



## DEANS KNIGHT INCOME AND GROWTH FUND



### **Annual Report**

Year ended December 31, 2006

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# Annual Management Report of Fund Performance

For the Period Ended December 31, 2006

This annual management report of fund performance for Deans Knight Income and Growth Fund (the "Trust") contains financial highlights and is included with the annual audited financial statements in the annual report of the Trust. You may request a copy of the Trust's current proxy voting policies and procedures, or quarterly portfolio disclosure at no cost from Fairway Advisors Inc., by calling toll free (1-866) 299-7929, or locally (416) 507-4110, by writing to us at: BCE Place, 181 Bay Street, Suite 3740 P.O. Box 750, Toronto, ON M5J 2T3, or by visiting our website at [www.fairwaycapital.com](http://www.fairwaycapital.com) or SEDAR at [www.sedar.com](http://www.sedar.com).

The Trust's proxy voting disclosure record for the period ending June 30, 2007 will be available free of charge upon request at any time after August 31, 2007, by visiting our website at [www.fairwaycapital.com](http://www.fairwaycapital.com).

## MANAGEMENT DISCUSSION OF FUND PERFORMANCE

Deans Knight Income and Growth Fund is a closed-end investment trust, the units of which are listed on the Toronto Stock Exchange under the symbol DK1.UN. The Trust effectively began operations on March 16, 2006 when it completed an initial public offering of 5,200,000 units at \$10.00 per unit for gross proceeds of \$52.0 million. On April 6, 2006 an overallotment option granted to agents was exercised for an additional 475,000 units of the Trust at \$10.00 per unit for gross proceeds of \$4.75 million.

Fairway Advisors Inc. is the manager (the "Manager") and trustee (the "Trustee") of the Trust.

### *Investment Objective and Strategies*

The Trust's investment objective is to:

- (i) provide unitholders with monthly distributions; and
- (ii) achieve long-term capital appreciation.

In order to achieve the Trust's investment objective, the Trust, including the borrowings under the Trust's Loan Facility (see *Borrowings*), will be invested in a portfolio consisting primarily of income-producing securities and to a lesser extent, equity securities. The income-producing securities will include income trusts, corporate bonds and other income-producing securities such as mezzanine, bridge and bank loans. The Trust may also invest in equity securities such as dividend and non-dividend paying common shares and preferred shares.

The portfolio manager of the Trust, Deans Knight Capital Management Ltd. (the "Portfolio Manager" or "Deans Knight"), will employ a credit-based analysis to identify income-producing securities for inclusion in the portfolio with attractive valuations in order to provide returns while reducing long term risk and preserving capital.

### *Risk*

The Trust's investment activities expose it to various types of risk associated with the financial instruments in which it invests directly. In addition to the risks of investing in income trusts, corporate bonds, and equity markets generally, the Trust is subject to other risks, including the following:

- Currency risk
- Interest rate risk
- Credit risk

For a detailed disclosure of risks associated with an investment in the Trust's units please refer to the Trust's Prospectus.

### *Results of Operations*

The net asset value per unit of the Trust as at December 31, 2006 was \$8.31 compared to the initial offering price of \$10.00 at March 16, 2006. Net assets were \$46.7 million at the end of 2006. The change in net assets from the initial offering is attributed to the various components of the net asset value as outlined below. For a further analysis as to the impact to the net asset value on a per unit basis, please see the section on *Financial Highlights*.

### *Managed Portfolio*

A discussion by the portfolio manager of the Trust – Deans Knight Capital Management Ltd.

### *Market Review*

The objective of the Trust is to provide investors with an annual distribution of \$0.70 per unit (paid monthly) and to achieve long-term capital appreciation. This represents a yield of 7% on the \$10 issue price. To accomplish these objectives, the portfolio was initially invested 60% in income trusts, 35% in corporate bonds and 5% in common equities. The investments in the portfolio currently generate sufficient income to pay the annual distribution, providing a yield of 8.9% based on the year end market price.

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

The rate of return for the fourth quarter was negative, primarily because of the Government's decision to impose income taxes on trusts, which resulted in a reduction in the valuation on most trusts. Furthermore, the Trust's largest portfolio holding, Vicwest Income Fund, had a disappointing third quarter and the unit value declined by almost 40%.

Deans Knight has two major issues with the tax change. First, the Conservative Government had clearly stated in January that they would not tax trusts. Canadian companies and individual Canadian investors made decisions and organized their affairs accordingly. The consequence: roughly \$30 billion of individual savings has been erased. Second, the Government stated that the primary reason for the decision was to stop tax "leakage". However, the Government has not released documentation to support the claim. On the other hand, there is enough anecdotal evidence to suggest that the opposite is the case: personal and corporate tax receipts have been stronger than forecasted.

In the opinion of the Portfolio Manager, the outcome of this decision may produce a classic inducement of the "law of unintended consequences". Government income tax revenues may decline and the Conservatives may be defeated in the next election.

## Portfolio

The job of professional investors is to take advantage of any given set of circumstances. Trusts are still just businesses, albeit businesses that now trade at lower and potentially attractive valuations. Since October 31, two income trust holdings have been added to the portfolio.

The Portfolio Manager has roughly doubled the position in Vicwest Income Fund following its disappointing Q3 results and the subsequent decline in unit price. In Deans Knight's opinion, the market has overreacted. Vicwest generated cash flow of \$10.5 million in the 3rd quarter of 2006 versus \$17 million for the same period last year. The volume of sales was similar to last year but margins were lower. Vicwest should generate cash flow of \$37 million for the full year in 2006, substantially above the \$30 million needed to maintain the current \$1.56 annual distribution. Vicwest carries very little debt, currently trades at approximately 5 times free cash flow, and yields approximately 15%. On December 7, Vicwest made an acquisition that should add \$2 million to cash flow next year and, on

December 19, announced its intention to buy back up to 900,000 units over the next 12 months, representing approximately 4.6% of the outstanding units.

