DEANS KNIGHT

INCOME CORPORATION

ANNUAL MANAGEMENT REPORT

OF FUND PERFORMANCE FOR 2011

This annual 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 annual financial statements of the Company for the year ended December 31, 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, visiting our website at www.dkincomecorp.com for contact details or on SEDAR at www.sedar.com. Readers 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. In particular, this Report contains forward-looking statements in respect of the Company's targeted dividend payout, investment strategy, behaviour of financial markets and reflects the Company's expectations regarding the growth, results of operations, performance and business prospects and opportunities of the Company and its investments. 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. Such forward-looking statements reflect the Company's current beliefs and are based on information currently available to the Company. 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, currency, exchange and interest rates. 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 global equity and capital markets, business competition, technological change, changes in government regulations, unexpected judicial or regulatory proceedings, and catastrophic events and 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 this Report 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 may not be able to 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 Objectives 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 with monthly dividends, which to date have been set at $0.0583 per share 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. Examples of investments made during the period are detailed below in the Results from Operations.

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 securities to purchase for the Company, Deans Knight focuses on the following:

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

Deans Knight intends to employ 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 of the Company dated March 9, 2012 (the "**AIF**").

Prior to the reorganization and change in business as discussed in Note 1 of the Financial Statements, the Company 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 uncertainty as to whether 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 in full, 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 $21,024,806 (2010 - $20,747,249), representing $2.00 per common share at December 31, 2011 (2010 - $1.97).

There were no significant changes during the year ending December 31, 2011 that affected the overall risk of investing in the Company. 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 are willing to tolerate volatility in the value of their investment.

Results of Operations

The net assets of the Company at December 31, 2011 were $141,539,920 or $13.43 per common share (2010 - $143,343,361 or $13.60 per common share). The net assets of the Company consisted of the following components:

	December 31, 2011		
	$	**Per common share[(1)]**	**%**
Investments[(2)]	129,918,543	12.33	91.8
Cash and short-term deposits	4,997,715	0.47	3.5
Accrued income	2,339,751	0.22	1.7
Prepaid expenses	73,151	0.01	0.0
Future income tax asset[(3)]	4,920,000	0.47	3.5
Accounts payable and accrued liabilities	(709,240)	(0.07)	(0.5)
	141,539,920	13.43	100.0

(1) 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.
(2) The details of the investments are outlined in the Summary of Investment Portfolio below.
(3) Refer to the Taxation note to the Financial Statements for more detail.

	December 31, 2010		
	$	**Per common share(1)**	**%**
Investments(2)	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(3)	6,550,000	0.62	4.6
Accounts payable and accrued liabilities	(692,474)	(0.07)	(0.5)
	143,343,361	13.60	100.0

(1) 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.
(2) The details of the investments are outlined in the Summary of Investment Portfolio below.
(3) Refer to the Taxation note to the Financial Statements for more detail.

The majority of the decline in net assets of the Company, from $13.60 per share to $13.43 was the result of the $1,630,000, or $0.15 per share, decrease in the value of the future income tax asset recorded by the Company. This asset decreased as the Company realized the benefits of the assets sheltering the current year's taxable income.

