LESTER
ASSET MANAGEMENT
RESPONSIBLE GROWTH

2019 FIRST QUARTER LETTER

April 25, 2019

We are pleased to present our 2019 first quarter results. The quarter was an exceptionally good one for our Canadian Equity strategy with a gross return (before fees) of +15%, ranking us #1 versus 82 other Canadian Equity managers in the **Pavilion Performance Appraisal Report** published by consulting firm **Mercer Global Investments**. Also, our 10-year gross annualized return of +15.7% continues to rank us #1 versus 69 peers.

We are also pleased to announce that our firm was selected for a mandate as part of the **Quebec Emerging Managers Program** ("QEMP") following a competitive and thorough due diligence process. As a result, we will be managing the **LAM Canadian Bond Fund** being launched on May 1st by **Innocap Investment Management Inc**. for QEMP's institutional clients**.** The QEMP was created to offer investment strategies to institutional investors seeking to diversify their sources of *alpha* by using emerging managers, promote entrepreneurship in finance by granting mandates to emerging managers, and to offer operational and structural support to new asset managers. This is the first true institutional mandate in our firm's history. We are very proud of this achievement as we believe it is a testament to the diligence, dedication and hard work of our entire team. Jordan Steiner, lead manager of our successful Canadian Fixed Income strategy will be managing this fund.

CANADIAN EQUITY

For the first quarter of 2019, the Lester Canadian Equity Fund rose by **+14.6%** net of fees and expenses, versus +13.3% for the TSX Composite total return including dividends. We are particularly proud of this outperformance since we have low exposure to the main sectors of the TSX namely Financials and Energy, and to the Healthcare sector which rose 50% and is now dominated by cannabis stocks. Our strong return was also helped by another take-over, our 40th in almost 13 years. Since inception in July 2006, our Canadian Equity strategy has produced a cumulative net return of **+220%**, more than double the +101% for the TSX. This represents an annual compound return of **+9.6%** net of all fees and expenses, versus +5.6% for the TSX. Measured in terms of "value added" active returns ("*alpha*"), we have generated **+4% per year net of fees in excess of the market's return** for nearly 13 years which included the financial crisis and several corrections.

Notable contributors to our returns in the first quarter of 2019 were:
Solium (+62%): Employee shareholder plan software provider agreed to be acquired by Morgan Stanley.
Blackberry (+39%): Security software leader is growing its sales and completed the acquisition of Cylance.
ATS Automation (+36%): Global automation solutions provider announced record backlog and bookings.
Goodfood (+33%): Canada's leading meal kit provider is rapidly growing its subscriber base and sales.
AG Growth (+33%): Manufacturer of grain storage & handling equipment was added to the TSX Composite.
Badger Daylighting (+26%): Hydrovac excavation provider posted record results and strong US growth.
Gibson Energy (+25%): Oil storage company is expanding its facilities and sold off its transportation business.
Keyera (+22%): Midstream LNG natural gas gatherer, processor and distributor announced good results.
Pembina Pipeline (+21%): Energy infrastructure firm announced strong results and expansion plans.
Sienna Senior Living (+20%): Canadian owner of retirement and long term care residences continues to grow.

The strong first quarter followed a brutal ending to 2018 during which global equity markets suffered a sharp correction on fears of an impending recession. As we stated at the time, the pull-back was mainly driven by computer program selling, the liquidation of large US funds and baskets of stocks from ETF redemptions, having nothing to do with actual company fundamentals. It appears that the "market" was wrong in predicting the next recession and that "the herd effect" took over. With the growth in automated trading and ETFs, bouts of over and undervaluation are becoming more pronounced and markets are becoming less efficient, creating better opportunities for active portfolio managers like us. Trying to "time the market" remains a mug's game, and what really matters when investing is "time in the market" allowing portfolios to grow over time.

While we took advantage of last year's correction to deploy cash and add positions in high quality businesses at more reasonable valuations such as **Stella Jones**, **CCL Industries**, **Dollarama**, and **ATS Automation**, we are cognisant that markets have being buoyed by central banks ceasing to raise rates for now and that the "punch bowl is back". TINA (There Is No Alternative) has now reappeared after a year hiatus. Thus, we continue to be disciplined in trimming positions as they become expensive and raising our cash weighting. Consequently, and as mentioned on previous occasions, we expect to lag the market if it continues to rise at the current rate.

