.	8.750%	15-Mar-18		3.5	<b>Convertible Debentures</b>		
Harvest Energy, Inc.	7.250%	30-Sep-13		3.3	Canadian denominated in CAD		3.3
Skylink Aviation Inc.	12.250%	15-Mar-16		3.3	Other Foreign denominated in AUD		1.1
Mercator Minerals	6.500%	3-Jan-13		3.1			
Cott Beverages Inc.	8.375%	15-Nov-17		3.1	<b>Investment Portfolio</b>		92.7
National Money Mart Company	10.375%	15-Dec-16		3.0	<b>Cash &amp; Short-term Deposits</b>		1.8
Cara Operations Ltd.	9.125%	1-Dec-15		2.7	<b>Other Net Assets</b>		5.5
Tembec Industries Inc.	11.250%	15-Dec-18		2.6			<u>100.0</u>
Trinidad Drilling Ltd.	7.875%	15-Jan-19		2.4			
Gateway Casinos & Entertainment Inc.	8.875%	15-Nov-17		2.0	<b>Sector Breakdown</b>		
Black Press Group	10.000%	4-Feb-14		1.9	Energy		57.0
Pacific Rubiales Energy	8.750%	10-Nov-16		1.9	Consumer Discretionary		9.6
Beazer Homes USA, Inc.	9.125%	15-Jun-18		1.9	Services		6.1
Garda World Security Corp.	9.750%	15-Mar-17		1.8	Materials & Metals		9.4
Sure Energy Inc.	6.250%	21-Jan-14		1.7	Forestry		3.8
Newalta Corp.	7.625%	23-Nov-17		1.6	Financial Services		3.0
McMoran Exploration	11.875%	15-Nov-14		1.4	Industrial/Manufacturing		3.8
					<b>Investment Portfolio</b>		<u>92.7</u>
					<b>Cash &amp; Short-term Deposits</b>		1.8
					<b>Other Net Assets</b>		5.5
							<u>100.0</u>