EVERYTHING THE MARKET THOUGHT TWELVE MONTHS AGO TURNED OUT TO BE WRONG

HEDGE FUNDS (Inception)	JUNE 2023	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**14.2%**	**18.9%**	**8.5%**
Venator Select Fund (September 2013)	**17.7%**	**26.1%**	**6.7%**
S&P/TSX Total Return (March 2006)	3.4%	5.7%	6.3%
Russell 2000 (March 2006)	8.1%	8.1%	7.1%
S&P Toronto Small Cap (March 2006)	0.6%	-0.3%	2.7%
S&P 500 (March 2006)	6.6%	16.9%	9.6%

ALTERNATIVE MUTUAL FUNDS (Inception)	JUN 2023	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**1.1%**	**5.2%**	**4.4%**	**4.4%**	**2.2%**	**4.3%**
Venator Founders Alternative Fund (July 2021)**	**13.9%**	**17.8%**	**8.1%**	**-**	**-**	**-**
B of A Merrill Lynch High Yield Index (August 2008)	1.3%	5.1%	8.5%	3.1%	3.1%	4.3%

** As of June 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*

The animal spirits were alive and well in the first half of the year. At least they were in the US thanks to large cap tech. The S&P500 is up over 15% this year, although the equally weighted S&P500 is only up 5%, which is probably more indicative of your average stock. Without any big cap tech, Canada is up around 5% as well. The market continues to hang on to every tiny piece of economic information such as the "Core PCE Deflator" not because we care about the number itself (if we even know what it actually represents or its economic implications); it's only because we care how the Fed will react to it relative to expectations (without really knowing who is creating these expectations).

Our own month was largely the result of our leverage to homebuilding in the US, including building products. It has been a stealthy strong market for new homes, not covered well by financial media due to a lack of "hype", few public companies, no brand names, and very little analyst coverage. For our own part, we had to become "self-taught" in this sector last summer after running a "less than 0.7x book value but profitable" screen. We think there is more upside as most builders currently trade around book value and well below the historically normal 10x earnings. The new home sales beat in May was driven entirely by homes "not yet started" which suggests future backlog increases for homebuilders and good times for building products for at least the next 12-18 months.

Our biggest gainers in the first half marked something of a return to form for us: established mid-sized market leaders with very little analyst coverage. **Hammond Power Solutions** ($650M in revenues, one analyst covering it, up 150% this year) is a leading power transformer manufacturer based in Waterloo. At 12x earnings and a robust multi-year outlook, we think this stock could trade higher in-line with more generous multiples afforded to Canadian-listed North American market leaders and/or US companies leveraged to electrical infrastructure. **M/I Homes** ($3.6B in revenues, one analyst covering it, up 85% this year) is a mid-sized public homebuilder that we found at 0.5x book value; trading near book value today, but at only 7x earnings, we still think MHO has room to run since it ranks highly on most homebuilder research quantitative models put out by brokers, even though the brokers don't cover them (M/I Homes is apparently important enough as a benchmark for other homebuilders but not interesting enough for coverage). Finally, **Preformed Line Products** ($700M in revenues, no analyst coverage, up 90% this year) manufactures a variety of products for electrical infrastructure; at 8x earnings (on 20%+ growth) and similar driving factors behind Hammond Power, we could see continued appreciation should Preformed get discovered by the Street.

One recent market characteristic we have observed over the past several years is the proliferation of bad macro theses that are attracting too much money, too quickly, and creating spectacular mini-bubble after mini-bubble that generally last less than two years. These aren't small bubbles either, amounting to over $100B in blink-and-you-miss-it "value" creation each. Our personal belief is that there is too much passive money (including automated trading strategies) that overflow half-baked narratives, with liquidity too early and too quickly, such that they get inflated and blown up with increasing regularity. Passive strategies and algo trading chase early-stage narratives and flood whole sub-sectors with liquidity (or withdraw liquidity) and little regard for individual company characteristics. Intra-sector correlations have markedly increased as of late as a result. This is because sector specific ETFs buy and sell everything indiscriminately, while algo-trading assumes it will be right most of time and, therefore, company specific characteristics become less relevant if there is confidence in the sector. "Follow the money" has never been a stronger mantra than it is today. Fundamentals, to the extent that macro narratives are only proven in due time through financial results, are becoming less important. After all, if there is a good thesis/narrative, who wants to wait several quarters for it to play out (for that matter who wants to see financial results get in the way of the narrative at all). There is a lot of money to be made in being flat out wrong as long as the narrative makes sense and doesn't need to be proven.