US EQUITY

The US stock market, as did Canada's, bounced back sharply from the irrational selloff in the fourth quarter of last year. The stock market went from pricing in a recession in December to signaling that all is well by March. We think the truth is in the middle and that the global economy is slowing down from 2018 but will still manage to grow albeit at a decent pace.

It is odd to state that we feel somewhat disappointed that we have returned almost 10% in just the first 3 months of the year, yet we have lagged the indices. For the first quarter of 2019, our US strategy returned **+9.8%,** versus +13.7% for the S&P500 total return and +14.6% of the Russell 2000. We aim to beat the average of these two indices, hence our disappointment despite a nice lift to portfolios. What helped us beat the indices by a large margin in 2018 has hurt us so far this year, namely being overweight defensive names and carrying a cash cushion. We still believe this is the right way to be positioned in 2019 and have not changed our stance, although we have changed some holdings in our portfolio, as described below.

In our last letter we wrote about **Yatra**, the Indian online travel business. We talked about how great the macro tailwinds are of online travel in India, and how Yatra was a relatively cheap company considering its potential. Then in January we promptly sold it and replaced it with competitor **Makemytrip**. We aren't in the habit of entering and exiting a name so quickly, so the following explains our rational. It was not any change in the great macro environment. India's middle class is continuing to grow and beginning to travel, with more and more people using smartphone apps to book their trips. What we saw was that Yatra's growth rate had slowed, while the growth rate of the largest player in the space was accelerating. History has taught us in this type of industry it is better to be the biggest player as most of the profits aggregate to one or two winners. In search engines think Google versus Yahoo, Altavista and Ask Jeeves, or in the travel industry, Expedia and Booking.com. We knew Yatra was smaller when we bought it but figured we were being compensated for that through a much lower valuation. After both companies reported their divergent earnings reports, we were more comfortable selling Yatra for the same price which we bought it at and buying market leader Makemytrip. There are also reports the Indian government is opposed to foreign companies buying local e-commerce players like Yatra and Makemytrip, encouraging local champions to emerge. Thus, we prefer to be invested with the largest, fastest growing player who has the greatest chance of succeeding independently.

During all this research in the online travel space, we were always using the global leader **Booking.com** (formerly Priceline) as the "benchmark". Booking.com is the global standard with over 2 million hotels on its platform, extremely high margins, and a US $80 billion market cap. The stock was a great performer for many years, and then has gone sideways for the last two. During that time, profits continued to rise. We realized on a valuation basis the stock was trading at its cheapest levels since 2010. While it is true that its fastest growth is behind it, it should still be able to grow profits at a comfortable 10% per year for a long time yet. We are happy when we find reasonably priced companies with built in growth and have very large moats. Being integrated with over 2 million hotels is a very large moat indeed.

FIXED INCOME

Bond prices rebounded in a big way during the first quarter of 2019 as yields continued to drop despite the stock market rally. This is an unusual occurrence as bond yields generally rise when stocks are climbing. During the quarter, our Fixed Income strategy returned **+3.6%** on a gross basis, slightly lagging the +3.9% return of the Canada Universe Bond Index and +4.5% for the Canada HYBrid Bond Index. The falling rate phenomenon above can be explained by the U-turn undertaken by both the US Federal Reserve and the Bank of Canada. Both central banks switched from talking about more rate hikes to discussing extended pauses or even more accommodative monetary policy. This caused investors to start pricing in rate cuts at some point in the next few years, and the softer policy discussion provided an extra boost to bonds as well as stocks.

Corporate bond spreads narrowed during the quarter after widening substantially last November and December. This isn't surprising to us, as the market was almost pricing a 2019 recession that doesn't appear to be materializing. Instead, it looks like more slow and steady growth. And that's good news for the bond market with the economy not too hot, nor too cold, and inflation under control.

