2019 THIRD QUARTER LETTER

October 22, 2019

CANADIAN EQUITY

For the third quarter of 2019, the Lester Canadian Equity Fund declined **-3.6%** net of fees and expenses, versus +2.5% for the TSX Composite total return including dividends. Year-to-date, the fund is up +**10.4%** net of fees and expenses (**+11.5%** on a gross basis) versus +19.1% for the TSX. Our underperformance in the quarter was mainly due to our zero exposure to the Gold sector, low weighting in Financials, high weighting in Industrials, some company specific events and cash drag. While we are not satisfied with these results, there are times when our investments will lag the market such as during the third quarter of 2015 following which we significantly outperformed during the next 2 years as shareholder value surfaced. Nevertheless, we are focused on improving returns and remain confident that our portfolio holds significant unrealized value and upside.

Notable contributors and detractors in the third quarter were:
Diamond Estates Wines (+45%): Announced Lassonde bought a 20% stake and will expand retail distribution.
Altus Group (+25%): Real estate services provider continues to grow its recurring analytics software revenue.
Boralex (+15%): Renewable energy producer posted good results while growing its list of power projects.
Algonquin (+14%): Utility and renewable energy producer announced conversion of coal plant to wind power.
Baylin (-41%): Wireless antenna maker warned of weaker results yet announced its largest contract ever.
Blackberry (-29%): Leading provider of security software reported lower than expected revenues.
NFI Group (-24%): Largest North American bus manufacturer lowered its delivery guidance of motor coaches.
AG Growth (-19%): Trade wars and bad weather are causing delays in agricultural infrastructure spending.

Despite the third quarter "air pocket", we continue to stay the course by favoring attractively priced stocks with low economic sensitivity and remain confident that our portfolio is well positioned for strong long-term returns. A good example is long-time microcap holding **Diamond Estates Wines & Spirits**. In July, the company announced that Quebec-based Lassonde Industries acquired 20% of the company. Lassonde is one of North America's largest fruit juice manufacturers and is also in the wine business. In acquiring a stake in Diamond, Lassonde sees a chance to expand in this growing beverage category which is also benefitting from deregulation in Ontario by allowing local vintners to increase sales in the grocery and convenience store channel. Diamond will benefit from Lassonde's national salesforce and distribution, strong agency presence in Quebec, and bottling and packaging expertise. We think Lassonde will eventually acquire the rest of Diamond at a significant premium to what its shares are trading at today, and thus increased our position in the company.

During the quarter we also increased our weighting in **Enbridge** as it continues to pay a healthy 6.3% dividend. Given the difficulty in getting new pipelines approved, companies like Enbridge with existing infrastructure will become more valuable. We also increased our weighting in **TECSYS**, another recent addition. TECSYS is a Montreal-based supply chain management solutions provider, specializing in complex distribution to hospitals and other high-volume businesses. The company is in the process of transitioning from a perpetual license to a SaaS (Software as a Service) model which temporarily depresses reported revenue. We bought the stock at an attractive valuation as it pulled back on this perceived slowdown in growth. Meanwhile, the company reported a record backlog and rising high-margin recurring revenue which the market should eventually reward with a higher multiple.

US EQUITY

US markets were choppy during the third quarter, with Donald Trump escalating his trade war with China by expanding and hiking tariffs. This market negative event was offset by the federal reserve cutting interest rates, likely due to continuous pressure from Trump. The net effect was a mixed market, with the small cap Russell 2000 down -2.4% and the large cap S&P500 up +1.7% during the quarter. Our US strategy performed well, returning **+1.3%**, ahead of the blended average of those two benchmarks. Year-to-date, we are up **+15.8%**, only slightly behind the mid-point between +14.2% for the Russell and +20.6% for the S&P500.

One new name we added to the portfolios during the quarter was **Green Plains** (GPRE). Blink and you would have missed it, as we sold it a week later. No, we didn't become day traders, so let us explain our rationale. GPRE is an ethanol refiner, using corn as an input and churning out ethanol to be blended into gasoline as an output. The trade war with China is taking its toll on the ethanol industry; China used to be a large importer of US ethanol but has ceased buying during the last 12 months. As well, the EPA has continued to give ethanol blending waivers to oil refineries, depressing demand. The combined result is an ethanol industry losing money and farmers getting increasingly upset with the Trump administration. We followed GPRE for some time and watched it fall from a high of $17.50 in April to the low $7's in August. We liked the clean balance sheet, the other businesses that GPRE owns such as cattle-feeding and the outlook for an eventual turnaround in ethanol margins. We eventually bought shares when our math showed that the market was pricing in close to zero ethanol refining margins forever, and we thought Trump would soon have to announce some relief for the industry or risk losing farmers votes which he so covets. Within a week of our purchase, the stock had rallied 30%. Rather than hold on for a potentially larger gain, we took our profits as the industry itself can be volatile, and we weren't looking to own the stock forever. We would look to reinvest at the right price and under the right circumstances, but for now are happy to follow it from the sidelines. This is an example of not liking Trump's politics but being able to generate good returns from his market interference.

We entered the fourth quarter maintaining larger than average cash balances, though we have since added a new name in the social media sector which we will discuss in our next letter.

