THIRD QUARTER LETTER 2020

October 15, 2020

CANADIAN EQUITY

During the 3rd quarter of 2020, the Lester Canadian Equity Fund rose **+12.3%** on a gross basis versus +4.7% for the TSX Composite Total Return (including dividends). Year-to-date, the Fund is up **+0.6%** versus -3.1% for the TSX. Our outperformance versus the index in the quarter and year-to-date is mainly due to our portfolio being comprised of businesses that are relatively immune to the ravages of the pandemic and still able to grow. Our performance has been particularly satisfying given that we have no exposure to the gold sector or Shopify which have contributed nearly +7% to the TSX return and without which the TSX would be down around -10%.

The 3rd quarter was characterized by a continued rebound in global equity markets from the March lows fueled by the reopening of economies and better than expected quarterly earnings. However, these earnings were very much buoyed by government subsidies and massive cost cutting, and the quarter ended with a sharp pull-back on worries about renewed lock-downs from a second wave of the virus, high stock valuations, and lack of progress with the discovery of a vaccine.

Our top contributors during the quarter were once again those companies whose growth has accelerated due to the pandemic such as **Goodfood Market**, **MDF Commerce** (formerly Mediagrif), **Tecsys** and **Stella Jones**, and businesses that continue to grow in spite of it such as renewable power producers **Innergex** and **Boralex**, real estate services provider **Altus Group** and diversified technology and consulting firm **Calian Group**. While Goodfood, MDF and Tecsys are booming due to a surge in e-commerce, others like Stella Jones are benefitting from an increase in home renovations which is boosting its lumber sales. Innergex and Boralex, two long-time core holdings, are enjoying the powerful trend of investing in clean energy such as hydro, wind and solar power.

Detractors included those in the energy sector such as **Pembina Pipeline**, **Enbridge** and **Keyera**, and a few micro-cap names. We once again trimmed positions that had risen sharply such as **Altus Group** and **Badger Daylighting**, while adding more defensive businesses on weakness such as **Canadian Apartment REIT** and **Morneau Shepell**. As mentioned in our monthly reports, we were preparing for a 2nd wave of the virus and have been careful in selecting new investments while continuing to hold cash, which has paid off to date.

While October has been strong so far with our returns up another +4%, the market's outlook remains highly uncertain with most companies unable to provide guidance for the remainder of 2020 and beyond. The on-going pandemic has created a stock-pickers market in which the divergence between winners and losers is large and investing in the general indices and ETFs is likely to be volatile and risky until a vaccine is developed.

Finally, we are pleased to report that according to ***Global Manager Research,*** a leading institutional database, our annualized gross returns have consistently ranked in the 1st and 2nd quartile out of over 160 Canadian Equity managers over the past 10 years. Specifically, as of the writing of this letter, we are ranked in the 4th percentile for both 10-year and 1-year returns up to September 30, 2020, meaning that we have outperformed 96% of our peers over the past 10 years and over the past year.

U.S. EQUITY

During the 3rd quarter, our U.S. portfolios were up **+10%** versus +8.9% for the S&P 500 Total Return (including dividends). Year-to-date, we are up **+7.4%** versus +5.6% for the S&P 500. The U.S. market performed well as it was pushed higher by liquidity provided by the Federal Reserve, better than expected 2nd quarter financial results from corporations and a rebound in economic data. Our positive performance for the quarter was mainly driven by our **Pinterest, Viacom CBS** and **Procter & Gamble** positions which rose +87%, +20% and +16% respectively. However, the largest source of our outperformance was our low downside capture in September as we were only down -1.1% versus -3.8% for the S&P 500. This was thanks to our decision to take profits and raise cash in August as the massive technology rally was due for a breather, which was the right call.

We are using this transition period to make further improvements to our U.S. strategy by giving it a larger-cap higher quality tilt. We added some stronger companies such as **UnitedHealth Group** (health insurance), **Activision** (video games), **NextEra Energy** (renewable energy), and **Amazon**, while exiting certain positions that did very well but no longer meet our criteria or quality threshold such as **IAA**, **Purple**, **KKR**, **Dropbox** and **Cigna**.

As the U.S. election looms large, we are maintaining a defensive stance by holding more cash. The outcome is still highly uncertain despite what the polls say. Other questions remain such as will the transfer of power be smooth if Joe Biden wins? Moreover, a second wave of the virus seems to be upon us, and, we believe the portfolio is well-balanced with pandemic-proof stocks and cash ready to be deployed if opportunities arise.