Prior to several years ago, we had only seen relatively few bubbles (defined as where valuations well exceeded fundamentals). Most of the theories backing the bubbles were proven out fundamentally, even if valuations and a number of speculative businesses were not. The internet is real, cloud computing is real, the rise of China did have a material impact on copper and oil and fertilizer in the 2000s. While the "housing bubble" was problematic, this was really a financing bubble where the money was directed at houses; if you bought a house, you still had a house, which retained most of its value in nominal terms (it was the leverage that wiped out the equity).

But lately, we are seeing macro theses after theses that are just flat out wrong but are getting a ton of attention due to the velocity of money and no time or patience to prove out the bull thesis. Again, we believe this to largely be a function of the increasing velocity of fund flows. While humans have general impatience when investing, algo trading has none and effectively lurches from sector to sector based largely on "price momentum". Years ago, AI algos used to search/listen to conference calls and transcripts for voice inflections or "optimistic/pessimistic" commentary, but this proved to be of little value since the results wouldn't be known until the next quarter came out and too much might have changed by then. This is why the velocity has become so much faster; these algos discovered it wasn't worth it to wait to see if the theories were correct, it was better to just trade the narrative.

In the last five years, we have seen tens to hundreds of billions made and lost in very short order on cannabis, meme stocks and second tier cryptocurrencies/NFTs – all busts. But in the last year, an amazing amount of market moving theories have been proven completely off base, yet much money was made by going with the flow of the soon-to-be-flawed theories. Consider the following narratives from a year ago:

- *Don't buy growth tech (long duration assets) in a rising rate environment*. As it turns out, rates are still rising, and technology is what everyone is buying. AI is only part of the answer since the vast majority of technology companies will not see their financials materially affected by AI (i.e., Tesla which is up 100% despite EPS estimates down 25%, and Apple which is up over 50% despite no materially incremental AI narrative). In fact, most tech companies have missed their numbers or lowered 2023 growth guidance this year even though the stocks are up. Cost cutting has helped, but you don't trade at 10x revenues unless you are expected to generate 30% pre-tax margins in the intermediate term anyways, so the growth should still be the overriding influence on valuation. The key factor in tech appears to be an increase in the number of mentions of AI they can jam into press releases and conference calls. That and being in the right ETF or being historically correlated with the right mega-cap.
- *Do buy defensive dividend stocks into a pending recession*. Again, despite an expectation of recession still on the horizon, the money flow into mega cap tech had to come from somewhere and healthcare and staples have suffered this year. Also note that no growth and 20x earnings is higher duration than 10% growth and 20x earnings (mega cap technology), meaning this theory was somewhat flawed at the outset (something we wrote about last year), but let's not let facts get in the way of a good narrative.
- *Don't buy homebuilders in a rising rate environment*: Granted no one considered that existing home sales would grind to a halt when those 30-year 3% mortgages became valuable, leaving the homebuilders as the only game in town. But this thesis was just 180 degrees wrong. Homebuilders are up 50% in 12 months.
- *There is going to be an oil shortage owing to the Russia-Ukraine situation*: Oil can be transported on water. There is always a buyer for crude oil at a price. There was never any risk of a global oil shortage. There is spare capacity. Oil has round tripped in price. The good news is that the higher energy prices (based on the faulty theory) allowed oil companies to pay off their over-levered balance sheets ahead of the rate increases, which could have been catastrophic for the sector.
- *There will be a natural gas shortage in North America as we will export too much to Europe*: This thesis never had a chance, although the fear factor did send gas prices from $3 to $9 and back again. Nearly all LNG export capacity is spoken for, and new capacity won't come online for several years (we wrote about this last year). Like their oil producing cousins, this flawed narrative offered instant balance sheet repair to companies that would have struggled mightily under the higher interest rates on debt, which is why many have held over 50% of their 2022 gains.
- *There is going to be a fertilizer shortage/food crisis*: Wrong. Fertilizer prices have collapsed in the past year along with their stock prices.
- *The recession will come in 2023*: Now it's going to come in 2024, and the market seems to be looking through this. Whether that's a good idea or not is another debate. The data often calls more recessions than actually occurs. Maybe it will come in 2024, or 2025, or not at all. Maybe it already happened based on the old calculation of real GDP contraction. We are not entirely certain that accurate recession calls are a good or bad way to invest, although the narrative around recession calls apparently can be if enough people believe it.