Deans Knight also more than doubled the Trust's position in KCP Income Fund. KCP operates in two business segments. They are North America's largest private-label bleach manufacturer and one of the largest contract manufacturers of consumer products in North America. Like many export-oriented Canadian manufacturers, KCP has experienced a very difficult operating environment in the last few years because of the significant appreciation of the Canadian dollar versus the U.S. dollar and also because of increased input costs, including most metals and petroleum-based packaging materials. To offset increasing costs, KCP negotiated three price increases on their private-label bleach, which significantly improved margins in 2006.

In 2005, KCP acquired two contract manufacturing businesses, APG Group and the custom division of CCL Industries. KCP is now one of North America's largest and most diverse contract manufacturers of consumer products. Many Fortune 500 consumer product companies, like Proctor & Gamble and Johnson & Johnson, have outsourced more product manufacturing to reduce costs.

Margins in the contract manufacturing industry are currently low, but there are some signs this is improving and that KCP may be able to increase pricing. A small increase in the total cost to the consumer has a huge impact on KCP's margins and to its bottom line. We feel KCP is attractively valued, has a strong position in its industry and the potential for growing cash flows.

During the 4th quarter Deans Knight was instrumental in structuring a \$30 million bridge financing for Jinshan Gold Mines Inc. Jinshan is a \$200 million publicly traded Canadian company with a 2.5 million ounce gold deposit in China. The purpose of the loan is to finish building the mine and to have it in production by early 2007. Ivanhoe Mines, a major copper and gold company, controls 49% of Jinshan. Ivanhoe itself is developing a large copper/gold project in Mongolia in partnership with BHP.

Jinshan has a strong board and management team, many of whom are well known to, and have had dealings with, the Portfolio Manager in the past. The Trust holds \$4.5 million of the Jinshan note with a term of 3 years

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

and paying interest of 12% quarterly. In addition, each \$100 of debt receives 20 warrants to purchase Jinshan shares at \$1.60 for 2 years (\$1.53 at year end). When the mine is in full production midway through 2007 at an annual rate of 120,000 ounces, given the expected cash costs of \$253 and using a gold price of \$500 per ounce, Jinshan will generate a projected cash flow of \$30 million per year. It is expected that the loan will be paid down out of cash flow or an equity issue within 2 years. In the interim, the Trust receives a cash yield of 12% on the note. Furthermore, if the shares rise to \$3 and the loan is repaid in 2 years, the potential total annualized return is 25%.

The largest bond holding of the Trust is Jean Coudu Group 8.5% August 1, 2014. The bonds were purchased at \$92, at a yield of almost 10%. In August, Jean Coudu announced the sale of their US pharmacy operations to Rite Aid. As part of the sale, it is intended that Rite Aid will assume the obligations of these bonds. As a result, Rite Aid has asked to remove Jean Coudu and their very profitable Canadian assets as guarantor of the bonds. The Trust, along with the majority of the bondholders, has challenged this and the matter is now before the courts.

The most significant common equity holding in the Trust is LionOre Mining International. The Portfolio Manager purchased shares at an attractive price of \$5.46. At that time, investors were so intently focused on Falconbridge and Inco during the dramatic takeover battles for these companies, that it was felt they failed to evaluate LionOre correctly. With Falconbridge absorbed by Swiss-based Xstrata, and Inco by Brazilian CVRD, LionOre became the largest publicly traded pure nickel producer in the world. This, combined with record nickel prices of over \$15 per pound in late 2006, led to a significant increase in LionOre's valuation which closed at over \$13 at year end.

## **Income, Expenses and Distributions (all information relates to the period February 23, 2006 ("Date of Inception") to December 31, 2006)**

For the period ended December 31, 2006, the Trust generated income from investments in the form of interest, dividends and distributions from income trusts in the amount of \$3.6 million.

The Trust paid management fees and operating expenses of \$0.8 million and had interest carrying charges of \$0.02 million on its Loan Facility. The management

expense ratio ("MER") for the Trust was 10.46% (1.91% excluding one-time costs associated with the offering of the Trust).

The Trust distributed \$3.0 million to unitholders during the period.

The average daily net assets for the period were approximately \$51.1 million. Income generated from the portfolio of investments and any operating expenses calculated as a percentage of the net assets of the Trust, such as management fees and some administration fees, are directly related to the amount of net assets in the Trust.

The 2006 calendar year was the first year of operations for the Trust.

## ***Borrowings***

The Manager, on behalf of the Trust, has entered into a revolving term credit facility (the "Loan Facility") with the Bank of Nova Scotia ("BNS"). The aggregate amount of borrowings under the credit facility and other forms of leverage may not exceed 25% of the total assets of the Trust at the time the borrowing or other transaction is entered into. The Trust has entered into a general security agreement providing BNS with a first charge on the assets of the Trust as collateral for indebtedness arising out of the credit facility.

As at December 31, 2006, the Manager, on behalf of the Trust, had drawn down a loan in the amount of \$6,000,000 which represented approximately 11.2% of the total assets of the Trust. This amount represented the highest draw down during 2006. The lowest amount drawn down on the Loan Facility was nil. Proceeds from the draw down of the Loan Facility are used to purchase investments for the Trust.

## ***Unitholder Activity***

The Trust's annual redemption feature allows unitholders to redeem out of the Trust at the end of September in any given year starting in 2007.

The Trust also has the right (but not the obligation), exercisable in its sole discretion, at any time, to purchase (in the open market or by invitation for tenders) units for cancellation up to a maximum in any twelve month period of up to 10% of the number of units outstanding at the commencement of such period, in all cases at prices not exceeding the net asset value per unit of the Trust on the valuation date immediately prior to the date of any such purchase. During the period, the Trust repurchased 38,400 units for

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

cancellation under the repurchase program, at a total cost of \$299,354.

On July 12, 2006, the Manager issued a notice of intention to repurchase units of the Trust through a normal course issuer bid (“NCIB”). Under the NCIB, the Trust may repurchase up to approximately 10% of the public float of units for cancellation at a price not exceeding the net asset value of the Trust. All such purchases would be accretive and enhance returns to continuing unitholders. Purchases of units commenced on July 14, 2006 and must terminate on July 13, 2007, or on such earlier date as the Trust may complete its purchase limit. For the period ended December 31, 2006, the Trust repurchased 17,300 units for cancellation under the NCIB at a total cost of \$139,984.

