2018 THIRD QUARTER LETTER

October 23, 2018

CANADIAN EQUITY

For the third quarter of 2018, the Lester Canadian Equity Fund increased by **+1.1%** net of fees and expenses, versus a drop of -0.6% for the TSX Composite Total Return including dividends. Our outperformance was due to our low weightings in the Energy and Materials sector, a high cash balance, and strong upward moves by several of our small cap holdings. The TSX Energy and Materials sectors were down -8.4% and -13.2% respectively, a sharp reversal from the previous strong quarter. Year-to-date, we are down **-1.3%** versus +1.4% for the TSX due to having lagged on the upside in the second quarter. Since inception in July 2006, our Canadian equity strategy has produced a cumulative net return of **+219%,** more than double the +97% for the TSX. This represents an annual compound return of **+9.9%** per year over 12 years, net of all fees and expenses, versus +5.7% for the TSX Total Return including dividends. Measured in terms of "value added" active net returns, we have generated **+4.2%** per year over and above the market's return during this period.

Notable contributors in the third quarter of 2018 were:
Baylin Technologies (+32%): World leading developer of wireless antennas is launching new products.
GoodFood (+28%): Canada's leading meal-kit provider announced strong growth and a plant expansion.
Centric Health (+28%): Specialty pharma co. announced cost cuts, asset sales and a medical cannabis deal.
Savaria (+25%): Provider of home accessibility products increased its dividend and profit guidance.
Gibson Energy (+16%): Oil storage and transportation firm announced strong results and expansion plans.

In our second quarter letter, we mentioned that when resource stocks rise quickly, such moves can be short lived. The runup in the Energy and Materials sectors that we saw in Q2 was indeed followed by a brutal pullback in Q3. Despite avoiding exploration companies and producers, we have always liked energy infrastructure owners such as **Pembina Pipeline**, a long-time core holding of ours, which are less subject to the whims of commodity prices. A recent infrastructure investment we made is **Gibson Energy** which owns oil storage facilities and is benefitting from the inventory build-up facing Canadian producers. While most energy stocks have declined lately, Gibson's shares have risen over 25% since we bought them a few months ago.

Much media hype has been given to the cannabis industry which now represents 1% of the TSX Composite and around 50% of Canada's publicly traded Healthcare sector (with legalization of recreational cannabis, this may eventually shift to the Consumer Discretionary or Staples sector). The industry's dizzying returns have even started to negatively affect the relative performance of portfolio managers who avoided it. At the core we are value investors, so cannabis stocks, with their lofty valuations and lack of real earnings, do not meet our investment criteria. To put things in perspective, Canada's largest agricultural product is wheat and total sales at the producer level are around $9 billion per year. The total value of publicly traded Canadian cannabis companies was approaching $90 billion, equivalent to over 10 X Canada's wheat sales. As producers of a commodity whose price should fall as supply increases, cannabis stocks are clearly overvalued and priced for world domination. Once reality sets in, valuations should start coming down as we have already started to witness.

We see market pullbacks, such as the recent one, as opportunities to buy good companies at better prices. One can never "catch the bottom" and we are always trying to position the portfolio for the next 3 to 5 years, rather than expect instant gratification. It takes time for the true intrinsic value of a stock to surface. Nevertheless, there are heightened risks in the market from rising interest rates, high debt levels, U.S. initiated

trade wars, and anti-globalization trends. This is why we continue to hold some cash and defensive dividend yielding stocks, while selectively adding new positions where we see significant upside over the next few years.

U.S. EQUITY

U.S. stock markets continued to soar over the summer, ending the quarter at, or close to, all time highs. Our U.S. strategy kept pace, gaining +**5.5%** in the quarter, right in the middle of the +**7.7%** return of the S&P500 and the +**3.6%** of the Russell 2000. This despite carrying a roughly 20% cash balance throughout the quarter. This cash balance came in handy entering October, where markets have been volatile so far. Year to date, we are ahead of both indices, returning +**12.8%** versus +**10.6%** for the S&P500 and +**11.6%** for the Russell 2000.

This summer was a bit of a clean-up period, where we exited some old names that had reached full value and started positions in new ones. We sold **Friedman Industries** as we anticipated in the last letter. After 3 years of doing nothing, the steel company hit our target price for a gain of about 40% after Trump's tariffs drove steel prices through the roof. We also sold out of **Iradimed**, the microcap medical device company that has been one of our biggest winners over the past year, more than doubling.

