2020 FIRST QUARTER LETTER

April 21, 2020

To begin with, we sincerely hope that you and your families are all healthy and able to cope under the exceptional circumstances that we are living today. Your investment team is well and has been operating without disruption from home and from our offices as we are considered an essential service. We also apologize in advance for the exceptional length of this letter; however, we are living in exceptional times…

THE GREAT LOCKDOWN

So far 2020 will likely go down as one of the most unpredictable periods in financial history. The economic collapse we are witnessing today in Canada and around the world is not being caused by a sequel to the 2008 Financial Crisis, the bursting of a bubble like the 2001 Tech Wreck, or a correction caused by computer program trading as in December 2018 (although the latter definitely contributed to the record speed of the recent bear market). It is largely the result of governments protecting their citizens from a deadly virus and forcing human and commercial behavior to be altered in order to contain its spread. Governments in Canada and elsewhere have imposed harsh restrictions on everyday life, forcing non-essential businesses to effectively shut down while many essential ones also struggle to cope. While central banks have stabilized the global financial system and governments announced massive stimulus packages, measures to contain the virus are having a material negative impact on businesses and it is not known how long these will last. It is not surprising that governments have chosen to protect the health and safety of its citizens over protecting the economy, however, at some point, this will come to a head as the population's economic welfare continues to decline.

For investment managers like us trying to assess the impact on our portfolios, there were no advance warnings to governments' sudden actions and little time to react. Businesses that were normally recession proof such as movie theaters and quick service restaurants were shuttered overnight. Thousands of businesses were ordered to close. Leisure and most business travel have been suspended. These drastic actions do not make for a normal environment in which to perform macro or micro economic analysis, and thus many curve balls have been thrown at us. Overall, we had little exposure to the sectors most severely impacted by the Great Lockdown such as travel, leisure, and retail; thus, we have had to make few changes to our investment strategy.

Unlike the Financial Crisis in 2008 which mainly caused a permanent impairment of capital in over-levered institutions such as banks, insurance companies and mortgages lenders, we are being forced to do a much deeper dive into all of our portfolio companies, no matter what business they are in, to assess how they are being impacted by the Great Lockdown, either directly or indirectly. And this assessment needs to be done on a near daily basis as the situation continues to evolve. We therefore continue to ask ourselves the following questions: How have our companies been impacted and how will they fare if the lockdown drags on? At what rate will they recover once restrictions are lifted? Will human behavior be forever altered such that this will cause a permanent impairment in certain businesses and create opportunities in others?

It has indeed been and continues to be an interesting intellectual exercise. Over the past 6 weeks, we have participated in more conference calls with senior management of our companies than we normally would in a year, so we are staying as close as we can to our businesses. We have also had direct access to the some of the most comprehensive and up-to-date research in the world through **Alpine Macro**, a leading global economic publication for which our Chairman Tony Boeckh is Editor-in-Chief. Our clients can rest assured that we have been working hard to ensure that our portfolios are sound and will recover strongly once normalcy returns.

CANADIAN EQUITY

During the first quarter of 2020, the Lester Canadian Equity Fund declined by **-21.6%** versus -20.9% for the TSX Composite Total Return Index including dividends, as panic selling gripped world stock markets due to the spread of the COVID-19 virus. Volatility was amplified by computer program trading, ETF and fund redemptions, and margin call liquidations. Canada was also hurt by a price war between Saudi Arabia and Russia causing the price of oil to plunge to historic lows. While we had been outperforming the market during the 4 months prior to the pandemic, we have since been performing in line. Given our exposure to small/mid cap companies which tend to underperform during periods of generalized panic selling, we are somewhat satisfied with this.

In a normal global economic slowdown, we would have expected to perform better than the market since most businesses we own are not cyclical and are somewhat recession resistant. However, as mentioned earlier, we are not living in normal times. Luckily, we have generally low exposure to areas most affected by the lockdowns and oil glut such as the Energy, Real Estate, Consumer Discretionary and Financial sectors. Our portfolio was nonetheless hurt by our energy infrastructure holdings such as **Enbridge**, **Pembina** and **Keyera**, and retailers such as **Aritzia** and **Restaurant Brands**. Even businesses considered essential services were caught in the downdraft. However, there were a few bright spots among our holdings such as **Goodfood Market**, Canada's leading online grocer which was one of the top performing stocks on the TSX in March, and **Centric Health**, a leading provider of medication to senior residences. Other stocks that are up year-to-date in our portfolio include **Kinaxis**, **Altus Group** and our renewable power producers **Algonquin**, **Boralex** and **Innergex**.

