UNINTENDED CONSEQUENCES

HEDGE FUNDS (Inception)	MARCH 2023	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-0.7%**	**9.0%**	**8.1%**
Venator Select Fund (September 2013)	**-0.3%**	**15.1%**	**5.9%**
S&P/TSX Total Return (March 2006)	-0.2%	4.6%	6.3%
Russell 2000 (March 2006)	-4.8%	2.7%	6.9%
S&P Toronto Small Cap (March 2006)	-0.4%	4.5%	3.0%
S&P 500 (March 2006)	3.7%	7.5%	9.2%

ALTERNATIVE MUTUAL FUNDS (Inception)	MAR 2023	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**0.2%**	**4.4%**	**-7.9%**	**9.0%**	**2.4%**	**4.5%**
Venator Founders Alternative Fund (July 2021)**	**-0.6%**	**8.4%**	**-29.1%**	**-**	**-**	**-**
B of A Merrill Lynch High Yield Index (August 2008)	1.1%	3.7%	-3.6%	5.8%	3.1%	4.0%

** As of March 31, 2023*
*** 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*

March was a bit of the crazy month in the markets, even relative to recent history. A lot of this was due to a new "crisis" (Isn't everything a crisis? No one ever clicked through to an article on "manageable problem"). Small caps took the worst of the fall, dropping nearly 10% by mid-month as investors shifted into large caps and mega cap tech indexes; anything to avoid exposure to the dozens of listed small cap regional banks in the US. In Canada, we had some collateral damage in our own banking sector, while last year's natural gas rally completely unraveled (not that there was ever any risk of a North American supply shortage) leading to weakness in the energy complex. But by the end of the month, the market had a decent rebound on waning inflation data, the Fed guaranteeing the security of bank deposits, and the hope that interest rate increases are nearly done.

We don't typically invest in the banking sector and are by no means experts, but for those who haven't unpacked what happened, we will do our best to briefly summarize what led to last month's events. A bank balance sheet basically consists of deposits on the liability side and mortgages and government bonds on the asset side. When the Fed raised rates last year, it sent prices of longer-term mortgage and government bond investments (assets) down as much as 25% for 20+ year maturities, while short-term deposits (liabilities) are always flat. This meant that some banks would not have enough liquidity to cover deposits if depositors wanted their money out today, even though the maturity/face value of the assets was more than enough to cover deposits. In the case of Silicon Valley Bank, there were roughly $195 billion of bank assets backing about $175 billion in deposits, leaving about $20 billion of breathing room. But when those assets dropped by 10%+ on a "mark-to-market" basis, it became clear that the bank wouldn't be able to cover withdrawals if it had to sell all the assets immediately, which is what happened. Most of the assets were carried at 100 cents on the dollar on the financial statements due to accounting rules, but that doesn't mean they could sell for that amount today. This sent shockwaves through the banking sector as the market came to the realization that there were over $600 billion of "unrealized losses" on bank balance sheets and that a lot of banks could find themselves in similar conditions to varying degrees. First Republic Bank, which fell from $150 to $15 per share, provides one illustrative example where one research report determined the value of the company to be $50 on a P/E basis, $30 on a stated book value basis, or negative $5.00 on a current book value basis.

When the Fed said they were willing to "break things" in their record rate hiking fight against inflation, we seriously doubt they contemplated causing the drop in safe bank assets (government bonds) putting real time balance sheets offside. Powell and Co were thinking more along the lines of unemployment going to 5%, or stock valuations coming down, or private equity owned investments going to zero as ownership transfers from equity holders to debt holders (the companies would survive), or earnings going down as debt gets refinanced at higher rates, or bond investors suffering short term losses but still recouping value at maturity. Sending bank balance sheets offside versus deposits on a mark to market basis was an unintended and unforeseen consequence of their actions. This is why they had to step in and guarantee bank deposits by allowing banks to borrow from the Fed against the face value of the bonds. If there is one thing the Fed knows, it is that people can't lose faith in the security of their deposits without the entire system collapsing. You can let banks and debt holders go under but not the depositors/customers (and before we start discussing "moral hazard", we would encourage you to ask your local CFO if they have read Note 23 on page 62 of their own bank's financial statements where the "unrealized losses on assets" disclosure is approximately located).

