WHAT A DIFFERENCE A QUARTER MAKES

Instrument (Inception)*	March 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-1.3%**	**7.5%**	**11.3%**
Venator Investment Trust (September 2007)	**-1.3%**	**7.6%**	**8.2%**
Venator Income Fund (August 2008)	**0.2%**	**4.0%**	**10.8%**
Venator Select Fund (September 2013)	**-0.4%**	**15.1%**	**15.8%**
S&P/TSX Total Return (March 2006)	1.0%	13.3%	5.5%
Russell 2000 (March 2006)	-2.1%	14.6%	7.3%
S&P Toronto Small Cap (March 2006)	-1.1%	10.7%	1.6%
S&P 500 (March 2006)	1.9%	13.7%	8.5%
Merrill Lynch High Yield Index (August 2008)	1.0%	7.4%	8.0%

The contrast between the fourth quarter of 2018 and the first quarter of 2019 has been astounding, going from one of the worst finishes to a year in market history, to one of the best starts to a year ever. The comparisons to 2008/2009 were out there in terms of overall market moves but without the existential risks to capitalism. The presumed guilty President Trump came out the other side of the Mueller Investigation unscathed, sending the conspiracy theorists into retreat, for now. Meanwhile, up here in Canada, the squeaky-clean Justin Trudeau has found his own administration caught red-handed in a judicial scandal. Does anyone even know what is happening with Brexit anymore? How did Canada's trade war with China somehow get worse than the States'? Come to think of it, whatever happened to the China-US trade war that tanked the market at the end of last year? What ever happened to blockchain? It's also interesting to note that the Fed, which was accused of being too hawkish on rates three months ago, is now being talked about as a potential rate cutter, even though the economy really hasn't shown any signs of change in the last three months.

As much as I would like to sort all of this out, the reality is that there is too much information/misinformation out there and the best we can do is buy low and sell high in what we believe to be a very stable economy. Volatility in an otherwise stable environment, driven largely by computer algorithms gang tackling immaterially directional indicators, should be able to present opportunities for profit, but, admittedly, may also result in some shorter-term setbacks.

That is not to say this isn't a tricky exercise. We like to think of ourselves as long-term investors, but that discipline can be tested when companies growing by less than 25% experience 50% moves in their stock prices, in less than three months. While we think we are buying undervalued stocks, these valuation gaps can close quickly in today's markets, while others seemingly take longer. Looking back, a good number of the securities that we purchased during the final week of 2018 have already been sold, despite our every intention of holding them long-term when we initially purchased them.

If there is one economic forecast that we see with some consistency in equity valuations, it's that cyclical stocks are preparing for the next recession. Valuations appear low on multiples of earnings, while profit margins appear high, but there are some mitigating factors. The first is the adage that cyclicals appear cheapest when they are most expensive (owing to profit margin degradation when cycles turn). We believe that technology forecasting simulations and pricing tools, coupled with outsourcing, have likely lessened the volatility in profit margins. Do you buy an industrial distributor trading at 7x earnings with the understanding that earnings could degrade in the short-term, knowing that it may likely trade above 12x earnings if you wait out the cycle (a potential three year 75%+ gain)? In our case, the answer is yes, followed by possibly buying more if the stock weakens. That said, in the short-term, being early is indistinguishable from being wrong.

Another first quarter phenomenon that we witnessed is the rebound in the super-hot sector of software-as-a-service (SAAS). There appears to be a false sense of stability with SAAS stocks because they operate on a utility pricing model. We have seen technology bubbles before, and, like all bubbles, they result when we see a collision of high valuations and a misunderstanding of risk. In the SAAS space, 10x revenues for sub-30% growth is where we draw our line in the sand on valuation (which is where I successfully drew it back in 1999 as well). In terms of risks, as was the case back in 1999, the market fails to recognize that the returns on software product investments (ROI) are somewhat ethereal (such as salesforce productivity, streamlining expense reports, employee training/education) as compared to a new plant or replacing a machine with higher hourly throughput. To be clear, these SAAS companies will likely continue to grow during a recession, but an economically driven slowing of the growth rate could have a devastating double-whammy impact on both forward expectations and valuations.

