2020 SECOND QUARTER LETTER

July 15, 2020

CANADIAN EQUITY

During the 2nd quarter of 2020, the Lester Canadian Equity Fund rose **+14.2%** on a gross basis versus +17% for the TSX Composite total return including dividends. Year-to-date, the Fund is down **-10.5%** versus -7.5% for the TSX. Our underperformance versus the index in the quarter and year-to-date is almost entirely the result of not owning Shopify nor having exposure to the Gold sector, as well as drag from our high cash weighting. During the quarter Shopify alone contributed +3.7% to the TSX return, while the Gold sector added +4.4%. Together they accounted for nearly half of the +17% return of the TSX, without which the TSX would have been up only +9% versus our +14.2%. Year-to-date, Shopify contributed +3.3% and the Gold sector +2.5% to the TSX which would have been down -13.3% without them. Neither Shopify's extreme valuation at over 40 times forward sales nor the unpredictability of the price of gold and volatility of gold stocks are consistent with our disciplined value-based investment strategy which nevertheless produced a strong return during the quarter.

The 2nd quarter was characterized by a rapid rebound in global equity markets following the forced liquidation and panic selling of March. The strong rally in stocks is attributable to a combination of record low interest rates and liquidity provided by central banks, massive government stimulus to prop-up businesses and consumers, and markets' forward-looking anticipation of the economy reopening and the eventual discovery of a vaccine.

Our top contributors during the quarter were split in two groups: those that rebounded strongly from being oversold during the sell-off such as energy infrastructure and service companies like **Keyera**, **Pembina Pipeline** and **Badger Daylighting**, and those that are benefiting from the pandemic such as **Goodfood**, **Mediagrif**, **Kinaxis** and **Tecsys**. While Goodfood's meal-kit business is booming due to an increase in demand for online food delivery, Mediagrif's e-commerce platforms are seeing a surge in usage from on-line shopping, and both Kinaxis and Tecsys are growing faster as their clients invest more in improving their supply chain management systems.

Detractors included **Sienna Senior Living** which has been caught up in some of the issues facing long term care facilities in Ontario, and **K-Bro Linen** which has part of its business tied to the hospitality sector in Canada and the U.K. While we trimmed a few holdings during the quarter, we added defensive names such as **Brookfield Infrastructure**, **Altagas** and **Loblaw,** and increased our position in Mediagrif to around 5% of the company.

While July has so far produced strong results for us up over +3%, the market's outlook remains highly uncertain with most companies having withdrawn guidance for 2020 and beyond. We therefore continue to take a cautious and selective approach by holding more defensive businesses and cash in case the economic recovery is weaker than anticipated or there is a second wave of the virus leading to further lockdowns.

It has now been 14 years since we launched our Canadian Equity strategy in July 2006. We are proud to have produced an industry leading cumulative gross return of **+251%**, more than double the +102% return for the TSX, representing an annual compound gross return of **+9.4%** versus +5.1% for the TSX. Measured in terms of value-added active return (*alpha*), we have generated **+4.2% per year in excess of the market's return** for the 14-year period which notably included the financial crisis, several corrections, and the current global pandemic.

U.S. EQUITY

In the 2nd quarter, U.S. markets staged a large comeback, as many things we discussed in our April letter came to pass; the economy gradually reopened, fiscal stimulus bridged many consumers over the shutdown period, and monetary policy was supportive of stocks. The decisive changes we made to the portfolio during the first quarter, both by adding new names and exiting old ones with poor prospects in the new world, drove our outperformance. Our U.S. portfolios returned **+33.7%** versus +20.5% for the S&P 500 and +25.4% for the Russell 2000. Year to-date we are only down **-0.2%** versus a decline of -3.1% for the S&P 500 and -13% for the Russell 2000. Given we did not make any large portfolio changes this quarter, we figured we would address the most common question that comes up in conversation with clients: "Given the global pandemic is still ongoing and the deep recession we are currently in, how is it that markets have come back so quickly?"