This whole fiasco put the Fed in a difficult position with regards to its fight against inflation. It can't raise interest rates anymore without directly sending bank balance sheets further offside. So, they need to find another way, likely stepping up its efforts to "shrink the balance sheet". If the Fed can't keep raising rates, then bond pricing can stabilize, companies can borrow again, acquisitions and go-private transactions can be financed again, and people can start buying houses again. Putting in a possible ceiling to interest rate hikes, with a speculative narrative about late year cuts, got people excited again. Even if there is an imminent recession, investors are looking past it for now. It is worth worrying about what the Fed is going to do if inflation perks back up and they don't feel they can raise rates much further without risk to the banking system. After all, they are somewhat directly responsible for the current state of the banking industry since it was their hikes that sent the balance sheets of held-to-maturity assets offside in the first place.

For our own part, we remain focused on homebuilding and electrical infrastructure as two secular themes for the next 5-7 years. We don't have any public homebuilders in Canada, and it isn't a very well followed industry in the US (since there are so few of them and they never do any corporate finance), so we had to learn this industry from scratch. The only reason we even started looking at this industry last year was because the builders were trading below book value. But after being invested in the sector for more than six months, we have become increasingly impressed with the sector. For one thing, they are incredibly nimble for companies that sell high priced low turnover assets. When "affordability" is low, they simply start building homes with smaller square footage or lesser finishings, same land, more houses. It's more of a turnover game than a maximizing dollars per house game. These adjustments have caused buyers to start coming back to the market recently. And while earnings across the group are expected to be down this year, they will still be earning and adding to book value. The sector has moved up over the last several months, much to the dismay of generalist market watchers who are perplexed by how the stocks have risen in the face of such a difficult macro environment for housing. The rise of the sector has been a rise to book value, although there is some concern around vintage 2022 land purchases being overvalued (impairment commentary has been low thus far and gross margins have fallen only slightly below pre-2021 levels). Given earnings are expected to remain positive, even during the current first quarter, which should mark the bottom, there are gains to be had while companies add to book value through the trough.

While under normal conditions, new homes might make up 10% of all home sales in a given year, they are expected to be over twice that rate this year. The "problem" of existing homeowners not being willing to give up their low rate 30-year mortgages by moving is an issue that will likely benefit homebuilders for the next ten years. Couple that with underbuilding for the last ten years, a household formation generation that has delayed homebuying, and a 40-year-old housing stock that is in dire need of significant renovation, or outright tearing down, and you have a long lived secular growth thesis.

Of course, if the stocks are trading at book value, then these homebuilders' bonds must be valued well below the tangible asset values. Most homebuilders have far less leverage than they were carrying 15 years ago, a function of caution out of the housing crisis as well as the outsized earnings they have experienced over the past three years. Even after discounting land values by 15%, most homebuilders still have better than 2x asset coverage. Although bonds have gone up in the sector, they are still yielding good returns for assets that are backed by tangible value.

We reserve the right to change our mind!

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

This commentary is intended for informational purposes only and should not be construed as a solicitation for investment in any of the Venator Funds. The Venator Hedge Funds may only be purchased by accredited investors with a medium-to-high risk tolerance seeking long-term capital gains. Please read the Offering Memorandum for each Hedge Fund in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of securities. All stated Venator Hedge Fund returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance. Commissions, trailing commissions, management fees and other expenses all may be associated with investing in any of the Venator Alternative Mutual Funds. Please read the prospectus and Fund Facts relating to each Alternative Mutual Fund before investing. The indicated rates of return of the Venator Alternative Mutual Funds are the historical annual compounded total returns, including changes in share or unit value and the reinvestment of all dividends or distributions, and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated.