

SKINNY DIPPING IN THE BUBBLE BATH

Instrument (Inception)	June 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund* (March 2006)	2.2%	10.0%	11.3%
Venator Income Fund (August 2008)	2.0%	6.0%	10.7%
Venator Select Fund (September 2013)	4.5%	18.1%	15.6%
S&P/TSX Total Return (March 2006)	2.5%	16.2%	5.6%
Russell 2000 (March 2006)	7.1%	17.0%	7.3%
S&P Toronto Small Cap (March 2006)	4.3%	10.4%	1.5%
S&P 500 (March 2006)	7.1%	18.5%	8.7%
Merrill Lynch High Yield Index (August 2008)	2.4%	10.6%	8.1%

** Venator Investment Trust is also available as an extension of the Founders Fund strategy; its monthly performance mirrors the Founders Fund, and it is eligible to be held in both registered & non-registered accounts*

The market enjoyed its best month of June since the 1930's (!), along with its strongest first half in 20 years - thankfully, each of the Venator Funds were able to participate. While the performance of the largely unhedged Select Fund strategy has kept pace with the blazing start to North American markets in 2019, the hedged nature of the Founders Fund strategy has lagged. I recently read that 60% of trading activity can be attributed to passive ETFs, while another 20% is technically oriented, making the rising and falling tides of money-flow the biggest challenge to outperformance in a hedged vehicle during periods of increasing stock market values (conversely, in down markets like last year hedging can be a strong benefit).

In the case of Venator Income Fund, it's working ahead of its annual targets but has lagged the high yield market. This is largely a function of shorter duration positions, less resource exposure, as well as lower yielding convertible bond investments that are held within the portfolio. Convertible bonds, specifically, represent the preferred method for generating excess returns within the strategy, as opposed to levering up the portfolio in a low yield environment or lowering the overall quality of our bond investments.

Last month we provided a limited dissertation on some of the excess valuations that we have observed in the markets, which is reminiscent of what we noticed during the tech bubble of 2000. Back then, the tech 'crash' was preceded by an incredibly strong six-month rally, but a market top that preceded any real fundamental weakness by several quarters. This is the problem with bubbles - when you think they have gone too far, they can always go farther (because once they go through any reasonable valuation parameters the 'new paradigm' thesis kicks in), and they tend to burst when fundamentals are still strong, so it is difficult to predict the end.

My personal belief is that bubbles tend to be created more by apathy and laziness than anything else. While the research and due diligence process continues during these times, red flags are often ignored, or at least not deemed material to the juggernaut that is the macro thesis driving the bull run. I wasn't around during the 'nifty fifty' bubble, however, I would imagine that these blue-chip stocks reached extraordinarily high valuation levels on the basis of their status as 'one decision' blue chips more than any directional or growth changes in their fundamentals.

More recently, the fundamentals of individual companies in commodity bubbles such as oil, gold, and uranium didn't matter as long as the commodity thesis was strong. Only when the commodities weakened did investors (speculators?) realize that most companies simply didn't have viable or economic resources, even with the benefit of inflated commodity prices. In fact, commodity prices themselves were subject to a bubble-like macro thesis that flew in the face of fundamental analysis, as Chinese growth was going to obliterate any pesky supply/demand fundamentals that had governed commodity prices for decades.

Fast forward to today, and it would appear the cannabis bubble is on the verge of bursting. Not unlike the dot com and commodity bubbles of prior years, there are too many low-quality start-ups carrying valuations in the hundreds of millions (or billions) of dollars; the vast majority of which are likely to fail. As with the other bubbles, the macro thesis is failing as demand is disappointing, prices are declining, margins are weak, and supply isn't there as the lack of operational expertise in many of these companies is becoming more apparent. The macro 'legalized cannabis is going to be huge' is meeting the fundamental reality of requiring justification through financial results.

The financial crisis represented a different kind of bubble; caused by the lowering of lending standards and due diligence. This, in turn, led to the housing bubble - but really it was the lending bubble that threw everything into turmoil. When an overriding macro thesis takes over from fundamentals, sectors get untethered from reality and bubbles form. Most importantly, when bubbles form, people stop asking questions, and when that happens, problems ensue.