## **Recent Developments**

In May 2006, Jovian Capital Corporation (“Jovian”) through its wholly-owned subsidiary Jovian Asset Management Inc. acquired 100% of the Class A Shares and 49% of the Class C Shares in Fairway Asset Management Corp. (formerly, Impax Capital Corp.), parent company to Fairway Capital Management Corp., the parent of the Manager.

On November 1, 2006, Jovian announced that its subsidiary, Jovian Asset Management Inc., had given notice of its intention to exercise its option to acquire the remaining 51% of the issued and outstanding Class C Shares of Fairway Asset Management Corp. As part of this pending change of control, Fairway Asset Management Corp. has been renamed JovFunds Management Inc. This change of control is expected to close on or about March 31, 2007.

On November 30, 2006, the Manager announced that the investment advisor for the Trust was changing from Impax Funds Management Inc. (“IFMI”) to Jove Investment Management Inc. (the “Investment Advisor” or “JIMI”). JIMI has assumed the responsibilities of being the Investment Advisor for the Trust. Both IFMI and JIMI are associated companies of JovFunds Management Inc. Dean Knight continues in its role as Portfolio Manager for the Trust.

Jovian is a publicly-traded company listed on the TSX Venture Exchange (JVN). Jovian is a management and holding company with interests in a variety of financial service firms specializing in wealth and asset management. The Jovian group of companies operates

as a national financial services organization with approximately \$13.5 billion of client assets.

## **Related Party Transactions**

The Manager provides all administrative services required by the Trust, including the appointment of the Portfolio Manager. The Manager receives a monthly fee at the annual rate of 1.1%, plus applicable taxes, of the net asset value of the Trust, calculated and accrued daily and payable monthly in arrears. The Manager is responsible for payment of the investment management fees of the Trust to the Portfolio Manager out of its annual management fees. For additional information, see *Management Fees*.

## **Recommendations or Reports by the Advisory Board**

The Fairway Advisory Board tabled no reports and made no material recommendations to management of the Trust in the period ending December 31, 2006.

## **Independent Review Committee**

National Instrument 81-107 – Independent Review Committee for Investment Funds (“NI 81-107”), came into force on November 1, 2006. NI 81-107 will require all publicly offered investment funds, such as the Trust, to establish an independent review committee (the “IRC”). The Manager must refer all conflict of interest matters for review or approval to the IRC. NI 81-107 will also impose obligations upon the Manager to establish written policies and procedures for dealing with conflict of interest matters, to maintain records in respect of these matters and to provide the IRC with guidance and assistance in carrying out its functions and duties.

According to NI 81-107, the IRC must be comprised of a minimum of three independent members, and will be subject to requirements to conduct regular assessments of its members and provide reports, at least annually, to the Trust and to its unitholders in respect of those functions. The report will be available on the Manager’s website [www.fairwaycapital.com](http://www.fairwaycapital.com), or at the unitholder’s request at no cost, by contacting the Manager at 181 Bay Street, BCE Place, Suite 3740, Toronto, Ontario M5J 2T3 or by email at [info@fairwaycapital.com](mailto:info@fairwaycapital.com).

While the initial members of the IRC will be required to be appointed by May 1, 2007, complete compliance with NI 81-107 will not be required until November 1, 2007. The Manager intends to implement the requirements of, and to comply with, NI 81-107, including appointing the members of the IRC.

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

The Fairway Advisory Board, which was established by the Manager to provide independent advice to the Manager on matters similar in nature to those now coming within the responsibility of the IRC, will cease to operate on the establishment of the IRC by the Manager.

## Forward-Looking Statements

The matters discussed in this management report of fund performance ("MRFP") include certain forward-looking statements. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements. Forward-looking statements may be identified, without limitation, by the use of such words as "anticipates", "estimates", "expects", "intends", "plans", "predicts", "projects", "believes", or words or phrases of similar meaning. Readers should not rely on forward-looking statements as they involve risks and uncertainties which could cause actual results or outcomes to differ materially from those expressed in the forward-looking statements. Market fluctuations and redemption levels are unpredictable and outside the control of the Trust. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors. The Trust makes no commitment to disclose any revisions to forward-looking statements, or any facts, events or circumstances after the date of this MRFP that may bear upon forward-looking statements.

## FINANCIAL HIGHLIGHTS

The following tables show selected key financial information about the Trust and are intended to help you understand the Trust's financial performance since its inception on February 23, 2006. This information is derived from the Trust's audited annual financial statements.

### The Trust's net asset value per unit for the period ended December 31,

	2006
Net asset value, beginning of period <sup>(1)</sup>	\$10.00
<b>Decrease from operations:</b>	
Total revenue	0.64
Total expenses	(0.14)
Realized gains for the period	0.04
Unrealized losses for the period	(1.10)
<b>Total decrease from operations<sup>(2)</sup></b>	<b>(0.56)</b>
<b>Distributions:</b>	
From income (excluding dividends)	(0.39)
From dividends	(0.02)
From capital gains	(0.04)
From return of capital	(0.08)
<b>Total annual distributions<sup>(3)</sup></b>	<b>(0.53)</b>
<b>Net asset value, end of period<sup>(4)</sup></b>	<b>\$8.31</b>

<sup>(1)</sup> Net asset value, beginning of period for 2006 represents the original investment amount as at March 16, 2006, the date of the closing of the initial offering of the Trust.

<sup>(2)</sup> Net asset value and distributions are based on the actual number of units outstanding at the relevant time. The increase from operations is based on the weighted average number of units outstanding over the financial period.

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

<sup>(4)</sup> The Financial Highlights are not intended to act as a continuity of the opening and closing net asset value per unit.