We used the sell-off to increase our weightings in **Sienna Senior Living**, **Stella Jones**, **Badger Daylighting** and **Savaria**. We also initiated positions in **Gibson Energy**, **Lightspeed** and **TD Bank**, all three of which contributed positively to our returns in the quarter. Note that during the Financial Crisis in 2008, our all-cap Canadian Equity strategy was severely stress tested, and after being down around 40% that year, we rebounded over 70% within 18 months, fully recovering our drawdown well before the market did. So far in April, we are up around +8%. However, amid such uncertainty, we recognize that "it is different this time" and that individual businesses will recover at different rates. We are therefore being prudent and continuously reviewing our portfolio to assess where the best investment opportunities lie to position it for strong long-term returns once governments loosen restrictions and allow everyday life and the economy to function more normally.

U.S. EQUITY

The quarter was one of two halves, with US equities hitting new highs in mid-February before being struck by the quickest bear market in modern history as the COVID-19 virus spread across the globe. As with politics, we never want to let a good crisis go to waste. The market selloff was indiscriminate, providing us with many opportunities to make changes to the portfolio to deal with the new world outlook shaped by the pandemic. Our US portfolios were down **-25.4%** in the quarter, right in line with the mid-point of our two benchmarks, the S&P 500 being down -19.6% and the Russell 2000 declining -30.6%. We are confident with our current portfolio, comprised of companies that can rebound strongly from here and thrive going forward. Here are some overarching views that shaped our outlook on how to best position our U.S. portfolio to succeed.

While balance sheet strength and business model flexibility are obvious attributes in any environment, companies must now be able to survive an extended shutdown of the economy. While some investments, like **Dropbox**, will actually benefit as people are forced to work from home, many businesses will clearly suffer a large drop in sales. How does that drop impact profitability? The answer varies by company, and ideally, we want to be invested in the ones that have a variable cost structure so that they can cut costs quickly as sales decline. **Booking.com** will clearly be impacted by the slowdown in travel. Yet they came into the crisis with 40% profit margins, and their biggest expense is online advertising which can quickly be reduced. They will likely still generate a profit this year. Airlines and cruise ships on the other hand have high fixed costs. Whether a plane flies near full or near empty, the costs to the airline is almost the same. Profits come from those last few passengers beyond the break-even point. While airlines will survive with financial help from governments, we prefer more flexible business models that offer greater downside protection.

The pandemic will also likely lead to permanent behavioral changes. We think some societal trends may be accelerated by the Great Lockdown. The most obvious is e-commerce. People who previously never shopped online suddenly find that they have no choice but to order groceries and other items on the internet. Some will go back to their old ways, while others will keep ordering online leading to an acceleration of long-term trends. With this in mind, we will explain some changes we made to the portfolio. Three companies that we sold didn't have good long-term prospects in the new world or for an immediate rebound. We sold **Tidewater**, an operator of offshore vessels that service the energy industry in order to buy **Williams**, a large pipeline company. This was actually done before COVID-19 impacted markets. While offshore oil and gas will come back at some point, the recovery keeps getting pushed out further into the future. Meanwhile, Williams sold off with the rest of the energy complex. Williams' main business is large natural gas pipelines that move gas across the U.S. with contracts that are fixed in price and long-term in nature, making their earnings very predictable. With an 8.4% dividend yield at the time of our purchase, we like the risk/reward profile of this business.

Another new position we initiated is **American Express** (Amex), the third largest credit card company in the world. We purchased it as the market began to crumble, viewing the company as a long-term secular grower with a very flexible cost structure. Historically the issue with Amex was that it wasn't as widely accepted as Visa or Mastercard. A few years ago, Amex set out to increase coverage to close the gap with its two larger peers, which they achieved last year. While earnings will be hit this year and transaction volumes will be down, Amex should maintain a healthy level of profitability. They will get back to growing next year as spending rebounds and credit cards continue to replace cash. This is truly a company one can own almost forever and we were able to buy it at a very attractive price after the pullback.

We sold two other companies, **Cinemark** and **Entercom** to fund new investments. With our belief in permanent behavioral changes, we think that Cinemark's business model may be at risk even after movie theaters are allowed to reopen. In the old world, Cinemark and the other exhibitors would have 90 to 120-day exclusivity windows to exhibit new movies before they would be allowed to be shown on other platforms, such as pay-per-view or streaming services. With theatres shut across the world, studios are moving to a direct to consumer model even for new content, disrupting the old model. As well, consumers are losing the habit of attending theatres during the shutdown and are signing up for new streaming services *en masse* (Disney+ just hit 50 million subscribers). Thus we view the trend of slow declines in attendance offset by higher ticket and concession prices as being broken. Entercom, the second largest radio network in the US, doesn't have the same problem with their model being broken. But with revenues derived from advertising budgets that will be reduced, and too much leverage, we decided to take our loss and move on to more productive investments.