As previously mentioned, most of the trading activity in today's market stems from ETFs, buying both good and bad companies indiscriminately (as determined by active managers who buy and sell individual positions in varying proportions based on their collective assessment of the merits of the investment value). Has anyone even bothered to question whether this is a good development for the markets? It probably made much more sense when fundamental buyers represented most of the trading volumes, and the ETFs trusted that there was some oversight into what was being bought. ETF buying runs the risk of being today's version of the nifty fifty, but varying levels of performance between sectors suggests that the fundamental buyers still have enough clout in the market to separate the wheat from the chaff.

We are also starting to see apathy in other less visible areas of the market. Within debt markets, we are seeing valuation concerns in both the new issue and secondary segments. In the new issue market, we are consistently surprised by the low interest rates, extended maturities, and lower levels of security being offered. Perhaps this is why so many debt issues trade below par post-issue, which was a rarity several years ago. More disturbing, however, is how far you need to go out on the risk curve to get a decent return. In recent screens that we have run, almost everything yielding over 9% carries the significant risk of the holder getting dragged through a bankruptcy restructuring, which is not an enviable prospect for junior debtholders. The quoted prices of some of the worst situations (sub-\$100 million market values, billions of dollars of debt, with bonds trading over 80) appear to be artificially held up on very low/non-existent volumes.

Finally, the last and most obscure potential bubble we are seeing today involves securities without a mark-to-market component - private debt and private equity. Private debt doesn't impair easily so long as the borrower continues to pay interest, and it doesn't tend to handicap the likelihood of default the way public debt does - which is somewhat understandable since privately held debt tends to go unrated. In short, it's rare for private debt to be marked down from 100 to 93 because interest rates moved, or a major customer pulled its business. This is unlike the public debt markets where changes in interest rates and business prospects, asset values and the likelihood of default are priced daily.

Private equity is a different animal entirely. Unlike private debt, private equity should be subject to regular valuation adjustments just like publicly listed stocks, and while they do undergo periodic valuation reviews, they don't tend to be 'written down' as often as they probably should. Instead, private investments work similarly to public real estate trusts (REITs) whereby the REIT index reflective of the market's view of the valuation of assets in real time can drop 20%, but this doesn't necessarily change the calculation of Net Asset Value on the financial statements (even if the value of what the assets can realistically be sold for has gone down). Private equity managers with third party investors are also loath to write down their investments, lest they shatter the myth that private equity investing is less volatile than public equity investing (the reality is that it's only less volatile, in theory). Perhaps this false sense of low volatility is why we are seeing premium valuations in private equity as compared to the public markets; investors are so fascinated with a lack of volatility, no matter how artificial, that they are willing to pay a premium for higher leverage and lower liquidity!

I have seen and anecdotally heard of several instances of private non-mark-to-market investments that I have thought should have been written down in portfolios but, without a public quote, have not. Generally speaking, most investors aren't going to ask questions and instead enjoy the false sense of security that comes with investments that don't move, especially if there are dividends involved, which oftentimes might simply be a return of their own capital while the equity value unknowingly deteriorates in the background. This lack of behind-the-scenes knowledge is what led to the financial crisis in 2008 (reading *The Big Short* will give you a sense of how hard it was to get a valuation 'mark' on private mortgage books). Apathy on black box investments like private companies can lead to abuse in the hands of the wrong managers. While Warren Buffett's famous quote might not have been aimed directly at private investing, its wisdom applies doubly so to this murky but currently popular corner of the market:

"Only when the tide goes out do you discover who's been swimming naked."

Despite these early warning signs, it's important to remember that bubbles can extend for several years before most issues are exposed. The financial bubble was fairly well understood in 2007 prior to the market crash that occurred at the end of 2008; the technology bubble was considered a form of investment insanity by the early fall of 1999, but the NASDAQ didn't peak until the spring of 2000; the 'Nifty Fifty' achieved an average P/E of 42 times earnings (the market multiple was 19 at the time) with the 'best' stocks running well past 60x times earnings! (I would imagine that many professional investors were questioning the last 50% of that move). That said, I would also point out that times have changed and today's 'nifty fifty' would likely trade based on EBITDA or revenue multiples (this would keep Amazon, Salesforce.com, Netflix, Uber and other sub-optimal profit margin profile companies eligible for such exulted status) - such is the devolution of investment valuation standards that we are seeing today.

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



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