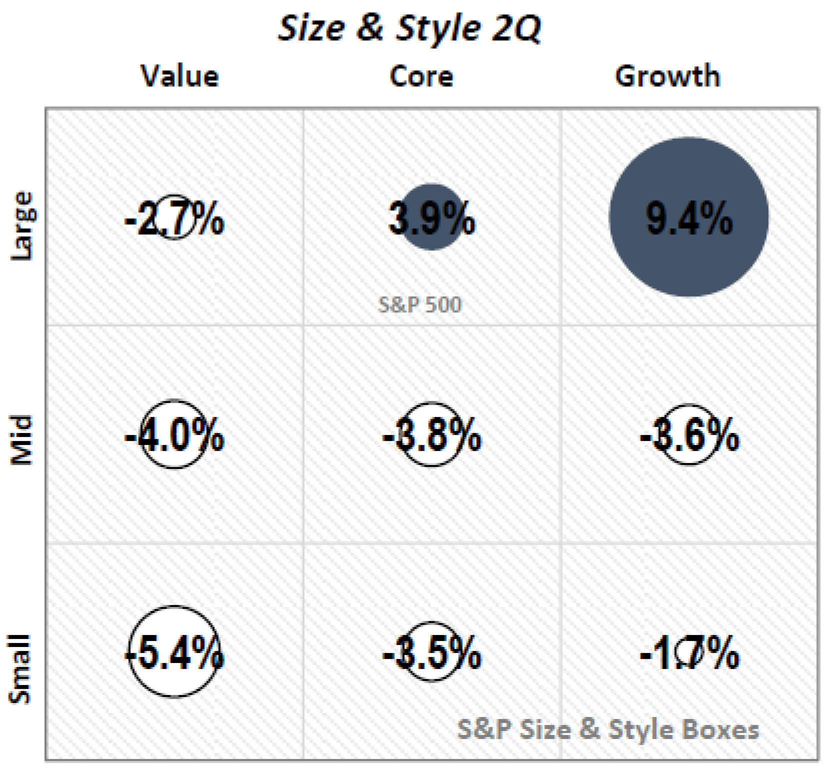
AI: IF YOU BUILD IT, THEY BETTER COME!

HEDGE FUNDS (Inception)	JUNE 2024	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-2.5%**	**0.8%**	**8.7%**
Venator Select Fund (September 2013)	**-3.4%**	**2.4%**	**7.3%**
S&P/TSX Total Return (March 2006)	-1.4%	6.1%	6.6%
Russell 2000 (March 2006)	-0.9%	1.7%	7.2%
S&P Toronto Small Cap (March 2006)	-1.9%	8.8%	3.3%
S&P 500 (March 2006)	3.6%	15.3%	10.4%

ALTERNATIVE MUTUAL FUNDS (Inception)	JUN 2024	YTD	1-YR	3-YR	5-YR	10-YR
Venator Founders Alternative Fund (July 2021)**	**-2.5%**	**-0.2%**	**12.7%**	**-**	**-**	**-**
Venator Alternative Income Fund* (January 2020)**	**0.7%**	**3.0%**	**9.8%**	**-0.7%**	**2.9%**	**3.7%**
B of A Merrill Lynch High Yield Index (August 2008)	1.2%	2.6%	10.8%	1.6%	3.7%	4.2%

** As of June 30, 2024*
*** 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*

June was another low event month that brought with it a continuation of US Mega Cap AI outperformance with your average stock in decline. With economic data becoming increasingly benign, the market has had only one narrative to focus on in artificial intelligence, with only the Fantastic Four (Nvidia, Microsoft, Amazon and Apple) seeing a consistent positive news flow around the mega trend. That's not to say other good things aren't happening out there, it's just that they are more case-by-case and often ignored and suffering from dollar outflows amidst the search for AI pixie dust. The following chart (courtesy of Piper in the US) shows just how top-heavy markets have become, with large cap growth (aka the Mag7 being the only profitable cohort in Q2):