## Ratios and Supplemental Data

	2006
Net assets (000's) <sup>(1)</sup>	\$46,721
Number of units outstanding <sup>(1)</sup>	5,619,300
Management expense ratio <sup>(2)</sup>	10.46%
Management expense ratio before waivers or absorptions	10.46%
Management expense ratio excluding issue costs <sup>(2)</sup>	1.91%
Portfolio turnover rate <sup>(3)</sup>	75.56%
Trading expense ratio <sup>(4)</sup>	0.30%
Closing market price	\$7.83

<sup>(1)</sup> This information is provided as at December 31 of the period shown.

<sup>(2)</sup> Management expense ratio is based on total expenses for the stated period and is expressed as an annualized percentage of daily average net assets during the period. For the 2006 period, the management expense ratio is annualized from the date of inception to December 31, 2006. The expenses for the 2006 period contain one-time costs associated with the offering of the Trust as detailed in the prospectus.

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

<sup>(4)</sup> The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net assets during the period.

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

## MANAGEMENT FEES

The Trust's MER consists of all of its operating expenses such as custody, valuation, transfer agent, reporting, audit and legal fees. In addition to these operational and administrative expenses, other significant components of the MER are fees that are calculated as a percentage of the net asset value of the Trust. These are the Manager and Dealer Service fees. Highlights of the key components of the Trust's MER are listed in the table below:

Description – % of Net Asset Value (NAV)	2006 (\$000's)
Manager – annual rate of 1.10% of NAV <sup>(1)</sup>	475
Dealer service – annual rate of 0.40% of NAV	173

<sup>(1)</sup> The Manager is responsible for the management and operational functions of the Trust. In addition, the Manager will monitor the Trust's investment strategy to ensure compliance with the investment guidelines. The Manager has retained the Portfolio Manager to provide investment advisory and portfolio management services to the Trust. The Manager is responsible for the payment of the investment management fees of the Portfolio Manager out of its fees.

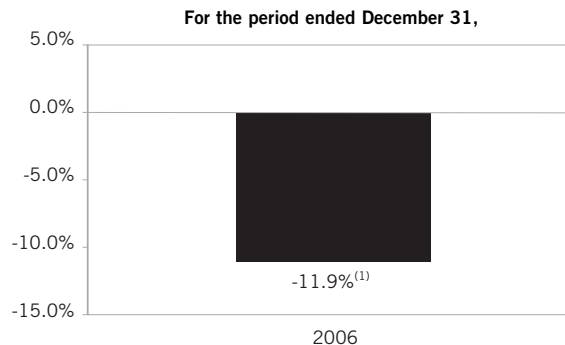
## PAST PERFORMANCE

### General

The performance information shown assumes that all distributions made by the Trust in the periods shown were reinvested in additional securities of the Trust. The performance information does not take into account sales, redemption, distribution or other optional charges that would have reduced returns on performance. The Trust's past performance is no guarantee of how it will perform in the future.

### Year-by-Year Returns

The following bar chart shows the Trust's annual performance for the year shown, and illustrates how the Trust's performance has changed from inception. The chart shows in percentage terms how an investment made at inception would have increased or decreased by December 31 for the period.



<sup>(1)</sup> Return from March 16, 2006 to December 31, 2006.

## Annual Compound Returns

The following table shows the Trust's annual compound return for the period ended December 31, 2006 as indicated. As a basis for comparison, the annual compound return is compared to a series of indices on the same compound basis.

Percentage Return:	Since Inception <sup>(1)</sup>
Deans Knight Income and Growth Fund	-11.9%
Blended Index	-3.1%
S&P/TSX Capped Income Trust Index <sup>(2)</sup>	-9.5%
Merrill Lynch Canadian High Yield Bond Index <sup>(2)</sup>	7.4%

<sup>(1)</sup> Return from March 16, 2006.

<sup>(2)</sup> Source: Bloomberg

The Blended Index is comprised of 65% S&P/TSX Income Trust Index and 35% Merrill Lynch Canadian High Yield Bond Index.

The S&P/TSX Capped Income Trust Index is a modified-market capitalization weighted index consisting of Canadian income trusts listed on the Toronto Stock Exchange (TSX). Each constituent income trust will have its relative weights capped at 25%.

The Merrill Lynch Canadian High Yield Bond Index is composed of high yield bonds of Canadian issuers denominated in Canadian or U.S. dollars.

# Annual Management Report of Fund Performance (continued)

For the Period Ended December 31, 2006

## SUMMARY OF INVESTMENT PORTFOLIO

As at December 31, 2006

Top 25 Investments	% of Net Assets
Vicwest Income Fund	10.35
The Jean Coutu Group (PJC) Inc. <i>8.50% Aug 01/14</i>	10.09
Jinshan Gold Mines Inc.	9.63
Paramount Resources Ltd. <i>9.86% Aug 28/12</i>	8.69
LionOre Mining International Ltd.	6.67
KCP Income Fund	6.51
Masonite International Corporation <i>11.00% Apr 06/15</i>	5.80
The Data Group Income Fund	5.23
Dollarama Group LP <i>8.88% Aug 15/12</i>	4.67
Bonterra Energy Income Trust	3.98
Avenir Diversified Income Trust	3.59
Harvest Operations Corp. <i>7.88% Oct 15/11</i>	3.56
Movie Distribution Income Fund	3.51
BlackWatch Energy Services Trust	3.00
Supremex Income Fund	2.99
First National Financial Income Fund	2.83
Marsulex Inc. <i>9.63% Jul 01/08</i>	2.77
Progress Energy Trust	2.69
Harvest Energy Trust	2.57
Essential Energy Services Trust	2.20
Peak Energy Services Trust	2.14
Newport Partners Income Fund	1.53
CanWest MediaWorks Income Fund	1.48
Sound Energy Trust	1.48
Hughes Network Systems LLC <i>9.50% Apr 15/14</i>	1.31
<b>Top 25 Investments</b>	<b>109.27</b>

Other Investments	1.98
Cash and Cash Equivalents	1.57
Liabilities less other assets	(12.82)
<b>Total Net Assets</b>	<b>100.00</b>

Portfolio Composition	% of Net Assets
<b>Equities</b>	
Canada	16.41
<b>Total Equities</b>	<b>16.41</b>
<b>Bonds</b>	
Canada	36.71
United States	1.31
<b>Total Bonds</b>	<b>38.02</b>
<b>Income Trusts</b>	
Canada	56.82
<b>Total Income Trusts</b>	<b>56.82</b>
Cash and Cash Equivalents	1.57
Liabilities less other assets	(12.82)
<b>Total Net Assets</b>	<b>100.00</b>
<b>Total Net Asset Value</b>	<b>\$46,720,973</b>

The investment portfolio may change due to ongoing portfolio transactions of the investment fund. Quarterly updates are available within 60 days of each quarter end at [www.fairwaycapital.com](http://www.fairwaycapital.com).