A recent new position for us might not be so new to some clients, depending on when they started with LAM. We bought back into **Western Digital**, a company we have owned (and done well on) in the past. The hard drive manufacturer has repositioned its business quite dramatically compared to when we sold it almost 5 years ago. Since that time, the company has completed the acquisition of SanDisk, becoming one of the largest flash storage manufacturers in the world as well. Flash storage has a better long-term outlook than hard drives, as it is the primary storage solution in smart phones and other devices with long runways of growth ahead of them. We still think the hard drive market can be very profitable, but are obviously happier owning a company where end markets are growing rather than stagnating. The company's shares are actually less expensive now than when we sold them 5 years ago, despite this better positioning in the market, a clean balance sheet and a higher degree of profitability. We bought shares at roughly 7x earnings and expect profits to start growing again after the industry digests the recently added production capacity.

We also initiated a very small position in **Yatra**, the Indian equivalent to Expedia and Booking.com. Similar to our **MercadoLibre** investment, this is a play on an established internet business model being rolled out to an emerging market. India has huge potential and is very similar to where China was 10 years ago. One thing that is clear is when consumers rise to the middle class, they begin to travel. While still early days for this company, we think there is massive upside should they succeed, and a potential for a take-out if a western company wants to enter the travel market in India.

U.S. markets have started off October quite weak, despite what is looking like the strongest economy in years. We have been using this opportunity to add to existing names that have sold-off despite the underlying businesses performing quite well. The reason to carry large cash positions is for situations like this, and you should expect us to keep buying as the market falls and to sell as it rises. Many active portfolio managers claim to abide by this philosophy, but few actually follow through when volatility rises.

CANADIAN FIXED INCOME

Bond yields rose sharply in the quarter, back up towards previous highs, just as a new NAFTA deal was looking imminent by quarter's end. In this rising rate environment many bonds lose value despite a strong economy. We held our own, as our Canadian Fixed Income strategy generated a gross return of **+0.85%** in the quarter, while the Canada Universe Bond Index declined -0.96% and the Hybrid Bond Index was off -0.14%. Year-to-date, we are also ahead of both indices, up **+2.8%** gross versus -0.35% for the Universe and +1.23% for the HYbrid Index. Individual client net returns year-to-date are lower by around +0.8% to +1% due to fees and the cash drag of not being fully invested at all times.

Given the improving economy in Canada, the only reason for the Bank of Canada (BOC) to justify near crisis level interest rates of 1.50% was the risk of a NAFTA blow-up damaging the Canadian manufacturing sector. With a new agreed upon NAFTA deal (or USMCA, good luck pronouncing that one), there should be nothing

left to hold back the BOC from normalizing rates. By the time you get this letter in late October, we expect the BOC will have hiked rates again, and we expect them to do so in early 2019 as well. This will impact long term bonds, causing their prices to drop. Despite having recently purchased a few longer dated bonds that do not mature until 2027 and 2028, the duration of our bond portfolio remains much shorter than those of the indices, hence our strong outperformance when rates rise as they did this quarter.

We continue to purchase more investment grade corporate bonds than in the past. Our bonds are still mostly of the high-yield variety, as we apply a similar analysis to what we do for stocks in order to pick bonds and other fixed income securities that are mispriced. However, the yield we are receiving for taking on that added risk (versus governments) is lower than we have seen for some time. With some mid-term investment grade bonds now yielding more than 4%, we will continue this migration to improve the quality of our portfolio. We should point out that just because we are buying bonds that do not mature until 2028 does not mean we intend to hold then until maturity. Like stocks, bond markets are liquid, and should the high-yield bond market experience a pull-back, as it invariably does, we would feel quite comfortable selling down our investment grade bonds to buy more high-yield ones after having sold-off. The trick is to ensure that we are being compensated enough for taking on this added risk and to be patient with our timing.

MACRO: Interest Rates, NAFTA Renegotiated, and the China-U.S. Trade War

We have entered the 4th quarter on the back of three major new developments: a significant sell-off in bonds and stocks, the last-minute negotiated NAFTA deal now called USMCA (United States-Mexico-Canada-Agreement), and the deteriorating China-U.S. trade war. Each has implications for investors.

