SECOND QUARTER 2011 LETTER

July 15, 2011

POSITIVE PERFORMANCE IN A DOWN MARKET

For the second quarter of 2011, we are pleased that the weighted average net return of our all-equity portfolios was a positive 1.0%, versus a decline of 5.1% for the TSX Composite total return and a drop of 0.4% for the S&P500 (in $CDN). Year-to-date, we are up 4.1% versus a rise of 0.2% for the TSX and 2.4% for the S&P500 (in $CDN). The adoption of a conservative stance earlier in the year has served us well. Our positive outperformance during a difficult quarter was mainly due to underweighting the resource sector and overweighting defensive sectors such as telecom, media and utilities. This is evidenced by our top 10 gainers for the quarter which included: Asian Television (+30.8%), Cineplex (+15.5%), Algonquin (+10.7%), Manitoba Tel (+8.7%), Telus (+7.9%), Transcanada (+7.7%), Shaw Communications (+7.6%), BCE (+7.4%), Bell Aliant (+7.0%) and Enbridge (+5.5%). Attached is our June report for Canadian equity portfolios.

Our balanced portfolios rose on average between 0.1% and 0.5% net of fees during the quarter, depending on fixed income weightings, helped by lower Canadian government bond yields, partially offset by wider spreads on corporate bonds. Year-to-date, balanced portfolios are up between 2.2% and 3.8%.

As we celebrate our 5-year track record since our new team implemented its investment strategy in July 2006, we are pleased to have generated a cumulative return of 70.6% net of all fees, more than double the 31.7% for the TSX, and far ahead of the -0.05% return of the S&P500 (in $CDN). Our performance equates to an annual compound net return of 11.3% over the 5-year period, versus 5.7% for the TSX. This result places us at the top of Canadian equity managers for the period. For more detail on our historical results and investment philosophy and strategy, please visit **www.lesterasset.com.**

LESTER HEDGE FUND

For the second quarter of 2011, the Lester Hedge Fund is down 4.3% net of all fees and expenses, versus a decline of 5.1% for the TSX Composite total return. Year-to-date the Fund is down 3.5 % versus a rise of 0.2% for the TSX. Since inception in April 2007, the Fund has produced a cumulative compound net return of 25.9% versus 14.1% for the TSX and has produced positive returns in 25 of the past 31 months. 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 expertise.

OUR MACRO-ECONOMIC VIEW: PERSISTANT GLOBAL RISKS

Our macro-economic view remains one of caution as serious global risks persist. Although our primary investment philosophy is rooted in fundamental bottom-up research, we are cognizant of world events. However, as Warren Buffet says, Mr. Market is also well aware of such events and anticipates the future (rightly or wrongly) by discounting it into the price of securities such as stocks and bonds. A good example is that many resource stocks, including oil producers, are trading at valuations which reflect much lower commodity prices. Now if only we knew what future commodity prices will be! Also, one must remember that financial markets and the economy are two separate things, and that a slow economy does not necessarily mean that there aren't good opportunities in the stock market.

The US: Headlines and Deadlines

Recent headlines have been dominated by the pending August 2nd deadline to raise the US government's borrowing limits (currently capped at $14.3 trillion) and the unthinkable possibility that the US could default on its maturing $30 billion debt repayments on August 4th. Despite the drama and political posturing, we trust that the US will once again resolve its debt-ceiling dilemma with an 11th hour compromise which should include temporarily raising the borrowing capacity in return for tackling the deficit through tax increases and spending cuts. This would be a positive start to dealing with the massive US debt burden before it becomes unmanageable.

With the end of quantitative easing (QE2), which provided some monetary stimulus and liquidity to financial markets through lower interest rates but failed to create badly needed jobs, the US economy will now need to stand on its own two feet. However, economic indicators are showing signs of weakness suggesting that US consumers are still deleveraging and lack confidence. This is as a result of persistent problems with no quick fix such as still declining house prices and nagging high unemployment, as well as temporary factors such as supply disruptions from the Japanese disaster and commodity price inflation.

The good news is that corporations are, for the most part, generating healthy profits and flush with cash. However, they are hesitant to hire new workers due to domestic and global economic uncertainty, and continue to look for ways to be more productive. This is great for shareholders of companies that are able to squeeze more profits out of their operations and return it to their owners in the form of share buy-backs and dividend increases, but bad news for the American worker. Therefore we expect US consumer confidence to remain low, housing and retail related sectors to stay depressed, and the US "soft patch" to persist. While Canada appears to be marching to its own drum, parts of our economy will be negatively affected as well, and the still high-flying Loonie will continue to pressure exporters.

EUROSTRESS: The Rating Game versus the Waiting Game

How ironic it is that, after failing to perform their fiduciary duties leading up to the 2008 global credit crisis by incorrectly assessing the risks of the US mortgage market, US rating agencies like Standard & Poor's and Moody's are now being criticized for respectively uttering the "D-word" (i.e. default) regarding efforts to restructure Greece's debt and downgrading Portuguese and Irish bonds to junk status. In bullying the rating agencies, European government officials are clearly in panic mode, trying to downplay the gravity of the sovereign debt crisis and prevent contagion. Pretending that Greece won't default on its debt is like pretending that tomorrow won't come, and so politicians and bankers hope to stop time and turn back the clock. Playing the waiting game won't make over-indebted nations' problems go away. Tangible solutions are needed such as supervised austerity programs and restructuring involving the private sector.

