

## 2021: YEAR IN REVIEW

HEDGE FUNDS (Inception)	DECEMBER 2021	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund** (March 2006)	0.2%	6.6%	12.3%
Venator Select Fund (September 2013)	3.3%	16.6%	17.2%
S&P/TSX Total Return (March 2006)	3.1%	25.1%	6.9%
Russell 2000 (March 2006)	2.2%	14.8%	8.8%
S&P Toronto Small Cap (March 2006)	1.2%	20.3%	3.6%
S&P 500 (March 2006)	4.5%	28.7%	10.9%

ALTERNATIVE MUTUAL FUNDS (Inception)	DEC 2021	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund*** (January 2020)	1.2%	8.9%	8.9%	7.8%	6.4%	8.4%
B of A Merrill Lynch High Yield Index (August 2008)	1.9%	5.4%	5.4%	8.6%	6.1%	6.7%

*\*As of December 31, 2021*

*\*\*Venator Founders Alternative Fund, which holds the same securities as Venator Founders Fund, is now available as a Liquid Alternative Mutual Fund; it is eligible to be held in both registered & non-registered accounts.*

*\*\*\*Performance data prior to January 24, 2020, relates to Class F Units of Venator Income Fund, which was distributed to investors on a prospectus-exempt basis in accordance with National Instrument 45-106*

December continued the narrative that characterized the year as a whole, with large caps doubling small cap performance, another COVID variant, and more inflation concerns. It was a strange year in which large caps moved up consistently throughout the year, while small caps made all their gains in Week 1 and Week 52 of the calendar year. Meme stocks, cryptocurrencies, and startups accounted for most of the small cap activity. A few closing observations about 2021 below is followed by commentary on our own strategies.

**SMALL STALLS AGAIN:** The Russell 2000 small cap index was trading at January 7<sup>th</sup> levels on December 20<sup>th</sup>; this means that all the years gains were made in the first and last weeks of the year (the Russell 2000 growth index was down nearly 5% on the year in mid-December, before rebounding for a sub-5% annual gain). This stands in stark contrast to large cap stocks, which got off to a slow January, followed by a near straight line to new highs on a monthly basis. A lot this was mega-cap tech, which dominated the market due to their huge market caps exerting outsized influence on the S&P500; but financials, healthcare, energy, and real estate had some pretty impressive gains as well. This is the fourth time in five years that big has outperformed small, and within the S&P500, the bigger the better continues to hold true. For reference, our sub-25% weighting in large cap stocks included Facebook, DR Horton, and Lowes in the win column, offset by losses in Uber, Snap and Disney. In a low interest rate environment, multiple appreciation has been the driving force behind the large cap gains (we read a recent report suggesting that earnings growth is responsible for less than 30% of stock market gains over the last decade; the rest being a combination of multiple expansion and financial engineering in the form of dividends and buybacks).

**DID THE TECH BUBBLE BURST AND NO ONE NOTICED?** At one point in December, your average Nasdaq stock was down approximately 40% from its 52-week high. The biggest stocks have held up, but many great emerging companies got hit hard from the spring top. The Cloud Computing ETF had fallen 25% from its high, the Ark Innovation Fund (a benchmark for some of the most promising technology names available; valuations be damned) was off 40% from its highs. We do not historically participate in manias, although we will invest in lower valuation businesses in hot sectors because they are often either underfollowed laggards or attractive takeover candidates. The only tech stock with respect to which we gave back gains due to the valuation correction would be, multi-year holding,

OptimizeRx, that doubled this year, ending at the mid-point of its \$30 start to the year and its \$90 high (which was 20x 2022 sales estimates). Many of these fallen stars are outstanding companies, a few of which we have been able to pick up after substantial drops. That said, there are still quite a few 20x sales companies out there where there may have been some hesitation to tax-crystallize multi-year gains, so January could still be volatile in the tech space.

**A PARADOX: RECORD INSIDER SELLING AND STOCK BUYBACKS:** 2021 was the year of the buyback. Many companies responded positively to stock buyback announcements because it is a show of optimism by management and, oddly, is considered in the “returning cash to shareholders” bucket with dividends, which truly return cash to shareholders (much of buybacks are used to offset option issuance to management rather than strictly reducing shares outstanding). What was not as extensively covered was that these optimistic executives also sold stock at record levels. So, they are buying back stock with shareholder money but selling it within their own portfolios. We would suggest that many management teams are looking at profit margins and stock multiples they have never seen before and are taking their chips off the table. Accelerated stock buybacks, coupled with record insider selling, is a classic “do as I say, not as I do” scenario, and we would urge investors to check out insider selling filings the next time a buyback is announced.

