GOOD RIDDANCE 2022

HEDGE FUNDS (Inception)	DECEMBER 2022	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-5.3%**	**-44.6%**	**7.7%**
Venator Select Fund (September 2013)	**-9.2%**	**-59.9%**	**4.5%**
S&P/TSX Total Return (March 2006)	-4.9%	-5.8%	6.1%
Russell 2000 (March 2006)	-6.5%	-20.4%	6.8%
S&P Toronto Small Cap (March 2006)	-1.8%	-9.3%	2.8%
S&P 500 (March 2006)	-5.8%	-18.1%	8.9%

ALTERNATIVE MUTUAL FUNDS (Inception)	DEC 2022	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-1.6%**	**-15.3%**	**-15.3%**	**-0.6%**	**1.3%**	**4.7%**
B of A Merrill Lynch High Yield Index (August 2008)	-0.8%	-11.2%	-11.2%	-0.2%	2.1%	3.9%

** As of December 31, 2022*

*** Venator Founders Alternative Fund, which holds the same securities as Venator Founders Fund, is 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*

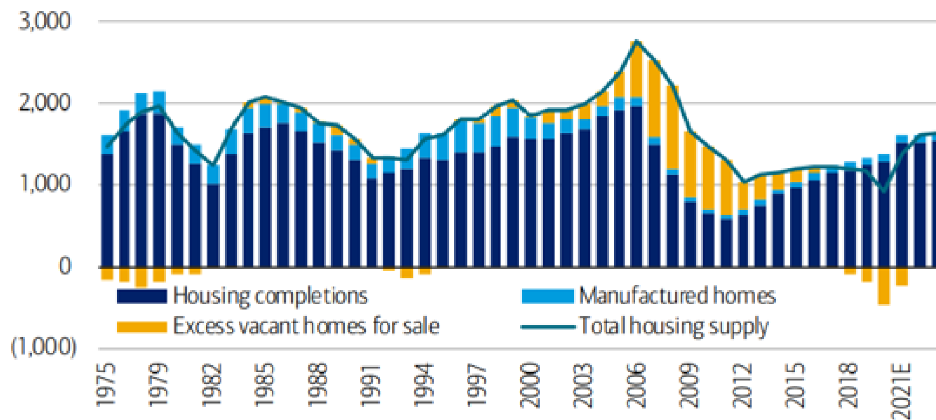
We tried to say goodbye to 2022 last month, but the market took one more step down into year-end. While another benign inflation report seemed to suggest that the worst of inflation is behind us, the Fed turned a blind eye to the CPI, a widely anticipated 2023 recession and accompanying earnings disappointments. We would note that if the definition of recession is two consecutive quarters of declining real GDP, we are already there. However, if the definition is a more subjective matter involving an undefined unemployment level and words like "significant declines in economic activity", then it might never happen (at least not until it is politically expedient to claim it did). Google "recession definition" and you will find that something that should be measurably objective has become incredibly subjective.