FIXED INCOME

During the third quarter, our Fixed Income strategy yielded a gross return of +1.3%. This is in line with returns of +1.2% for the Canada Bond Universe and +1.4% for the Canada HYBrid Bond indices. Although we still lag these benchmarks year-to-date having returned +5.1% versus +7.8% for the Universe and +8.7% for the HYBrid. For the quarter, our in-line performance was in spite of Canadian government bond yields continuing to drop which tends to hurt our relative performance, with the 10-year Canada bond yielding 1.38% at quarter end. This is close to the all-time lows of 2016 when oil was trading in the $27 a barrel range. Today Canada is in a much healthier place economically, with unemployment at all time lows and wages rising at their fastest pace since 2008. So, what is the bond market telling us?

The first is that inflation is dead, which is hard to disagree with. Inflation in Canada has not been a problem in decades, and consumer expectations for future inflation keep coming down. Recent increases in wage growth have had no impact either in Canada or the US. With inflation seemingly tamed, bond buyers appear ready to accept less total yield since they will lose less to inflation than in the past.

The second is that the rest of the world is in a worse spot than Canada. With even Greece recently issuing bonds with negative yields, European investors have no choice but to look elsewhere. At one point in the quarter, there was $17 trillion of negative yielding debt around the globe, with most of it coming from Europe and Japan. Canada, with its strong rule of law, well developed capital markets, solid fiscal position and stable currency, represents an attractive investment destination. Foreign investors will gladly buy our government's debt and take a bit of currency risk than lock in negative yields in their home countries. The impact of these buyers coming to Canada means our bond yields are being driven down to levels that are lower than one would expect purely based on domestic reasons.

For the rest of the year we continue to believe the Bank of Canada will sit on the sidelines and leave rates unchanged. So far, we have been correct on that call, with yields creeping higher in October helping our relative performance given the shorter maturities of our bonds. We continued adding mostly investment grade bonds to the portfolios, while selectively adding attractive high yield bond issues as they present themselves. Overall, we think we are much better positioned for turbulent markets than we would have been a year ago. Though we think the outlook is currently bright for Canada, we see no harm in being cautious with our bond holdings.

MACROECONOMIC OUTLOOK

There is no doubt that concerns over economic weakness and even recession are widespread, both globally and in Canada. Recent data for Canada does show a persistent decline in industrial production, retail sales, imports (which reflect domestic demand), the Leading Economic Indicator (LEI) and the Purchasing Managers Index (PMI). Internationally, there are concerns over economic softness in China, Japan and the EU. GDP in the US, our largest trading partner by far, has so far held up, but the PMI for manufacturing has declined and there is evidence of that spreading to non-manufacturing.

Economic news, however, tells you where you are in the cycle, not where you will be in six or nine months. That is what the market focuses on. Fortunately, there are a number of positive forces that are emerging out of the prevailing pessimism. Significant progress has been made between China and the US on ending the current trade war. An interim trade pact between the two countries would trigger stronger growth in China and that would be a big plus for all export-dependent countries like Canada. Another important development is the likelihood of a Brexit deal. The fear of a hard Brexit has been casting a pall over the UK, the EU and the rest of the world for some time. So, this is another good piece of news.

Liquidity conditions are important for economies and markets. They are improving in both the US and Canada. For example, Canadian money supply has moved up quite sharply from the low point in 2018—from roughly 4% p.a. to around 8% p.a. In the US, most measures of liquidity are also more positive. The Federal Reserve and foreign central banks have ended their programs of balance sheet reduction (QT) and have recently been purchasing assets, which adds to liquidity in the financial system, both in the US and globally.

Both Canadian and US government bonds are yielding negative returns after adjusting for inflation. This means that the real cost of borrowing is free for governments, which will encourage more infrastructure spending. Private borrowers obviously pay more than governments to borrow but their costs are at record lows. This will eventually trigger money flows towards the purchase of goods, services and assets like stocks and undervalued companies.

The Canadian Election

Investors naturally have concerns about policy changes when there is a general election. In particular, there is a perceived risk that a minority left of centre Liberal Government, propped up by a leftist NDP, could lead to higher taxes and increase spending and deficits. While it is too early to draw definitive conclusions from the election result, investors should keep in mind that both the Liberals and the NDP combined lost 47 seats since the previous election in 2015. The weakened position of the NDP clearly means they have lost a lot of leverage over the Liberals in pushing for extreme policy change. The weakened position of these two parties together suggests that the public may have reduced its enthusiasm for left wing, tax and spend policies which are negative for investors. The Liberals will probably face another election in two years and a sensible approach for them would be to shift towards the centre and opt for growth-oriented rather than redistribution policies to try and undercut the Conservatives. However, until the next budget, it remains to be seen whether they will actually pursue a more conservative agenda.

Financial Markets

A broad and widely used measure that monitors inflation in Canada is core CPI. It has moved up gradually over the last year and a half from about 1% p.a. to 2% p.a., the Bank of Canada's policy target. Some may be concerned that this will push the central bank towards a tighter policy. That is unlikely. First, the Producer Price Index (PPI) has fallen for over a year from around 6% p.a. to around -2.5% p.a., consistent with the generally deflationary global environment and the softness in the Canadian economy. Second, Canada's real effective exchange rate has begun to firm up and currently shows the Canadian dollar only about 15% undervalued. The Bank of Canada will not want to risk a significant rise in the currency because it would negatively impact Canada's exports, which have already seen a drop in growth from almost 20% p.a. to zero. This in turn would impact the economy which is currently going through a soft patch.

Canadian stocks as a whole are not expensive when compared with the US, and after adjusting for the very low level of interest rates. Improving liquidity, a better international backdrop and a cheap but slowing rising currency, are all positives for Canada. In particular, the market is extremely bifurcated with some sectors trading at very cheap levels, offering excellent potential returns for investors with a medium to long-term view.

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