It seems evident that recently conducted stress tests on 91 European financial institutions will reveal that many would be insolvent and need to raise capital should Greece and others default (either by having to write-down or exclude such debt as collateral). We suspect that a definitive solution will involve measuring the extent to which such institutions can or cannot cope with restructuring efforts. For example, the "French solution" to reinvest maturing proceeds into new 30 years bonds at lower rates is a *de-facto* restructuring (or "selective default" as the ratings agencies call it) that would finally put some of the burden on the backs of banks and their shareholders rather than squarely on European taxpayers who are fed-up of funding bail-outs. Therefore, the battle between the private and public sectors rages on. However, as we stated in our last letter, the repercussions of Europe's debt crisis on the global financial system are unquantifiable. The complex web of credit default swaps among global banks and insurance companies is a potential time bomb that will take much political will and effort to diffuse, and thus avoidance of global financial stocks, which have been among the worst performers, remains warranted.

MENA Menace

While the recent conflicts in the Middle East and North Africa are worrisome, a sea change is inevitable. In Thomas Friedman's book *The World is Flat,* he describes how advances in telecommunication and technology will continue to open up competition not only on the economic front but also on the social front. Computers and smartphones, armed with applications like Twitter and Facebook, are examples of tools that can now be used by the masses to instantly transmit real time information around the world in order to mobilize protests in regions where fascist dictators still ruthlessly rule. The overthrowing of brutal regimes by pro-democracy movements in the MENA is a positive development that will create short term pain for long term gain in the form of freedom of rights for its people. All we can hope for is minimal loss of lives and as few disruptions as possible in the supply and trade of goods and services such as food, oil and humanitarian aid.

China Syndrome

China continues to raise interest rates in an effort to reign-in inflation. However, more worrisome reasons include cooling-off overheated asset prices that are reaching bubble proportions and causing social unrest from rising food, shelter and energy prices, as well as curtailing rampant risky lending by Chinese banks. This of course is negative for the resource sector as China is the largest marginal buyer of commodities and any slowdown in its economy reverberates worldwide. Local governments in China, which are not allowed to borrow for infrastructure projects, have racked-up debts of $2.1 trillion (one-third of China's GDP) in 10,000 separate off-balance sheet "special financing vehicles" involving funds borrowed from friendly regional banks. These local governments don't have the municipal tax base to service even the interest on this debt and in all likelihood will need the huge surpluses of the Chinese Central Government to bail-out them out so that they can repay the banks.

If the Sino-Forest fiasco (and other Chinese based publicly-listed companies in North America that are purported to be frauds) is any indication of how domestic businesses are run in China, then one can only imagine the number of potential scandals which may eventually surface there and in other emerging markets with murky legal and accounting standards. Moody's is now raising red flags on 61 publicly traded Chinese companies with questionable corporate governance and accounting practices. Nevertheless, we continue to believe in the massive growth of emerging and developing markets and the positive impact this growth will have on resource rich countries such as Canada (albeit with increasing volatility going forward), and prefer to profit from this by investing in soundly managed Canadian companies.

IN SUMMARY: HANGOVER 2

As Christopher Whalen recently wrote in the Institutional Risk Analyst and put so well: "*The refusal of the political class to impose losses on large bank creditors since the collapse of Lehman Brothers and Washington Mutual in 2008 illustrates the extent to which the financialization of the western industrial economies has turned into a gradual coup d'état by the banks and the global speculators who dominate their client base*". In other words, not much has changed on Wall Street or elsewhere, as big bonuses and risky lending are back and investors continue to be at the mercy of financial institutions and politicians.

Only one thing is certain: interest rates will remain low for now. The world is still recovering from the 2008 global credit crisis, and savers earning negative real rates of return on fixed income investments are still being made to pay dearly for the damage wreaked by governments, financial institutions, rating agencies and borrowers. The US housing market is still deflating and many businesses and consumers (both employed and unemployed) are still suffering from that hangover. Sovereign debt problems in Europe have revealed a massive second hangover which may take a generation to cure.

The good news is that low interest rates will continue to support the stock and bond markets. However, investors need to be more selective than ever in a world that seems poised for an economic slowdown.
In light of persistently low interest rates, we continue to favor high dividend yielding equities. Due to political conflicts in the Middle East and North Africa and the potential for supply disruptions, we continue to hold Canadian oil producers among our largest positions. We also continue to hold gold (hitting a record high of US$1,594.90 an ounce on July 14) and gold producers as a hedge to financial instability and further currency debasement in a world awash with debt. As per our previous letter, the uncertainty facing the nuclear industry has encouraged us to gradually add to our gas infrastructure and renewable energy holdings, both of which performed particularly well in the past quarter. We continue to be very cautious in keeping a low exposure to more volatile sectors such as financials and resources, and maintain a disciplined approach towards profit taking as valuations become stretched relative to future growth prospects as well as reinvesting funds when markets pull back.

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