VENATOR CAPITAL MANAGEMENT LTD.

BUFFETT WINS THE (RIGGED) BET

Instrument (Inception)*	September 2017 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**1.6%**	**1.6%**	**11.7%**
Venator Investment Trust (September 2007)	**1.7%**	**1.6%**	**8.1%**
Venator Income Fund (August 2008)	**1.5%**	**6.0%**	**11.9%**
Venator Select Fund (September 2013)	**6.2%**	**1.0%**	**14.1%**
S&P/TSX Total Return (March 2006)	3.1%	4.5%	5.6%
Russell 2000 (March 2006)	6.2%	10.9%	7.8%
S&P Toronto Small Cap (March 2006)	2.1%	-1.9%	2.3%
S&P 500 (March 2006)	2.1%	14.2%	8.3%
Merrill Lynch High Yield Index (August 2008)	0.9%	7.0%	9.0%

By now you have read, or will likely soon read, about Warren Buffett winning his $1 million, 10-year hedge fund vs. the market bet, by a substantial margin I might add. The basic premise of the bet was that over the course of 10 years (beginning in 2008) the S&P 500 would outperform a hedge 'fund of funds' portfolio, as the hedge fund fees would eat up too much of the returns. Presumably, a group of equity based mutual funds would have also underperformed the S&P 500 due to their fee structures as well, but that's neither here nor there. The point was to advocate for low fee index funds over high fee specialist funds, as it's tough to beat the market over 10 years.

The other side of the bet was taken by Ted Seides of Protégé Partners, who invested his capital across five 'funds of funds', combining for underlying exposure to over 100 funds. In Buffett's own words "the overall performance of the funds-of-funds would not be distorted by the good or poor results of a single manager". What is wrong with selecting single managers whose results might distort the performance? Over ten years, one would think that any short-term *'luck'* exhibited by a single manager would average out over time to better reflect the strategy and skill set of that individual. I understand that Mr. Buffett wanted to put some parameters around the bet to virtually guarantee victory, but I would have suggested different parameters if I was Ted (such as limited net exposure to avoid structural advantages, and holdings that can only be public securities with market caps over a certain threshold).

From the beginning of 2008 to the end of 2016, Vanguards S&P Index Fund was up 85.4%, and the five Funds-of-Funds were up 8.7%, 28.3%, 62.8%, 2.9% and 7.5% respectively; weighed down by fees, trading and administrative costs, and short positions in a bull market. Note that all but one of these funds would have trailed the S&P 500 before fees, suggesting that perhaps the problem was fund/manager selection and not the fee structures.

Like a number of Buffett bets, this one was rigged (this is the genius of The Oracle, who is very cognizant of 'odds'). In fact, the premise itself was rigged. To summarize, Buffett's argument was that "fees levied by a variety of *helpers* would have their clients – in aggregate – worse off than if amateurs simply invested in an unmanaged, low-cost index fund". Of course, 'in aggregate' is important language here because, in aggregate, the active funds are the market!!! Mathematically, they combine to underperform by their fees. This was the 'gotcha' in Buffett approving the counter-trade of 100 hedge funds on the other side.

Mr. Buffett is a very smart investor, and financial bookie, to say the least. While I doubt he is reading this, I would be willing to bet that more single manager hedge funds in the US will beat the S&P 500 than whatever S&P 500 index fund he would like to choose from over the next 10 years. Of course, the reason why Mr. Buffett would never take me up on this bet is my worst-case scenario is a tie, as an index fund returns the index minus it's admittedly low fees, making outperformance a mathematical impossibility.

That said, Mr. Buffett does concede that there are managers (such as himself) that can/will outperform for long periods of time; but he notes that it's difficult to identify them in advance. He also skeptically noted that there are many managers that can outperform for short periods of time, which I would posit is often due to risk taking in periods of high momentum (this can take many forms, but the most obvious/prevalent would be the use of leverage and beta to enhance upward volatility).

Admittedly, we likely wouldn't be writing about this topic if our own Venator Founders Fund didn't make the cut. Since 2008, Founders Fund (net of fees) has beat the four indices that we track, which is no small feat given our historical weighting to the lesser performing Canadian market, and our historical short positions which have left us less than fully exposed to the rising stock market. Please note that ETFs carry fees as well, and while they are low, they would have resulted in net performance numbers that are slightly less than those outlined below:

TOTAL RETURN *(January 1, 2008 through September 29, 2017)*	
VENATOR FOUNDERS FUND LP	**135.2%**
S&P/TSX Total Return	50.9%
Russell 2000 Total Return	123.1%
TSX Small Cap Total Return	21.0%
S&P 500 Total Return	112.0%

ETFs have become something of a self-fulfilling prophecy which we have not participated in. They have driven the large caps which, in turn, have driven the ETFs. It's a somewhat circular effect, led by the most popular companies in the S&P 500 (also known as the household name tech stocks). My fear is that index-ETFs aren't stocks and are likely to be traded by most investors, who can't handle a buy-and-hold strategy during market turbulence. For example, if you own Apple stock, you tend to like both the company and its products. If the market were to fall, perhaps the stock holds up better because you and other shareholders believe in the company. If you own an S&P 500 ETF on the other hand, you have no such allegiance, loyalty or belief in a company; it's an abstract, a poker chip.

Therefore, I worry about what could stand in the way of a volume driven market correction, and I theorize that it will show a high degree of large cap correlation. The eventual correction will be characterized more by a stampede of broad market sell orders, and will require the few remaining fundamental value investors (who are interested in owning specific companies at the right valuation) to put a floor into it. Should the time come, that's where the buying opportunity will be, and that's where you will find us.

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

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.