FIXED INCOME

Fixed income markets did well again in the 3rd quarter as governments continued to make massive injections into their respective economies to support businesses and workers affected by the pandemic. Central banks have put everything in place to help governments achieve their objectives. The Federal Reserve and the Bank of Canada have continued to reiterate their support to allow financial markets to function properly. In Canada, even if the bond purchase programs have been unpopular, this shows considerable support for the market in the event of a downturn. In an environment of indefinitely low interest rates combined with the accommodative actions of central banks, investors are comfortable taking on higher risks for higher yields. This has been beneficial for riskier parts of the fixed income market, such as corporate credit, especially high yield bonds. The combination of all these factors pushed credit spreads to tighten further during the quarter.

As expected, our Fixed Income portfolio did very well in this environment, as we have a large exposure to corporate bonds, returning **+3.9%** for the quarter versus +0.5% for the Canada Universe Bond Index and +2.4% for the Hybrid Bond Index. For the year, we are still lagging with a **+3.9%** return versus +8.0% for the Canada Universe Bond Index and +6.4% for the Hybrid Bond Index. This is because the much longer duration of the two benchmark indices has contributed to their strong performance year-to-date as interest rates have decreased considerably since the beginning of the year. However, the market seems to have hit a bottom on rates at around 0.50% for the 10-year Canada bond which has been trading range-bound over the past several months.

Can the bond market's sizzling performance last? While the yield to maturity of a 10-year BBB rated investment grade bond of a well-known corporation such as Telus only pays 2.05% per year, this is still 4 times more than a Canadian government bond of the same maturity. This huge difference suggests that demand for corporate credit will continue to push spreads tighter. Nevertheless, we feel that a yield to maturity of 2% for a 10-year bond is not very attractive. So we continue to look in the high yield market where we are still able to find reasonable risk/return opportunities or securities trading at a deep discount to our fundamental analysis.

Our hunt for attractive value has also led us to the preferred share market, specifically rate reset preferred shares with a floor that trade at a discount to par. Rate resets give the ability for an issuer to redeem the preferred shares every 5 years at par ($25) or reset the dividend rate for another 5 years based on the 5-year Canadian bond yield plus a pre-determined spread. If the yield on the Canada bond plus the spread falls below the floor on the reset date, investors are guaranteed the floor rate as their dividend rate. But if the yield plus the spread rises higher than the floor rate on the reset date, then investors get the higher yield as their new

dividend rate. This is as close to a “heads you win, tails you win” investment as one will ever find. Floor dividend rates range from 5% to 6% on these preferred shares which are issued by well-known investment grade companies such as **Brookfield Renewable**, **Brookfield** I**nfrastructure**, **Enbridge**, **Pembina Pipeline**, and **AltaGas.**

These are certainly interesting times. We need to remain highly vigilant on many fronts such as the U.S. election, economic data, tensions between China and the U.S., delays in reopening parts of the economy and a second wave of the pandemic more problematic than the first. We will consider reducing exposure to corporate credit, particularly high yield bonds in case the economy contracts again or if valuations become too expensive.

MACROECONOMIC OUTLOOK

As we go into the 4th quarter of this roller coaster year, uncertainty, as pointed out above, remains high which is naturally disturbing for those who focus on the short term. The list of major worries includes the U.S. election, the economic impact of increasing virus infections, a delayed U.S. stimulus package, rising inflation fears and stretched valuations in the stock market. The biggest U.S. election risks are twofold. One is the potential for tax hikes should the Democrats win a clean sweep of the Presidency and Congress. We don’t know how beholden Joe Biden would be to the extreme left of the Democratic Party, but he does appear to be a moderate thinker. From a policy perspective, the negative effects of increased taxes would be at least partly offset by increased government spending. The bigger risk is a constitutional crisis if Donald Trump does not concede should he lose by a narrow margin. This is a very real scenario based on many statements he has made, and yet there is no way to rationally assess the risk, other than to say that the odds seem low at this point.

The pandemic risk is becoming more psychological than real. So far, the rebound in cases is partly explained by increased testing, and the mortality rate and hospitalizations are much lower per case than in the spring. Vaccines should be available by mid 2021, and no widespread lockdowns are likely as with the first outbreak. A delayed stimulus package (the President appears to be using this as leverage) does pose a near term risk to the U.S. economy. However, a new package will likely get passed no matter what, sometime after the election.

While not wanting to downplay the short-term risks which are very much present, investors should focus on the bigger picture. The 2nd quarter saw an unprecedented compressed recession that triggered the biggest global stimulus in history, involving both fiscal and monetary policy and huge efforts to support private incomes and risky debt. Interest rates were effectively driven to near zero in North America and to negative levels in Japan and Europe. The result was a classic “V” shaped recovery, now in the process of flattening out. With the lapsed policy stimulus package and delay of a new one, U.S. growth should slow which will impact Canada. However, a new business cycle has likely already begun which will gradually gain strength throughout 2021.