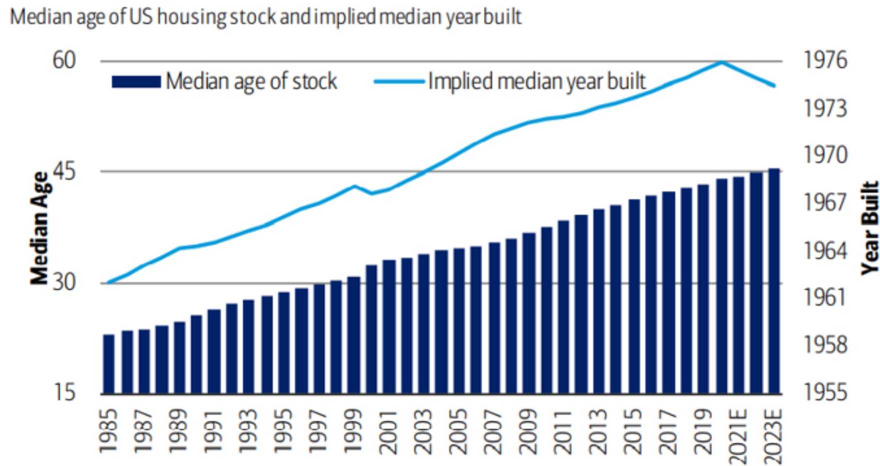
While some bears are concerned about a widespread aggregate earnings miss next year, we would note that the last two times that the markets experienced catastrophic earnings misses were in 2009 and 2020 – pretty good years for the stock market. The bull/bear earnings call is often characterized by the optimistic stock analyst "bottom up" crowd (aggregating the earnings for all individual companies estimates) and the pessimistic macro "top down" crowd (a group that basically says: no way all those companies are going to hit their numbers). The truth is that some companies will beat, and some will miss, some will grow, and some will not, and some stocks will go up and others will go down. There are a lot of sectors in the broad indices of companies and, even just breaking them down by sector, we can glean some insight into earnings next year. Using this year's extreme ends of the of the performance spectrum, cloud/SAAS sector (down 50% last year) earnings will likely be higher because these are utility-like subscription models that add to revenues each year and these companies are now cutting costs; that's not to say that they will meet expectations, only that earnings are likely to grow. On the other hand, energy earnings (sector up 50% last year) will likely decline, with oil prices down 30%+ from their peak and natural gas prices down 50%; but the stocks are believed to have low earnings multiples so they could continue to work. In a counter-cycle example, homebuilder earnings are set to implode next year, and sentiment can't get any worse, but the stocks have been strong in the past six months because they traded below book value despite the expectation that they will still earn money next year. The point is that it's not enough to say that earnings will beat or miss in determining equity performance. As the saying goes, *"Prediction is very difficult, especially if it's about the future"*.

Even hindsight can yield surprises! Hands up if you knew that European markets massively outperformed North American markets last year!!! European stocks rallied into year end with the German (DAX), Paris (CAC) and London (FTSE) indexes finishing the year down “only” 13%, 10%, and flat, respectively, despite the energy-induced inflation “crisis” and recession conditions that were far worse than anything we experienced on this side of the pond. This compares with S&P500’s near 20% drop and the NASDAQ’s over 30% fall. Short America/Long Europe netted you a 12% net gain for the year, and a 9% gain if you put this trade on *after* Putin attacked the Ukraine and cut off Europe’s main source of energy (this trade still would have been profitable after adjusting for the Euro and Pound weakness). Maybe Powell really is screwing this landing up compared to his international counterparts given that the problems of Europe from an inflation and recession standpoint are far worse that what is a comparatively mild and seemingly temporary inconvenience here in energy secure and militarily remote North America.

TWO THEMES FOR TWO YEARS

Nearly all industries are inherently cyclical and there are bull and bear arguments for all of them. At the top of the cyclical chain are units of supply and demand, and the second tier are estimates around pricing and costs. Failing that, there will always be valuation as stocks usually bottom well before the fundamentals do (2020s March low being a case in point as the market bottomed while business was largely still open on the way to lockdown). A more recent example, the housing market is extraordinarily weak right now, but the stocks of homebuilders have been very strong, possibly starting six months before the “bottom” which will probably be in Q1 2023. This happened because many were trading below book value – the historical valuation bottom. Earnings can fall dramatically, and assets can be impaired, but homebuilders rarely lose money on a home sale. As it stands now, gross margins in the sector are expected to decline from all-time highs of 27%-29%, to cyclical lows of 17%-19%, impactful for earnings, but not for book value. While the population has grown over the last several decades, housing supply has not. As a result, the average age of an existing home in the US is now over 40 years old, giving a positive longer-term narrative to both homebuilding and the repair and renovation market. It is estimated that two-thirds of all home improvement costs are non-discretionary.





