VENATOR
CAPITAL MANAGEMENT LTD.

QUESTIONS FOR 2007

December was another solid month for the Founders Fund which posted a 6.1% gain, putting the fund up 33.2% since its March launch. North American markets were generally OK over the course of the month, although we believe the markets were "juiced" by some last second "high-closings" in the last, and illiquid, week of the year. While the third month of a quarter is always an "iffy" proposition for us given the lack of earnings news (low trading volumes in December made last month an even "iffier" proposition), we did get some news out of several of our larger positions, including an acquisition, an application for an AMEX listing (the company is currently on the US Bulletin Board), a surge in uranium prices and a small IPO that we helped rescue after the original underwriters failed to complete the deal.

As we plow into 2007, we have some big picture issues we need to figure out in order to get our macro view in order. While we are "bottom-up" stock pickers, we do use macro views as a guide in determine which companies can sustain current revenue levels, earnings and growth, and which are likely to garner the attention of the market, hopefully resulting in valuation expansion.

- **Oil:** If $60.00 is the new $30.00 (something we hear a lot of nowadays), what's the new $10.00 (the previous cyclical low)?
- **The End of Cheap Oil:** We would agree that current higher cost oil finds are likely to keep oil prices above $25.00 in the future. However, if new oil finds are getting more expensive then why buy oil producers with higher costs? If you believe in high price oil, wouldn't it make more sense to buy the commodity and not worry about costs?
- **OPEC:** We tend to forget that OPEC used to "try" to keep oil below $30.00. It's debatable whether they have any control over oil prices. