# FOURTH QUARTER AND 2009 YEAR-END LETTER

## AN EXCEPTIONAL YEAR AND PERFORMANCE

Our outperformance versus market indices widened in the fourth quarter of 2009 as our all-equity portfolios increased by an average of +12.9% versus the TSX Total Return which rose by +3.9%. This variance was most pronounced in October when the TSX declined by -4% and stock markets retreated worldwide, while our portfolios advanced by +2.9%. This low correlation to stock market indices is due to our industry diversification, our disciplined value oriented approach to stock selection and our focus on profitable and growing companies. Also, as we anticipated, the chase for yield by investors accelerated, and our large weightings in utilities and high quality business trusts proved fortuitous.

For the year ending December 31, 2009, we are proud to report that the weighted average return of our all equity portfolios is +58.2%, which substantially exceeds +35.1% for the TSX Total Return, +26.5% for the S&P500 Total Return, and +30.8% for the MSCI World index. In Canadian dollars, the S&P500 Total Return is up only 12.8%, while the MSCI World is up 17.1% due to the US dollar having tumbled 13.7% versus the Canadian dollar. Our balanced portfolios, which hold 30% to 70% in fixed income securities, gained between +28% and +45% for the year, implying an average return of approximately 13% on the fixed income portion of balanced portfolios. When measured against nearly 1000 mutual funds that invest in Canadian equities (both large and small cap), our returns rank us in the top 5% of portfolio managers.

## LOW RISK – HIGH RETURNS

It should be noted that our returns came not from a heavy bet on risky sectors such as resources which other top ranking managers made, but rather from a diversified group of profitable companies, most of which have been core holdings of ours for years, as well as the timely purchase of high quality corporate bonds. In fact, three of our companies paid a “special” dividend in 2009 in addition to their regular dividends (Calian, Vicwest, and Direct Cash), while several companies increased their dividends (BCE, Arbor, and Fortis) and others began paying dividends during the year (Wi-LAN, and Velan). Our top 12 performing equities of 2009 (briefly described), excluding dividends and distributions, were:

Neo Materials (+259%): Processor of rare earths used in consumer electronics, auto and medical fields.
TVA Group (+155%): Largest television broadcaster and publisher in Quebec.
Connacher Convertible Debentures (+153%): Oil and gas production and refining.
Vicwest (+145%): Manufacturer of products for the agricultural and construction industries.
Mosaid Technologies (+124%): Licensor of high tech patents to the computer and telecom industries.
Direct Cash (+116%): Largest independent network of ATM machines and debit cards in Canada.
Bank of Montreal (+79%): The highest dividend yielding Canadian bank.
Crescent Point (+74%): Oil and gas production in Western Canada.
Wi-LAN (+64%): Licensor of high technology patents to the consumer electronics industry.
Stella Jones (+57%): Second largest manufacturer of railway ties and utility poles in North America.
Calian Technologies (+56%): Systems engineering for satellite/defence industries and business services.
Uranium One (+52%): One of the world’s largest uranium producers with major holdings in Kazakhstan.

In essence, our superior returns came with lower-than-market risk and one may ask how is this possible? Intuitively, high returns are associated with taking high risks. In order to generate high returns with low risk, one needs to dig deep and unearth companies that are undervalued by the public marketplace and are trading at a large discount to what they are really worth. Ultimately, stock markets are simply a collection of publicly traded companies and our goal is to invest in the ones that we believe will generate the highest returns with the lowest risk over an extended period of time. This implies that we buy shares in companies that not only have good prospects, but are well managed, are growing profitably by generating "free" cash flow (after capital expenditures, debt repayments, distributions to shareholders, etc…), and are trading at a price which is well below private market value (i.e. if sold to a strategic or financial buyer). At the end of the day, our job boils down to company selection (i.e. stock-picking), and if we do our job properly we can generate high returns with low risk.

**THE SCENIC ROUTE TO NOWHERE AND THE SUSPENSION OF DISBELIEF**

Most investors are still in awe of the two stock market crashes and recoveries of the past decade: the tech wreck and the credit crisis. Those who panicked and sold near the bottoms have lost fortunes, and Canadians who stayed the course and invested in US stocks also lost money, exacerbated by the brutal depreciation of the US dollar. For those who fell for the sales pitch by banks, brokers, and the mutual fund industry expounding the virtues of large cap global diversification and structured products, it has mostly been a "scenic road to nowhere" over the past 10 years. The "lost decade" was avoidable had investors not bought bank-manufactured products and entrusted funds to closet indexers, rather than select an active value-added manager. By investing in Canada with a value philosophy, and staying focused on analyzing company fundamentals, we generated real returns well above the market for our clients.

While the mountain of cash and money markets on the sidelines has dwindled, it has mostly gone into the perceived safety of bonds rather than equities. This has caused long dated corporate and government bonds to become overvalued, making them vulnerable to a big drop once interest rates start to rise. Many pension funds (i.e. Caisse de Dépot) and shell-shocked investors remain underinvested in equities and have watched in disbelief as stock markets have risen over 60%+ from the bottom. Despite a mixed bag of anemic economic data emanating from developed countries, rising sovereign default risk (i.e. Greece, Dubai) and the eventual end of government stimuli and low interest rates, we suspect that investors will continue to put money into equities as they suspend their disbelief in this powerful stock market rally.