# Management's Responsibility for Financial Reporting

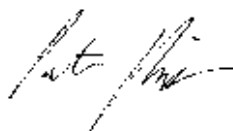
The accompanying financial statements of Deans Knight Income and Growth Fund (the "Trust") are the responsibility of the manager and trustee to the Trust, Fairway Advisors Inc. (the "Manager"). They have been prepared in accordance with Canadian generally accepted accounting principles using information available and include certain amounts that are based on the Manager's best estimates and judgments.

The Manager has developed and maintains a system of internal controls to provide reasonable assurance that all assets are safeguarded and to produce relevant, reliable and timely financial information, including the accompanying financial statements.

These financial statements have been approved by the Board of Directors of the Manager and have been audited by Ernst & Young LLP, Chartered Accountants, on behalf of the unitholders. The auditors' report outlines the scope of their audit and their opinion on the financial statements.



Steven J. Hawkins  
*Chief Executive Officer*  
*Fairway Advisors Inc.*



Peter Rizakos  
*Managing Partner*  
*Fairway Advisors Inc.*

March 12, 2007

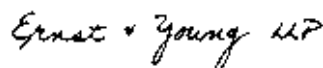
## Auditors' Report

### **TO THE UNITHOLDERS OF DEANS KNIGHT INCOME AND GROWTH FUND**

We have audited the statements of net assets and investments of Deans Knight Income and Growth Fund [the "Trust"] as at December 31, 2006 and the statements of operations, changes in net assets and cash flows for the period from February 23, 2006 ("Date of Inception") to December 31, 2006. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the net assets and investments of the Trust as at December 31, 2006 and the results of its operations, changes in its net assets and cash flows for the period from the Date of Inception to December 31, 2006 in accordance with Canadian generally accepted accounting principles.



**Chartered Accountants**

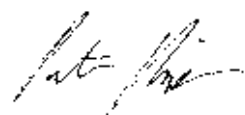
Toronto, Canada,  
**March 12, 2007.**

# Statement of Net Assets

As at December 31, 2006

<b>Assets</b>	
Investments, at market value ( <i>cost – \$57,901,464</i> )	\$ 51,976,875
Cash and cash equivalents	734,936
Accrued interest, dividends and distributions from trusts	826,622
Prepaid interest on loan	49,846
	<u>53,588,279</u>
<b>Liabilities</b>	
Unit repurchases payable	32,070
Loan facility payable (Note 7)	6,000,000
Due to brokers	149,193
Payable for open forward contracts (Note 8)	262,450
Management fees payable	52,046
Accounts payable and accrued liabilities	43,540
Distributions payable	328,007
	<u>6,867,306</u>
<b>Net assets, at market value</b>	<b>\$ 46,720,973</b>
<b>Number of units outstanding</b> (Note 6)	<b>5,619,300</b>
<b>Net asset value per unit</b>	<b>\$ 8.31</b>

Approved on behalf of the Board of Directors of the Manager:



Peter Rizakos  
Director



Steven J. Hawkins  
Director

# Statement of Operations

From February 23, 2006 (Date of Inception) to December 31, 2006

<b>Investment income</b>	
Interest	\$ 3,503,590
Dividends and distributions	102,726
	<u>3,606,316</u>
<b>Expenses</b>	
Management fees (Note 4)	648,002
Administration fees	49,135
Audit fees	28,362
Custodian fees	8,900
Legal fees	12,189
Securityholder reporting costs	16,607
Transfer agency fees	11,454
Interest (Note 7)	19,172
	<u>793,821</u>
<b>Net investment income</b>	<b>2,812,495</b>
<b>Realized and unrealized loss on investments</b>	
Net realized gain on sale of investments	443,721
Change in unrealized depreciation on investments	(5,924,589)
Realized foreign exchange loss	(234,610)
Change in unrealized depreciation on foreign currency	(251,076)
<b>Net loss on investments</b>	<u>(5,966,554)</u>
<b>Decrease in net assets from operations</b>	<b>\$ (3,154,059)</b>
<b>Decrease in net assets from operations per unit</b>	<b>\$ (0.5599)</b>

The accompanying notes are an integral part of these financial statements

## Statement of Changes in Net Assets

From February 23, 2006 (Date of Inception) to December 31, 2006

<b>Decrease in net assets from operations</b>	\$ (3,154,059)
<b>Distributions to unitholders</b>	
Capital gains	(211,130)
Income	(2,312,873)
Return of capital	(450,623)
	(2,974,626)
<b>Capital unit transactions</b> (Note 6)	
Proceeds from issuance of trust units	56,750,000
Issue costs	(3,461,004)
Repurchase and cancellation of trust units (Notes 12, 13)	(439,338)
	52,849,658
<b>Increase in net assets during the period</b>	46,720,973
<b>Net assets, beginning of period</b>	-
<b>Net assets, end of period</b>	<b>\$ 46,720,973</b>

