2010 YEAR END LETTER

ANOTHER YEAR OF OUTPERFORMANCE

We are very pleased to report that 2010 marks our 4th year of outperformance versus the TSX Composite Total Return out of the past 5 years. Since July 2006, when we implemented our new investment strategy, we have generated a cumulative compound return of 64.1% net of all fees, more than double the 31.5% for the TSX, and far ahead of the S&P500 ($Cdn) at -2.7%. This performance places us in the top decile of Canadian equity managers in the country. For a summary of our historical results please refer to the attached report or visit our new website at www.lesterasset.com which contains complete information on our firm and investment strategy.

For 2010, the weighted average return of our equity portfolios was 28.1% net of all fees, versus a total return for TSX Composite and S&P500 (in $Cdn) of 17.6% and 8.9% respectively. Our excess return was driven by specific stock selection in the consumer discretionary, industrial, technology and resource sectors, as well as continued exposure to gold, uranium and select income trusts. Our top performing holdings included: UR-Energy (+268%), Asian TV (+189%), Wi-Lan (+143%), Score Media (+142%), Encanto Potash (+114%), Neo Materials (+72%), Uranium One (+66%), MTY Food Group (+57%), Mosaid (+56%), Logistec (+50%), Direct Cash (+39%), Telus (+32%), Stella Jones (+29%), Claymore Gold Bullion (+29%), iShares Global Gold (+26%) and Cenovus (+26%).

Equally important is our outperformance during months when markets were down due to overweighting high yielding sectors such as telecom and power generation, while keeping a low exposure to volatile sectors such as financials, energy and commodities. During 2010, our balanced portfolios rose on average 12.1% to 20.6% depending on fixed income weightings, due to the strong performance of our equities and a net return of approximately 7% on our bonds.

LESTER HEDGE FUND

For 2010, the Lester Hedge Fund was up 17.7% net of all fees, and has produced positive returns in 24 of the last 25 months. Since inception in April 2007, it has produced a cumulative compound net return of 28% versus 13.9% for the TSX Composite Total Return. This fund is managed using alternative strategies not available to most investors, including short selling and merger arbitrage, and is a good complement to our core portfolio management competencies.

NEW DEVELOPMENTS: LESTER CANADIAN EQUITY FUND

We are also pleased to announce that due to strong interest, we are launching the Lester Canadian Equity Fund so that smaller accounts may achieve better equity diversification by owning units of the fund than if managed on a segregated basis. This vehicle will also permit outside investors such as institutions and clients of investment advisors, financial planners and consultants to access our portfolio strategy while maintaining their current relationships. The fund will hold the same 30 to 40 stocks that will be held in our segregated equity accounts and will be managed with the same strategy that produced the above strong returns.

THE NEXT FIVE YEARS

The following represents our macro views of the world over the next half decade, which for now warrants little change from our current investment stance which has served us well thus far:

Euro-mare

The sovereign debt crisis in Europe continues to dominate headlines and rightfully so. From the US$300 billion bail-out of Greece and Ireland, to concerns that Portugal, Spain, Italy and Belgium are next, a dangerous game of debt dominos is taking place. The failure of politicians to police cheating member countries and their impotence in enforcing rules on the 16 that joined the EU is finally starting to haunt them. The use of a common currency by radically different and independently governed economies to facilitate free-trade among them is in jeopardy. Despite Merkel and Sarkozy's reassurances, frustration in Germany and unrest in France are putting the viability of the Euro in doubt. While the productive Germans are benefiting from a common market and a declining Euro, they refuse to foot the bill for the mismanagement of others. The French, mired in an inefficient bureaucracy, refuse to make any sacrifice in their quality of life.

With over US$500 billion in Spanish and Italian debt coming due for refinancing in early 2011, and risk premiums rising throughout Europe, the possibility of default is real. European banks, which passed flawed "stress tests" with flying colors in 2009, are at risk of having to take massive write-downs on sovereign debt and be bailed-out, with unknown repercussions on the global financial system. Authorities in Europe are increasingly of the view that no bank should be too big to fail which will surely force further bank regulation and put more pressure on shareholders and bondholders to bear the risk of failure, rather than taxpayers. Like Japan, with extreme debt levels, an aging population and a shrinking share of the world economy, the Euro Zone is in for an inevitable and painful restructuring and is a market best avoided for now.

The US: Postponing the Day of Reckoning

If problems in Europe weren't so serious, investors would be focusing more on the US. Like an airplane running low on fuel but carrying an increasingly heavy load, the US is still coasting for now, yet continues to flirt with disaster. Despite record low interest rates, a 2nd round of US$600 billion in quantitative easing (QE2), and a trillion dollars in stimulus, no progress has been made in reducing the real unemployment rate which now stands at 21 million Americans (14.5 million that are looking for work plus 6.5 million that have given up). The situation will only worsen as cash-strapped state and local governments slash spending. Housing prices have now fallen 26% from their peak, surpassing the decline during the Great Recession, while continuing foreclosures are increasing the inventory of unsold homes (over 2 years worth of supply). One in seven, or 44 million, Americans are now living in poverty, and while the savings rate is rising, it is not translating into higher retail sales as US consumers continue to hoard cash and pay down debt.

Like the Japanese have attempted many times before, and despite the US government's denial, quantitative easing (or the buying of bonds by the government in order to lower long term interest rates) is really meant to lower the currency and generate higher inflation. A lower dollar assists US exporters, and a little "import inflation" helps avoid the deflation that is so feared.

However, reality is quite different. Since announcing QE2, 10-year US treasury yields have actually risen from around 2.5% to over 3.25% (a phenomenon falsely attributed to the assumption that extended Bush-era tax cuts will strengthen the economy). Also, when factoring out the impact of the residential real estate crisis (a sector that is clearly in deflation and represents a large part of Americans' net worth), Consumer Price Inflation is estimated to be closer to 5% in the US* *(Boeckh Investment Letter, Volume 2.19, December 6, 2010)*. This suggests that despite QE2, rising yields are signaling that the market is concerned with rising inflation expectations and/or rising risk premiums on US government debt.

Finally, in a world of competitive devaluations, where nearly every country is trying to protect its exports by either intervening in foreign exchange markets to prevent its currency from appreciating (Japan and Brazil) or pegging its currency to the US dollar (China and most other Asian countries), the US isn't able to devalue its money fast enough to boost exports or deflate its ballooning debt. Unlike the UK which is tackling its problems head on, political constipation in the US is postponing its day of reckoning. It appears that the US is headed for a prolonged period of "stagflation", nagging unemployment in a stagnant economy coupled with rising inflation.

Staying Close to Home

In light of the preceding, we advocate, as we have been for nearly 5 years now, investing close to home. Foreign investors seem to agree and see Canada as a safe haven having purchased (net of sales) a record $56 billion in government bonds during the first 10 months of 2010. Despite the Bank of Canada having now stopped raising interest rates and the Loonie finally breaching parity (both which we forecasted), the Canadian dollar will remain a strong currency in a developed world that badly needs to restructure its finances. The Euro, if it survives, along with the US dollar and Japanese Yen, will continue their gradual debasement versus the currencies of more soundly managed and commodity rich countries as well as versus hard assets such as oil and gold.

Commodity prices will continue to rise in US dollar terms, having as much to do with a declining Greenback than supply/demand imbalances. China, the price driver of most commodities due to it being such a large marginal buyer, continues to raise interest rates, tighten capital requirements for banks and revalue the Yuan in small doses, in a bid to slow its growth and tame inflation causing commodity prices to remain highly volatile. Emerging countries, while having better growth potential, remain subject to political risk, murky accounting, "risk-on risk-off" hot money flows, illiquid and volatile markets (China had one of the worst performing stock markets in 2010 down 15%), and currency manipulation. From a purely Canadian perspective, the next 10 years could be another lost decade for investors adventuring too deeply into foreign markets. By all means, take as many holidays abroad as you can afford, but stay invested at home !

In Summary

Interest rates will remain low and continue to provide liquidity to the stock market. Huge amounts sitting in bond funds, which are vulnerable to rising rates, are slowly making their way back into equities which offer more attractive returns. Many corporations are full of cash and are seen to be less risky than governments. We therefore continue to favor investing in profitable domestic companies trading at low multiples or at attractive dividend yields, while maintaining a low exposure to volatile sectors such as financials and resources. In the fixed income market, we continue to look for value among corporate bonds with maturities of less than 10 years.

THE END OF STOCK-PICKING ? Not a Chance !

Many articles have appeared recently on the merits of stock-picking. Some claim that the days of deriving Alpha or above-market returns by careful and clever stock-picking are over. Others claim that stock-picking is becoming increasingly important. These diametrically opposite views are reminiscent of the first sentence in *A Tale of Two Cities* by Charles Dickens: "*It was the best of times, it was the worst of times*." The "end of stock-picking" articles point to recent statistics that indicate rising correlations among stocks within an index and among global indices themselves. "It's a waste of time picking individual stocks when they all go up and down together", this reasoning goes, also referring to this behaviour as "risk-on risk-off" trading. Why the increased correlation between the movements in certain stock prices and global indices? Without getting too technical, the answer seems to be threefold:

Globalization – Markets around the globe are increasingly linked to each other by free trade and technology. More companies are doing business abroad, while investors have instant access to international news. Financial markets operate 24 hours a day and are moving more in lock-step.

High Frequency/Program Trading – There has been a proliferation of computer trading as advances in technology allow for the design of programs that automatically buy or sell as certain market conditions occur. These programs can trade high volumes of securities in fractions of seconds. Large surges in trading volume can trigger other programs creating a domino effect. This "algo-trading" was blamed for the Flash Crash last May, undermining investor confidence.

Index Based Products – Perhaps the biggest reason for increased correlation amongst stocks and indices is the massive growth of index futures and exchange traded funds (ETFs). From retail clients who have earned poor returns from brokers and mutual funds, to the largest institutions who live or die by being measured against benchmarked indices, investors are throwing in the towel buying individual securities. They are instead relying on index futures and ETFs in the hopes of lowering fees and making sure that they don't underperform "the market". However, as more investment dollars flow into index futures and ETFs, the underlying securities that form part of these indices become overbought and increasingly correlated as part of "risk-on risk-off" trading.

Then why do some managers, including us, believe that this is a great time for stock-picking? It's quite simple. The more that index investing is in vogue, the less attention is paid to companies outside indices (such as small/mid cap or illiquid stocks) and thus more bargains are available for us to invest in. This benefits our clients. By looking for stocks outside the popular indices, we avoid securities that tend to become overvalued and more correlated as part of index futures and ETFs. As mentioned in the past, we prefer small/mid cap companies because they are more attractively priced and generally ignored by analysts and investors. The universe of companies we generally select from is less subject to overvaluation, high market correlation and volatility caused by the indexing phenomenon, and therefore we are able to outperform "the market" with lower volatility (risk). Stock-picking (and "bond-picking", the fixed income equivalent) is about maximizing returns while lowering risk. In the end, adding value by selecting specific securities that optimize our clients' return objectives is what we as managers are paid to do.

On this positive note, we wish you a new year filled with happiness and good health !

Ken Lester **Stephen Takacsy** **Peter Dlouhy**