2017 YEAR END LETTER

January 22, 2018

We are pleased to present our fourth quarter and 2017 results. It was an exceptional year for Lester Asset Management, both in terms of transitioning seamlessly through some ownership and management changes, as well as once again generating strong returns for our clients in both equity and fixed income. We handily beat our benchmarks in both Canadian Equity and Fixed Income. Since we implemented our new investment strategy in 2006, we have generated higher equity returns than the TSX Composite in 9 of the last 12 years, and higher fixed income returns than the Canadian Bond Universe in 7 of the past 10 years. We can only promise to work hard in trying to continue to do so. With respect to our team, we added bench strength to our research capabilities with Martin, are updating compliance with Helen, and remain dedicated to providing outstanding client service, administration and reporting with Lorie, Patricia, Peggy and Celine.

CANADIAN EQUITY

For 2017, the Lester Canadian Equity Fund increased by **+14.1%** net of fees and expenses, versus +9.1% for the TSX Composite total return including dividends. We are particularly pleased to have achieved these results with high cash balances which averaged around 10% for much of the year. Our outperformance was mainly due to low exposure to the oil & gas sector which hurt the TSX, and the realization of maximum shareholder value through several take-overs among our core holdings. During the fourth quarter, the Fund rose **+7.5%** versus +4.5% for the TSX, our outperformance being mainly due to strong returns from our small and mid-cap holdings, in particular Pure Technologies and NAPEC which both received takeover offers in December.

Since implementing our new investment process in July 2006, our Canadian equity strategy has produced a cumulative net return of **+223.4%,** more than double the +94.7% for the TSX. A $100,000 investment with LAM on July 1, 2006 (two years before the financial crisis) would be worth $323,400 today. This represents an annual compound return of **+10.8%** over the past eleven and a half years, net of all fees and expenses, versus +6% for the TSX. Measured in terms of "value added" active net returns, we have generated **+4.8% per year for 11.5 years over and above the market's 6% return**. In fact, we have even surpassed the S&P 500 total return in Canadian dollars of 9.9% per year over this same period. We achieved these results with lower correlation to, and less volatility than, the market, a feat few money managers have been able to accomplish.

Notable contributors to our strong returns in 2017 were:
NAPEC (+106%): Contractor in electrical and gas transmission and distribution received a take-over offer.
Pure Technologies (+78%): Leak detection and pipe inspection firm is being acquired by U.S.-based Xylem.
GoodFood (+69%): Canada's leading meal kit supplier is rapidly growing its subscriber base and revenues.
Savaria (+68%): Mobility equipment supplier is acquiring companies in the U.S. and posting record profits.
5N Plus (+68%): Processor of minor metals reduced debt, refocused sales and increased profit margins.
Sandvine (+56%): Developer of broadband control systems was acquired by U.S.-based Procera Networks.
Halogen (+51%): Human resource software developer was acquired by California-based Saba Software.
Baylin (+46%): Leading developer of wireless antennae is now profitable and expanding into new markets.
Park Lawn (+45%): Owner of cemeteries and funeral homes has been making acquisitions in the U.S.
Veresen (+41%): Pipeline and mid-stream infrastructure company was acquired by Pembina Pipeline.

A year ago, we mentioned that markets appeared expensive, and we remained defensively positioned with high cash balances while focusing on non-resource dividend paying firms and small/mid-cap companies that were growing their businesses in the U.S. Our stance paid off as we avoided most of the oil & gas sector decline, and five of our holdings, each with a substantial presence and sales in the U.S., were the subject of takeovers. However, most global stock markets continued to rise, and are even more expensive today in relation to growth rates. With low unemployment in North America, the Fed and BOC have begun to raise interest rates despite persistently low inflation and inconsistent GDP growth. These rate hikes have put upward pressure on government bond yields and consequently on consumer borrowing costs such as mortgages, and created some currency volatility with the Canadian dollar rising 7% versus the US dollar in 2017.

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. In this uncertain context, we continue holding high cash balances and remain prudent in our search for investment opportunities that meet our stringent criteria.

