

## 2017 EQUITY PREVIEW

Instrument (Inception)*	December 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	2.1%	-0.3%	12.4%
Venator Partners Fund (July 2014)	1.5%	-3.6%	-0.1%
Venator Investment Trust (September 2007)	1.8%	-2.1%	8.6%
Venator Income Fund (August 2008)	1.2%	13.7%	12.3%
Venator Select Fund (September 2013)	3.7%	7.0%	17.2%
S&P/TSX Total Return (March 2006)	1.7%	21.1%	5.5%
Russell 2000 (March 2006)	2.8%	21.3%	7.4%
S&P Toronto Small Cap (March 2006)	3.9%	38.5%	2.6%
S&P 500 (March 2006)	2.0%	12.0%	7.6%
Merrill Lynch High Yield Index (August 2008)	2.0%	17.5%	9.0%

### OUR FINAL WORD ON @)!^ (whoops, accidentally kept my finger on the "shift" button)

Venator Founders Fund, our flagship long/short equity strategy, finished 2016 on just the wrong side of breakeven, falling roughly 0.2%. The Fund was down 0.5% in 2015, which wasn't such a bad result given that North American markets were down over 5%; however, its 2016 performance has been disappointing given the strength of North American equity markets. Despite positioning the Funds for a possible Trump victory in early November, our portfolio managed to miss the bulk of the post-election, six-week market rally which accounted for the vast majority of the annual gain in the non-resource segment of the market where we primarily invest. I would note that on an attribution basis, our long portfolio was up roughly 10% on the year, while our short portfolio cost us 10%. While this may seem like an extraordinary loss on the short side, this is not unprecedented. In fact, it's the fourth time the short side of the portfolio has cost the fund approximately 10% in a calendar year; the difference being that the previous three times this happened, the long portfolio was up approximately 40%+. Going into 2017, the Fund has an unusually high 80% net long equity position, owing largely to the lower than usual correlation to broader markets that has been observed over the past six weeks. It's worth noting that the Founders Fund is approximately 1% off its all-time, year-end closing high; while former Partners Fund holders are approximately 7% off their 2014 closing high.

Venator Select Fund, our more concentrated, and less short, strategy enjoyed a better year, finishing up approximately 7% in 2016. There were a lot of give and takes over the year in the Fund, but in the end, not being short (for the most part) helped it post a profit for the year relative to our long-short strategy. The Fund is currently fully invested, and typically concentrated with 10%+ weights throughout. Venator Select Fund finished 2016 at an all-time high.

Venator Income Fund enjoyed a strong 2016, finishing up over 13% on the year. While this return is lower than the 17% gain generated by the Merrill Lynch High Yield Index, it was roughly in-line with the 14% return posted by its comparable ETFs (the Merrill Lynch High Yield Index is notoriously un-investible, unlike the S&P 500 as an example). Overall, being up over 13% is a good result considering our bonds have shorter durations, and the

portfolio has lower exposure to resources. We remain quite proud of the short, intermediate, and long-term track record of the Fund as a capital preservation strategy that has annualized at over 12% from inception (August 2008). We are currently in the process of adding several new bond opportunities to the portfolio, so we'll hold back from offering up a 2017 preview until next month, when we'll have a better idea of yield numbers across the portfolio. Venator Income Fund closed 2016 at an all-time high.

## WHAT WE ARE THINKING FOR 2017

We don't tend to put ourselves in either the bear or bull camps. Our hedging process makes our investing style fairly neutral in our preference for market direction, however, there are macro themes that we need to be aware of, and the following is a non-exhaustive list of themes that we think will dominate the year ahead.

