2018 SECOND QUARTER LETTER

July 20, 2018

CANADIAN EQUITY

For the second quarter of 2018, the Lester Canadian Equity Fund decreased by **-0.2%** net of fees and expenses, versus a rise of +6.8% for the TSX Composite Total Return including dividends. Our underperformance was due to our low weightings in the energy and materials sector, high weightings in utilities and cash, and declines in the value of several of our small cap holdings. The energy and materials sectors were up +17% and +8% respectively during the quarter and were responsible for nearly +5% of the rise in the TSX. Year-to-date, we are down **-2.6%** versus +1.9% for the TSX for the same reasons as outlined above. Since inception in July 2006, our Canadian equity strategy has produced a cumulative net return of **+215%,** more than double the +98% for the TSX. This represents an annual compound return of **+10%** per year over 12 years, net of all fees and expenses, versus +5.9% for the TSX Total Return including dividends. Measured in terms of "value added" active net returns, we have generated **+4.1%** per year over and above the market's return during this period.

Notable contributors in the second quarter of 2018 were:
Badger Daylighting (+23%): Hydrovac truck excavator continues to post strong growth in sales and profits.
CN Rail (+14%): Having reinvested in its infrastructure, CN is "back on track" servicing its customers' growth.
Pembina Pipeline (+13%): Energy infrastructure operator posted good results and a robust outlook.
Logistec (+12%): Marine cargo & environmental services firm announced strong results and an acquisition.
CGI Group (+12%): World leading IT consulting firm has a strong backlog and is expanding profit margins.

Notable detractors included:
Centric Health (-38%): Specialty pharma and clinic operator dropped on negative regulatory reforms.
Input Capital (-21%): Canola royalty streaming company stock weakened amid lower capital deployment.
Velan (-17%): Global valve manufacturer released weak results and backlog amidst intense competition.
Baylin Technologies (-17%): Wireless antenna maker raised equity at a discount to finance an acquisition.
Rogers Sugar (-15%): Delays in integrating acquisitions in the maple syrup industry caused stock to sell off.

In our first quarter letter, we mentioned that "*we expect to lag if markets rebound"*. That was indeed the case during the second quarter as the TSX recovered strongly from its slump, mainly on the back of volatile resource stocks which we have traditionally been significantly underweight. Over the years, we have had a few such periods of underperformance, particularly when oil and mining stocks rise sharply, although these tend to be rather short lived. We prefer avoiding investments in sectors and companies that depend on the prices of commodities that management has little or no control of, and that eventually "self correct" when production increases and supply outstrips demand. While such moves in commodities may present "trading opportunities' or benefit from "momentum investing", our long term buy-and-hold philosophy is not conducive to exposing our clients' funds to the risks and uncertainties of such cyclical sectors.

We remain confident that disciplined and patient investing with a focus on value wins the race, and that by not following the herd we are able to distinguish ourselves from it in a meaningfully positive way as we have done over the past 12 years. Despite our view that stock markets are expensive, we see tremendous value in our portfolio holdings which will surface over time. Nevertheless, we see heightened risks in the market from escalating trade wars and protectionism, higher borrowing costs from rising interest rates, and potential instability in the Eurozone from Italy's new populist government and Brexit. Consequently, we continue to hold high weightings in defensive stocks and cash, and are selectively adding new positions where we see significant upside over the next few years, while trimming others that are fully valued.

US EQUITY

Last quarter we talked about the risks of a potential trade war emanating out of the US and how in theory small cap US focused stocks should outperform large caps given their almost exclusive domestic exposure versus large caps that sell their products all over the world. Luckily for us that prediction came to pass, benefitting our US portfolio. For the quarter, our US strategy was up +**6.3%** versus +3.4% for the S&P500 and +**7.8%** for the Russell 2000. Year-to-date, we are up +**6.9%** versus +2.7% for the S&P500 and +7.7% for the Russell 2000. We are pleased with these numbers, especially considering we have been carrying a large cash position that ended the quarter at approximately 16%.

Our winners were widespread this quarter and we were quite active in trimming some names that have had big runs and adding to others that have pulled back for what we think are the wrong reasons. One of the winning positions was **Friedman Industries** (FRD), a name we haven't mentioned before mainly because it is an extremely boring company. Friedman runs a single steel mill in east Texas. The company goes through periods of decent profitability and periods when it breaks even. What was interesting to us when we purchased shares was that the company was a classic Benjamin Graham "net-net". "Net-net" means a company whose current assets (cash + inventory + accounts receivable) minus all of it's liabilities is equal to or greater than its market cap. In theory, if such a company were to go bankrupt and sell off everything to distribute to shareholders, you would get more than the current share price. Such an investment is obviously low risk, and when we purchased shares we viewed it as a good place to wait until profitability returned and the shares traded up. Thanks to Trump's steel tariffs, FRD had bumper first quarter results and the stock rallied 38%. We will most likely hold a little while longer but eventually exit, as the thesis plays out.

