THE EARNINGS APOCALYPSE THAT WASN'T

HEDGE FUNDS (Inception)	APRIL 2023	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-1.9%**	**6.9%**	**7.9%**
Venator Select Fund (September 2013)	**-2.7%**	**12.0%**	**5.5%**
S&P/TSX Total Return (March 2006)	2.9%	7.6%	6.5%
Russell 2000 (March 2006)	-1.8%	0.9%	6.7%
S&P Toronto Small Cap (March 2006)	-1.2%	3.3%	2.9%
S&P 500 (March 2006)	1.6%	9.2%	9.3%

ALTERNATIVE MUTUAL FUNDS (Inception)	APR 2023	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-1.0%**	**3.4%**	**-4.5%**	**6.3%**	**2.0%**	**4.1%**
Venator Founders Alternative Fund (July 2021)**	**-1.9%**	**6.4%**	**-21.6%**	**-**	**-**	**-**
B of A Merrill Lynch High Yield Index (August 2008)	1.0%	4.7%	1.0%	4.9%	3.1%	3.9%

** As of April 30, 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*

Earnings season is halfway through and, thus far, hasn't been the disaster that was expected, as even cautious outlooks weren't so bad relative to expectations. Admittedly, some mega-caps in the US have done most of the heavy lifting, with Meta and Microsoft posting better than expected results (although expectations for Meta were for zero growth), while Alphabet, Amazon, and Tesla all disappointed. Nonetheless, the year-to-date performance of the market has been very top heavy, with market breadth near all-time lows (the top five market caps, all tech, have accounted for over 90% of the market's gains this year), while mid-caps and small caps sit at breakeven levels year-to-date. Not to be left out, the TSX has had a surprisingly strong start to the year considering the weakness of energy prices and financials, both overrepresented sectors relative to the US, coupled with the absence of mega-cap tech that has driven the US markets. Although, like our southern neighbors, small caps aren't doing much up here either.

Last month, we discussed our affinity for the homebuilding industry and, with most major homebuilders having reported, and the building product companies yet to come, we thought a follow-up was in order. Generalist market watchers have had a tough time explaining the strength in the sector over the last six months, largely because markets are so focused on broader general narratives (AI!) over actual company fundamentals and financial statements (looking at charts and headlines is easy and quick, reading financial statements is not). The starting point was book value, whereby many of these companies were trading below book value and appeared to likely keep adding to the book value. But the follow-up has been surprisingly strong fundamentals, to the extent that homebuilders that "pulled back" on new construction due to macro forecasts last year are now regretting that decision.

Basically, what has happened here is that the existing home sales market has collapsed as no one is willing to trade in their old low 30-year mortgages for new higher ones. Existing home sales are down about 25% year-over-year, but new home sales are relatively flat year-over-year as they pick up market share in the absence of existing supply. DR Horton, the largest builder in the US, is expected to see revenues fall only 5% this year, virtually all of which is price related. Granted, there are regional differences, but the bottom line is that the new home market looks like it will stay resilient.

One consistent comment that we heard repeatedly last year was that there would be a “pull back” in building in light of the negative narrative for new homes as the market adjusted to the interest rate shock. Many mid-size builders appear to be expecting dips in sales in Q2 and Q3, and material revenue decreases, entirely because they slowed down their development pipelines late last year. They generally carry three years of lots, plus a few more in “options”, but this caution could cause a new supply crunch in 2024 as the market absorbs a six- month building stall from cautious planning in late 2022. While the market is catching on to this, with the homebuilding index up 15% this year, there are still some great values out there that trade below book value, or projected book value one year out. One particularly interesting name remains Forestar, trading at 25% discount to book value and 8x earnings, and DR Hortons’ primary land supplier (also majority owned by DR Horton). If land shortages become an issue in 2024, as we think they could, Forestar will reap the rewards.

Building products are also an interesting area, although perhaps a bit more variable than the solid outlook for building. Last year, product suppliers and retailers (Lowe’s and Home Depot) were singing praises of the stability of the repair and renovation (R&R) markets. Indeed, most companies would highlight their 30%-50% exposure to R&R like today's technology companies talking about their currently nascent AI product roadmaps. We suspect that the narrative will start to flip as the homebuilder narrative has flipped. Pricing is generally holding outside of lumber, and worst-case fears discussed on February conference calls will likely give way to the brighter outlooks of the homebuilder sentiments. After the supply chain mess of 2021-22, we would also anticipate that homebuilders will be calling early to secure supply. Currently, the two biggest shortages appear to be transformers and garage doors. In garage doors, there is a highly concentrated market where leader Griffon Corporation trades at 8x earnings and is not ceding pricing given the extended backlog.

April was a bit of a frustrating month. Continued small cap weakness did not help. But more than that, our winners were made up largely of companies that reported their earnings while our monthly losers generally have yet to report—most will report their numbers in the next two weeks. More specifically, our homebuilders were gainers and have all reported, our building products companies were mixed and have yet to report, while our electrical infrastructure names were our biggest losers and have yet to report. Also, our technology names were weak and have yet to report; contrary to the market narrative around technology in general, enterprise technology has been a fairly weak subsegment during earnings season. The Income Fund’s small loss was entirely due to a single security. The company in question did an entirely unnecessary refinancing, which amounted to no new “net debt” but subordinated our debt tranche (previously the only debt, backed by over 100% cash coverage at the market value of the debt) with incredibly punitive covenants owing to the new securities. The Income Fund currently yields over 9%, with a substantial amount of that expected to come in the form of lower tax capital gains.

We reserve the right to change our mind!

Brandon Osten, CFA
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