LESTER ASSET MANAGEMENT RESPONSIBLE GROWTH

THIRD QUARTER LETTER 2010

PORTFOLIO RETURNS: AN EXCEPTIONAL QUARTER

For the third quarter of 2010, the weighted average net return of our all-equity portfolios was 9.6% compared to a total return of 10.3% for the TSX Composite and 7.8% for the S&P500 (in $CDN). Our performance emanated from a diverse group of profitable, growing companies and was again underpinned by overweight positions in high dividend yielding sectors such as power, pipelines, telecom, media and select income trusts, as well as special situations. Our exposure to gold also continued to shine. Our top gainers for the quarter are all long time holdings including: Neo Materials (+37%), Uranium One (+34%), Wi-Lan (+31%), Viterra (+27%), Shoppers Drug Mart (+22%), Direct Cash (+21%), Mosaid (+21%), Shaw Communications (+18%), Fortis (+17%), Corus Entertainment (+15%) and MTY Food Group (+15%).

Year-to-date, our equity portfolios are up 12.5% net of all fees, while the total return of the TSX Composite and the S&P500 (in $CDN) have risen by 7.5% and 1.8% respectively. Our outperformance mainly occurred in months during which world stock markets dropped sharply such as January and June when the TSX plunged by 5.2% and 3.7% respectively, while our equity portfolios declined by an average of only 0.5% and 0.8%. Our portfolio's downside resilience demonstrates a low correlation to indices due to our stock selection and avoidance of closet indexing. We outperformed on the upside during August and September in large part due to our over-weightings in high yielding sectors such as utilities, telecom, and media which benefitted from the announcement of BCE acquiring CTV, as well as our exposure to gold and special situations. Our balanced portfolios have risen on average between 7.2% and 9.4% (depending on fixed income weightings) due to the strong return on equities and a judicious choice of corporate bonds.

LESTER HEDGE FUND

As at September 30, the Lester Hedge Fund is up 9.1% year-to-date net of all fees, and has produced positive performances in 22 out of the last 23 months. This fund is managed using alternative investment techniques including short term trading, shorting, and event driven strategies such as risk arbitrage. Our objective is to take on low market risk, while generating absolute positive returns independent of market movements. Its portfolio has very little overlap with positions held by our clients in their segregated portfolios, and is a good complement to our core long portfolio management competencies.

OUR MACRO-ECONOMIC VIEW

Double-Dipping

There is much talk again about the dreaded "double D" word these days, as markets oscillate between fragments of hope and disappointment. Already some economies (i.e. Ireland) and some sectors (i.e. the US and UK housing market) are back on the decline. The economic anemia infecting much of the developed world leaves no doubt that many countries are flirting with deflation implying that interest rates will stay low for years to come. Even Canada's economy has begun to contract, and we suspect the Bank of Canada will likely change its solitary hawkish stance and stop raising interest rates. While such a scenario is bullish for bonds, a prolonged period of slow growth is now largely discounted in bond prices which are arguably overbought as a result of massive inflows into bond funds. There are still pockets of value in corporate bonds, but like stock-picking, “bond-picking” is of paramount importance at this time. We feel that, in general, more attractive returns can be found in dividend yielding stocks, although at this juncture, one must be very selective and hold companies that are able maintain or grow dividends. Record low interest rates, combined with the fact that many corporations are financially strong and generating healthy profits, are helping to drive-up equity valuations and providing buoyancy to stock markets.

Turning Japanese ?

Around 20 million Americans are still looking for full-time work or have given up. After nearly a trillion dollars in stimulus spending by the US government, employment and economic growth have barely budged. The increased savings rate in the US continues to represent a deleveraging process by consumers who are repaying debts and hunkering down because of job insecurity, not accumulating cash for future shopping sprees. In fact, nearly 44 million Americans, or one in seven, are living in poverty. Home prices are on the decline again with 14% of all mortgages being delinquent and an annual rate of over 1 million homes being repossessed. In addition, there is concern for the 20% whose homes are currently worth less than their mortgages and the reckless institutions that financed them. Banks continue to shrink as they accumulate capital in order to brace themselves for more residential and commercial real estate write-downs and to meet new regulatory requirements. Meanwhile the US government continues to bloat its balance sheet by taking on astronomical amounts of debt (90% of GDP and rising) and is ready to resort to more quantitative easing. With increasing pension and other liabilities, an aging workforce, an economy flirting with deflation and interest rates at near record lows, the US in some ways is looking a little like Japan did 20 years ago when it suffered its own real estate induced deflationary spiral from which it has yet to recover. Most European countries are not looking much better. Under such conditions, we remain cautious and advocate minimizing exposure to foreign markets while expecting more volatility to come.

Currency Wars

With such fragile economic recoveries around the world, it’s no wonder countries are fearful of any appreciation in their domestic currency which would dampen exports. Japan has begun massive interventions in an attempt to stop the Yen from rising by purchasing US Dollars. The Chinese wisely resist un-pegging the Yuan in order to prevent any significant re-evaluation which would reduce their competitiveness while at the same time deflate the value of their massive US Dollar holdings. This balance of financial terror serves to artificial prop-up the US Dollar while central banks quietly diversify their reserves. European countries are shackled to the Euro and have lost the ability to set independent monetary policies in order to deal with their respective problems. Brazil is now whining that the Real is too high. With most of the developed world deep in debt and printing money to stay afloat, governments are engaged in a war of competitive currency devaluations in the hopes of exporting their way out of the doldrums. This is why perceived “stores of value” such as gold and other commodities keep rising. Oil, metals and agricultural products however remain subject to the volatility of traditional supply/demand imbalances, while gold, having reached a record value in September, is benefiting from investment demand as an alternate currency. We expect the currency wars to continue (and hopefully not degenerate into trade wars), with commodity-based currencies such as the Canadian and Australian dollar remaining strong.

IN SUMMARY: MAKING MONEY IN AN UNCERTAIN WORLD

In a recent Globe & Mail article, a money manager wrote about 3 success factors to investing. These were:
1) Invest based on long term information; 2) The stock market doesn't equal the economy; and 3) Don't run with the herd. We agree, paraphrasing these mantras in our own terms as follows: 1) Act like a shareholder by investing for the long term and stop trying to time the market or flip hot stocks; 2) Stay focused on company fundamentals and don't let the economic headlines dictate your investment decisions. In fact, we think that this is one of the biggest mistakes the average investor makes. It seems very hard to accept the concept that we can have a horrible economy and a positive performing stock market at the same time. For example, a poorly performing company can have an attractive share price because it is oversold, and the same can be said for the entire stock market. In addition, it is important to remember that the market is forward looking and is generally trying to project 6 to 18 months into the future; and 3) Avoid buying investments that are overvalued when everyone else is buying them (i.e. purchase companies when they're cheap because they are unloved or less known). Investing is not about "playing the market", making a quick buck on stock tips, or placing speculative bets. It's about a long term disciplined approach to growing your hard earned capital by diligently evaluating companies and investing as a shareholder (or bondholder), with the ultimate aim of maximizing returns while minimizing risk. These principles are all the more important in an uncertain world and require deep street-smart analysis, patience, timely execution, constant follow-up and sometimes nerves of steel.

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