WHAT HIGHER FOR LONGER MEANS FOR THE MICRO

HEDGE FUNDS (Inception)	OCTOBER 2023	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-0.8%**	**8.9%**	**7.8%**
Venator Select Fund (September 2013)	**-3.7%**	**7.5%**	**4.8%**
S&P/TSX Total Return (March 2006)	-3.2%	0.1%	5.8%
Russell 2000 (March 2006)	-6.8%	-4.5%	6.2%
S&P Toronto Small Cap (March 2006)	-2.6%	-3.7%	2.4%
S&P 500 (March 2006)	-2.1%	10.7%	9.1%

ALTERNATIVE MUTUAL FUNDS (Inception)	OCT 2023	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-1.1%**	**5.0%**	**3.5%**	**2.5%**	**2.1%**	**3.9%**
Venator Founders Alternative Fund (July 2021)**	**-0.9%**	**7.5%**	**-3.3%**	**-**	**-**	**-**
B of A Merrill Lynch High Yield Index (August 2008)	-1.2%	4.7%	5.8%	1.2%	2.9%	3.8%

** As of October 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*
***** Venator Offshore Fund is available as the US dollar version of Founders Fund strategy*

Markets continued their recent turbulence in October. The reason this time related to “higher for longer”, a theme that has been coming and going for over a year, and a theme we have subscribed to for some time as well. Once the market accepts that rates will likely remain in the 5% range for the foreseeable future, we can start to differentiate between the winners and the losers. This year has seen aggressive run ups and downs for stocks in general. Your average stock was up 10% by February, down 3% by March, up 10% in the summer, and down 9% by the end of October. Small caps have been worse, still down 32% from their peak two years ago. Even an equally weighted NASDAQ is down 20% from that time. The average stock on our watchlist of roughly 150 names is 25% off its four-month high and only 1% off its four-month low.

In the process, the market has latched onto so many false themes in the past two years, it’s difficult to keep track of how much money was made and lost on themes that haven’t come to fruition. With hindsight, all false themes seem obvious. All the money flowing in and out of “narratives” at the same time has created unprecedented volatility even in stocks that shouldn’t be very volatile. This year, the market has come after so-called “defensive” names, where all the money went into last year over recession fears. Food, staples, utilities, healthcare and telcos have been among the worst preforming sectors this year. With multiples causing 30%+ swings in the absence of material financial changes, the volatility can be stomach churning. How long can chronic market share donor Walmart hold onto its 25x P/E when everything else that looks like them (grocery and department stores) trades at 10-15x?

Last year’s theory was that higher rates were no good for growth stocks because future earnings would get discounted at higher rates, compressing values. This year, only growth stocks can outrace the discount rate deterioration, which led to an early year rally in large cap tech. Last year, you bought defensive names because they are recession resistant. This year, the market has decided that higher rates also impact the current value of “out years” of defensive companies trading at high multiples because they don't have the growth to defend against this deterioration of present value. Last year, higher interest rates would kill homebuilders. This year, higher interest rates have left public homebuilders as the only ones that can finance a new build and the only ones with homes for sale. Last year, oil supply was at peak. This year, OPEC has been cutting production because of excess supply. Last year, EVs were set to take over new car sales. This year, Tesla's earnings are set to decline while Ford and GM are scaling back their EV ambitions.

Of course, the ultimate defensive investments, government and blue-chip bonds, have been among the worst performers. Issued when times were better, they don't have the higher interest rate coupons to defend against long-term rates. High yield has done better to the extent that they have higher coupons to bridge the rate adjustment. We think these bonds, with higher coupons and shorter 5–7-year horizons, are primed to offer 10% returns for the next several years and better on a tax adjusted basis as many trade at discounts leaving a portion of gains eligible for preferential tax treatment. Our own Income Fund currently shows a yield of over 10% but a 12% equivalent after-tax yield owing to half of the expected returns being on account of capital gains.

Probably the biggest problem, on an individual company basis, is how companies with debt are going to deal with the impact of rising interest rates on their financial statements. This concern is largely why we have avoided REITs as a category. You don't have to do a lot of work to simply assume nearly all debt will be refinanced at 8% over the next several years and figure out how that will impact their distributions. It's not even worth the effort to go into the details of debt maturities because whether it happens in two years or four years is immaterial in the grand scheme of things. Expect material hits to REIT distributions over the next several years as debt comes due. For operating businesses, we go through the same exercise assuming all debt will refinance at 8%-10% and whether the income statement will be materially impacted. For a company with $100M in cash flow, $1B in equity and $1B in debt, this could impact earnings by $30M; at 10x earnings that's a $300M impact on the equity valuation, or 30% downside just from the rolling of interest on the debt. Without real estate that can be collateralized, this can create a near impossible situation for over-levered companies looking to roll debt or reduce leverage. In the example, they could now only chip away at $1B in debt by $70M per year instead of $100M per year.

There are worse situations than that. We would imagine a lot of private companies are in worse situations as many tax shield all their earnings with interest expense, leaving no excess to pay for higher interest rates when bonds need refinancing. It's unfortunate because digging your way out of a bad balance sheet used to be a great way to invest in turnarounds. Now a company that can de-lever by 30% could find all those income statement gains wiped out by debt refinancing. Those companies promising to reduce their debt may find the effort not as fruitful as they had hoped.

It's tough to find an absolute beneficiary of higher rates. This used to be financials, but higher rates have been no friend to banks. Strong balance sheets can benefit vs weaker competition, but you still have to watch fundamentals in a slower economy. We still think that one of the only true macro beneficiaries will be homebuilders (and possibly building products as they draft on increased building volumes). There will always be a baseline of people that need to move, and there is a known housing shortage. Unfortunately, the mortgage "lock in" effect has effectively killed the resale markets for the foreseeable future. What's more, existing home sellers can't compete with the "rate buy down" incentives offered by builders (whereby they are effectively paying the bank to lower your mortgage by up to 2%). Private homebuilders are currently paying 12%+ for construction loans, while public builders finance their projects at 7%. Finally, a number of public builders still trade below book value while almost all trade below 10x earnings. "Higher for longer" only plays into their hands operationally, while the low valuations offer a nice cushion to valuation, even if the sector has sold off over 20% since the summer.

Of course, the real beneficiaries of higher rates will be those direct investments in higher rates. That means the above-mentioned high yield bonds, while the greatest companies might not offer much more than 7% yields. The next tier offers compelling opportunities in not great but cash flow positive businesses that aren't going anywhere. Companies like Victoria's Secret, The Gap, ZipRecruiter and Cineplex. In some cases, you can find 9%+ yields backed by real estate such as StorageVault and Brookfield REIT. In some cases, we are finding 9%+ yields in companies with no net debt. It seems that a "golden age" for high yield bonds could be in front of us.

On the equity side, the playbook is going to be to avoid highly leveraged companies at all costs (although we still need to watch them lest they have some attractive debt). With your average stock down precipitously over the last two years, there are plenty of high earning, low multiple, low debt companies out there to invest in without worrying about how they are going to refinance their debt. The cycles will eventually turn, and this time it's the low debt companies that will make the bigger gains.

We reserve the right to change our mind!

Brandon Osten, CFA
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