As stated last month, taxes are the real story coming out of the US Election. New tax policy is what is going to determine whether the post-election rally was justified. Without meaningful tax reform, the rally will retrace, but I think there will be one really big 'give' in the form of a meaningful tax cut, with several offsetting takes that will be the primary focus of the first half of 2017:

- **The tax cut:** this is the big one, a meaningful tax cut that sees the corporate tax rate for domestic companies drop from the current 35%-40% rate to a new 20%-25% level.
- **Interest rate deductibility:** this is the biggest potential take back of proposed tax policy. Right now, the incoming government is suggesting changes that would mean that interest expense would no longer be tax deductible. In theory, the idea is to make companies indifferent as to whether they finance investments with debt or equity by taking away the tax shield that debt provides. In practice, this could be a lot more complex, with debt issuance moving to foreign subsidiaries and wreaking havoc for the structural business models of Private Equity and leveraged Mergers & Acquisitions.
- **The repatriation of foreign funds at a reduced tax rate may be a mild positive, although not as material as people think.** It boils down to how that money is used. It could simply be used to retire debt if interest is no longer deductible. It could be used for M&A, although that is a zero-sum game economically. It could be used for dividends or buybacks, but I have never been convinced that giving shareholders money back that is already theirs is the way to sustained prosperity relative to smart management teams who can reinvest that money into the business smartly.
- **Destination-based taxes is probably the most controversial, but least likely proposal to pass.** This proposal is effectively a back-door tariff that may be in violation of international trade agreements and plays favourites with some industries and business models over others. It's an interesting idea in terms of influencing production to move back to the United States, but ultimately, there are probably too many roadblocks in the way of implementation to make this a reality.

Another potential roadblock to the rally is that companies still must report earnings, even if Trump is the President. Nearly all the gains in the US this year came in the three weeks following the Presidential election (alternatively, Canada got its move largely from gold in the first half of the year, oil in the second half of the year, and financials throughout). A lot of the big, post-election movers have already started retracing their gains, especially in consumer-driven sectors, as the market has come to the realization that these companies will still have to report several quarters before any new policy hopes and dreams start to have even a small



effect on fundamentals. Post-election, general market euphoria will give way to individual fundamentals over the first half of 2017, although anticipated tax policy has likely created some permanent lift in the market.

Interest Rates will move higher, but how far and how fast? Thanks to the recent rally, the Fed appears to be ready to move full steam ahead on rate increases. Our opinion is that with stock markets pushing all-time highs, unemployment at cyclical lows, GDP stable, and the Presidential election in the rear-view mirror, the Fed has some serious catching up to do on the rate front. At this point in the economic cycle, interest rates should be several percentage points above current levels; bullets for when they may need to lower rates in the future. We believe that the implementation of lower tax rates will give enough of a boost to the economy to give the Fed the leeway to consistently raise rates every several months for at least the next two years. This should subdue any future hard market rallies, but the gives and takes should result in a quiet strength to markets over the near term.

While there are other things that we are watching, such as commodity cycles, international developments and currency effects, as well as general industry specific cycles, these themes will be the overriding ones that will likely effect everything. Canada is a bit tougher to call given our dependence on banking, combined with an extended housing cycle, as well as energy, which we remain bearish on. It also remains to be seen what effect higher taxes, combined with an alarmingly escalating deficit (both on Federal and Provincial levels), will have on global investment flows into Canada. We remain cautious on the prospects for Canadian companies that generate nearly all their business from Canada.

In closing, we are looking forward to 2017. We have recently witnessed some appreciation in our long ideas that were left behind in the market rally, and have used the broader rally to add some shorts and take down our ETF exposure. We are only a few percentage points from the Founders Fund reaching all-time highs, and are looking forward to exceeding that level and pushing forward from there.

As always, we reserve the right to change our mind!

Wishing you a healthy, happy & prosperous 2017 on behalf of all of us at Venator Capital Management Ltd.

A handwritten signature in black ink, appearing to read "BO", is positioned above the name of the signatory.

Brandon Osten, CFA  
CEO, Venator Capital Management Ltd.

*This commentary is intended for informational purposes only and should not be construed as a solicitation for investment in any of the Venator Funds. The Funds may only be purchased by accredited investors with a medium-to-high risk tolerance seeking long-term capital gains. Read the Offering Memoranda in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares. All stated Venator returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance.*