**MORE MANAGEMENT SELLING: A RECORD YEAR FOR IPOs (WHICH WERE MOSTLY DUDS) AND ACQUISITIONS:** IPOs also had a record year. But after customary first day rallies, most IPOs turned out to be either too early, or too expensive, with the IPO ETF ending the year down nearly 30% from its high. Even in private markets there has been too much money chasing too little quality, as multi-billion-dollar valuations have been awarded to multi-million-dollar businesses (often with multi-million-dollar losses). We understand the model in that there will be a few homeruns to offset the many duds, and that the financings are structurally different than public equity, but if you are buying sub-\$100MM revenue streams for multi-billion valuations, you can find better value in public markets. Even among larger private equity deals, institutional investors appear to be losing their valuation discipline, and many deals include an insider sale block by current management. The point is that, along with insider selling, principals appear to be “sellers” in the current market, while the agents (outside investors) seem a little too eager to buy.

**MEME GAME(STOP) OVER? CRYPTO TO FOLLOW?** The “meme” craze kicked off in January, with GameStop stock going from \$20.00, at the beginning of the month, to nearly \$500, near the end of January. AMC Theatres and Bed Bath & Beyond followed the same schedule, although AMC had a further resurgence in June. Clearly, there was a casino aspect to the markets where suspect businesses were achieving dizzying market values, which often happens at the tail- end of a bull market. Start-up Electric Vehicles were achieving \$100BB valuations without a single car on the road (and getting top reviews by publications that usually wait to see mass production build quality and parts issues after months of driving), while EV nascent charging networks were being gifted market values between \$10BB and \$30BB (anyone who owns a Tesla knows how rarely you charge away from home).

At some point, the most speculative investors, influenced by some notable financial celebrities, turned to crypto-based memes like “Dogecoin” and “Shibu Inu”. Once Crypto got too boring, the fringe moved onto art/collector NFTs and videogame avatar NFTs costing thousands of dollars to play (which may constitute the “metaverse”, a term made popular by Facebook to distract from political fallout and privacy changes impacting its business; the recent metaverse spin is the third kick at the can for Facebook after buying Oculus in 2014 for \$2.3B and still not having achieved any widespread use or practical applications after billions of dollars invested since). NFT investing is akin to buying artwork/collectible with the intent of flipping it within a week; or doing the same with virtual real estate that is going for millions of dollars (someone recently paid US\$2.5M for a parcel of virtual real estate – that is more than the average house in most large North American cities). We will see if people maintain their convictions in these new

paradigms when “values” stop going up. Making money has a way of decreasing the level of skepticism that you began the investment with.

**THE DEATH OF DUE DILLIGENCE:** In an era where everyone is chasing memes and deals, we have found the due diligence of investors to be lacking. We have been on two “bet the company” acquisition calls in the last six months in which the CEOs could not even tell analysts what the targets’ growth rates and margins were in 2019 – basic stuff. We keep hearing about private equity due diligence periods lasting hours vs weeks out of fear of losing the deal. We get a ton of airtime on group investor calls because no one else wants to ask questions. If you do not ask questions, how are you going to get any answers? Thankfully, the analysts are still doing the work, even if we might disagree with their conclusions. But, in a market like the last two years, research and due diligence have been temporarily devalued. Computer/algo trading does not do research, most Reddit subscribers do not do research, and ETFs do not do research. That is about 90% of all market trading!

**SHORTAGES ARE CREATING A PEAK OF CYCLE FOR SOME, STILL TROUGHING FOR OTHERS:** Clearly, nothing is back to “normal” yet and won’t be for another year. Accelerated growth in “work from home” businesses are now up against tough year-over-year comparisons, and true growth rates will not be known until 2023. Many of these businesses have collapsed as 2022 forecasts have come down with companies like Peloton sitting near its 2019 IPO price despite a materially higher installed base driving the profitable subscription part of the business; Teledoc is suffering a similar fate – as we have been saying: valuation does not matter until it does! Restaurant and travel stocks are facing the triple threat of restrictive operations, labor availability, and commodity inflation. Retail is getting peak margins due to low discounting, but far from peak volumes owing to weak traffic and supply issues. Homebuilders are seeing unprecedented demand, but unprecedented labor supply shortages and unprecedented long lead times for materials. Transportation companies are achieving peak margins, while their customers have been hit by peak pricing. Venator multi-year holding LoveSac recently told us that their Q3 gross margins of 50% would have been 65% but for shipping costs! The number one question that we tend to ask growth cyclicals nowadays is: what was your pricing growth vs your volume growth? There will be a lot of moving parts in opposite directions (i.e., volumes up, pricing down) to keep track of in the coming year.

**COMMODITIES CORNER (GOLD, COPPER, OIL, GAS):** Commodities had a booming year. The star of the show was energy, with OPEC curtailments held through the reopening phase of the economy causing a spike in the price of oil even while North American storage levels stayed at normal levels and the world accelerated its move to end gasoline powered vehicles, hastening a multi-decade secular deterioration in oil demand. Natural Gas experienced a similar boom in the summer/fall, despite weather speculation having proved to be unfounded, and stocks ended up having a surprisingly good run even though winter pricing ended up sub-\$4.00, which is not anything particularly special. The “tier 2” notables included lumber off the housing boom, iron ore, and lithium off EV hype. Unfortunately, our mid-year bet on gold did not pay off notwithstanding that our prediction of second half inflation did. Gold seems to have lost its inflation-hedge crown to Bitcoin as institutions embraced the digital currency. Our personal belief is that Bitcoin was embraced as an inflation hedge narrative more because it was going up than people really believing it is “digital gold”, but a correction will be needed, possibly a level below \$25,000 sustained for six months, in order to separate the true believers from the “true believers as long as it is going up” crowd. Our copper call has not worked out yet, but we are sticking by it as a multi-year secular play on the electrical grid build-out, coupled with an acute production shortage (copper did stay above \$4.00 all year but it did not help our stocks as much as we would have thought).