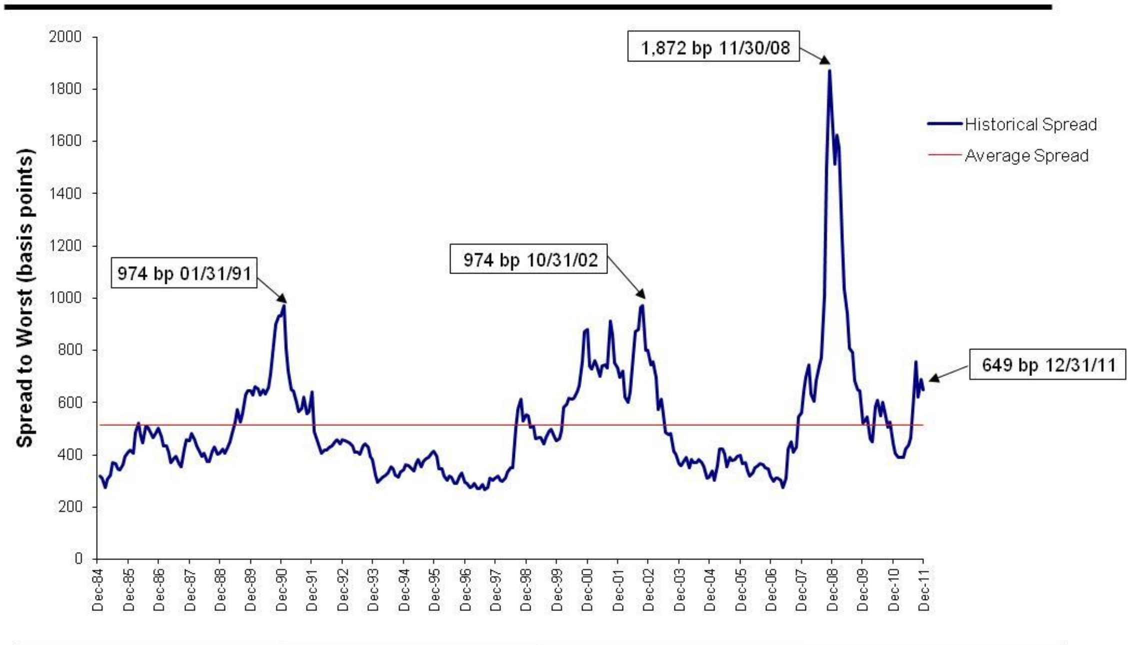
Net investment income for the year ended December 31, 2011 was $8,837,650 or $0.84 per share (2010- $7,376,571, or $0.70 per share). The increase in net investment income of $1,461,079 was predominantly from the Company's investment portfolio having more capital invested in 2011 than 2010, and from redeploying capital into higher yielding income generating securities upon the sale of a portion of Whitecap Resource Inc. common shares held by the Company. At December 31, 2011, the Company still owned 1,254,167 shares of Whitecap (7.3% of the Net Asset Value at December 31, 2011).

During 2011, the Company made monthly dividend payments totalling $7,371,869, or $0.70 per share (2010 - $7,371,869, or $0.70 per share). This represented approximately 83.4% of Net investment income (2010 – 99.9%). On January 9, 2012, the Company announced it will maintain monthly cash dividends at $0.0583 per share for each of the first three months of 2012.

As we outlined in our Q3-2011 press release, high yield bond prices were volatile for the first 9 months of the year with spreads peaking around September 30, 2011. High yield bond prices improved in the fourth quarter and, despite the volatility, the net assets of the Company remained relatively flat in 2011, excluding the decrease in the future income tax asset. As you will see from the graph below, although spreads have declined since September 30th, they are still above the long term average, and as such the Company is still seeing attractive investment opportunities.

Credit Spread History

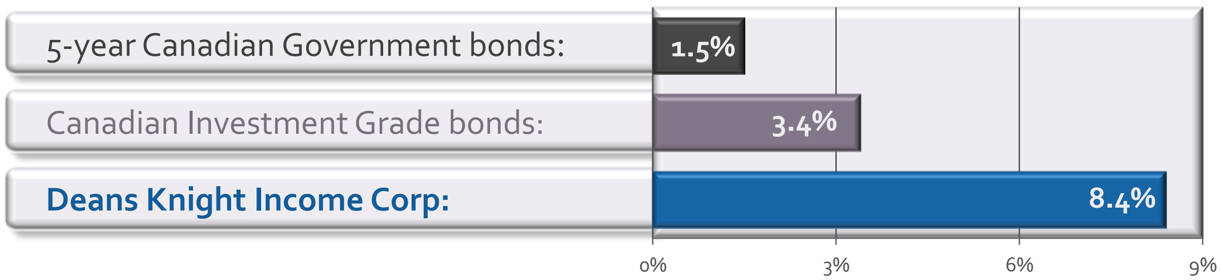
Merrill Lynch US High Yield Master Index Less 10 year Treasury Yield



