2017: THE YEAR THE TAIL WAGGED THE DOG

Instrument (Inception)*	December 2017 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-0.7%**	**4.7%**	**11.7%**
Venator Investment Trust (September 2007)	**-0.8%**	**5.1%**	**8.3%**
Venator Income Fund (August 2008)	**0.4%**	**8.2%**	**11.8%**
Venator Select Fund (September 2013)	**0.8%**	**12.1%**	**16.0%**
S&P/TSX Total Return (March 2006)	1.2%	9.1%	5.8%
Russell 2000 (March 2006)	-0.4%	14.7%	8.0%
S&P Toronto Small Cap (March 2006)	2.6%	2.8%	2.6%
S&P 500 (March 2006)	1.1%	21.8%	8.7%
Merrill Lynch High Yield Index (August 2008)	0.3%	7.5%	8.8%

At the end of bull markets, the narratives (stories) tend to overtake fundamentals (facts) as the primary drivers of stocks. In the late 1990's it was 'eyeballs', while in 2007, it was 'peak oil' and China expansion. These days, it has been the proliferation of non-discriminatory ETFs, and valuations using EV/EBITDA (a lazy-investor's P/E, which is, in turn, a lazy form of free cash flow). We have now evolved into just needing to be in the right place at the right time – such as $1 billion blockchain startups/near-startups with no/little proven software code, to say nothing of revenues or customers – when investors really should be looking for *the right company, at the right price, at the right time*.

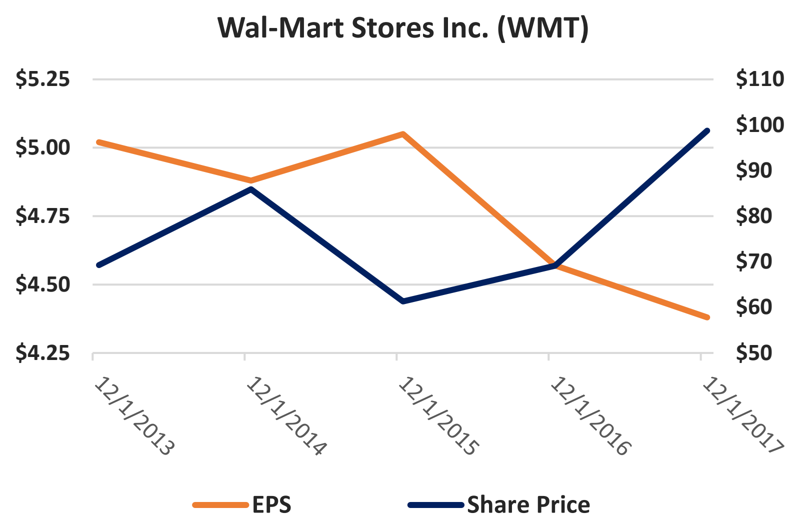
Canada is notorious for this type of shotgun approach to investing which, in my opinion, has something to do with our history of speculative resource investing. It wasn't too long ago that billion-dollar valuations were given to unpermitted and unproven (in terms of economic resource size) mining projects, years away from breaking ground, in risky third world countries. Before that, Canadians were as guilty as anyone, if not more so, in giving billion-dollar plus valuations to start-ups operating in the then-hot wireless telematics space. The boom-bust cycle is quite extraordinary up here, where 1000% gains followed by 90% losses, for 20-start-up stocks seems normal.

While we have given some robust valuations to the made-in-Canada marijuana sector (some more deserved than others), there will likely only be a few winners based on advantages of scale, in what looks to be a heavily over-supplied industry. Lately, Canada has joined the blockchain craze, where companies with, shall we politely say, spotty track records of operational competency, have seen their stock prices soar on the mere announcement of their desire to get into blockchain enablement, or cryptocurrency mining, despite no evidence of the technological competency to do so (my go-to due diligence question is "how many lines of code have they *actually* written?").

Granted, ETFs, which continue to experience strong inflows, don't invest in fundamentals. By design, all stocks are bought in the same proportions, regardless of whether they are beating numbers, missing numbers, or have just declared bankruptcy. ETF's don't discriminate. In this sense, the tail is wagging the dog in that we truly have a stock market, and we no longer have a market of stocks.

While we are not calling for the end of this post-Trump-victory run, it's worth noting that this type of increasingly thematic-macro-style investing, in the absence of knowledge-based research, coupled with FOMO (fear of missing out), is symptomatic of the late stages of a bull market. Without arguing the bull/bear case for noted winner Amazon.com, we wonder how many non-institutional investors own it because it's a 'great retailer', without understanding that its retail operations barely break even, and that over half of its value is attributed to its very profitable Amazon Web Services technology platform outsourcing division. To be fair, we doubt that most investors understood what Cisco or Nortel did back in 2000 as well.

We've mentioned this on several occasions beforehand, but an excellent example of the narrative winning out over fundamentals would be Wal-Mart, and its losing battle against Amazon. For some strange reason, the street thinks Wal-Mart is winning, despite Wal-Mart's earnings having declined by roughly 10% over the past three years, with virtually no revenue growth! This revelation comes as a surprise to some Wal-Mart bulls in this era of lazy investing, and illustrates how the narrative can win out when no one bothers to look at, or acknowledge, the actual numbers. A few years back, we noted a mismatch between Wal-Mart's depreciation and its capital expenditures, that would result in 2017 earnings being closer to $4.50 per share, as opposed to the expectation at the time of $5.50 per share. Fast forward to today, and the street has lowered Wal-Mart's 2017 earnings expectation to $4.43 per share.



The false perception of Wal-Mart's success stems from some obfuscating statistics it publishes relating to its ecommerce business. Wal-Mart does not publish actual useful numbers, only a narrative disguised as useful metrics, so bear with me. Comparable sales, ex-hurricanes and ex-ecommerce was only up about 1% last quarter - which isn't great. However, people get excited when they read that ecommerce sales were up 50%. To explain, one big part of that number stems from acquisitions, while the other is the 'order online, pickup in store' concept; the former being bought growth, and the latter being almost entirely cannibalistic of in-store sales, with neither offering indicative proof of any sustainable ecommerce competency.

Wal-Mart's immediate future also continues to be challenged. Target has already announced plans to push wages beyond Wal-Mart's levels over the next three years. Meanwhile, Amazon is not likely to let up on pricing pressure anytime soon, and the runaway success of Amazon Web Services gives them even more leeway to continue operating the retail arm with marginal profitability. In addition, Amazon is only now getting into the last two pillars of Wal-Mart's business that had been previously left alone: grocery and low income/food stamps, which combine for more than 50% of Wal-Mart's business. Put another way, 50% of Wal-Mart's business that was previously considered defensible against online competition is about to come under attack. Despite Wal-Mart's fundamentals having unquestionably deteriorated, its stock has appreciated by roughly 50% over the past couple of years, moving its P/E from 12x earnings to roughly 20x. Although the narrative has dominated to date, fundamentals will eventually become too significant to ignore, and will very likely prevail in due time.

A quick word on blockchain/bitcoin. Last week, a drink distribution company called Long Island Iced Tea went up 500% because they changed their name to Long Blockchain. As near as we can tell, they have no R&D

department or any other technological capabilities. The business currently loses $9 million per year, on $5 million in revenues. When it comes to the current hype phase: *IT'S OK TO MISS IT*. Blockchain is a 10-to-20-year opportunity and there will be money to be made post-shake out when the credible winners emerge from the rubble, just like in 2002.

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

Wishing you a healthy, happy and prosperous 2018 on behalf of all of us at Venator Capital Management Ltd.

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