## Statement of Cash Flows

From February 23, 2006 (Date of Inception) to December 31, 2006

<b>OPERATING ACTIVITIES</b>	
Decrease in net assets from operations	\$ (3,154,059)
Add (deduct) items not affecting cash:	
Gain on sale of investments	(443,721)
Change in unrealized depreciation on investments	5,924,589
	2,326,809
Net change in non-cash assets and liabilities	(780,882)
<b>Cash provided by operating activities</b>	<b>1,545,927</b>
<b>FINANCING ACTIVITIES</b>	
Borrowing of loan facility	6,000,000
Distributions paid to unitholders	(2,646,619)
Net proceeds from issuance of trust units	53,288,996
Payments for redemption and/or repurchase of trust units	(407,268)
<b>Cash provided by financing activities</b>	<b>56,235,109</b>
<b>INVESTING ACTIVITIES</b>	
Proceeds from sale of investments	24,657,928
Purchases of investments	(81,704,028)
<b>Cash used in investing activities</b>	<b>(57,046,100)</b>
<b>Net increase in cash during the period</b>	<b>734,936</b>
Cash and cash equivalents, beginning of period	-
<b>Cash and cash equivalents, end of period</b>	<b>\$ 734,936</b>

The accompanying notes are an integral part of these financial statements

# Statement of Investments

As at December 31, 2006

Number of Shares	Description	Average Cost (\$)	Market Value (\$)	% of Net Assets
<b>EQUITIES</b>				
<b>Canada</b>				
4,500	Jinshan Gold Mines Inc.	4,500,000	4,500,000	9.63
235,000	LionOre Mining International Ltd.	1,283,523	3,113,750	6.67
56,484	Sure Energy Inc.	60,707	53,095	0.11
<b>Total Equities</b>		<b>5,844,230</b>	<b>7,666,845</b>	<b>16.41</b>

Par Value (\$)	Description	Average Cost (\$)	Market Value (\$)	% of Net Assets
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## BONDS

<b>Canada</b>				
1,240,206	Canada Mortgage Acceptance Corporation 5.08% Mar 15/11	527,088	527,088	1.13
1,800,000	Dollarama Group LP 8.88% Aug 15/12	2,033,295	2,181,630	4.67
1,500,000	Harvest Operations Corp. 7.88% Oct 15/11	1,680,350	1,665,066	3.56
1,107,000	Marsulex Inc. 9.63% Jul 01/08	1,263,637	1,296,549	2.77
2,500,000	Masonite International Corporation 11.00% Apr 06/15	2,761,174	2,709,556	5.80
3,500,000	Paramount Resources Ltd. 9.86% Aug 28/12	3,903,375	4,058,508	8.69
4,000,000	The Jean Coutu Group (PJC) Inc. 8.50% Aug 01/14	4,258,608	4,714,046	10.09
		<b>16,427,527</b>	<b>17,152,443</b>	<b>36.71</b>

<b>United States</b>				
500,000	Hughes Network Systems LLC 9.50% Apr 15/14	576,676	611,107	1.31
		<b>576,676</b>	<b>611,107</b>	<b>1.31</b>

<b>Total Bonds</b>		<b>17,004,203</b>	<b>17,763,550</b>	<b>38.02</b>
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Number of Units	Description	Average Cost (\$)	Market Value (\$)	% of Net Assets
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## INCOME TRUSTS

<b>Canada</b>				
235,000	Avenir Diversified Income Trust	2,083,852	1,675,550	3.59
230,000	BlackWatch Energy Services Trust	2,300,000	1,400,700	3.00
72,700	Bonterra Energy Income Trust	2,123,856	1,858,939	3.98
100,000	CanWest MediaWorks Income Fund	954,000	690,000	1.48
197,500	Essential Energy Services Trust	1,802,700	1,028,975	2.20
97,900	First National Financial Income Fund	978,999	1,324,097	2.83
45,833	Harvest Energy Trust	1,565,047	1,202,200	2.57
408,800	KCP Income Fund	3,523,254	3,041,472	6.51
200,000	Movie Distribution Income Fund	1,746,751	1,640,000	3.51
123,300	Newport Partners Income Fund	1,164,940	713,907	1.53
50,000	Norcast Income Fund	424,250	345,500	0.74
200,000	Peak Energy Services Trust	2,415,897	1,000,000	2.14
100,000	Progress Energy Trust	1,741,389	1,257,000	2.69
135,000	Sound Energy Trust	1,134,000	689,850	1.48
165,000	Supremex Income Fund	1,650,000	1,397,550	2.99
287,000	The Data Group Income Fund	2,878,148	2,445,240	5.23
475,000	Vicwest Income Fund	6,565,948	4,835,500	10.35
<b>Total Income Trusts</b>		<b>35,053,031</b>	<b>26,546,480</b>	<b>56.82</b>

The accompanying notes are an integral part of these financial statements

# Statement of Investments

As at December 31, 2006

<b>TOTAL INVESTMENTS</b>	<b>57,901,464</b>	<b>51,976,875</b>	<b>111.25</b>
<b>Liabilities less other assets</b>		<b>(5,255,902)</b>	<b>(11.25)</b>
<b>NET ASSETS, AT MARKET VALUE</b>		<b>46,720,973</b>	<b>100.00</b>

The accompanying notes are an integral part of these financial statements

# Notes to Financial Statements

December 31, 2006

## 1. THE TRUST

Deans Knight Income and Growth Fund (the "Trust") is a closed-end investment trust established under the laws of the Province of Ontario by a Declaration of Trust dated February 23, 2006 ("Date of Inception") and amended March 15, 2006 (the "Declaration of Trust").

The Trust effectively began operations on March 16, 2006 when it completed an initial public offering of 5,200,000 units at \$10.00 per unit for gross proceeds of \$52.0 million. On April 6, 2006 an overallotment option granted to agents was exercised for an additional 475,000 units of the Trust at \$10.00 per unit for gross proceeds of \$4.75 million.

The Manager and Trustee of the Trust is Fairway Advisors Inc. (the "Manager").

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The following is a summary of significant accounting policies followed by the Trust in the preparation of its financial statements:

### *(a) Cash and cash equivalents*

Cash and cash equivalents consist of cash on deposit and short-term, interest bearing notes with a term to maturity of less than three months from the date of purchase.

### *(b) Valuation of Investments*

Investments in publicly traded securities are valued at the closing market price from the relevant exchange. Investments in securities for which closing market prices are not readily available are valued at the last reported sales price. If no sales price can be ascertained or if the securities are not quoted on an exchange, the value is based on the average of the last bid and ask prices quoted by a major dealer in such securities. Securities for which no such information is readily available are valued at fair value as determined by the Manager. The difference between market value and average cost, as recorded in the accounts, is shown as change in unrealized appreciation (depreciation) on investments.