In the consumer space, as Amazon focuses more on non-retail business lines (currently representing 80% of its profits and most of its growth) the market seems to be getting less concerned about specialty retail stocks getting 'Amazon-ed', and this sector has experienced some renewed strength amidst reports that Amazon is actually losing online market share as consumers increasingly buy direct from brands online. While we have profited, to a limited extent, from this phenomenon, it's still too new a development to call a long-term trend.

Finally, let's talk about the cannabis space; not because it's important, but because it's topical. We are in the bubble phase of this market, where there are great short-term gains to be had, but with little doubt longer-term losses will be experienced from here, for the most part. Financial results in the space post-legalization, and on both sides of the border, have been generally disappointing in terms of pricing, volumes and profit margins. Equally disappointing has been government tax receipts, suggesting the problems stem from over-optimism and not company specific factors. Several weeks ago, I attended one of the larger annual small cap conferences in the U.S. and was surprised by the volume of cannabis start-ups looking for financing. While congratulations are in order for the Canopy Growth and Cronos' of the world, it may be tough to meet the lofty expectations in this business outside of the first movers. Licenses, both domestically and internationally, are not scarce; agriculture is a commodity; pricing is under pressure; and branding will not get you more than a 25% premium, in a deteriorating price environment (according to cannabis retailers). While there will still be a few winners out there, there will likely be more losers among the over 100 public companies carrying traditionally high valuations from here on out.

Equity Strategies Q1 Review:

Overall, we are happy with the performance of our equity strategies in the first quarter. Our unhedged Select Fund managed to outperform the markets on the back of some advantageous positions we purchased around Christmas. Meanwhile, Founders Fund/Investment Trust performed in-line with our net market exposure. While the long-side of the portfolio managed to keep up with the markets, it was difficult to make money on the short side in the quarter. We were surprised by some of the post-quarterly report upside moves of both our long and short positions, but a 10%+ move in the overall markets has a way of forgiving missteps in financial reporting. There was also a 'sold too early' aspect to some of our long positions (again, largely initiated around the holiday season) that held us back as we shifted some money from growth to value as the quarter moved on (winners sold include Ringcentral, EPAM, Wayfair, Salesforce.com and Shopify). Entercom Communications continues to frustrate us and management, who continue to aggressively pursue insider purchases in $1 million chunks (with the understanding that insider buying with personal money should be a more positive indicator than corporate buybacks, which are done with shareholder money). We continue to hold our Skyline Champion position and have added their main competitor Cavco Industries after a C-Suite scandal, as we remain bullish on the multi-year prospects for manufactured housing. Northwest Healthcare REIT continues to be rock solid, and one of the better performing REITs in North America despite an analyst community that continues to shun the stock (1 Buy, 5 Holds). We have also maintained our holdings in a few 'mega caps' such as Google, Disney and FedEx. Overall, we own a very balanced portfolio of both growth and value, which is also largely devoid of energy and financials.

Income Strategy Q1 Review:

Venator Income Fund is off to a good start in 2018 and is currently on pace to reach an 8%-10% total return for the year, well above its underlying yield. Exposure to convertible bonds, in addition to several high-yield bond positions that we initiated in late December when liquidity concerns were over-stated, have been sources of outsized returns within the portfolio. Our biggest challenge of late has been ‘recycling’ positions that have been called away from the portfolio into new opportunities that are equally attractive. The bond market has tightened up again, and loan quality is again at a low (interest rates are too low, maturities are too long, and covenant protection is nearly non-existent). This has resulted in our continued focus within the convertible space, with the rationale that if we aren’t going to receive any covenant protection, we might as well benefit from potential upside, while still getting the protection of par at maturity. We also have ample room to initiate new positions in the portfolio should opportunities present themselves.

With Select Fund currently ahead of the market, Founders Fund off to a solid start, and Income Fund on pace for a strong return year as well - we are happy with the start to 2019. We continue to find new opportunities in the markets and have our ‘shopping list’ ready in the event of market weakness. Despite the hyper-sensitivities of the news cycle and market technicals, we will continue to invest with the view that we are in a very stable economic environment, with interest rate noise and political rhetoric not being significant enough to affect this view materially. Near-term volatility can create profitable opportunities for us in the future.

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

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.