Housing is cyclical and cyclical adjustments will happen, as we are seeing today, and you can have a bad cycle within a good secular market. But there is little doubt that demand growth and undersupply are secular issues. Going into 2020, homebuilding supply had not kept pace with demand, a remnant of ten years of underbuilding following the financial crisis. Freddie Mac estimates a current shortage of nearly 4MM units, and nearly 300K are torn down every year, while 1.3M are built. In other words, there is at least four years of catching up to do, plus the unmeasured supply crunch of existing owner hesitation to move that involves trading in a sub-4% mortgage to a 6%+ one. Higher interest rates, to the extent that they persist, will likely exasperate the unit supply-demand problem, rather than alleviate it, even if prices decline. With higher mortgage rates keeping existing house trading subdued, the homebuilding and renovation markets should be in a position of strength once the market finds its price/rate balance.

Within our own holdings, we have identified several investment opportunities in this sector. One of our larger holdings is M/I Homes, a mid-sized homebuilder that trades at 0.6x of our projected book value. The company also trades at only 5x next year's projected earnings. While those earnings could miss expectations, we are reasonably confident that they will earn something, which will add to book value. We believe the stock can double to book value+ in the two years. We are also selectively buying some building products companies that are levered to the renovation sector and are not as sensitive to commodity pricing for their products (i.e., doors and finishings vs wallboard and lumber). Masonite, one of the leaders in the two-company oligopoly in door manufacturing, is a position that we recently re-entered. Prices rarely come down for doors, and, with their main competitor struggling as of late, we don't think that they are in a position to initiate a price war, even with cost inputs coming down in the last six months. Finally, the market for doors is roughly a 50/50 split between new homes and renovations, providing some insulation depending upon which way the market tilts.

The other theme that we believe has secular longevity is the build out and "hardening" of the electrical grid. As the world attempts to transition to renewables and infrastructure, electrical transmission and storage build out and grid modernization should be a multi-year theme, because it is going to take a lot of time and a lot of money to materially lessen our reliance on fossil fuels despite unrealistic government narratives. The recently passed US federal stimulus bill caters directly to this market. We have found several companies that are currently experiencing strong financial results yet are trading at what we consider to be deep discounts to their value. Portfolio holdings Wesco International, Atkore, and Hammond Power Solutions all trade below 10x earnings yet, in our estimation, hold the promise of near-term 50%+ upside. In the case of Wesco, they are still absorbing and improving on their transformative acquisition of Anixter from two years ago, making them the market leading distributor for electrical and utility solutions with over $20 billion in revenues and a growing backlog. Its acquisition of its largest competitor, Anixter, in 2020 was the result of a highly contentious bidding war against a large private equity firm that was so attractive that the PE firm contemplated buying both companies; but in the end, Wesco won out. Atkore and Hammond Power, both recent re-entries into positions that we have owned in the past, have each recently announced demand induced multi-year

material capacity expansions, yet the growth they are both seeing is being heavily discounted. In fact, all three companies trade at less than 8x earnings in sectors where comparables trade on average at 14-20x.

EQUITY PORTFOLIO

The current portfolio is decidedly leaning towards value, with approximately half of the portfolio trading below 15x earnings, and most of that below 10x. That said, these companies all have growth characteristics to them, and we believe are deserving of decidedly higher valuations; in many cases, over 50% higher. The balance of the portfolio is made up largely of companies that we also consider value stocks on metrics not as explicit as the P/E ratio. For example, we recently purchased leading dental consolidator Dentalcorp, a unique asset that put itself up for sale; we believe that they will receive multiple bids from deep pocketed buyers after this recession resistant former market darling fell 50% last year. We also recently purchased shares of small cap software company D2L, one of a handful of education technology companies catering to K-12 and post-secondary education (as opposed to more discretionary COVID programs such as tutoring); at 0.7x revenues net of a $100MM cash balance. This is a very cheap software business after having fallen 50% this year (competitors trade at over 4x revenues). While we aren't necessarily looking to invest in fallen angels exclusively, with over 3,000 of the approximately 10,000 listed North American stocks down over 50% from their 52-week highs, there must be some gems among the rubble.