IAA is our latest investment. It operates salvage vehicle auctions. When it is cheaper for insurance companies to issue the customer a cheque instead of repairing their vehicle, they send it to IAA to auction off the vehicle. IAA and competitor Copart are effectively a duopoly controlling 40% of the market each. Business is sticky with insurers looking for the large buying pools that IAA brings to the table. As vehicles become more complex with sensors, cameras and other electronics being continuously added, more vehicles are deemed as total losses scheduled for salvage. This coupled with the small increase each year in total miles driven leads to a very consistent business. The biggest risk is a huge drop in miles driven from something like a pandemic. IAA shares fell about 42% from recent highs before we started to buy. Their cost structure is mostly variable, so even in a prolonged slump they should still generate profits. We view a recovery in total miles driven as likely over the next 12 months. This is a high-quality company that never would have fallen to such a reasonable valuation if not for the recent market panic. So while the stock market drop is painful, it does sow the seeds of the next bull market, and portfolio changes we made should lead to strong returns.

CANADIAN FIXED INCOME

The first quarter in fixed income markets was also one of two halves; through the first 6 weeks bonds performed well with investors having a healthy risk appetite. The second half was defined by the pandemic, which started as a trickle of bond selling before escalating into a full-blown liquidation. Investors, desperate for liquidity as they faced margin calls on their equity investments, were forced to sell anything they could. As well, investors were left grappling with how their investments in corporate bonds would fare under a prolonged shutdown scenario. Overall, we underperformed our benchmarks in the quarter since we have a higher component of high yield bonds in our portfolios as well as preferred shares and convertible debentures.

For the quarter our fixed income accounts were down on average -**7.7%** compared to -5.2% for the Hybrid Bond Index and +1.6% for the Canada Universe Bond Index. Performance varied between accounts based on preferred share weightings. The TSX preferred share index dropped -22.8% in the quarter due to panic selling in this less liquid market. It is important to note that so far in April both bonds and preferred shares are on the rise as rational markets gradually return.

As mentioned above, we witnessed irrational panic selling followed by unprecedented moves by the Bank of Canada (BoC). As investors rushed to sell anything they could, the bond market actually froze up. In normal times, Canada's Big 6 banks act as "market makers" in bonds by using their balance sheets to hold them in inventory to facilitate the buying and selling of bonds while pocketing a spread. In early March, all six banks suddenly ceased this important function, wanting to reduce their risk and preserve capital. At the same time, some investors were forced to sell as markets fell rapidly. The mismatch of sellers and lack of buyers caused bond markets to freeze. During the worst days of March, it wasn't even possible to buy or sell Provincial bonds at reasonable prices. This caused a liquidity freeze as investors who would in normal times increase their exposure to corporate bonds due to great prices, could not make the switch as they were unable to sell their government bonds at reasonable prices. The BoC took notice and followed the US Federal Reserve (Fed) by announcing a government bond buying program (known as quantitative easing) for the first time in its history. The BoC thus became a direct buyer of both Federal and Provincial debt. This move succeeded in unfreezing the market, allowing investors to trade again, and having a positive cascading effect on liquidity.

At the same time as bond markets became almost untradeable, we saw investors trying to sell anything they could. This included convertible bonds and preferred shares since they trade on exchanges like stocks. These were hit especially hard being less liquid than stocks. Mass redemptions in preferred share ETFs caused automatic selling at "any price" driving down preferred share prices to nonsensical levels. Generally, preferred shares are issued by large stable companies like BCE, TransCanada, Emera and Power Corporation. Even during a crisis like this, these companies tend to perform well with minimal deterioration in their businesses. However, preferred share yields soared to levels equivalent to those of junk bonds (7% to 8%+) in addition to offering the benefit of a dividend tax credit versus interest income on bonds. We did not panic sell and are not worried about the solvency of our portfolio positions. Prices on fixed income securities may fluctuate, but as long as the underlying businesses are sound, as they are now, our dividends and interest income are not at risk.

So far in April, we have seen a return of some normalcy in the bond market, both from a liquidity and pricing standpoint. Helping this was the BoC's recent announcement (again following the Fed but with a 2-week delay) that it would begin purchasing short-term investment grade corporate bonds. This move is a big boost for Canada's largest companies, helping to ensure that they get through these unprecedented times and rehire workers when ready. While we saw many "talking heads" calling for the next Great Depression, our view was that, with the right policy response from both government and central banks, we could see a strong rebound coming out of this crisis. We are happy with what we are seeing so far and expect fixed income prices to recover.