Short-term investments, including notes and money market instruments, will be valued at cost plus accrued interest which approximates market value.

The value of any bonds, debentures and other debt obligations will be valued by taking the average of the bid and ask prices on the valuation date.

### *(c) Investment transactions and income recognition*

All investment transactions are accounted for on the trade date. Realized gains and losses from investment transactions and unrealized appreciation or depreciation in the value of investments are calculated on an average cost basis.

Interest income and expenses are recognized daily on an accrual basis.

Dividend income is recognized on the ex-dividend date.

Distributions from income trusts which are treated as dividend income, interest income or capital gains for tax purposes are included as dividend income, interest income or capital gains distributed from income trusts, as appropriate, in the statement of operations.

Distributions from income trusts which are treated as return of capital for income tax purposes reduce the average cost of the investment in the Trust on the statement of investments.

### *(d) Foreign currency translation*

Investments at market value and other assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the rate of exchange applicable on the valuation date. Investment transactions and income and expenses are translated at the rate of exchange on the date of such transactions.

### *(e) Forward foreign currency contracts*

Forward foreign currency contracts (see Note 8) are valued at current market value on each valuation day. Gains or losses incurred when forward foreign currency contracts entered into by the Trust, which are of the nature of a general hedge of the currency exposure of the underlying portfolio of investments, mature or are closed out are included in "realized foreign exchange gain (loss)" in the statement of operations.

# Notes to Financial Statements (continued)

December 31, 2006

## **(f) Futures contracts**

The value of a futures contract is the gain or loss that would be realized if, on the valuation date, the position in the futures contract was closed out. Margin paid or deposited in connection with futures contracts is reflected on the statement of investments. The unrealized gains or losses on futures contracts are reported as part of the change in unrealized appreciation or depreciation on investments until the contracts are closed out. Realized gains and losses from futures contracts that are specific hedges are accounted for in the same manner as the underlying instrument being hedged. All other realized gains and losses on futures contracts are accounted for as gains or losses and are included in net realized gain (loss) on investments in the Statement of Operations.

## **(g) Accounting estimates**

Allocations of distributions received from income trusts among dividends, interest and other income, capital gains, or return of capital are based on estimates of the categorization of distribution provided by those income trusts. These allocations may change once final categorizations of the distributions are received from the respective income trusts.

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires the Manager to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

## **(h) Net asset value per unit**

The net asset value per unit is computed by dividing the net assets of the Trust by the total number of units outstanding on the valuation date.

### **3. TAXATION**

The Trust qualifies as a “mutual fund trust” within the meaning of the Income Tax Act (Canada). The Trust is subject to applicable federal and provincial taxes on the amount of its net income for tax purposes for the period, including net realized taxable capital gains, to the extent such net income for tax purposes has not been paid or made payable to unitholders in the period.

No provision for income taxes has been recorded in the accompanying financial statements as all income and net realized capital gains are distributed to the unitholders.

Capital losses realized over and above realized capital gains in the current taxation year can be carried forward indefinitely and may be applied against future years' capital gains. Non-capital losses arising in tax years ending after 2005 may be carried forward for a period of twenty years and applied against future years' taxable income. Previously the carryforward period was ten years. If the non-capital losses are not applied within the relevant time frame from the taxation year in which the non-capital loss arose, the non-capital loss will expire.

As at December 31, 2006, the Trust had no capital or non-capital losses to carry forward into future years.

### **4. EXPENSES OF THE TRUST**

#### **(a) Management fees**

Pursuant to the Declaration of Trust, the Manager provides all administrative services required by the Trust, including the appointment of investment advisors to the Trust.

In return, the Manager receives a monthly fee at the annual rate of 1.10%, plus applicable taxes, of the net asset value of the Trust, calculated and payable monthly in arrears. The Manager is responsible for payment of the investment management fees of the Trust's Investment Advisor and Portfolio Manager out of its annual management fees.

#### **(b) Other expenses**

The Trust is responsible for all other expenses incurred in connection with its operation and administration, such as custodian, valuation, transfer agent, reporting, audit and legal fees. Brokerage commissions paid on securities transactions are not considered to be part of total expenses. These commissions are included in the cost of purchasing, or netted out of the proceeds from selling securities. For the period ended December 31, 2006, brokerage commissions were \$123,422.

The Trust will pay to registered dealers an annual service fee equal to 0.40% annually of the net asset value of units held by clients of the sales representatives of such dealers, calculated and payable quarterly in arrears. Dealer service fees for

# Notes to Financial Statements (continued)

December 31, 2006

the period were \$172,801 and are included in management fees in the Statement of Operations.

## 5. UNITHOLDERS' EQUITY

The Trust is authorized to issue an unlimited number of voting, transferable, redeemable trust units of one class, each of which represents an equal, undivided interest in the net assets of the Trust. On termination of the Trust unitholders will be entitled to receive their pro rata share of all of the assets of the Trust remaining after payment of all debts, liabilities and liquidation expenses.

The Trust is expected to terminate operations on March 31, 2016 (the "Termination Date") and the net assets will be distributed pro rata to unitholders unless an alternative later termination date is approved by the unitholders.

Beginning in 2007, units may be surrendered for redemption not more than 45 days, and at least 20 business days, prior to the second last business day of September in any year. Unitholders will receive a redemption price per unit equal to the net asset value per unit of the Trust determined as of the valuation date.

Additionally, and in accordance with the Declaration of Trust, unitholders are entitled to a monthly redemption at a redemption price equal to the lesser of:

- (a) 95% of the average of the daily weighted unit trading price for the 10 business days prior to the second last business day of the month (the "Redemption Date"); and
- (b) an amount equal to:
  - (i) the closing unit market price on the applicable Redemption Date, if there was trading on the applicable Redemption Date and the stock exchange provides a closing price;
  - (ii) an amount equal to the average of the highest and lowest prices of units on the applicable Redemption Date if there was trading on the applicable Redemption Date and the stock exchange provides only the highest and lowest trading prices of units on a particular day; or
  - (iii) the average of the last bid and ask prices on the applicable Redemption Date on the stock exchange if there was no trading on the applicable Redemption Date.

