

CORRECTION OR ROTATION?

Instrument (Inception)*	September 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	0.4%	20.2%	12.6%
Venator Investment Trust (September 2007)	0.4%	20.4%	9.5%
Venator Income Fund (August 2008)	0.1%	2.4%	11.2%
Venator Select Fund (September 2013)	-5.0%	26.5%	18.8%
S&P/TSX Total Return (March 2006)	-0.9%	1.4%	5.6%
Russell 2000 (March 2006)	-2.4%	11.5%	8.4%
S&P Toronto Small Cap (March 2006)	-1.3%	-4.4%	2.1%
S&P 500 (March 2006)	0.6%	10.6%	9.0%
Merrill Lynch High Yield Index (August 2008)	0.6%	2.5%	8.3%

With one quarter left to go in the year, the market continues to push forward, but at a mixed and slow pace. Both the debt and equity markets appear to have atrophied, waiting for a jolt to earnings from third quarter results, or punitive international trade policies from the unpredictable President Trump. With that in mind, we tread very cautiously into year-end as we see parallels between today's 'in-style' sectors and the investment environment of 1999-2000.

What we are witnessing is a move from bubble to bubble in retail investments, marked by amazingly high trading volumes (stocks turning over their entire non-insider shares outstanding multiple times per week) and extraordinary valuations and volatility by any historical standard. The past 18 months in crypto-currency and cannabis stocks is very similar to yesteryears' euphoria for e-commerce and wireless stocks. In the case of cannabis specifically, we are referring to multi-billion-dollar valuations for what are effectively startups, with no tangible proprietary advantages, in a market with low/no barriers to entry. To make matters worse, the current infrastructure of greenhouse assets will struggle to be price competitive against good old-fashioned farming, rendering whatever head start the Tilrays and Aphrias claim to have as worthless in a market that is expected to be multiple times over-supplied during full recreational deployment over the next six months.

That said, it's not just the retail investor that is getting swept up in the current euphoria, as institutional investors have found their own bubbles in what they believe are 'higher quality' sectors of the market, where they can tout better fundamentals as justification for their investment ideas, while ignoring the ominous parallels between 2000 and today. Unfortunately, fundamentals won't provide any meaningful line of defense in a sector focused, valuation-led correction – similar to what occurred 18 years ago. Back then, it didn't matter if you owned the fundamentally strong Cisco over the future zero that was Pets.com - either way, you were going to lose over 70%. When bubble valuations deflate there is no winning, there is only degrees of losing.

In my view, we are seeing multiple bubbles right now due to a lack of valuation discipline and a general ignorance of accounting standards. Whereas 'value' used to be anything below 10x earnings, the market now uses the lazier and pricier 10x EBITDA as the value yardstick (which is equivalent to 15x-23x earnings, depending on interest expense and capital expenditures). In technology and medical hardware, we have seen continued advancements in price-to-sales ratios to the point where they are often exceeding those witnessed in 2000 (10x sales-plus), despite materially lower growth rates today vs what was being achieved 18 years ago (sub 30% today vs over 60% back then). Price-to-sales and multiples of EBITDA, like earnings per share, are supposed to be stand-ins/proxies for normalized free cash flow valuations, but because they are further up the income

statement they contain less of the factors that make free cash flow the final determinant of value that it is supposed to be.

To further define the risk involved, you also need to consider the time that would be required to recover if a stock came down to more normalized valuations. For example, a 25% growth technology stock trading at 10x sales, which falls to 5x sales, may only take 3 years to recover its value (assuming no slowdown in fundamentals), whereas a 5% growth industrial trading at 30x earnings, that falls to 15x earnings, could take over 10 years to get back to level. These are the types of situations that we are currently trying to avoid, while at the same time acknowledging that both the business environment and the consumer remain relatively strong.

It's also worth noting that ETFs and algorithmic trading represent a much larger percentage of daily volumes today (the vast majority) as compared to 2000 (the small minority), and a stampede out of the market would very likely create selling volumes that the small remaining percentage of fundamental buyers could not come remotely close to matching. You won't see my Amazon bid in the system until it falls below \$1000, assuming I don't see any more attractively valued alternatives at that time.

As it relates to the Venator Funds, we continue to mitigate the element of risk through hedging (put options and short sales) and rotation. While it's painful to let go of some big winners that are fundamentally strong (such as Wayfair, Salesforce.com, and Tactile Medical), we see value in continually rotating into neglected companies (see our Gap, Inc. writeup from last month), along with un-discovered emerging companies and/or laggards such as Biolife Solutions and Wesco International. This strategy of rotation is the application my experience from 2000; while not everything went down, it just seemed that way because what went down were the only stocks that people were talking about.

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



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