US EQUITY

US markets continued their climb in 2017, with the major indices hitting new record highs seemingly every day. Despite our conservative positioning and 10% to 15% in cash balances throughout the year, LAM participated in these gains as well, with our US strategy returning 20% in 2017. For the year, the S&P500 total return was +21.8%, while the Russell 2000 returned +14.7%. We therefore beat our benchmark, which is the average of the two indices. It was the year of big cap growth stocks such as Facebook, Netflix and Amazon. While, as value investors, we find it difficult to ever own these names due to the nosebleed valuations they trade at, we held our own in a frothy market by finding undervalued small cap stocks that investors may have missed or by focusing on sectors that are currently out of favour. In the fourth quarter, we added a few new positions that fit the bill such as AMAG (convertible bond), Entercom and Macy's.

We stumbled upon AMAG in a back-door way. When Jordan and Michelle had their first child in June, Michelle decided they needed to save the cord blood which contains stem cells that can be cryogenically frozen. These cells offer great potential to treat a variety of diseases (the science is expanding every year) for the baby or the immediate family members. You have only one opportunity at birth to save these cells, and more people are opting for this service every year (4% in North America, but 25% in Singapore). We were naturally attracted to this great business model. Customers pay about $1,200 up-front and are then committed to paying $150 a year for as long as the cells are frozen. Gross margins are over 80%! This industry naturally lends itself to the leaders getting stronger. Try telling your partner you found a cheaper version online that will save you a few hundred dollars. Customers will always opt for going with the industry leader with the longest track record. After some research, we discovered that the industry leader in the U.S. had been acquired by AMAG pharmaceuticals a few years ago. AMAG was not attractive as we know little of the main drug development business, but AMAG had issued convertible bonds. We purchased these bonds with the following thinking: if one of their new drugs is a hit, we will get most of the share price gain with our bonds since they are convertible into AMAG stock. If they are all disasters, our bonds are likely to at least get paid off in full thanks to the stable value of the cord blood business. We think this investment offers great upside with limited downside.

We also bought and sold a position in Macy's. We have long held Dillard's as we eventually think the company will be bought-out by the Dillard family. This stock can have large swings week to week, so occasionally we trade it and have been successful thus far. During the fall, retail stocks were hitting fresh lows as headlines hit every day that Amazon was running every single retailer out of business and soon stores will cease to exist. We thought the sector, and Dillard's, was getting oversold and overly cheap. As well, given record low unemployment in the U.S. and Trump potentially getting tax reform passed, consumers should be healthy. However, given Dillard's large footprint in Texas and Florida, and the hurricanes that struck there during the quarter, we opted to increase our exposure to retailers through Macy's instead. We bought Macy's and ultimately sold before year-end for a +20% gain (and would have made even more had we held it through

Christmas). Overall, we are happy with Dillard's as a long term undervalued investment, but will continue to trade around it given the volatility in the share price and the sector.

2017 was a prosperous year, yet we enter 2018 playing defense. We look around and find most stocks are expensive, even some of our own. We continue to have large cash balances and are looking to add defensive names to the portfolio. There is a time for offense and a time for defense, and while we do not have a crystal ball, a look back at history tells us that now is a time for caution.

FIXED INCOME

Our Canadian fixed income strategy continued to outperform the general bond markets in 2017. For the year, our fixed income portfolio returned **+7.3%** before fees and cash drag, with individual client returns net of fees ranging between **+5.7% and +6.3%.** The Canadian Universe Bond Index, heavily weighted with government bonds, returned +2.5%, while the Canada Hybrid Bond Index, with higher yield corporate bonds, returned +5%.

Much of our outperformance was due to an increased weighting in preferred shares over the past two years. These have continued their recovery from the sharp drop in 2015, and have almost come back to normalized levels. We have recently begun to selectively sell some rate-reset preferred shares that have risen in value and would be most prone to a decline if interest rates were to decrease again. We are keeping our higher rated securities, such as those issued by the largest financial institutions, as we feel they are safer and offer a higher yield than what is currently available in the corporate bond market. We are also keeping preferred shares with a guaranteed floor (i.e. a minimum yield), as they should be immune to an interest rate drop.