FIXED INCOME PORTFOLIO

Currently, the fixed income portfolio is targeting a yield of approximately 10% using minimal leverage of less than 20%. We continue to see several interesting opportunities in this market. As mentioned above, we have a strong intermediate view of the homebuilding sector and have found several high yielding bonds offering 2-3x asset coverage consisting largely of land – even a land value impairment of 20% would leave these bonds whole with a significant margin of safety. Current interest rate fears have created several good credits with higher yield opportunities. While the economy appears to be under attack by Central Banks, the existential risk that existed in 2009/2020 is not a parallel to today's markets where risk is largely "mark to market" rather than solvency. For example, long time holding Northwest Healthcare REIT has convertible bonds that mature in a year and carry a 7% yield, a very attractive opportunity considering the company's assets consist largely of hospitals on 10+ year inflation protected leases. With most bonds trading below par, future returns should offer some tax advantages as well. We also hold larger positions in UBER (which is inflecting cash flow positive), Ziprecruiter (which is very profitable and has net cash), StorageVault (backed by extensive property holdings), and Chemours (a chemical company that rarely loses money, even in downturns) among others carrying 7%+ yields.

OUR FINAL WORD ON 2022 AND THE ROAD FORWARD

After some bold and successful moves during the turmoil that was 2020-2021, we put up our worst year in our history, in both absolute and relative terms. While we foresaw inflation coming in early 2021, we also saw it abating by the end of 2022. One of our more critical errors was assuming that the Fed would draw the same conclusion and stop hiking rates as inflation slowed (with hindsight, if they didn't see it coming when we did, we should not have assumed that they would see the end coming either). While we consciously avoided what we thought were all the "bubble traps", such as cannabis, crypto, startups, SPACs, electric vehicles, and high revenue multiples in tech, this provided little defense for what we thought was a lower risk growth portfolio than it ended up being, as growth went out of favor in general, rather than just specifically for the bubble sectors. Even our "blue chips" suffered, such as Disney, which beat streaming subscriber numbers and park attendance expectations at a time when the competition was faltering but suffered from the moving goalposts of anti-streaming sentiment once Netflix went out of favor, and

vacation experiences once recession concerns took over. Caesars Entertainment finished the year with record results in Las Vegas, Regionals and Online, but its stock managed to suffer a worse fate than the Macau casinos, where operations were closed for much of the year! Finally, UBER managed to grow by 80% (over 2x the competition's growth rates) while ramping profitability and increasing its competitive advantages, but still suffered a 40% decline. That's not to say all our companies suffered simply from valuation contraction. There were some misses that we didn't see coming, such as the black swan soap opera in the drug discovery space we wrote about last month, which was our worst loss ever in terms of percentages. Finally, while our option hedging strategy was ahead of the curve in 2020, the slightly-in-the-money three-to-six months out Put option strategy stopped working this year as it became more popular among hedgers, premiums increased, and the market didn't have any big directional changes in this bear market that lasted from January to December.

After further reflection on the year, we have made some changes to the portfolio structure of the equity portfolios. Naturally, while we prefer to "buy and hold" as long as we see the fundamentals being intact and valuations being reasonable, this was a strategy that failed us last year. For the most part, our biggest losers experienced revenue and earnings growth that exceeded expectations, but a stock that goes from 18x earnings to 9x earnings, or 1.2x book value to 0.6x book value is still down 50%, which demands a lot of growth to make up for, even with fundamentals intact. We have developed several internal algorithms to prevent this year's poor performance from recurring. Specifically, we designed these models to avoid outsized single position losses, but always with an eye to better re-entry points at a later date. These metrics relate to initial position sizing, entry points, and exit points based on internal targets and underlying volatility. Extensive back testing of fifteen years of our historical positions suggests no negative impact to historical returns but materially lower downside volatility in times of market stress. Importantly, it doesn't alter the characteristics of the pool of candidates from which we profited from in the past. We expect that this will result in better downside management while letting the upside take care of itself.

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 2023!

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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