There are a few reasons why markets have recovered quickly, and while not obvious, they are logical. From an economic standpoint, stock prices don't simply reflect a single point in time, but the entire future discounted back to today. When someone buys Amazon or Microsoft, they aren't just considering what those companies will earn in 2020 but what they will earn over the next 30 years. While many companies will have terrible second quarter earnings reports in the upcoming weeks, their prospects over the next 30 years haven't changed much. Even if they generate zero profit in 2020 and half the normal amount in 2021 before returning to baseline, it's hard to see these companies deserving to be valued more than 15% below where they were trading at the start of the year. Similarly, interest rates are at rock bottom levels. The 30-year U.S. Treasury bond started 2020 at 2.4%. Today it is down to 1.3%. Low interest rates mean investors are willing to give greater value to a dollar of profit earned in the far future than they otherwise would have if rates were higher. After all, when you don't get paid to keep money in the bank, you may as well invest it for greater profits later on.

On the political side, we often hear that a second wave is coming (or is here right now in July) and will lead to further shutdowns. That is possible, but a big reason the market has rallied is because President Trump and some Governors made it abundantly clear they would not shut down the economy again, whatever the cost. While this may offend us on a personal level, it should be positive for stocks. Trump realizes a further shutdown would guarantee a deep recession lingering into November and cost him in the election. Therefore even with the massive spikes in cases we are seeing coming out of Florida, Texas and Arizona, there has only been a limited rollback of business openings.

We realize these arguments are qualitative: they apply equally when the S&P500 is at 2700 or at 3100. There is a point when stocks have run too far and are overvalued. A 10% pullback could happen anytime and would not be surprising. Of course, the market could equally move up by another 10%. At this time, we are edging back towards caution when making portfolio decisions, despite the reasons that are driving the market higher.

FIXED INCOME

Corporate bond markets recovered during the 2nd quarter as government policies made it clear there would be support for companies that needed bridge financing to survive the virus-related shutdowns. As well, the Bank of Canada did in fact follow the U.S. Federal Reserve in starting a corporate bond purchase program. This program, while small, added much needed support, liquidity and confidence to the corporate bond market, enabling investors to sell some of their safest bonds in order to purchase ones with much more attractive yields.

As expected, our corporate bond portfolio did well in this environment returning **+8.2%** for the quarter versus +5.9% for the Canada Universe Bond and +9.5% for the HYBrid Bond indices. For the year, we are still lagging with a flat return versus +7.5% for the Canada Universe Bond and +3.9% for the HYBdrid Bond indices. The main reason for the difference is our much shorter duration which is roughly half that of the indices. Having a shorter duration prevents your bonds from dropping in value as much when interest rates rise, but also means they do not increase as much when interest rates drop. Given the big move in the 10-year Canada bond from 1.7% at the start of the year to 0.5% at the end of June, longer duration bonds have outperformed in 2020.

Where does that leave us today? We are still finding good deals in the BBB rated and lower high yield space. While these bonds have recovered, the yield spreads are still much wider than at the start of the year. Conversely, some of the safer bonds are looking overvalued when a utility like Fortis BC can issue 30-year bonds at a 2.54% coupon. While Fortis is an exceptionally safe name, a rise in interest rates of 1% could cause this bond to fall nearly 20%. This highlights the risk of long duration bonds which we are not willing to take. While such bonds look great in a falling rate environment, they can hurt a portfolio when rates rise.

This "duration" risk is not without reason either. As the Canadian government has responded to the pandemic and shutdowns by sending Canadians cheques in the mail to make up for lost wages, the money supply has grown dramatically. As Milton Friedman famously said: "*Inflation is always and everywhere a monetary phenomenon*". What he meant was that the more money in the system chasing the same amount of goods, the greater the inflation rate. To be sure, inflation should be weak for the remainder of the pandemic, as the supply of goods and services outweighs weak demand, although there may be pockets of inflation with certain items such as food. We believe that inflation is a long way off, that rates will remain low for quite a while, and that there is still room for spreads on corporate bonds with decent balance sheets and prospects to narrow further.

MACROECONOMIC OUTLOOK

In our last letter, we pointed out that the COVID-19 crisis would be transitory. There has obviously been a lot of human suffering. Investors also suffered a lot as a lifetime of wealth accumulation and retirement money was damaged severely in March. However, much of that has been reversed as markets also came to believe in the transitory nature of the pandemic and began to look ahead to the future.