It's a strong narrative that is desperately trying to extend itself into energy (oil, gas, wind solar), infrastructure (utilities), and personal computing, which hasn't seen a strong replacement cycle in five years for PCs or phones. Perhaps the only red flag for the AI frenzy is the general weakness in the growth-deteriorating enterprise software sector still searching for the "killer AI app", because if they can't sell the new GenAI features, they aren't going to be paying to rent all that datacenter capacity for long, which could lead to overcapacity relative to the $500 billion of datacenter infrastructure being built over the next several years. The investment gains are rightfully being made on the infrastructure build, but, currently, the end customers aren't there either because customers can't make the investment math work for additional spend, or because much of AI is evolutionary as opposed to revolutionary; new GenAI vs various forms of AI in use for the last decade. This is why semiconductors are generally strong (up 37% this year) while software is generally weak (WCLD cloud computing ETF down 7% this year). If you build it, will they come? $15 trillion is depending on it (the combined market caps of Microsoft, Apple, Nvidia, Alphabet, Amazon, Meta, Broadcom and Tesla).

It is also clear that the broader corporate indicators appear to be sluggish. Retail, industrial distribution, home improvement, human resources and transportation sectors are seeing fairly low growth on bottom-of-cycle levels and valuations seem quite reasonable or downright cheap among smaller companies (usually valuations look expensive at the bottom of the cycle owing to expectations of a cyclical upturn). This is largely because the 99% of the market under the top 1% of the S&P500 is getting ignored, and only idiosyncratic opportunities are exhibiting any momentum. The combination of an almost willful avoidance of 99% of all stocks has led to a continued proliferation of cheap companies, although patience is still needed in a market batted around by passive ETF flow. It's best to focus on more idiosyncratic growth drivers, or as portfolio managers call them: special situations.

We still believe Forestar, which we wrote about earlier this year, remains an underfollowed idiosyncratic growth name trading at an exceedingly cheap valuation of less than one times our estimate of tangible book value. While the housing market data has been mixed, the public homebuilders have continued to push ahead with increased development and healthy margins. Forestar's largest partner, DR Horton, has been very public about its intention to double its business with Forestar over the near term. With development land in short supply, as stated consistently by every homebuilder out there, Forestar couldn't be in a better position to fundamentally succeed while its at-book value valuation, coupled with the backing of majority owner DR Horton, makes this investment incredibly attractive, if currently misunderstood.

Lakeland Industries is a new entry to the portfolio after meeting with management at a conference. The company supplies "protective clothing" to a variety of industries, much of which is recurring in nature and specialized, evidenced by its fairly high gross margins. After being a COVID beneficiary, the company got a bit lazy and floundered for a few years before a management turnover brought in a team that put the balance sheet to work targeting the market for firefighter equipment. We didn't know much about this market, but as it turns out, this is a very attractive industry, with expensive highly specialized and high margin equipment, a frequent upgrade schedule, and a maintenance component. There is a lot of runway here in terms of margin improvement, growth and acquisitions. It's difficult to project how far this one can go, but we believe we are at a starting point that should prove to be under 10x earnings with a single comparable competitor that trades much higher. A double-plus seems very plausible.

Here in Canada, we acquired shares in Sylogist earlier this year, a company we have watched from afar for years, but a lack of internal growth kept us sidelined. Sylogist used to be a low growth, high margin industry consolidator but has recently moved to rebalance the model under new management, and now exhibits growth in excess of 10% and trades at a reasonable 20x earnings with potential upside in both growth and margins. The company competes in the market for back-office software for public institutions, an area that has recently attracted private equity interest. Generally, this sector has antiquated software in need of an upgrade, but Sylogist has an interesting quality in that their software is developed on top of Microsoft Dynamics's back-office code base. This admittedly creates some margin/expense trade-offs inside the income statement, but it's worth noting that Sylogist has previously experienced EBITDA margins in excess of 40% when it wasn't focused on product improvement or revenue growth. In our view, piggybacking off of Microsoft Dynamics provides a unique go-to-market advantage in that Sylogist's offerings have tight integration with Microsoft Azure, Microsoft 365 apps, and critically, ensures that they have access to Microsoft/OpenAI capabilities without having to risk their own R&D efforts in hopes of having competitive product in GenAI.

On the bond side, yields are still "juicy" but are getting tight vs the 4-5% "risk free" rate, so returns in the 7-9% range are achievable, but the use of leverage is quite pointless. With the next move in rates most likely down, we think the bond market should see accelerated gains over the next two years, enhanced by a potential refinancing boom like we saw in 2009 when companies that were overextended and "worried" about refinancing their balance sheets took advantage of a bond buying boom.

We reserve the right to change our mind!

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.