**HOW MUCH DID STIMULUS COVER -UP IN FINANCE?** We looked at several lenders last year. One of the recurring themes was that their Artificial Intelligence had been refined to the point where delinquencies were at all-time lows, despite low or non-existent credit scores among their customer bases (we have heard some executives of new fintech lenders claim credit scores no longer matter). No one seemed to think that a combination of stimulus checks and a lower cost of living (from not going to work) was the main factor behind this two-year improvement. We suspect that many of these models are set to return to historical levels of delinquency, and those customers will be more discerning about paying usurious interest rates when the money is earned vs free. We are particularly interested in areas like sub-prime automotive loans, where used car pricing could collapse once new car production gains steam and recent used car buyers just “put” their cars back to the lenders.

## VENATOR FUND REVIEWS

**VENATOR EQUITY STRATEGIES:** Our equity strategies had mixed results with our Founders Fund underperforming after a stellar 2021 and our Select Fund having another strong year. Our biggest issues in the Founders Fund were a lack of 200%+ gainers (we had our share of doubles but not home runs), and our hedging, which effectively cut our returns in half (we were approximately 60% net invested for most of the year). While our option strategy did do better than being short the market, without much volatility/reversals, it was difficult to produce any periodic gains as we did last year. Without the hedges, our Founders Fund would have produced similar returns to the Select Fund, and we continue to refine the strategy to offer similar crash-protection but better upside participation.

From a sector standpoint, we had a good mix of software, technology-enabled innovators (companies like Uber and ZipRecruiter), consumer products, building materials and copper producers. We also have select positions in real estate (long-term holding Northwest Healthcare), automotive parts, industrial products and other growth special situations. Late in the year, we started buying some previously overvalued growth fallen angels that we have been watching for years. We have always believed that when great companies fall 50%, without any negative impact to their greatness, it's time to take another look; and just because it is out-of-favor, owing to a previously too-high valuation, the underlying value of the business hasn't been impacted.

We believe that we are invested in strong multi-year secular themes and extended cyclical themes. For example, we are extremely bullish on a shift to online recruiting (currently only 5% market penetration) and believe ZipRecruiter may only be trading at 10x 2024 earnings per share despite a 7-year double digit growth outlook. We believe that Skechers has been largely ignored, trading only at 12x 2023 earnings per share, despite being the third largest shoe company in the world, with a higher growth rate than the leading two vendors; it trades at half the multiple of the rest of the sector. We believe Uber is set to reap the rewards of a reopening economy, while food delivery has more staying power than expected; to those who say: “What about regulation?” my response is simply, “If they raise prices, what are you going to do, call a cab?”. We believe that Shawn Nelson, of LoveSac, is an unappreciated innovator and pioneer in the furniture industry, and the company deserves more sell-side attention. We believe Caesarstone is too cheap, trading at book value, with a good secular tailwind and brand name recognition. We believe Victoria's Secret is too cheap at 7x earnings. This is obviously a small sampling of our holdings, but some of these theses seem too obvious to ignore.

Not everything is going to work out the way that we expect, even if we think they all will. The markets will move some sectors in and out of favor. Some of these companies will disappoint us; some will surprise us. Some might make good acquisitions; some might make bad deals. But, on balance, we think we have a great mix of growth, value, proprietary products, secular outlooks, and overall strong businesses. We look forward to a year of solid returns.

**VENATOR INCOME STRATEGY:** Our Income Fund had a great year, while high yield bond markets got weighed down by low interest rates on new issues. As we have been saying all year, our convertible strategy has been a big part of

our strong performance. Because this is largely a “capital preservation” strategy, we don’t hold our convertible securities very far through “zero yield” as underlying stocks move through conversion prices, so we found ourselves selling some highflyer technology converts prior to the late year tech valuation correction. But the correction did give us a chance to continuously reload the portfolio on favorable terms.

While we have been maintaining our current yield at approximately 5.5%, and our yield to maturity above 6.5%, we would note that heavy weighting to more equity sensitive convertible bonds can cause some temporary fluctuations in the portfolio as these securities do not generally have high coupons attached to them. This is a small price to pay for the higher credit quality and optionality embedded in these bonds, coupled with relatively short duration and tax advantages of capital gains vs income treatment.

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

On behalf of the entire team at Venator Capital Management Ltd., wishing you a happy, healthy, and prosperous 2022!



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