



FIRST QUARTER LETTER 2010

OFF TO A GOOD START

For the first quarter of 2010, the weighted average return of our all-equity portfolios was +4.5% versus +3.1% for the TSX Total Return. Our outperformance occurred in January when the TSX declined by -5.2% along with most global indices, while our equities dropped by only -0.6%. As was also the case during October 2009's market pullback, our portfolio's resilience indicates a low correlation to stock markets due to our industry diversification and our value oriented approach to stock selection. The S&P500 Total Return was up +2.1% (in \$CDN) while the MSCI World Index was up only +0.1% (in \$CDN) during the quarter, as a -3.3% decline in the US dollar versus the Canadian dollar continued to take its toll on foreign returns. Our balanced portfolios generated between +1.6% and +3.9% depending on fixed income weightings, a solid performance given that government bonds lost value during the quarter while corporate bonds were flat. Our top 10 winners included many familiar names: Mosaid (+21.5%), Logistec (+15.4%), Loblaw (+15.1%), Stella Jones (+13.2%), TVA (+12.8%), Telus (+11%), Glacier Media (+11%), Cineplex (+10.7%), BMO (+10.4%) and Northland Power (+10.1%), as we continue to focus on a combination of profitable growing corporations trading at low multiples or at attractive dividend yields.

LESTER HEDGE FUND

The Lester Hedge Fund, which utilizes alternative investment techniques such as short term trading, shorting, and event driven strategies such as risk arbitrage, is up 5.5% year-to-date, and in fact produced a positive performance during the market decline in the month of January. This fund attempts to take on low market risk, while generating absolute positive returns independent of market movements. With very little overlap with security positions held by our clients in their segregated portfolios, this fund is an ideal complement to our core long portfolio management competencies.

OUR MACRO-ECONOMIC VIEW

Our macro-economic view remains largely unchanged from our previous letter.

US/Canadian Economies:

Despite a few encouraging signs, the US economy is still in a very fragile state. While the labor market is stabilizing, the true unemployment rate is still around 17% when accounting for those who have given-up looking for a job. The glut of mortgage defaults and homes for sale continues to plague the residential real estate market, and banks stubbornly continue to contract credit while postponing the day of reckoning with respect to commercial real estate loan losses. The US consumer continues to hunker down in a deleveraging/savings mode. Canada, on the other hand, while still tied to the fortunes of its largest trading partner to the south, is gradually "breaking-away" from its dependence on the US. In 2009, the percentage of Canada's total trade with the US fell to 63% from 71% in 2005. This trend will continue as Canada increases its exports to Asian and emerging markets.

Interest Rates:

While the US continues to teeter on the edge of deflation, government induced low interest rates will stay at record levels for a long while yet. While money markets have begun to price-in rate hikes in Canada, it will be difficult for the Bank of Canada to decouple its monetary policy from the US. In the

past, when Canada has raised rates prior to the US, it has always back-tracked as the recovery stalled. And while Canada is gradually lessening its dependence on the US, it still cannot afford to allow the Loonie to rise much further without harming Canadian exporters who have barely begun to recover, without major improvements in productivity.

US Dollar versus the Canadian Dollar:

As we anticipated, the US dollar continues its' decline versus the Canadian dollar. If it wasn't for Europe's current woes with Greece and several other heavily indebted nations, the US dollar would be trading even lower. Investors fleeing the Euro have largely sought safe haven in the US\$, however a few currencies such as the Loonie, the best performing currency of the G7, and some commodities such as gold and oil have also been big beneficiaries. In fact, record amounts of foreign investment are flowing into Canadian securities, at an average rate of over \$10 billion a month. This flow of funds represents a strong underpinning for the Canadian dollar, and we expect it to continue for the foreseeable future. Canada is being increasingly seen as a safe haven in the developed world.