Source: Merrill Lynch high yield

Will the volatility in high yield bond prices continue in 2012? The honest answer is we don't know. What we do know is as a bondholder, the most important consideration is the borrowers' ability to meet their coupon payments and pay us back our principal at maturity. A secondary consideration is whether or not we are being compensated for the risk that they fail to meet these obligations. We own corporate debt of businesses with tangible assets as collateral, strong cash flows and reasonable leverage. There are currently no defaults in our portfolio and all of our holdings are servicing their debt while, in most cases, continuing to reduce leverage. Although bonds could get cheaper, the Company believes current prices offer investors attractive returns; especially given their position in the capital structure.

At December 31, 2011, the Company is paying a monthly dividend equal to $0.70 per share per annum, or 5.2% of the net asset value at December 31, 2011. Further, the investment portfolio provides a yield to maturity of 8.4%. 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.



In addition to corporate bonds, we will also opportunistically invest in private debt financings with equity incentives that provide equity-like returns.

During the fourth quarter, Deans Knight Capital Management designed and the Company participated in a $12 million Secured Note with Conifex Timber Inc. ($3.0 million or 2.1% of the Net Asset Value at December 31, 2011). 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. It owns sawmills in two British Columbia locations, Fort St. James and Mackenzie, with a combined capacity of approximately 745 million foot board measure. Conifex holds forest licences with average allowable cut of 1.573 million m3 of timber in the Prince George and Mackenzie Timber Supply Areas, providing them with ample supply of sawlogs.

In the last three years, Conifex has invested $80 million into its sawmills and current operations are generating positive EBITDA despite depressed lumber prices. A recent sale of assets in British Columbia, by Tembec, for $60 million provides further evidence that the debt of Conifex is secured by the assets. They have 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 31, 2012 and bear interest at 10% for the first six months and 12% for the remaining term of the loan. In addition to the coupon, the Company received a commitment fee of 2% and warrants to purchase 81,250 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.

As reported in our Q3-2011 operational update, the Company participated in an $18 million Secured Subordinated Revenue Note with RapidEye Canada Ltd. The proceeds from the financing were used to acquire the assets of RapidEye AG, a global provider of highresolution imagery and geospatial solutions, out of bankruptcy. On December 7, 2011, RapidEye Canada repaid $5 million of the Notes, at Par, leaving $13 million outstanding. At December 31, 2011, the Company held $5,281,250 of these Notes, equaling 4.1% of the 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”) and (ii) another for all other purposes, including unit pricing for investor transactions (referred to as “net asset value”). 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 an insignificant difference of approximately $0.06 per common share at December 31, 2011 (2010 - $0.05 per common share), as outlined in the notes to the Financial Statements.

International Financial Reporting Standards

The Company will be 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) would replace current Canadian standards and interpretations as GAAP for publicly accountable enterprises, which include investment companies.

In December 2011, the AcSB issued a decision to defer adoption of IFRS for investment companies currently applying Accounting Guideline 18 - Investment Companies until years beginning on or after January 1, 2014.

Under the above noted decision, the Company’s first set of financial statements to be reported on under IFRS would be for the semi-annual period ending June 30, 2014. These statements would include corresponding comparative financial information for 2013, including an opening statement of net assets as at January 1, 2013. However, the Company has a termination date of April 30, 2014, and as such will not be required to issue statements reported on under IFRS. The Company will continue to monitor any further AcSB decisions that may affect the Company’s requirement to adopt IFRS.