A new investment we made in the quarter was **Mercado Libre** (MELI). Clients often ask us why we don't invest in fun companies like Amazon or Netflix. In truth, it is difficult for value investors to purchase these fast-growing companies as they don't yet generate much cash flow or earnings. We can see that they are clearly dominate businesses, but Amazon at a $400 billion market cap makes as much sense to us as Amazon at $800 billion. They are both equally valid guesses as to what Amazon can generate in profits in the very distant future. What's more interesting to us, is finding companies that are following the well-established road maps of these internet trailblazers, yet are not reflecting that fact in their stock price. MELI is effectively the Amazon+ Paypal of Latin America. It is the biggest online marketplace and the largest online payment system in the region, with a specific focus on Brazil and Argentina. Founded in 1999, the company is following the Amazon playbook and growing rapidly. MELI has generated strong profit margins in the past, but is currently reinvesting in the business to build an even stronger moat, being the first player in the region to offer free shipping. It`s the right move to make for the long term as eventually other players will enter the space and offer free shipping as well. MELI will build on their first mover advantage as much as possible. MELI may be a volatile investment in the short term, with exposure to Brazil and Argentina`s currencies, but in the long run we think it will be a phenomenal success, and that its current market cap of $13 billion is cheap given the size of the prize.

Finally, a note on our large cash position. As David Rosenberg recently said in the Globe & Mail, "cash is no longer trash". With US 2-year Treasury bonds now yielding around 2.5%, we are investing much of our cash balances into a very liquid Vanguard ETF of short term US bonds. We can sell these in an instant if the right opportunities present themselves, waiting patiently while earning a better yield than has been possible for 10 years. This also gives us more freedom to trim holdings that we view as having reached full value without worrying about redeploying funds back into suboptimal investments. We continue to see the US market as expensive, and are thus easing into new names while selling older investments that are fully valued.

CANADIAN FIXED INCOME

It was another solid quarter for our Canadian fixed income strategy with a gross return before cash drag of **+1.2%** versus +0.5% for the Canada Universe Bond Index and +0.7% for the Canada HYBrid Bond Index. Client portfolio returns ranged between **+0.7% and +0.9%** after fees and cash drag. Year-to-date, our fixed income portfolio is up +**1.9%** gross versus +0.6% for the Universe and +1.4% for the HYBrid index respectively.

Interest rates hit multi-year highs in May with the Canada 10-year yield spiking at over 2.5%, however by the end of the quarter it had retraced entirely ending at 2.17%. The move up was driven by positive Canadian economic data and the move down coincided with Trump beginning his trade war with Canada on steel, threatening to escalate it by imposing auto tariffs. Ontario has a strong auto parts industry (Magna, Linamar, and Martinrea) and such a move could be very damaging to the Canadian manufacturing sector. The market was originally betting that with such a threat hanging over the country, the Bank of Canada would be hesitant to raise rates too quickly. Nevertheless, Stephen Poloz raised rates for the fourth time in 12 months. He will likely put rate hikes on pause should economic data start to show a negative impact from US tariffs.

We are looking past the noise and thinking more long term. That means evaluating where we are in the economic cycle and if we are being adequately paid to take on credit risk. Our feeling is that we are getting closer to the end of this cycle given that we are 9 years into the economic expansion, and that bond spreads are still too tight given high corporate debt levels. As such, we are continuing to improve the credit quality of our bond portfolio. While still buying lower rated high yield bonds, we are moving into safer names, as well as adding higher quality investment grade issuers. Though we are sacrificing a small amount of yield today, we think this will be justified to avoid a downdraft when markets become fearful and riskier bonds fall in value.

TRADE WARS

In our last quarterly letter, we commented on President Trump, his protectionist policies and risks for the Canadian economy and the stock market. We took a relatively sanguine view of those risks and said that, in spite of a high degree of uncertainty, the likelihood of a trade war between Canada and the U.S. was not high. This was mainly because a trade war is a lose-lose proposition and we believe that rational minds would prevail. In light of the last three months of Trump's escalated rhetoric and bullying posture, and particularly his recent imposition of additional tariffs on Chinese imports, it is worth revisiting these risks.

Experience—recent and longer-term—shows that Trump is rational when looked at from his perspective and what he is trying to accomplish. Ultimately, he wants a deal with China, the European Union and Canada on trade that will be a win for the U.S. and he has a strong hand for two reasons. Firstly, the U.S. is a huge market and it is running an $800 billion global trade deficit on goods. Secondly, China, the European Union and Canada do have some protectionist policies in place that the U.S. has always found to be unfair. However, compared to China, both other economies are relatively open and, even using U.S. data, Canada runs an overall current account deficit with the U.S, not a surplus. The balance with Canada is simply not a big deal in the total U.S. trade picture. However, we should not expect Trump to back down on his pressure tactics.

