2013 YEAR END LETTER

January 27, 2014

A STRONG FINISH TO GOOD YEAR

We are pleased to report that for 2013, the dollar-weighted average return of our segregated equity portfolios was +17.3% net of all fees (approximately +19% before fees), versus +13% for the TSX Composite total return (including dividends) and +41.6% for the S&P500 (in $CAD). This marks the seventh year out of eight that we have outperformed the TSX. For 2013, depending on fixed income and equity allocations, our balanced portfolios rose on a dollar-weighted average basis between +7.8% and +13.7% (approximately +9% to +15% before fees), versus +5.9% for a benchmark comprising 50/50 DEX Bond/TSX Composite. Fixed income returns were up +3.1% (around +4.5% before fees), versus -1.2% for the DEX Bond Universe. Our superior returns were due to our focus on higher yielding corporate debt which continues to outperform investment grade and government bonds.

Our outperformance in equities versus the TSX during 2013 was mainly due to two factors:
1) Increased exposure to and strong returns in the Technology sector, as well as companies listed below.
2) Limited exposure to the Materials sector.

Our top performing large cap stocks (excluding dividends) during 2013 included:
CCL Industries (+84.3%): Global packaging manufacturer (acquired Avery Dennison's label division).
Open Text (+75.6%): Global provider of content management software (acquired GXS Group).
Shoppers Drug Mart (+38%): Largest Canadian drugstore chain (acquired by Loblaw).
Pembina Pipeline (+31.5%): Extraction, processing, storage and transportation of oil and gas.
Veresen (+20.6%): Extraction, processing and transportation of oil and gas.

Our top performing small and mid-cap stocks (excluding dividends) during 2013 included:
Redknee Solutions (+180%): Global supplier of converged billing software.
QHR Corporation (+130.9%): Canadian medical records software developer.
Logistec (+124.5%): North American marine cargo handling and environmental services provider.
Sirius XM (+59.7%): Satellite radio broadcaster in Canada (started declaring dividends in 2013).
High Liner Foods (+55.4%): Leading North American supplier of frozen seafood.
Guardian Capital (+47.1%): Institutional asset manager with large holdings in Bank of Montreal.
Andrew Peller (+37.3%): Largest domestic producer and importer of wines in Canada.
FP Newpapers (+30.7%): Publisher of the Winnipeg Free Press and local community newspapers.
MTY Foods (+27%): Leading Canadian franchisor of quick service restaurants.
Newalta (+22.2%): Leading North American processor of recycled industrial waste.

As can be seen above, our strong returns continue to be generated by a diverse group of businesses operating in unrelated industries and that have low correlation to the global economy. Over the past few years, we generally outperformed during times when equity markets were down. This defensive characteristic of our portfolio aims to protect our clients' capital while still being able to generate higher returns than the market (low risk/high return objective). Large weightings in power, pipelines, renewable energy and telecom, as well as higher than normal cash balances, acted as a drag on our performance during 2013, yet helped protect the downside and dampen volatility.

LESTER CANADIAN EQUITY FUND

For 2013, the Fund was up +17.8% (+19.5% gross of all fees and expenses) versus +13% for the TSX Composite total return. The Fund, which now represents 12% of our assets under management, holds mostly the same stocks as our segregated accounts and employs the same investment strategy that we use to manage these accounts. Our strong performance was due to the aforementioned reasons, particularly our 13% weighting in the technology sector which includes several recently added small cap companies. As in our segregated accounts, we took profits in several holdings such as MTY Food Group, Redknee Solutions, Shoppers Drug Mart and High Liner Foods, finishing the year with 6.3% in cash.

Since inception in July 2006, and including the Fund's performance since January 2012, our equity strategy has generated a cumulative return of +135.7% net of all fees, nearly triple the +45.4% for the TSX and more than double the +60.6% for the S&P500 (in $CAD). This represents a compound annual return of +12.1% (net of fees and expenses) over the seven and a half year period, compared to +5.1% for the TSX and +6.6% for the S&P500 (in $CAD). These results continue to rank us among the top 1% of Canadian equity managers in the country over the period.

CANADA: A Great Year ex-Resources

The weak global economy, particularly a slowdown in China, and the bursting of the gold bubble, took a big toll on resource companies. As a result of a -31% decline in the Materials sector, the TSX Composite was only up +13% in 2013 compared to +32% for the S&P 500. When excluding resource companies however, most of Canada's other sectors performed in line with other developed countries: Consumer Discretionary (+40%), Industrials (+35%), Technology (+35% despite Blackberry being down -33%), Financials (+22% mostly in the final quarter) and Consumer Staples (+21%). So there was plenty of money to be made in Canadian stocks as long as one avoided the resource companies.

During 2013, the Loonie dropped 7% versus the US dollar as the Bank of Canada's previous tightening bias under Mark Carney has been replaced by a more dovish stance under Stephen Poloz given soft commodity markets. Also, yields on 10-year bonds in the US rose above those in Canada, inciting a shift by investors into higher yielding US bonds. This trend is continuing in 2014, and as such, a lower Canadian dollar will be a welcome boon for Canada's long suffering exporters. While Canadian housing prices are holding up and employment levels have generally been stable, there is a noticeable slowdown at the consumer level. The still recovering US economy should help Canada make up for slower growth in other parts of the world.

