LESTER
ASSET MANAGEMENT
RESPONSIBLE GROWTH

1st QUARTER 2023 LETTER

April 17, 2023

The 1st quarter of 2023 was marked by continued extreme volatility in both global stock and bond markets. After a sharp correction in 2022, most world equity indices rebounded strongly. However, investor sentiment was subject to wild swings from a strong rally in January as interest rates appeared to have peaked, to a sharp sell-off in February as high inflation persisted, followed by a relief rally at the end of March as regulators stepped in to protect depositors after Silicon Valley Bank collapsed. Global bond indices have also started rallying on the anticipation that the interest rate hiking cycle is coming to an end thanks to slowing inflation but also due to potential stress on the financial system following the failure of several regional U.S. banks and the rescue of Credit Suisse by UBS in Europe. While investor sentiment remains fickle and financial markets continue to be momentum-driven, we are well positioned in both equities and fixed income securities to weather any further volatility or a potential economic slowdown.

During the quarter, **Lester Asset Management** received two more Global Manager Research *GMR Top Performer Awards* in the Canadian Fixed Income category for the best 5-Year and 10-Year returns for the periods ending December 31, 2022. This follows a *GMR Top Performer Award* we received for the highest 1-Year Return for 2021 in the same category. The *GMR Top Performer Awards* recognize the leading Canadian asset managers and funds with the highest annualized 1-year, 5-year, and 10-year returns across 15 distinct investment categories. The *GMR Top Performer Awards* are based on total gross annual and annualized returns tracked by the Global Manager Research Database (GMRD) in both traditional and alternative asset classes. We are very proud of this achievement, and continue to work hard in generating strong risk-adjusted returns for our clients.

CANADIAN EQUITY

For the 1st quarter of 2023, the **LAM Canadian Equity Fund** produced a gross return of **+6.8%** versus +4.6% for the TSX Composite Total Return including dividends. Our outperformance was mainly due to strong returns by many of our small and mid-cap holdings and our low exposure to Energy which was the only negative sector of the TSX down -2.3%. Our top contributor was **Velan**, a global leader in industrial valves which accepted an offer to be acquired by Flowserve at a nearly 100% premium to the price its shares were trading at the day before. Other strong contributors included agricultural equipment manufacturer **Ag Growth**, instant lottery ticket printer **Pollard Banknote**, automation solutions provider **ATS**, and accessibility equipment supplier **Savaria**, all of which reported strong financial results during the quarter. Auto parts and paint distributor **Uni-Select**, a new holding we had started to accumulate, also received a takeover offer, contributing to our strong return. The two take-over offers during the quarter were at significantly higher prices than what the shares of each company were trading at, which demonstrates the stock market's inefficiency, as these companies were being grossly undervalued by investors. Our main detractors included **TD Bank**, e-procurement platform **MDF Commerce**, property & casualty insurer **Definity Financial**, and renewable energy producer **Northland Power**.

Most of our holdings reported record results during the quarter and are trading at reasonable valuations. Despite lingering uncertainties in the markets, we continue to use volatility to invest in high quality companies at attractive prices which is a key element for the portfolio to generate strong long-term returns.

U.S. EQUITY

During the 1st quarter of 2023, our U.S. portfolio rose by **+2.8%** versus +7.5% for the S&P 500 Total Return. Our underperformance was due to our more defensive positioning and our lower exposure to tech-related stocks, which drove much of the S&P 500's return. In fact, 7 companies, all tech-related, accounted for roughly 82% or +6.2% of the +7.5% return of the S&P 500 as the technology sector rebounded strongly after a disastrous 2022. On any tech-driven rally, while we own shares of **Microsoft**, **Alphabet**, and **Amazon**, we will participate on the upside but to a lesser degree since we are underweight in technology stocks. However, our investors' capital is better protected on the downside, as seen by our strong outperformance in 2022.

Our top performers were not surprisingly tech-related, with online travel platform **Booking Holdings** and **Microsoft** leading the way. Also, we were pleased to see **FedEx** as a top performer this quarter after a challenging 2022. The company reported improved results and increased guidance from its restructuring efforts which are materializing faster than anticipated and was our main thesis for buying shares. Top detractors included healthcare provider **CVS Health**, railroad **Norfolk Southern**, and regional bank **Fifth Third Bank**. While the latter is classified as a regional bank, it has few similarities with Silicon Valley Bank. Fifth Third's deposit base is highly diversified spread across many industries and states, operates in smaller towns where competition is less fierce, and holds very low "held to maturity" (HTM) securities on their balance sheet.

During the quarter, we completed building our position in **Jacobs** and increased our weighting in **Alphabet** on price weakness during the ChatGPT media frenzy. To fund these purchases, we reduced our weighting in drug developer **Eli Lily** after an incredible run in 2022, which drove valuations to over 40x forward earnings. Looking ahead our plan is to opportunistically deploy capital, and thus far this year, we have reduced our cash level to 4.7% of the portfolio. As we go through a period of slower growth, we plan to add companies that are trading at attractive prices, and that will eventually benefit from a re-acceleration of the economy.