## 6. NET CAPITAL TRANSACTIONS

Net capital transactions for the Trust for the period from the Date of Inception to December 31, 2006 consisted of the following:

	Units	\$
Number of units outstanding, beginning of period	–	–
Subscriptions	5,675,000	56,750,000
Repurchase and cancellation of units (Notes 12, 13)	(55,700)	(439,338)
Issue costs (including agents' fees)	–	(3,461,004)
<b>Number of units outstanding, end of period</b>	<b>5,619,300</b>	<b>52,849,658</b>

## 7. LOAN FACILITY

The Manager, on behalf of the Trust, has entered into a revolving term credit facility with The Bank of Nova Scotia ("BNS"). The aggregate amount of borrowings under the credit facility and other forms of leverage may not exceed 25% of the total assets of the Trust at the time the borrowing or other transaction is entered into. The Trust has entered into a general security agreement providing BNS with a first charge on the assets of the Trust as collateral for indebtedness arising out of the credit facility.

The following table summarizes the loan drawn down by the Manager on behalf of the Trust as at December 31, 2006.

Loan Interest Rate and Maturity Date	Canadian Dollar Principal (\$)
4.36%, March 7, 2007	6,000,000
<b>Aggregate Loan Principal Drawn Down</b>	<b>6,000,000</b>

The highest amount drawn down on the loan facility in 2006 was \$6,000,000. The lowest amount drawn down on the loan facility in 2006 was nil.

## 8. FORWARD CONTRACTS

As at December 31, 2006, the Trust had entered into forward currency contracts to deliver currencies at specified future dates as follows:

<b>Sale</b>	USD
<b>Amount (\$)</b>	14,700,000
<b>Purchase</b>	CAD
<b>Amount (\$)</b>	16,862,958
<b>Settlement Date</b>	January 10, 2007
<b>Unrealized foreign exchange loss (\$)</b>	(262,450)

# Notes to Financial Statements (continued)

December 31, 2006

## 9. SECURITIES LENDING

In order to generate additional returns, the Trust may enter into securities lending agreements with borrowers deemed acceptable to the Trust. Under a securities lending agreement, the borrower must pay the Trust a negotiated securities lending fee, provide compensation to the Trust equal to any distributions received by the borrower on the securities borrowed and the Trust must receive collateral security of 102% for the loaned security.

There were no securities lending transactions during the period.

## 10. DISTRIBUTIONS

The Trust endeavours to make monthly cash distributions to unitholders consisting primarily of distributions received on securities in the investment portfolio and, in certain circumstances, of net realized capital gains from the investment portfolio. These monthly distributions will be paid to unitholders on or about the last business day of each month. The monthly distribution declared to unitholders of record, at the end of each month in the period, was \$0.05833 per unit.

## 11. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The Trust's investment activities expose it to various types of risk associated with the financial instruments in which it invests directly. In addition to the risks of investing in equity, income trust, bond and option markets generally, the Trust is subject to other risks, including the following:

### *Currency risk*

The Trust invests in securities denominated in currencies other than its reporting currency, the Canadian dollar. Consequently, the Trust is exposed to risks that the exchange rate of the Canadian dollar relative to the other currencies may change in a manner which has an adverse effect on the reported value of that portion of the Trust's assets. The Trust manages its currency risk through foreign currency hedging strategies.

### *Interest rate risk*

The Trust invests in interest-bearing securities. The income of the Trust may be affected by changes in interest rates relevant to particular securities or

as a result of the investment advisors being unable to secure similar returns on the expiry or sale of securities.

### *Credit risk*

Credit risk on financial instruments is the risk of a financial loss occurring as a result of the default of a counterparty on its obligation to the Trust. Credit risk is managed by dealing with counterparties the Trust believes to be creditworthy and by regular monitoring of credit exposures.

## 12. MARKET REPURCHASE PROGRAM

The Trust has the right (but not the obligation), exercisable in its sole discretion, at any time, to purchase (in the open market or by invitation for tenders) units for cancellation up to a maximum in any twelve-month period of up to 10% of the number of units outstanding at the commencement of such period, in all cases at prices not exceeding the net asset value per unit of the Trust on the valuation date immediately prior to the date of any such purchase. During the period, the Trust repurchased 38,400 units for cancellation under its market repurchase program at a total cost of \$299,354. The units repurchased for cancellation under the market repurchase program are included in repurchase and cancellation of trust units in the Statement of Changes in Net Assets.

## 13. NORMAL COURSE ISSUER BID

On July 12, 2006, the Manager issued a notice of intention (the "Notice") to repurchase units of the Trust through a normal course issuer bid (the "NCIB"). Under the NCIB, the Trust may purchase up to approximately 10% of the public float of units. Purchases of units commenced on July 14, 2006 and must terminate on July 13, 2007, or on such earlier date as the Trust may complete its purchases pursuant to the Notice. Purchases will be made in the open market through the facilities of the TSX in accordance with its rules and policies. The price that the Trust will pay for any such units may not exceed the net asset value per unit. Any units purchased by the Trust will be cancelled. All such purchases would be accretive and enhance returns to continuing unitholders. During the period, the Trust repurchased 17,300 units for cancellation via the NCIB at a cost of \$139,984. The units repurchased for cancellation under the NCIB are included in repurchase and cancellation of trust units in the Statement of Changes in Net Assets.

# Corporate Information

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Listed

**The Toronto Stock Exchange**

Ticker Symbol

**DKI.UN**

## About Fairway

Fairway is a specialized financial services firm focused on the creation, marketing, distribution and management of investment products in both traditional and alternative asset classes. Fairway's products are structured to provide yield enhancement, tax advantages and other benefits that complement the needs of Canadian investors. Fairway's principals are experienced investment professionals who share a strong track record as innovators in the Canadian securities industry.

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