MACRO ECONOMIC OUTLOOK: COVID-19 and the Markets

Markets hate uncertainty and they always try to look ahead, often six months or more. With the lightning fast spread of the COVID-19 virus and the resulting fear of the unknown, markets for riskier and illiquid assets sold off sharply in March while markets for perceived "safe haven" assets have strengthened. Canada has, of course, been much harder hit than some other countries because of its dependence on the energy sector which is experiencing an additional crisis of its own due to the collapse in energy demand and prices.

At present, markets and people are trying to deal with unprecedented uncertainty while, at the same time, looking ahead as to when the virus will come under control in the West and when the economy will begin to reopen without risking overwhelming the health system with new cases. In this environment, it is natural for investors to struggle in trying to understand what lies ahead because there are no definitive answers and opinions from various experts around the world often seem in conflict. The bottom line is that, yes, great uncertainty will prevail in the coming weeks and months, but this virus-induced crisis will be transitory and much, possibly most, of the enormous damage that will be done to the economy has been discounted by the sudden fall in equity and credit markets.

In terms of where we are in the progression of the virus, experience in China and other Asian countries, together with mathematical models of epidemics supported by some leading specialists, indicate that the rate of new cases of the virus in the West should soon be peaking. Recent data seems to be consistent with this.

The apparent recent stabilization and rise of equity markets well above the lows of late March are starting to reflect this, but again, it is too early to have a high degree of confidence. As the rate of new cases decelerates, it is only a matter of time until new cases start falling in absolute terms. If Europe and North America follow the Asian pattern, the absolute number of new cases could fall to double-digit levels or less by June or July. This is the optimistic case and it is a reasonable hypothesis. Under this scenario and taking into account both the massive increase in fiscal support for business and individuals—amounting to 10% or more of GDP in most countries—and the unprecedented amount of monetary support providing liquidity to capital markets, the worst may soon be behind us. Parts of the financial system are still struggling but central banks, including the Bank of Canada, are working hard to fix this.

As to the timing of economic recovery, there will be an uncertain time lag even with a deceleration in cases of newly infected people for several reasons. For example, we don't know the time lag between the peak in new cases and when businesses will feel comfortable reopening or when people will lose their fear of going back to work and shopping again. The evidence in China and other parts of Asia is encouraging. Indicators of Chinese production are now rising quickly, businesses are reopening, and people are becoming more confident about going out in public and going to work. However, it is not yet known whether a second wave of the virus will occur as business tries to get back to something like normal. This is very important for the West since the health system is still stressed, although in general it is coping very well. However, until there is a lot more testing and medications to reduce mortality are widely available, there will continue to be some risk in trying to reopen the economy prematurely.

In support of the more optimistic case, a significant second wave has not occurred in Asia since their economies began to reopen. There are grounds for believing that this will also be the case in Europe and North America, for two reasons. Tracking devices are being rapidly developed and hopefully will be put in place in the months ahead. Testing kits are also being ramped up. The testing and tracking of infectious people, and rapidly quarantining them, will be critical. These, along with the increasing "herd immunity", provide grounds for optimism. Also, there is a huge amount of financial and human resources now being put into the repurposing of existing medications and new discoveries which could be very important in taking pressure off the health system, reducing the mortality rate and making people less fearful, a necessary condition to moving back to something like normality. Also critical is the development of antibody and antigen testing which could be widely available in the near future. Vaccines will be developed but unfortunately nobody believes that it will occur in less than 12 to 18 months.

Making sense of all this is clearly not easy and no one has all the answers. But we should all keep in mind that we have science on our side. Promising potential breakthroughs are being reported almost daily. While there are obviously no grounds for complacency, a realistic outlook is probably not nearly as pessimistic as the doomsayers are predicting. It is very easy in this environment of fear and anxiety to get spooked, to let our imaginations run too easily to the dark side, and this will continue to foster volatility in financial markets. The reality is that even if the path forward is not as positive as the optimistic scenario outlined above, there are strong grounds for believing that we will get to the point where an exit from this crisis will become apparent by the summer. If so, the financial markets will react well.

Painful as it is, psychologically and financially, this crisis will be transitory, markets will recover, and it is important to stay focused on long-term valuation. We must keep in mind the encouraging evidence that Asia is now moving back to something like normality, the fiscal and monetary authorities will "do what it takes", thousands of scientists around the world are getting billions of research dollars to find medications, vaccines, and better and faster testing. Meanwhile, the supply of vital health care supplies, equipment and hospital beds is being ramped up dramatically.

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