THE US: Towards Sustainable Growth

Despite the threats of falling off fiscal cliffs and hitting debt ceilings, the US continues to make economic progress with GDP expected to grow between 2.5% and 3% in 2014 (up from an average of 2% since the Great Recession). It took a while, but after injecting $3 trillion in liquidity since 2007, Ben Bernanke's medicine is finally starting to kick in. Indeed, on December 18, The Federal Reserve (the Fed) announced that it would taper its asset purchases (printing money) by $10 billion per month. This modest but meaningful decrease from $85 billion to $75 billion signals an important change of direction for the Fed. Roughly 2.2 million jobs were created in 2013 and the unemployment rate has fallen to 6.7%, albeit in part due to a declining participation rate showing Americans still dropping out of the work force. As a result of these positive trends, combined with historically low interest rates (i.e. easy money), US stock markets were finally propelled to new highs after nearly 14 years. However, after a +32% rise in 2013, valuations of most S&P500 companies now appear stretched in historic terms and in relation to growth prospects, with profit warnings, earning misses and stock downgrades becoming the norm these days.

Indeed the "wealth effect" has played a large role in Americans feeling more confident and fueling a partial return of the US consumer-driven economy. But such growth has been modest at best. Recovering housing prices and rising stock and bond portfolios have been important drivers, however these have been somewhat pumped up by artificially low interest rates which the Fed is now trying to figure out how to delicately unwind, without bursting any bubbles. Much more important for a sustained and robust economic recovery are secure high paying jobs and rising real wages. These have been more elusive as corporate America, with its record profits and huge cash hoards, continues to squeeze its labor force, leading to an ever widening income gap between the wealthy and the poor. Nevertheless, the Fed's low interest rate policy is expected to extend well beyond 2015 in order to allow millions more US home-owners to refinance their mortgages and incentivize corporations to increase capital spending and hire.

EURO-ZONE: A False Sense of Security

Other than Angela Merkel easily winning the German elections and Latvia (another haven for dirty money) becoming the 18th member of the EURO-zone, a lack of news from Europe during 2013 helped both stock and bond markets to recover there. However, much anxiety remains. In November, the European Central Bank (ECB) slashed its discount rate in half to 0.25% to fight-off deflationary forces (core inflation is running at a record low 0.7%) and help nudge Europe out of its longest ever recession. On January 9, Mario Draghi, head of the ECB, reassured markets that "We are not in a Japanese scenario" referring to Japan's lost decade. Since the summer of 2012, when Greece was only a few votes away from possibly destroying the EURO-zone, the ECB has remained armed and ready to "do whatever it takes" and buy unlimited amounts of sovereign bonds. Draghi also stated recently that rates would remain low for a long time and that unemployment at 12.1% across the EURO-zone was "unacceptably high". While 10-year sovereign bond yields have receded from around 7% to under 4% for the PIIGS, the economic disparity between the North and South of Europe continues to grow. Italy's debt has risen to 130% of GDP, and its jobless rate has increased to 12.7% with youth unemployment having joined the ranks of Spain and Greece at over 40%. Even France's economy has weakened considerably, having contracted by 0.1% in the third quarter.

A new problem is that the ECB has created a false sense of security for profligate nations. With Super Mario ready at any time to save the day, there is little incentive to institute reforms to cut wasteful spending and reduce debt as long as sovereign bond yields are held artificially low (i.e. they do not reflect the true credit risk of each country). Meanwhile, European banks remain undercapitalized and will be the subject of yet another stress test as the EU tries to set-up its Single Resolution Mechanism in order to deal with future bank failures. Debate rages on about "bail-in" rules, whereby losses would be imposed on bank investors and creditors as they were in Cyprus. With anemic growth, inflation below 1%, increasing debt and social welfare burdens, high unemployment and aging demographics, Europe remains a concern.

JAPAN: Fadenomics

The impact of Prime Minister Shinzo Abe's gargantuan stimulus package, dubbed "Abenomics", unveiled in early 2013, is already showing signs of fading. While it helped fuel a massive stock market rally (the NIKKEI was up +51.9% in 2013), it has also caused the YEN to devalue by -35% versus the US dollar over the past 15 months. Japan's annualized GDP was up only 1.1% from July to September (down from 3.6% the previous quarter), a shockingly low figure given the amount of stimulus. An increase in sales tax from 5% to 8% next April is forecast to push its economy into contraction, and thus corporations there rightfully remain cautious, which in turn has led to weaker than estimated business spending.

In order to "pump up the jam" again, Japan recently unveiled a record budget of YEN 96 trillion aimed at boosting spending (YEN 30 trillion is social security spending on welfare and pensions of its aging population). Already the world's most indebted nation with public debt estimated at a whopping 242% of GDP by the end of 2014, Japan plans to issue another YEN 41.25 trillion in bonds to pay for 43% of the budget (annual debt servicing costs alone are estimated at YEN 23.3 trillion).