First, the sell-off in bonds was triggered by concern over rising U.S. and Canadian inflation and the likelihood of further interest rate increases by both the Federal Reserve and the Bank of Canada (BOC) as they seek to normalize interest rates. Both real short and longer-term interest rates, after adjusting for underlying (core) inflation, are still around or slightly above zero, a level that is still quite supportive of asset prices. The big unknown is how far and fast both the Fed and BOC will continue to push the interest rate agenda. There are signs that the North American economy will soon start to slow as the stimulus from the big Trump tax cuts is digested. That, and the recent nervousness in the stock market, combined with the likelihood that the increase in inflation over the past year is temporary, suggest that the rise in interest rates will be limited. However, until there is more clarity on this front, risk and uncertainty for investors will remain elevated.

Second, on the trade side, a potential economic crisis for Canada has been avoided, even though there still remains considerable uncertainty about the final outcome of the USMCA. Our view in recent quarterly client letters was that this would be the likely outcome but only after a lot of brinkmanship on both sides. Trump, the bully, always tries to see how far he can push the other side in negotiations. Canada stood firm where it counted. The bottom line is that huge uncertainty for investors in Canada, both domestic and foreign, has been lifted but not yet totally eliminated. That will only happen in the weeks and months ahead when the final text of the agreement can be analyzed, and loose ends tied up. As Canada's ambassador to the U.S. said, "*Lots of progress was made but we are not there yet; there are still a couple of tough issues to resolve*".

Below we summarize the big agreements that are critical to Canada:

1. Autos: Canada can increase auto parts and cars by 40% before any new tariffs come into play. 75% of content must originate in North America and 40% of a car must come from workers earning more than $16/hour. This will likely generate demand for more robots to limit cost increases. Some early views of experts indicate that the negative impact on automakers in Canada will not be big.

2. Agricultural Supply Management: Virtually all of the discussion has been focused on dairy concessions which now allow greater quota access for American producers. However, there are four other supply managed agricultural sectors, which include eggs, chickens and turkeys, that will be affected. The impact on particularly inefficient producers might be substantial yet the macro effects on Canada's economy are likely to be relatively trivial, particularly as the Canadian Government has already made clear that substantial assistance to farmers will be forthcoming.

3. Intellectual Property in Canada: It remains protected.

4. Dispute Panels: There has been some fiddling, but the overall picture is that Canada won on this, which is important from the perspective that it will go some way to ensure that Trump will have more trouble than usual in breaking promises.

5. Steel and Aluminum: The 25% tariff remains but renewed talks have generated considerable hope that this will be renegotiated and softened. The wording is that "*the U.S. and Canada shall seek to negotiate an appropriate outcome based on industry dynamics and historical trading patterns*".

6. Pharmaceuticals: The agreement will delay the entry of cheaper generic copies of brand-name drugs which will increase health care costs for governments and consumers in Canada.

Both the U.S. and Canada have declared victory. The direct impact on Canada's macro economy is likely to be small and, most importantly, a huge amount of negative uncertainty has been lifted, although not yet eliminated. This is obviously good for capital investment, financial markets, investors and the Canadian dollar. The future path of the Canadian economy can now be seen with a bit more clarity. The growth rate is likely to remain around the 2% level, core consumer inflation should stay contained and, as a result, any further increase in interest rates should be limited. Currently, inflation-adjusted short-term interest rates are around zero and the 10-year rate is slightly above. Consumer confidence remains quite strong and business confidence will rise with the greatly reduced uncertainty over trade. However, the perception that the Liberal Government in Canada is not friendly toward business and has other priorities will not be easily dissipated.

The third development of importance to investors is the state of the trade war between China and the U.S. There is rapidly growing evidence that China will not back down in the face of U.S. pressure. While it is clear that China has manipulated many aspects of its trade to favour its domestic economy, it is refusing to accept U.S. bully tactics. China sees the U.S. as trying to dismantle its system of state capitalism and intrude on its sovereignty. China's exports to the U.S. are only about 3.5% of its GDP and with a combination of RMB devaluation, tax cuts and other fiscal stimulus, its economy is not very vulnerable to U.S. tariffs. As a result, it is hunkering down for a long battle with the U.S., a sort of "economic cold war". In the meantime, China seems to be open to improving trading relations with Canada, and our exports have been rising at about a 20% annual rate in recent months. Canada may even benefit should U.S. products become less competitive in international markets compared to equivalent Canadian products, as a result of increases in input costs from tariffs on imported materials and components from China into the U.S. and higher U.S. labor costs.

Conclusion

There are both pluses and minuses evident in the Canadian and U.S. landscape that will affect Canadian investors, with the overriding theme being elevated uncertainty over Central Bank policy and interest rate trends, offset to a considerable degree with improving prospects for trade. However, until there is more clarity, a conservative investment posture makes sense for both equity and fixed income portfolios.

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