**OUR VIEW OF THE FUTURE: PROCEED WITH CAUTION**

Below is a summary of our macroeconomic views, which remain unchanged from the beginning of 2009, and which continue to guide our choice of investments:

**US/Canadian Economies**: With 7.5 million Americans having lost their jobs over the past two years, there are now over 15 million out of work. The true unemployment rate is above 17% when accounting for those who have given-up the search. While the pace of job losses has slowed, it may take decades to return to the previous peak employment level. Combine this grim statistic with the fact that 23% of homeowners in the US have mortgages that are greater than the value of their houses, delinquencies on mortgages and credit cards are running near all time highs, consumers are still in a deleveraging/savings mode, banks are doing little lending and the US is on the verge of a commercial real estate debacle, it is no wonder that we have little confidence in the US consumer-driven economy. We thus continue to

avoid companies whose fortunes are tied to the Americans. In Canada, employment, housing, consumption, debt levels, banks, etc… are in good shape, and our dependence on the US is lessening as our resource based economy grows with the fortunes of Asia and emerging market countries. Canada's stature as a favored nation for international investors who are seeking attractive returns will continue to increase over the next decade.

**Interest Rates**: For the above reasons, short term interest rates in the US will remain at historic lows for a prolonged period of time. This poses a dilemma for the Bank of Canada (BOC) as it cannot raise rates without sending the Loonie into orbit. This would harm already struggling exporters, and thus the BOC will keep rates low for as long as possible. This is very bullish for the stock market, as cheap money is the ultimate fuel for driving equity valuations higher. With persistently low interest rates, savers are having a tough time keeping-up with inflation let alone growing their capital, and thus dividend yielding stocks look attractive as an alternative to fixed income securities. We are keeping a close eye on US government long bond yields for signs that inflation is creeping up and/or that investor confidence in US debt is waning. Rising yields in the US pose a serious risk to the global economic recovery.

**Currencies**: With a $1.4 trillion budget deficit in 2009, US$600 billion in stimulus money still to be spent, and huge amounts of bad debt sitting on bank balance sheets, the US government will continue printing massive amounts of money rather than increase income taxes to fund its' black hole. This will continue to exert downward pressure on the US dollar, a desirable outcome for US exporters which may eventually prompt rounds of competitive currency devaluations worldwide. Commodity currencies like the Canadian dollar should remain strong, and so we continue to avoid US dollar exposure.

**Commodities**: With the US dollar under pressure, commodities have risen sharply. Gold in particular is setting new records and is expected to continue to do so as gold producers have stopped hedging their production and central bank selling has turned into buying (in order to diversify reserves away from the US dollar and protect purchasing power against inflation). While we remain leery of the recent rise in base metal prices, the fear of US dollar debasement should continue to prop up the value of such hard assets. We continue to favor oil, uranium and agricultural product related companies over the long term.

In summary, governments around the world are still navigating in uncharted waters from the fall-out of the worst financial crisis since the Great Depression. Therefore, caution is warranted while historically low interest rates, government stimuli and investors' suspension of disbelief continue driving stock markets higher up the wall of worry. Consequently, we are positioning ourselves more defensively by taking profits and overweighting portfolios with high yielding equities in pipelines, power generation, telecoms, and selected industrials, while continuing to use our value driven philosophy to seek-out special situations and attractive investments among a shrinking supply of bargain-basement priced securities.

## LOOKING BACK

Our website at www.lesterasset.com, which is in the process of being enhanced, lists among other things all the quarterly letters we sent our clients since June 2007. It is interesting to look back and see what we thought at various intervals and even more interesting from a client's perspective to see how accurate we were as events unfolded. In our December 2008 letter, at perhaps the scariest time for financial markets worldwide, we outlined our strategy going forward by focusing on the following: Buying credit opportunistically, getting paid to wait, owning defensive growth and special situations, reducing US dollar exposure, and building a store of value. In our conclusion we said: "…we feel that the

market is going through a bottoming process and that current valuations are compelling for investing with a long term investment horizon". The last sentence of the March 2009 letter that followed reads: "In the meantime, the key is to be properly invested (i.e. in the right securities and in the right companies), while positioning oneself for what will undoubtedly be the investment opportunity of a lifetime". The events of the nine months that followed have proven us right and our clients have benefited. However, what we would really like to highlight is the confident tone we maintained while many in the industry became cynical and sullen. It would have been easier to go with the crowd but, fortunately for us and our clients, we analyzed the situation soberly and without emotion, and stuck to our convictions. To quote the late Cambridge University economist A.C. Pigou: "Prosperity ends in a crisis. The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born, not an infant, but a giant."

## LESTER HEDGE FUND

Please note that our firm also manages the Lester Hedge Fund for sophisticated investors wishing to benefit from alternative investment strategies such as short term trading, shorting stocks, and risk arbitrage. This fund, managed by one of our partners Peter Dlouhy, returned a remarkable 63.4% in 2009 while taking on low market risk, and has very little overlap with security positions held by our clients in their segregated portfolios. Peter's sage trading strategies and vast industry knowledge not only allowed him to make enviable profits for clients who invested in this fund, but, through the cross-fertilization of ideas which occurs within our firm between partners, our segregated accounts (which are still the core of our client focus) benefited substantially as well.

On this positive note, our team wishes you a healthy, happy and prosperous new decade ahead!

January 14, 2010