Harmonized Sales Tax

The Corporation is subject to non-recoverable Harmonized Sales Tax on its expenses. The BC Government has announced that the Harmonized Sales Tax will be replaced by the Federal Goods and Services Tax and a Provincial Sales Tax in 2013; however, the legislation has not yet been announced. Accordingly, until further information becomes available the impact cannot be quantified

Related Party Transactions

The officers, and certain directors, of the Company are also employees of Deans Knight, the Company's investment advisor. 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 year ended December 31, 2011, management fees totaled $2,283,158 (2010 - $2,110,657). At December 31, 2011, $575,224 (December 2010- $599,474) was owed to Deans Knight, which was included in accounts payable and accrued liabilities in the statement of net assets, and is payable immediately. In calculating the management fee, 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 Company. During the year ended December 31, 2011, the Company incurred $42,750 (2010 - $30,195) in legal services and disbursements received from this related party. At December 31, 2011, accounts payable and accrued liabilities include $4,185 (2010 - $1,355) due to the law firm for legal fees and disbursements.

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 (1)

	2011 $	2010 $
Net assets, beginning of year (2)	13.60	12.21
Increase from operations		
Total revenue	1.10	0.94
Total expenses	(0.26)	(0.24)
Realized gains	0.36	1.82
Unrealized losses	(0.52)	(0.27)
Future income taxes	(0.15)	(0.16)
Total increase from operations (2)	0.53	2.09
Dividends (2)(3)		
From income	(0.70)	(0.70)
Net assets at end of year (4)	13.43	13.60

(1) The information is derived from the Company's audited annual financial statements. Common shares outstanding are 10,537,263, including 10,191,592 voting common shares and 345,671 non-voting common shares.
(2) 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 year.
(3) Dividends were paid in cash.
(4) 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 (1)

	2011	2010
Net asset value (000's)	$142,178	$143,880
Number of common shares outstanding (000's)	10,537	10,537
Management expense ratio (2)	1.90%	1.91%
Portfolio turnover rate (3)	79.90%	86.60%
Trading expense ratio (4)	0.00%	0.01%
Net asset value per common share	$13.49	$13.65
Closing market price – common share	$11.84	$12.54

(1) This information is provided as at December 31 of the years shown.
(2) 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 year.
(3) 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.
(4) 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. This expense is $nil for 2011 (2010- $13,500), as the purchasing and selling of bonds do not attract a commission from the buying or selling party.

Management Fees

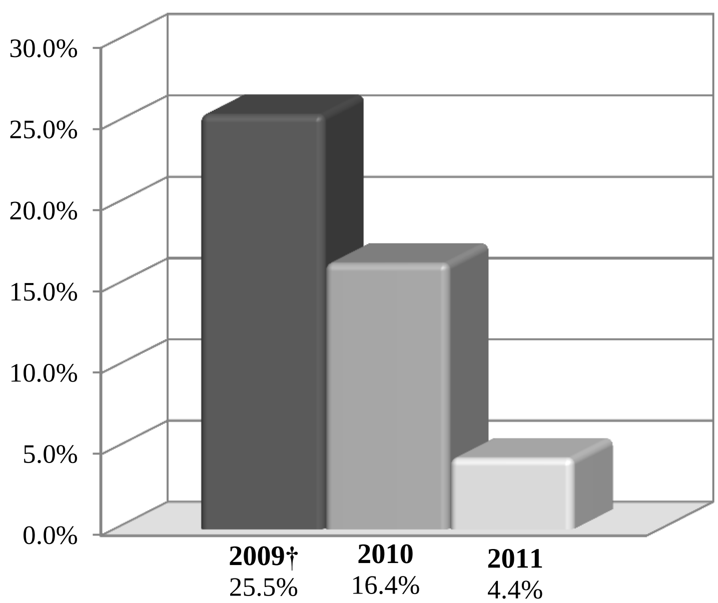
Deans Knight provides investment management services to the Company, as well as administration, financial reporting and other ancillary services required by a publicly listed company. Management fees are computed and paid quarterly, at an annual rate of 1.5% of the net asset value plus applicable taxes, 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 years shown and illustrates how the Company's performance has changed from year to year. The bar chart shows, in percentage terms, how much an investment made from when the Company began its operation as an investment fund on March 17, 2009 to December 31, 2009, and how much an investment made for the years ending December 31, 2010 and 2011.