These were overriding theses developed in the wake of the Russia-Ukraine conflict and the Feds rapid rise in rates – the dominant themes of 2022. If you watched a replay of CNBC from a year ago, you would have heard about the energy crisis, the food crisis, don't fight the fed, buy defensive staple dividend "value" stocks (at 20x earnings or higher), a pending home prices collapse, an imminent recession, a pending wave of layoffs, sell all growth/tech stocks. What is so telling is that a year later Russia and Ukraine are still at war, rates are still rising, and a recession is still imminent. In other words, all the conditions that were in place for these calls last year are still in place today, but no one is still making those calls because they were flat out wrong. Fun fact: according to Ned Davis Research, the stocks of the S&P500 that don't pay a dividend have outgained those that do 18% to 4% (the worst relative performance for divided payers since 2009). If you were to back out sub-1% payers Microsoft, Apple and Nvidia, that disparity gets even greater (we haven't done the math but using a back of the envelope calculation given the weighting of those three stocks (over 10% to start the year) and the year to date performance (over 50%) moving those three to the non-dividend bucket would likely skew the numbers to a 23%+ gain for team "no dividend" vs a 1%+ loss for "team dividend").

We have had to make our own adjustments to our own methods as a result of these observed changes. These changes took effect in January. In the simplest terms, we have a long list of stocks we would like to own at any given time based on fundamentals and valuation upside. We then let the markets decide which of these we should Buy and which we should Sell. It takes the market timing out of the equation. It takes the shifting false narratives out of the equation. Any macro analysis we do is strictly relegated to the economic effect on the stocks on our list and our targets. Our more technical ownership levels are fairly broad as to avoid unnecessary turnover. But there are also measures that allow for contrarian holdings as well, such as buying homebuilders last summer. In short, rather than trying to time the market (which we have never done and has historically been proven to be a fruitless effort through multiple cycles, even if someone gets a lot of press from being right occasionally, although these "pundits" often miss the turn), we are allowing the market to time us insomuch as telling us the right time to own the undiscovered or cheap or contrarian companies that we know we want to invest in.

Yes, the market has been accommodating this year, although perhaps less so than meets the eye. Despite the performance of the market weighted AI-fueled S&P500, the average stock is up just over 5% this year. The Russell 2000 small cap index was flat going into June. But for us, along with most money managers, bigger cap doesn't mean bigger weight, which can be strength but has actually been a weakness for over a decade as the biggest companies were all technology, highly correlated, growth, and in the financial media. We now have everyone buying Nvidia without the slightest idea of what a GPU is, just like everyone was buying Cisco 25 years ago without any idea of what a router was. It is possible that knowing the growth rate and valuation could be enough if you treat GPUs like widgets (you don't need to know the technical details of a product to know enough), but we would suggest most investors are unaware of the valuation multiples and/or growth rate either.

Market cap weighted indexes aren't quite as advantageous in Canada where financials and telcos, vs more dynamic growth companies, dominate the benchmarks. There will be a time when most stocks go up more than the largest stocks which will cause index underperformance and the media will point to "stock picking" again. Simply buying a lesser publicized equal weighted index vs the more popular and well-known market weighted indices would create perceived outperformance. Although greater breadth of liquidity would probably provide better opportunities for stock pickers (if one-third of Apple's $3 trillion tried to find another home in small caps, it would create over one-third of incremental buying in the combined market cap of the Russell 2000).

As for our Income strategy, we are "clipping coupons" at this point. There is little need to get creative in a land of 9% yields. That most 3–5-year vintage bonds are trading below par creates a tax efficient capital gains component as well. While risk-free rates continue to move through 5%, more opportunities are being created.

We would note that leverage is getting a lot more expensive, which is why we are barely using any. That said, the capital gains created by bonds trading below par will have a much lower tax rate than the fully deductible interest for the leverage we do use. We don't report taxed equivalent gains, but they are an enhancement of after-tax returns for investors beyond the 9%+ yield to maturity profile of the Fund.

We reserve the right to change our mind!

Brandon Osten, CFA
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