The bond market itself is at an interesting point in time. Spreads for corporate issuers are now as tight as they were during 2005 to 2007, levels that were later determined to be unsustainably low. On the other hand, Canadian government bond yields have finally climbed back where they offer more than the rate of inflation. The 5-year Canada bond started the year around 1.1% and finished at 1.87%. Given this dynamic, we don't think we are being adequately paid for credit risk in the high yield market. Thus, we have recently been buying investment grade bonds of higher rated issuers such as Telus, and of well-known REITs which are backed by some of the best real estate in Canada. That said, there are always misunderstood companies, or our favorite opportunity, fallen angels. This is where an issuer of bonds has its rating downgraded from investment grade to speculative, and institutional investors like pension funds are forced to sell its bonds. It is in these situations that a majority of our time is spent. By adding these higher yield bonds to our investment grade holdings, we can achieve a blended target yield in the 5% to 6% range while taking an acceptable level of risk. We discussed this barbell approach in our last letter, and we expect to continue pursuing this strategy in 2018.

CRYPTO MANIA

There is a rapidly growing fascination among investors and non-investors with the vertical rise in value and numbers of so-called cryptocurrencies which have created many instant millionaires and even billionaires. The whole phenomena, from bitcoin to the mushrooming of look-alikes, and to companies (e.g. Kodak) getting a massive revaluation by adding "blockchain" to their name, is a replay of a movie we have seen many times before. The names and places may have changed, but the plot is the same, and the ending, when it comes, will be familiarly bad as well.

Promotional investment bankers, hedge funds and other asset managers have also begun to join the game. Proliferating blockchain currencies can now be traded on futures exchanges, and there is now pressure to launch mutual funds and ETFs that invest in bitcoins, which would likely lure the unsuspecting public into risking retail investors' hard-earned dollars in this frenzy. Most disturbingly, some banks now seem determined to get in on the action and are setting up trading desks to participate in the greed. And, believe it or not, some central banks are contemplating their own digital currencies. The more credible the players, the more the magical thinking can go mainstream.

The cryptocurrency phenomenon is clearly traveling down the well-worn mania path laid out by the late Charles Kindleberger in his classic text "*Manias, Panics, and Crashes*"[1]. Every mania feels different but looks the same. Cryptocurrencies are no exception, with plenty of signs of broadening investor participation and the increasing "fear of missing out". Cryptocurrencies benefit from Kindleberger's three ingredients necessary for a full-blown mania: a "displacement" that captures investor imaginations; plentiful liquidity providing fuel to encourage leverage and retail participation in "the next big thing"; and the difficulty in valuing the asset, which encourages "new era thinking". Like the tulip bulb "Tulipmania" of the 17th century and the technology bubble in 2001, speculators can justify any value they want if they have enough imagination and hope.

The reality is that cryptocurrencies are not money. They are not widely used or even useful as a medium of exchange, nor as a measure of, or, a store of value. They are objects of pure speculation. The 17th century tulips were also not money even though they were temporarily worth a fortune. Cryptocurrencies are, presumably, useful for money laundering, terrorist financing and conceptually pleasing to libertarians. Tulips also had a use: making gardens look beautiful. So, what is the sustainable value of cryptocurrencies and tulips?

Speculative vehicles, like blockchain currencies, that derive their apparent value for nefarious purposes, are a great risk. Eventually, governments will want to close them down or at least end the general public's ability to hold and trade them. People should remember that in 1933, the U.S. Presidential Executive Order 6102 made the holding of gold and gold coins illegal. Penalties were steep. Those caught with gold or gold coins could be fined $10,000 (almost $200,000 in today's money) and put in prison for up to 10 years. So, governments can act when they set their minds to it.

The big risk is that the building mania in the crypto/blockchain space gets seriously out of control if regulators don't get involved. As we know from the sub-prime financial crisis, we cannot trust banks to protect capital markets and investors. If that were the case, the inevitable crash could become big enough to create a systemic risk. Luckily, we are nowhere near that presently, however it is worth monitoring developments closely. An early end by regulators and governments to the mania would be a plus for conventional investing as it would get investors to refocus on long-term fundamental value. Cryptocurrencies are anything but.

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[1] See "Manias, Panics, and Crashes" A History of Financial Crises" by Charles P. Kindleberger and Robert Z. Aliber, Seventh Edition, Palgrave Macmillan, 2015.