Commodities:

Commodities have risen in part due to demand recovery driven by government stimuli and the needs of developing behemoths such as China, but this is also occurring in the face of gradually devaluing currencies. As the Euro, British Pound and Yen sink, and the US\$ rises relative to these other currencies, commodity prices will continue their act of levitation. However, they remain vulnerable to corrections caused by fundamental supply/demand imbalances and an eventual pull-back as government stimuli are withdrawn. Gold held up well during the January commodity correction, as the lack of central bank selling (recently net buyers) combined with lower producer hedging, increased investment demand and the recovery of jewelry sales provides good support for the yellow metal.

Sovereign Debt: Corporations safer than Governments ?

The unthinkable has occurred: Some companies are now perceived to be safer than the US government, as yields on some corporate bonds with 2 year maturities fell below treasuries. With the massive shift of debt from the private sector (like banks) to the public sector, combined with massive stimuli packages, most governments are running record deficits, and will be printing money and issuing bonds for years to come. This glut of government paper versus the relative scarcity of high quality corporate bonds has caused an unusual reversal in the market. The 10-year US bond yield has been creeping up to just under 4%, which is as much a sign of diminishing confidence in the US, than it is of the expectation of rising inflation. This is worrisome indeed, and one of the telltale signs we have been keeping our eye on, confirming our conservative investment stance. Rising bond yields in the US pose a serious threat to the global recovery.

OUR MARKET VIEW

In summary, we are still living in a deflationary world with plenty of excess production capacity and mounting government debt problems. Low short term interest rates will continue to be the fuel that drives equity markets higher, while the search for yield will keep pushing up high dividend paying stocks and corporate bonds. However, gains in the stock and bond markets will be more difficult to produce. Commodities, the supposed holy grail of inflation protection, will remain volatile as the world walks a fine line between deflation and inflation, and so investors need to tread carefully. Consequently, we continue to position ourselves defensively and are taking profits as valuation become stretched. We

continue to overweight portfolios with high yielding equities in pipelines, power generation, telecoms, and selected industrials, while staying true to our value driven search for growth and attractively priced investments.

OH, CANADA !

A common theme in our quarterly letters over the past few years has been the financial strength of Canada and its relative attractiveness as a country to invest in. In our last letter, we talked about the “scenic route to nowhere”. It described how investors in the S&P 500 in the US have not made any money during the last 10 years, while at the same time being subjected to tremendous ups and downs. For Canadians investing in the US over the past decade, the experience has been much worse as our dollar has appreciated significantly against its American counterpart.

To our credit, we embraced the theme of Canada as being the best place to concentrate one’s investments in very early on. Recently, a plethora of articles in trade journals as well as in the popular press have expounded on the numerous investment virtues of Canada. A prime example is the latest issue (March 24th, 2010) of the world renowned Bank Credit Analyst (BCA) Research entitled “*And the Winner is... Canada*”. It, like many in a similar vein, highlights the factors that make Canada so attractive to investors everywhere. Some of the attributes commonly brought up are:

- Canada is rich in base metals i.e. copper, nickel, iron ore, uranium etc... which are growing in demand as the third world industrializes and becomes more urbanized.
- We are rich in oil and natural gas, and have a stable and democratic political system.
- Canada’s banking industry is the envy of the world with its sound and conservative practices that became especially evident during the recent worldwide credit crisis.
- Abundant grain, potash and fertile land, as well as fresh water, which a growing world population desperately needs.
- Throw in a little global warming and what’s not to like about our great country.

With the wonderful success, warm weather notwithstanding, of the recent Winter Olympics in Vancouver, Canada’s image worldwide was further enhanced. A beautiful example of how Canada is perceived is Tom Brokaw’s much talked about post Olympic video editorial entitled “*Tom Brokaw Explains Canada to Americans*” (catch it on YouTube if you missed it).

While we clearly have reasons for optimism, Canada is certainly not perfect. In fact, we are still concerned with its close economic link to the US which, although as described earlier, is not as pronounced as it once was. This is a positive thing in good times but will work to pull us down if economic conditions south of the border deteriorate. As well, unemployment, though improving, is still at an uncomfortable level and it is not clear to us where the new jobs will come from. Overall, however, on a relative basis Canada offers many advantages as a country to both live and invest in.

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