Certainly, there remains a lot of uncertainty but there is also some clarity on a few key issues. First, governments and central banks have committed to doing "whatever it takes" to support their economies with unprecedented fiscal and monetary support. Personal incomes are being heavily supported by fiscal measures and all central banks, including the Bank of Canada, have unleashed massive asset purchases and support for the credit markets. As a result, spending is coming back slowly, although the savings rate is still very high. Credit markets are functioning well, corporate yield spreads have narrowed sharply after a major sell-off in March and liquidity is at record levels.

In Canada, the COVID-19 crisis is coming under control, but it will still take some months before we get back to "normality". A number of states south of the border have not yet brought new cases down to levels that would be considered "under control", but a repeat of a major lockdown is not likely. The border is still closed for most travel but not for commerce. So, we still need to be concerned about the impact that the U.S. will have on Canada. In addition, there is growing evidence that a change in political leadership in the U.S. will occur and that could mean a shift to the left in terms of policy. If so, it would probably mean a reversal of the Trump Trade (i.e. a shift towards higher taxes and government expenditures) which would not be good for the U.S. market. However, it is likely that both the U.S. and Canadian stock markets will continue in a positive trend, driven by the classic combination of recovering economies, falling inflation and powerful monetary and fiscal stimulus.

The Canadian dollar has recovered from the sharp March sell-off but remains cheap. The Canadian stock market remains inexpensive against the U.S. and most other countries. The price of crude oil, while still below the pre-COVID peak, has moved up significantly and should rise further next year as the world economy continues to recover, pushing up demand while the collapse in production will inevitably result in reduced supply. Rising oil prices are good for the Canadian economy, the market in general and the currency. With all the problems in the U.S., Canadian financial assets should look increasingly attractive to domestic and international investors.

On the fixed income side, risk-free interest rates will remain very low, reflecting a still huge gap between actual and potential output, excess savings, massive liquidity and very weak inflation. High unemployment means that central banks will keep monetary policy very expansionary. Credit spreads are still somewhat elevated, providing attractive potential returns as the economy continues to recover and lingering credit fears abate.

Stephen Takacsy **Jordan Steiner** **Tony Boeckh**

BUSINESS UPDATE AND HOUSEKEEPING ITEMS

All members of the Team at Lester Asset Management remain in good health with all of us alternating between working from home and the office. On the human resource front, Jordan Steiner has decided to leave us by the end of July to pursue other interests. We thank him for his excellent work over the past 9 years and wish him the very best. While I will personally handle all of his client relationships, we are pleased to announce the appointment of Olivier Tardif-Loiselle as his replacement as Portfolio Manager, Fixed Income. Olivier is a CFA and spent the past 8 years at Industrial Alliance, Canada's 4th largest insurance company, helping manage over $10 billion in fixed income assets including $2 billion in corporate bond funds. We are confident that Olivier will quickly add value to our fixed income returns with his deep-seated knowledge of the bond market and strong industry contacts. In this persistently low interest rate environment, his role will be all the more important in helping us generate strong returns for our clients for balanced and fixed income portfolios.

Martin Gagné, who is Senior Research Analyst and Portfolio Manager co-managing our Canadian Equity strategy, will expand his role to cover U.S. Equity as Lead Portfolio Manager. You may recall that prior to joining us 3 years ago, Martin, who is both a CFA and CA, helped manage U.S. Equity for over 6 years at Fleming Canada, so our clients will be in good hands as he returns to familiar territory. Finally, Marc Dansereau will increase his role in Operations, IT and Compliance with the goal of soon becoming our Chief Compliance Officer. With these appointments, Tony Boeckh, our Chairman, and I are convinced that we will have a stronger team than ever.

Please note that enclosed with this month's quarterly statements is an updated version of our Relationship Disclosure Information (RDI) document. Updates include the addition of our Proxy Voting Policy and additional details regarding our statements and those sent by our custodian National Bank Independent Network (NBIN). For example, the terms *Average Cost* and *Book Value* which are mentioned in our quarterly Position Report are now defined in the RDI, while the custodian officially supplies the Statement of Transactions report. Also, the Canadian government is allowing for reduced RRIF withdrawals during 2020, so if you wish to take advantage of this opportunity please contact Lorie or Patricia as soon as possible.

We hope that you and your families are well and coping under the current exceptional circumstances, and invite you to call us anytime should you have any questions.

Sincerely,

Stephen Takacsy
President & CEO, Chief Investment Officer