With spreads being tighter, we continue to be selective when adding new holdings, and look for opportunities to top up the high yield positions we like when we can. Preferred shares have not experienced the same rally as the rest of the fixed income market. We are looking at adding more as we think they offer the best risk adjusted return in the market today. Our overall fixed income portfolios are still offering attractive yields on a blended basis and we believe that we are reducing risk by increasing the ratio of investment grade issuers. This will give us the flexibility to quickly shift back to mostly high yield positions when the time is right.

MACROECONOMIC OUTLOOK

Improving Fundamentals

Since the December low in stock prices, the major indices in Canada and the US are up close to 20%, one of the sharpest rallies on record. While obviously good news for equity investors, such strong upward moves usually create an "overbought" situation, setting the stage for a correction. However, notwithstanding this near-term risk, investors should note that most of the basic fundamentals have been improving. Therefore, any near-term correction is likely to be temporary.

On the monetary front, the broad measure of money supply (M_2) has picked up after several months of decline, signifying improving liquidity which is always good for equities. The yield curve, which measures the gap between short and long-term interest rates, had narrowed sharply in the previous two years, reflecting Bank of Canada and Federal Reserve tightening. This created fears of a central bank-led recession and ignited investor concerns, contributing significantly to the fourth quarter market decline. In recent weeks, the yield curve has steepened again (long rates rising relative to short rates) by 15-20 basis points, reducing fears of an imminent recession and thereby supporting the stock market rally. Most importantly, both the Canadian and US central bank have indicated that any further tightening is on hold as trade disputes continue to overhang the market. Another reason is that there has been a marked softening in inflation. Currently, various measures of inflation are below central bank targets, leaving room to keep adding liquidity to the system. Looming elections in both Canada and the US also are important factors as central banks always try to avoid the risk of being blamed for negatively affecting election outcomes. Policy is, therefore, likely to remain benign.

During the latter part of 2018, many pundits had become concerned that monetary tightening by the Federal Reserve and Bank of Canada, combined with very weak Chinese and European economies, would create a recession in the 2019-2020 period. That, in turn, had a negative impact on corporate profit expectations. Those fears have been substantially lifted as monetary policy is now expected to remain supportive and the Chinese and European economies are rebounding which will have spillover effects on the world. While economic growth in North America is likely to be slower than in recent years, it is likely to be satisfactory while not creating inflationary fears. As a result, 2019-2020 looks to be shaping up as a possible replay of the 2014-2015 period when a soft economy and stock market transitioned to a stronger 2016-2017.

Canada has additional positives going for it. The WTI oil price, after dropping about 50% in 2018, has rebounded by about 60%. The spread between Alberta and WTI prices has narrowed in Canada's favour with the result that the Western Canada select price is up about 100% from the December low. Needless to say, oil is very important for Canada. Again, comparing the current period with 2014-2016, the oil price then fell about 75%. It then rose in both countries in the following two years by more than 100%, providing a huge support to stock prices and the economy in that period. It should also be noted that the outlook for energy policy in Canada has sharply improved with the elections of "conservative" governments in Quebec, Ontario and Alberta. And PEI just elected another Conservative government. The Federal Government will be paying close attention to this shift in the political winds and is becoming more energy sector friendly. Prospects for pipeline expansion in Alberta have improved considerably, another hugely important development in Canada.

On the fixed income side, there have also been significant improvements in the first quarter, as discussed earlier in this report. Prices of both government and corporate bonds rose significantly, producing good returns for investors. The yield curve also improved (steepened) and the spread between government and riskier corporate bonds narrowed as concerns for a recessionary economic outlook abated. With inflation well under control, the environment for fixed income investors should remain positive.

Conclusion

The improvement in fundamentals has been considerable and psychology has become much more positive compared with the latter part of 2018. Notwithstanding the risks of a near-term correction, the market is likely to have a good year. The rally in the first quarter of this year was broadly based in both the US and Canada as the number of stocks advancing far exceeded those declining, a very comforting sign in a market rally. It should also be kept in mind that the Canadian stock market has lagged the US in recent years due to negative investor sentiment, particularly regarding the resource sector, and with improving fundamentals in Canada and attractive equity valuations relative to the US, some catch-up is likely.

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