The key to sustainability will be continued powerful monetary and fiscal stimulus combined with low inflation. There is some concern about a big rise in inflation because of the size of the global stimulus, however these fears are premature. The stimulus should be seen as “anti deflationary”. The global economy has not nearly recovered to its previous peak, and there is huge unused capacity in the labour market and in goods and services. This is unlikely to be absorbed for many years and the experience post-Great Financial Crisis was one of price inflation undershooting central bank targets and market expectations. Therefore, the Federal Reserve and the Bank of Canada will keep monetary policy easier and for longer than in past business cycle upswings. Short-term rates will remain in the cellar while longer term rates will very gradually move higher. Prospects are for a sustained economic recovery, in conjunction with low inflation and low interest rates. This is the sweet spot in the cycle and is good for profits and stock prices. It will also mean improving credit quality. However, not all sectors will recover equally as in previous recoveries due to the particularities of the pandemic, and we will remain very much in a stock-pickers market where careful securities selection should outperform the general indices. Another risk with interest rates so low, is that financial asset prices could get further stretched and result in bubbles and painful corrections. We are already seeing what looks like the beginning of a rotation to better valued equities including small and mid-cap stocks and, if extended, this would be a healthy sign.

Stephen Takacsy **Martin Gagne** **Olivier Tardif-Loiselle** **Tony Boeckh**

BUSINESS UPDATE

Changes to the Lester Canadian Equity Fund

In order to simplify and standardize the names of existing and future pooled funds that we manage, we will be renaming the **Lester Canadian Equity Fund** to the **LAM Canadian Equity Fund**. We also plan on normalizing the operating costs and expenses of this fund to be more in line with standard industry practices. Operating costs and expenses of operating a mutual fund trust or pooled fund are typically charged to the fund and not to the manager of the fund. When we launched this fund in January 2012, operating costs and expenses associated with the fund such as accounting, auditing, trustee services and transaction processing would have materially reduced the returns of the fund since the assets under management in the fund were modest at the time. Lester Asset Management, as the manager of the fund, therefore agreed to absorb these costs and expenses.

Since the inception of the fund in January 2012 through to September 30, 2020, it has generated a gross annualised return of approximately +**9.3%,** well in excess of the +6.7% return of the S&P/TSX Composite Total Return Index (including dividends). The fund has now successfully grown to a size for which the current operating costs and expenses of the fund would no longer have a material impact on returns of the fund if paid for by the fund, as is the standard industry practice. However, in order to limit the impact of such operating costs and expenses on the returns of the fund, these will be charged to the fund only up to a maximum of 0.1% of its Net Asset Value, beyond which we will continue being responsible for such operating costs and expenses.

Launch of the LAM Canadian Fixed Income Fund

We are pleased to announce that we will be launching the **LAM Canadian Fixed Income Fund** on January 1, 2021 in order to provide access to our complete Fixed Income strategy for all of our clients. Corporate bonds, preferred shares and other types of fixed income instruments are not always available for purchase at any given time or in sufficient quantities to allocate to all of our accounts in the optimal weightings. A pooled mutual fund trust such as we created for our Canadian Equity strategy will benefit our clients and ensure that they have full exposure to our strategy which also affords better diversification. The fund will carry an annual management fee of 1% and will thus be of additional benefit to those smaller accounts who are currently paying a higher fee.

As of September 30, 2020, our Canadian Fixed Income strategy, launched in January 2008, has produced an annualized gross return of +**6.9%** versus the Canada Bond Universe Index of +4.9%. This is a full 2% per year above the most commonly used benchmark to measure Canadian bond returns. While interest rates and bond yields are much lower today than they were over the past 12 years, we are confident that we will be able to continue adding significant value to our clients' fixed income returns.

As explained in the previous section, we will be following standard industry practice by charging the costs and expenses of operating the **LAM Canadian Fixed Income Fund** to the fund itself. However, in order to mitigate the impact that such costs and expenses would have on the fund's returns, we will be limiting these to 0.1% of the Net Asset Value of the fund, beyond which Lester Asset Management will absorb such costs and expenses.

We hope that you and your loved ones are staying healthy and able to cope with the challenges that the pandemic has thrust upon us all and invite you to call us anytime should you have any questions.

Stephen Takacsy
President & CEO, Chief Investment Officer

Tony Boeckh
Chairman