These mind-numbing amounts are only expected to increase real GDP by 1.4% next year. How Japan gets out from under this mountain of debt with such subdued growth and aging demographics is anyone's guess. The only way to reflate its economy would be to devalue its currency even further. If history is any guide, attempts to devalue the YEN back in the late '90s eventually led to the Asian currency crisis, which we believe is a real repeat possibility. Stay tuned…

CHINA: No Such Thing as a Cash Crunch

The world's second largest economy continues to slow down and recently admitted that it has a little debt problem. China's GDP growth is forecast to slow again in 2014 to as low of 7%, the weakest level since the 1998 Asian currency crisis. The latest HSBC Manufacturing PMI Index fell to 49.6 (signaling a contraction) while the government grapples with over-capacity, environmental issues, work safety and maintaining employment levels. A few weeks ago the Chinese National Audit Office announced that local government debt (regional and municipal) has skyrocketed to US$3.15 trillion (mainly from massive wasteful infrastructure overspending since 2008), half of which is coming due this year and half of which is estimated to be non-performing. Bond yields and interbank lending rates have been spiking, as banks scramble for cash to repay investors who purchased US$2.4 trillion in securitized short term high-yield wealth management products (WMPs) backed by corporate loans (China's version of Canada's Asset Backed Commercial Paper fiasco). A record amount of non-performing corporate loans are appearing on Chinese bank balance sheets stemming from a lending binge during the frenzied growth years.

Including the "shadow banking" system and some US$1.7 trillion in higher risk investment trusts, China's total debt is estimated at twice its' US$9 trillion GDP. In a move stranger than fiction, the government recently banned local media from publishing the Chinese character for the term "cash crunch" in order to avert panic. Will the Chinese government bail-out local governments, banks and investors if a real crunch hits and risk creating "moral hazard" (i.e. encourage more risky lending)? No wonder the Shanghai Composite, 42% of which is made up of financial services, was the worst performing Asian stock market in 2013 down -6.7% (worse even than Thailand), and is already down -3.1% this year.

EMERGING MARKETS: The Broken BRIC and the Fragile Five

The worse performing stock markets in 2013 (and so far this year) include those of Brazil, Russia and China (India eked out a positive return last year after a shaky start). The heavily touted "BRIC" investment theme has faltered despite the hype and supposedly huge growth potential. Reversal of hot money flows, shaky finances, political risk and other factors such as rising US bond yields make this exotic form of diversification a volatile one (borrowing from Peter Lynch, we call it "diworsification"). Most emerging markets have failed to live up to expectations, with several promising stars now referred to as the "Fragile Five" due to limited financial flexibility (India, Indonesia, South Africa, Turkey and Brazil). These and other countries facing civil unrest like Thailand or currency pressures like Argentina, are the most likely to start a domino effect from ongoing currency wars exacerbated by Japan's aggressive devaluation of the YEN.

IN SUMMARY: Scanning the Horizon

As markets rise, at times to unjustifiable levels, we as portfolio managers climb the wall of worry. The more stretched valuations become, the more we get concerned with capital preservation, or protecting the downside. That is why we have become increasingly defensive over the past few years, yet never giving up the chance to try to beat the market on the upside when we find opportunities to do so. We have again shown that bottom-up fundamental research and analysis, combined with a patient but vigilant "buy and hold" strategy with strong consideration given to companies and sectors that are either underrepresented or not included in the TSX index, can outperform the market. Nevertheless, there will be years when we lag, particularly when banks and resources perform strongly.

As the world continues to recover from the great financial crisis some six years ago, many negative after-effects remain, and it is these that we are watching carefully. Just as most governments, institutions and investors missed the sub-prime debacle and its profound effects worldwide, we are never quite sure where the next nasty surprise will come from. Based on what we are able to observe today, the main risks that could hurt capital markets are: another Asian currency crisis (like in 1998), a credit crunch in China, and a long period of chronic Japanese-style deflation in Europe. Of course, there's always the "other crisis" that we didn't see coming: the one we didn't know that we didn't know.

On the fixed income side, we continue to pick away at investment grade and high yield corporate bonds that we consider mispriced due to illiquidity, overly pessimistic credit ratings or improving prospects. Our equity portfolios continue to be anchored by stable dividend yielding stocks in growth sectors such as telecom, media, renewable energy, power generation and energy infrastructure. While many of these actually muted our performance in 2013, they tend to act as ballasts when markets are down. This roughly 35% core of dividend yielding large cap stocks is complemented by small/mid cap companies operating in diverse business segments. This combination has served us well over the past 8 years, generating torque and outperformance when markets are up (high alpha), and providing protection and low correlation when markets are down (low beta). We also continue to hold higher than normal cash balances (up to 10%) having sold several positions where we felt that valuations were stretched.

We expect the current weak global economic backdrop to persist, underpinned by low interest rates and massive (yet diminishing) printing of US dollars, EUROs and YEN in order to keep stimulating growth in a fragile world. Such a climate will continue to provide some support for financial asset prices, although less so now for bonds, preferred shares and real estate which face the headwinds of higher bond yields, and less so for stocks where high valuations are questionable in relation to value and growth prospects.

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