FIXED INCOME

Fixed income markets finished a volatile 1st quarter of 2023 with a healthy rebound following a year of historic negative returns for bonds. 2023 began on a strong note as demand for fixed income securities was brisk, while the Bank of Canada (BOC) indicated that its January rate hike would likely be the last for the time being. Despite the Federal Reserve (Fed) continuing to raise rates, the most important event occurred with the collapse of Silicon Valley Bank and bail-out of Credit Suisse by UBS. This caused much nervousness in financial markets. The intervention by U.S. Federal regulators to insure bank deposits reassured depositors and investors causing markets to rebound sharply at the end of March. This turmoil led investors to question the Fed's ability to continue raising rates without causing instability in the financial system. While bond yields declined sharply, credit spreads unsurprisingly widened, negatively affecting corporate bonds. Preferred shares also fell under pressure. During the 1st quarter of 2023, the **LAM Canadian Fixed Income Fund** generated a gross return of **+1.9%** versus +3.2% for the FTSE Canada Universe Bond Index. Our underperformance was due our lower duration than the index (long duration bonds outperform when yields decline) and our weighting in corporate bonds and preferred shares.

Despite the widening of credit spreads, some of our corporate bonds contributed positive returns. This was the case for our **Quebecor** bonds as the attractive terms given to them to complete the Rogers acquisition of Shaw, reassured investors. Longer duration bonds such as **Hydro One 3.91% February 2046** also performed well. Among our detractors was the hybrid debt of **Laurentian Bank 5.3%** as a result of a selloff in bank bonds. Also, some of our rate reset preferred shares underperformed, such as those of **Brookfield Office Properties**, as the commercial real estate sector came under pressure following the U.S. regional bank debacle. While economic data will dictate monetary policy, financial markets have begun to feel the stress of recent rate hikes. The BOC seems to have done the right thing by pausing while it awaits the impact of higher rates. The good news is that high quality corporate bonds are now offering a unique opportunity for investors to earn equity-like returns with what we consider to be low risk. This is reflected in the **LAM Canadian Fixed Income Fund** which currently offers a very attractive yield to maturity of **6.5%** with an average duration of less than 4 years.

MACROECONOMIC OUTLOOK

The outlook for stocks and bonds remains dependent on the future course of inflation. Central banks remain concerned that inflation has moved to a higher structural level, though there is no evidence that this is the case. Published inflation is a lagging indicator, and leading indicators of inflation have been falling sharply, which will certainly result in a drop in the headline inflation numbers. Two of the sticky (and lagging) components of published inflation – rents and wages – are already softening. The rent component will adjust downward reflecting the shakeout in the housing market. Wage growth has topped out and tightness in the labor market has started to ease.

Inflationary pressure will likely weaken markedly in the months ahead for several reasons. First, the U.S. economy appears headed for recession which will result in rising unemployment and downward pressure on wages. The Canadian economy should fare better because of the importance of the resources sector but may still have a couple of weak quarters providing a further tail wind to easing of inflationary pressures. A second important factor is the developing credit crunch in the U.S. as a result of the recent regional banking crisis. Lending standards in the U.S. have tightened, impacting consumers and small businesses. Canada is not experiencing anything like the tightening credit in the U.S. which bodes well for a softer landing. A third factor that will support lower inflation is a weak global economy, with much of Asia already flirting with deflation.

Both the BOC and the Fed have been focused on driving inflation lower by sharply raising short-term interest rates. With prospects for a weaker economy and a decline in inflation, central banks will soon cease tightening and, once unemployment starts to rise, will start to ease. Short-term rates could fall sharply, taking pressure off longer-term rates. It seems likely that the 10-year government bond could decline another 100 basis points. This would be very good news for bondholders as falling yields increase bond prices. Stock markets have been performing remarkably well in the face of high short-term interest rates and the liquidity crunch stemming from the U.S. regional bank crisis. The reason is that stocks are responding to an improvement in longer-term bond yields, the anticipation of lower inflation, and a possible central bank pivot towards easing. In effect, stock prices have already discounted a weaker economy. There is, of course, concern that corporate profits will suffer along with a weaker economy. However, falling interest rates are a very powerful positive force for stock prices as they tend to expand price/earnings ratios and offset a temporary softening of profits.

For its part, the Canadian dollar has been weak against the U.S. dollar, primarily reflecting a more hawkish Fed and a “flight to quality” amid the financial volatility which has led to an overvalued U.S. dollar against virtually all currencies. However, the Canadian dollar appears to be bottoming out and looks set to finally move higher due to the likelihood that the Canadian economy will outperform the U.S. for the reasons mentioned above and the probability of the Fed becoming more dovish as the U.S. economy slows and the banking sector remains vulnerable. A stronger Canadian dollar would also support lower inflation and higher stock and bond prices.

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