

2018 YEAR IN PREVIEW

Instrument (Inception)*	November 2017 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	3.8%	5.5%	11.9%
Venator Investment Trust (September 2007)	4.2%	5.9%	8.4%
Venator Income Fund (August 2008)	1.1%	7.8%	11.9%
Venator Select Fund (September 2013)	10.5%	11.3%	16.1%
S&P/TSX Total Return (March 2006)	-0.2%	7.1%	5.8%
Russell 2000 (March 2006)	2.7%	15.0%	7.8%
S&P Toronto Small Cap (March 2006)	-1.2%	-1.5%	2.4%
S&P 500 (March 2006)	2.2%	19.5%	8.4%
Merrill Lynch High Yield Index (August 2008)	-0.3%	7.1%	9.0%

With 2017 now largely behind us, it's time to start thinking about 2018. The 13 months following the US election have been a period of ecstasy for the markets, with The Economist recently dubbing this *'The Bull Market in Everything'*, except for Put options (presumably), and laggards such as natural gas and gold. Several factors that have played into this bull market include:

- No real uncertainty:** Love him or hate him, Trump's election rid the market of political uncertainty. The market loves stability, and prefers slow progression to faster and unpredictable improvement. Indeed, when it was erroneously believed that Michael Flynn was set to give impeachment worthy testimony against Trump in a plea bargain with the FBI, the market tumbled nearly 2%. The market hates uncertainty.
- Interest rates and inflation:** Low and lower has been the name of the game. Cheap money, and no real fear of the primary justification for it, has continued to force 'widows and orphans' elsewhere into the market in search of better returns which, in some cases, has involved the use of increasing amounts of leverage. Either way, investors who generally don't want to take on more risk are being forced to do so to achieve adequate returns.
- ETFs:** Coming up on a 10-year bull run anniversary, coupled with low volatility, has led investors to believe that the easiest way to grab those 10% annual returns is to invest passively in the market. What this has caused is a general outflow of capital from specific stocks (and active managers) into the general market, where those with the highest weighting in the index (and not necessarily the best quality/valuation characteristics) get the most money. Played to its absurd conclusion, if the whole market worked this way and active managers became truly extinct, Amazon could declare bankruptcy tomorrow and the stock would not move, or could even possibly go up if ETF flows were strong enough!
- Low expectations:** This characteristic of the current bull market is often overlooked. Growth expectations are subdued for so many companies that it has become difficult to miss expectations - which is why we are seeing premium multiples (20x or higher) for relatively low growth businesses such as Proctor and Gamble, Coca-Cola, industrial distributors, and other growth challenged businesses. It seems as if the only thing that will get you a sub 16x multiple nowadays is neglect, or Amazon moving onto your turf. Watching Wal-Mart's stock rally past 20x earnings this year is an excellent example; it seems that two years of -5% earnings growth, on 1% revenue growth, is OK relative to these low expectations.

- **FOMO (Fear of Missing Out):** A classic sign of a speculative market, FOMO has overtaken FOLI (Fear of Losing it), and the recent fervor around Bitcoin is a perfect embodiment of this phenomenon. Without commenting on the specific characteristics of the headline grabbing flavour of the day, at this juncture, most people who want to buy it are doing so simply because it's going up; almost everything else you hear from this general group is simply a soundbite that they heard on CNBC/BNN. This 'fundamental based' tidbit of justification for wanting to buy Bitcoin is simply substitution for the real reason: because it's going up (some of the more plugged in people I know have real fundamental reasons for wanting to own cryptocurrencies; I am referring more to the investment community at large here).

This is by no means an exhaustive list of what has been driving the markets over the past 13 months, but it does summarize some of the strongest fundamental and psychological factors. We try not to get too hung up in market timing at Venator, as we are true 'bottom up' investors and try to let the fundamentals of the individual investment opportunities that we find dictate how exposed we are to the market at large. Historically, this has worked out well, even if the past 13 months have lacked market-like momentum. That said, we always have some broad-based concerns that could derail some of our long investment theses, enhance our short book, or simply serve as 'something to watch for' in terms of shifting the portfolio between large and small caps, all else being equal. The following is a list of potential market '*bogeymen*' that currently concern us for the 2018 investment year:

- **Wages and Inflation:** This represents the single greatest 'in your face' risk to markets today and it's already taking place, with the only question being how well it can be managed. It's a topic that probably deserves its own letter in the future, but for now, let us be brief. Wages are skyrocketing, and inflation is sure to follow, which could beget higher interest rates, which would be bad. Forget government mandated minimum wage increases - Corporations have moved ahead without them. Walmart just finished a two-year process of increasing their minimum wages, and earnings that were originally expected to get close to \$6.00 this year are now going to finish at around \$4.50. Recently, Target announced that their minimum wage initiatives over the next three years will push wages materially above where Walmart's are currently, meaning more pain for both, and possibly all retailers. We also hear similar stories elsewhere; and if labour continues to be scarce, businesses will need to pay more and more to get it. In terms of the current bull market, this is likely the single biggest, happening-right-now, concern that could blow the whole thing up.
- **ETF proliferation (this door swings both ways):** Passive investing is an easy way into the market, but it's also an easy way out of it. In the past, a longer-term investor may have thought twice before selling – *'the market might be going down, but Apple is a good company, so I'm not going to worry about it'*, or *'I still use Crest/Gillette/Tide (P&G) so let's ride this one out'*. Next time around, there will be much less individual security discrimination and/or loyalty. Instead, there will be more of an indiscriminate 'get me out' mentality, and everything in an ETF will go down together. With less and less '*active*' money in the markets, '*dinosaurs*' like us won't be as effective in creating a floor on the price of individual stocks. ETF sell orders, begetting individual stock sell orders, will simply overwhelm the market.
- **Speculation collapse:** As mentioned above, speculative fervor has gripped the market. The recent Bitcoin fervor is the most obvious example. In short, it's simply drawing in too many investors who don't know what they are investing in. The bear case: at least the famed Dutch Tulip Mania of the 1600's was backed by actual tulips. The bull case: if you're living in a third world country like Nigeria, you would rather have money in Bitcoin than a local bank. However, if you live in North America, where we have a stable banking system, the primary reason to '*invest*' in Bitcoin is because you think it will go up in U.S. dollars. In the stock market, investors are clamoring for Blockchain technologies much the same way they were clamoring for Linux-based technologies back in 2000 (to be fair blockchain *is* the future, but it's tough to see who will make money in it, much like Linux or Bluetooth). Bitcoin is the embodiment of FOMO at this juncture. FANG is so passé.

The performance of the Venator Funds during 2017 has been a tale of two cities. **Venator Income Fund** continues to put up stellar results, despite the general state of shorter-duration high yield bonds, and our limited use of leverage (typically less than 30%). We have continued to successfully exploit less crowded segments of the yield market in this strategy, with

a recent focus on convertible bonds, re-affirming the 'yield plus' investment philosophy that we utilize. **Venator Founders Fund**, on the other hand, has continued to tread water, and has largely missed out on the rally post the US election. That said, the Fund has generated some success of late, fueled by two successive earnings seasons in which our "hit rates" exceeded 70%. Similarly, **Venator Select Fund** has also posted strong results over the past few months, fueled by its concentrated exposure to our best ideas. With our portfolio companies proving out our theses over the past six months, we remain hopeful that the value discovery and share gains still lie ahead of us.

On behalf of the entire team at Venator Capital, I'd like to wish you and yours a Happy Holiday season – and a healthy and prosperous 2018!



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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.