To understand Trump better, it is important to look closely at how he operates. An excellent analysis was recently written by Daniel Greenfield. It provides clear insights into the posture that Trump has always taken to get the deal he wants. Greenfield asserts that Trump follows five basic rules, and this applies to his negotiations on foreign policy:

1. *Act, Don't React*
2. *Try Everything*
3. *Chaos is Power*
4. *Never Show Your Hand*
5. *Don't Be Afraid to be the Bad Guy*[1]

[1] Daniel Greenfield, "Trump's 5 Rules for Ruling the World," *Frontpage Mag* (June 15, 2018).

Trump always prefers to make the first move, giving others no choice but to respond. He counts on others' need for a return to stability to create opportunities that he can exploit and is not afraid to fail and try something different. Unlike most leaders, he doesn't care about looking like the bad guy. Bullying, lying, fake news and made-up data are all fair game. Anything to take the offence and make the other side uncomfortable enough to offer concessions. This is Greenfield's assessment and we think he's bang on. When viewed by others, Trump obviously appears thoroughly unlikeable and comes across as ignorant of basic economics and the historic fundamentals and logic behind the complex web of global trade agreements and supply chains.

He is likely going to get some kind of win against China, the EU and Canada because they have more to lose than the U.S. However, because of the way Trump operates, it is not possible to say how things will play out with any certainty. He can and does change his mind in an instant, a master of the bait and switch. But the way he operates is very consistent and rational from his perspective. Further, his popularity has been rising in the U.S., indicating that a lot of Americans like what he is trying to do and admire the tough guy posturing. This provides him with positive feedback, so we can expect more of the same.

Canada does have a number of protectionist and non-free market policies. Supply management and marketing boards in the dairy industry, for example, have always been troublesome for the U.S. and not necessarily in the best interest of Canadians, who are forced to pay high prices to benefit a small number of farmers. However, it should be kept in mind that Canada's dairy industry is only worth about $15 billion. The total dairy trade (imports and exports) is valued at about $1 billion. Canada's dairy imports are four times its exports. The lumber industry is also a continuing contentious issue but that has to do primarily with the structure of the industry. The big point, however, is that, contrary to fake news generated in the U.S., Canada actually had an overall current account deficit with the U.S, not a surplus. For the 12 months ended March 2018, a U.S. surplus on services of $25.6 billion more than offset a deficit of $13.9 billion on traded goods. That U.S. deficit in goods dropped 10% from the previous 12 months and amounts to under 0.1% of U.S. GDP.

It is also worth pointing out that much of the total U.S. trade deficit in goods of $800 billion with the world (of which Canada's portion is less than 2%) is caused by the U.S. fiscal deficit, which will be boosted sharply by Trump's tax cuts. Fiddling with tariffs while the U.S. economy is already at full employment will not likely move the needle much on the U.S. trade deficit. Further, as protectionist pressure escalates, the U.S. dollar rises. Its trade-weighted value is up 8% since the end of January. In Canada's case, our currency has fallen about the same amount against the U.S. dollar since September 2017. Devaluation of the Canadian dollar will benefit Canada's trade by making our exports more competitive and making imports less competitive (i.e. more expensive). Thus, currency depreciation will provide an important offset to increased U.S. tariffs.

The bottom line is that even though the data shows that Canada is not the villain behind the U.S. trade deficit as Trump claims, we are still in his crosshairs. Uncertainty and risk have clearly risen but it is premature to get too bearish on the trade front alone. How things will play out is quite complex but there are important potential offsets if the U.S. persists with the imposition of higher tariffs on Canada or a detrimentally revised NAFTA agreement.

Conclusion

The problem for Canada is that we have no idea what a revised NAFTA agreement would look like, how long it could take to get a deal (Trump postponed negotiations until after the mid-term elections), whether we will ever get a deal and what sort of tariff and non-tariff agreements could finally be reached. In the meantime, economies, businesses and markets hate uncertainty, risk and particularly chaos. Given Trump's *modus operandi*, which thrives on chaos and unpredictability, investors are having to live with this. The rational response for investors to take in the face of increased risk is to take a more conservative stance.

HOUSEKEEPING ITEMS

Please note that you received extra documents in your quarterly mailing. This is part of our ongoing compliance with the second phase of the Client Relationship Model (CRMII) information that securities regulators require us to present to you annually on an account by account rather than household basis. It contains useful information for you, the client, though it is different from the quarterly format that you are used to receiving from us (some of the information may be repetitive to our standard mailing). As well, we have included a note on Custody Disclosure, also newly required by regulators. Please read these documents at your leisure. It is also important for you to let us know as soon as there are any significant life changes that may affect the way we should be managing your portfolios.

Finally, as you are hopefully aware by now, the Bell Media building at 1800 McGill College in which our office is located suffered a serious roof fire on Friday July 13th. Thankfully we evacuated the premises safely. We also had a contingency plan in place for such a situation in order to continue operating seamlessly and service our clients without interruption. Our temporary offices are located at 1002 Sherbrooke Street West, suite 1725 only a few blocks away, and we will advise you once we return to 1800 McGill College. Meanwhile, feel free to drop us a line at our regular number (514-849-5566) and we thank you for your understanding.

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