2018 FIRST QUARTER LETTER

April 24, 2018

We are pleased to present our 2018 first quarter results. On January 22nd, we wrote the following in our 2017 year-end letter: *"Such a mix of high stock valuations, rising interest rates and increasing borrowing costs doesn't usually make for a good cocktail. We therefore expect the party to end soon with TINA (There is No Alternative), as the punch bowl is being withdrawn. Equity markets are likely to become more volatile and good returns difficult to achieve."* We admit that we were more lucky than smart in getting the timing right — just four days before a 10%+ plunge in the S&P 500 — however, the reasoning behind our analysis that stock markets were vulnerable was correct. As can be seen from our results, our large cash balances and low exposure to more volatile sectors helped us outperform in a difficult first quarter. That being said, we expect to lag if markets rebound as we continue to conserve cash.

CANADIAN EQUITY

For the first quarter of 2018, the Lester Canadian Equity Fund decreased by **-2.4%** net of fees and expenses, versus -4.5% for the TSX Composite total return including dividends. Our outperformance was mainly due to low exposure to the resource and financial sectors which hurt the TSX, and our high cash weighting. We were also helped by yet another take-over, representing our 38th in almost 12 years. Since inception in July 2006, our Canadian equity strategy has produced a cumulative net return of **+215.6%,** more than double the +85.9% for the TSX. This represents an annual compound return of **+10.3%** over nearly 12 years, net of all fees and expenses, versus +5.4% for the TSX. Measured in terms of "value added" active net returns, we have generated **+4.9%** per year over and above the market's +5.4% return during this period.

Notable contributors to our returns in the first quarter of 2018 were:
NeuLion (+102%): Live sports video streaming technology provider received a take-over offer.
Andrew Peller (+16%): Canada's second largest wine producer and marketer posted strong results.
Diamond Estates (+12%): Small vintner is benefiting from expanded distribution in Ontario grocery stores.
Baylin (+12%): Leading developer of wireless antennae is launching new products and made an acquisition.
Logistec (+9%): Marine cargo & environmental services firm announced strong results and an acquisition.
CGI Group (+9%): World leading IT consulting firm has a strong backlog and expanding margins.
Park Lawn (+7%): Owner of cemeteries and funeral homes announced further acquisitions in the U.S.
GoodFood (+7%): Canada's leading meal kit supplier is rapidly growing its subscriber base and revenues.

Over the past few years, we have repeatedly stated that the stock market was expensive yet there were always bargains to be found. Remarkably, as the general market got more expensive (mainly large cap valuations inflated by massive amounts of money flowing into ETFs and manias such as cryptocurrencies, blockchain and marijuana stocks), bargains in the small/mid cap space multiplied. This is because money was being sucked out of the less popular areas of the market and going into the more popular ones. Another reason is because there are fewer managers like us who are flexible enough to take advantage of such market inefficiencies.

Despite the recent market correction, we still find stocks expensive, particularly large cap liquid stocks in the popular indices. These are the most vulnerable to bad news, which is exactly what we saw in the recent market volatility as higher inflation reared its ugly head and Donald Trump threatened trade wars. We took advantage of this volatility to start building a position in **CN Rail**. We therefore remain cautious and are redeploying cash slowly, topping up some of our existing holdings and initiating new positions on market weakness.

US EQUITY

The first quarter of 2018 marked the return of volatility to US equity markets. Markets started off the year up over +7% in the first 3 weeks before seeing the first correction (a drop of -10% or more) in over 2 years. The cause of the selloff was a fear that increasing inflation would force the Federal Reserve to raise rates at a quicker pace than expected by the market. These fears abated somewhat by the end of the quarter, however the S&P500 was still down -0.8% while the Russell was down -0.1%. LAM managed to post a modest gain of **+0.6%** due to some of our small caps faring well and our healthy cash position.

Our 2 biggest winners were both positions we talked about in our last letter. We finally sold Dillard's at an average price of $85 after it had appreciated 25% in the quarter. Dillard's has a large short position which makes it prone to large swings, both up and down. We have successfully traded it in the past adding on weakness and trimming on strength. This time, we felt the move up was large enough that we should exit the entire position. We still believe the Dillard family will eventually buy out minority shareholders, but logically they will do so when the stock price is weak, not when the shares are trading at a 2-year high. At the pace of recent stock buybacks, the family will run out of shares to purchase on the open market in 3 years. We will look to repurchase shares when the market sours on brick-and-mortar retailers again, as it invariably will.

AMAG pharmaceutical convertible bonds also performed well in the quarter. The bonds had faded in price from the time we purchased them, from 98 to 86. However, in the quarter they rebounded to 103 cents due to two positive developments. Firstly, AMAG received FDA approval to broaden the label of one product, effectively doubling the addressable market. Secondly, the FDA also approved a new delivery system for their one blockbuster drug, which should extend the revenue stream after competing generics arrive later this year. All this should fully backstop the value of our convertibles from any downside risk, and we still get to participate in the upside should their next blockbuster drug get approved (expected Q1 2019). We continue to collect a small coupon while we wait. As we said last quarter, we like the asymmetry of this investment and it shows the value of being able to invest in both the equity and debt markets.

Looking into the second quarter, U.S. markets seem to be concerned about brewing trade wars with China and others. Our companies should be less affected as small caps tend to be domestically focused. We continue to hold large cash balances and welcome the volatility, as it eventually leads to more attractive opportunities.

FIXED INCOME

Our fixed income strategy returned approximately **+0.6%** before fees and cash drag, with individual accounts returning +0.4% to +0.6%. The Canada Universe Bond Index returned +0.1% due to its higher weighting of long term government bonds, and the HYBrid Bond Index returned +0.7% thanks to its higher coupon rates. During the quarter, Canadian interest rates continued to climb, peaking at 2.38% for the 10-year Canada bond. By the end of the quarter, much of the increase had reversed, ending at 2.13%, marginally above year-end 2017 levels. The bond market tracked the Canadian economy which appears to have cooled off towards the end of 2017, and which has shown signs of slowing in the early part of 2018. We expect the economy to level out closer to its +2% to +2.5% growth rate. That muted pace of growth may still require the Bank of Canada to hike rates later this year given that the Canadian economy is close to its long run potential. Expectations are for a summer hike, yet, if the data continues to come in softer than expected, that hike could get pushed out further. We are somewhat immune to the vagaries of the BOC interest rate policy timing given that our portfolio continues to have low duration of 3 to 4 years and much higher coupon rates than most bond managers. This tends to have a dampening effect from the impact of government rate changes on our portfolio. We still view this as a time for caution in the bond markets with spreads for corporate issuers relatively tight. Therefore, we are continuing our barbell approach of adding investment grade names coupled with unrated bonds that carry much higher yields. We are also beginning to selectively sell some of the preferred shares we accumulated in 2015, as they have appreciated in value and yields are not as attractive as when we purchased them. This ensures we have cash to put to work when spreads widen, and we see better opportunities.

THE THREAT OF U.S. PROTECTIONISM

Since Donald Trump came onto the political scene, he has been threatening to start trade wars and tear up NAFTA, which has been a cornerstone of Canada-U.S. trade for three decades. It is clearly far more important to Canada than the TPP and its successor. This has naturally been a cause of concern for investors in Canada, but the concern seems to be exaggerated for a number of reasons. At this point however, it is difficult to be sure what will happen to Canada-U.S. trade because the bargaining postures of both countries changes significantly from day-to-day. However, we can get a sense of what is likely to happen by looking at some background factors.

First, the integration of North America's economic system began well before NAFTA was signed in the early 1990s. NAFTA moved the restructuring process a lot further and there now exists highly complex supply chains that companies will fight hard to maintain. Corporate managers have demonstrated that they are highly adaptable in getting around obstacles.

Second, NAFTA is seriously out of date; it is a trade agreement for the second half of the 20th century. The North American industrial structure, based on totally new technologies and services, has changed dramatically in the last 10 to 15 years based on the new digital world. NAFTA will have to be revised in any case and this could well be positive for Canada as a whole.

Third, the overall balance of payments situation between the two countries is not a big deal. U.S. data for 2017, which is usually more favourable to the U.S. than to Canada, shows the U.S. had a trade deficit of $18 billion in goods and a surplus of $26 billion in services for an overall surplus of almost $8 billion.

Fourth, NAFTA is only one of many important issues reshaping North American economies. These would include security, continental energy policies, the dominance of service industries, climate change, inadequate and outdated infrastructure. In addition, there are huge demographic, immigration, health and other issues. The future of NAFTA is just one of many complex issues facing both Canada and the U.S. All of these raise serious questions of competitiveness for both the U.S. and Canada, and negotiations on these issues will take years and require thoughtful people on both sides. Both countries have a huge vested interest in reaching an optimal resolution.

Fifth, Trump, in spite of appearances, is a smart negotiator and ultimately rational. He plays the bully and doesn't mind coming across as a little crazy — both good bargaining tactics. But, in the end, he needs to show some progress on trade before the coming elections which look bad for Republicans. He also needs a good stock market since he uses that as a measure of his personal success. Each time he threatens serious protectionist action, the market drops and then he backs off. He wants a quick win on a NAFTA deal to fit in with the election cycle and he will only get this if he makes compromises, which he has been doing.

Conclusion:

In the short term, we should assume that Trump is rational and that a revised NAFTA will occur that will not be a big problem for Canada and could even be quite positive. Longer term, there is a high degree of uncertainty over trade as the U.S. political landscape could change markedly after the November elections. Republicans could well lose one or both the House and the Senate. And, the Canadian political landscape is also being shaken up. Federal/provincial constitutional battles are now in the open. The Federal Government finally seems to understand that it has played a material role in souring the investment climate in Canada. It seems ready to step up to the plate and start making some needed painful changes, but how far it will go, and the timing, are still open questions. The fundamental issues, as pointed out above, between the two countries—and there are many—are extremely complex. It will take years to work them out and require a lot of brain power and experience, but both countries have a strong vested interest in a win-win resolution. In the meantime, uncertainty prevails but the likelihood of a trade war between the U.S. and Canada is not high.

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