† March 17, 2009 (Inception) to Dec. 31, 2009

Annual Compound Returns

The table below summarizes the Company's annual compound total returns for the periods ended December 31 as indicated. As a basis for comparison, we have provided the performance of the Merrill Lynch Canada High Yield Bond Index ("Index"). The Index is a broad based index that tracks the performance of the Canadian high-yield bond market. As the criteria for determining the constituents of the Company's investment portfolio and the Index differ, it is not expected that the Company's performance will mirror that of the Index. Further, the return of the Index is calculated without the deduction of management fees and fund expenses whereas the performance of the Company is calculated after deducting fees and expenses.

Annual Compound Returns	**Company**	**Index**
1 Year	4.4%	3.1%
2 Years	10.3%	8.2%
Since Inception	16.7%	24.4%

Summary of Investment Portfolio

The following is a summary of the Company's investment portfolio as at December 31, 2011. This is a summary only and will change due to ongoing portfolio transactions of the Company. A quarterly update is available at www.dkincomecorp.com.

Summary of Investment Portfolio

Top 25 Investments			% of Net Asset Value
WHITECAP RESOURCES	N/A	N/A	7.3
PARAMOUNT RESOURCES	8.250%	13-Dec-17	6.8
STONE ENERGY CORP	8.625%	1-Feb-17	6.3
NORTH AMERICA ENERGY	9.125%	7-Apr-17	6.0
CCS INC	11.000%	15-Nov-15	5.4
MIRABELA NICKEL LTD	8.750%	15-Apr-18	5.0
SOUTHERN PACIFIC RES	10.750%	7-Jan-16	4.2
CALFRAC HOLDINGS LP	7.500%	1-Dec-20	4.2
RAPIDEYE CANADA	5.000%	31-Aug-14	3.7
TEMBEC INDUSTRIES	11.250%	15-Dec-18	3.7
PERPETUAL ENERGY INC	8.750%	15-Mar-18	3.3
MERCATOR MINERALS	6.500%	3-Jan-13	3.2
SKYLINK AVIATION INC	12.250%	15-Mar-16	3.1
NATIONAL MONEY MART	10.375%	15-Dec-16	2.9
SHERRITT INTL CORP	8.000%	15-Nov-18	2.7
CARA OPERATIONS LTD	9.125%	1-Dec-15	2.5
CONIFEX TIMBER INC	10.000%	31-Dec-12	2.1
GATEWAY CASINOS	8.875%	15-Nov-17	2.0
BLACK PRESS GROUP	10.000%	4-Feb-14	1.9
GARDA WORLD SECURITY	9.750%	15-Mar-17	1.8
SURE ENERGY	6.250%	21-Jan-14	1.8
PACIFIC RUBIALES	7.250%	12-Dec-21	1.7
BEAZER HOMES USA	9.125%	15-Jun-18	1.6
MCMORAN EXPLORATION	11.875%	15-Nov-14	1.5
NUMBER MERGER SUB	11.000%	15-Dec-19	1.3

Portfolio Composition	% of Net Asset Value
Equity and Warrants	7.3
Fixed Income	
Canadian denominated in CAD	43.7
Canadian denominated in USD	23.1
United States denominated in USD	16.1
	82.9
Convertible Debentures	
Canadian denominated in CAD	-
Other Foreign denominated in AUD	1.1
Investment Portfolio	91.3
Cash & Short-term Deposits	3.5
Other Net Assets	5.2
	100.0
Sector Breakdown	
Energy	50.4
Materials & Metals	12.2
Consumer Discretionary	7.5
Technology	3.7
Services	4.2
Forestry	6.9
Industrial/Manufacturing	3.5
Financial Services	2.9
Investment Portfolio	91.3
Cash & Short-term Deposits	3.5
Other Net Assets	5.2
	100.0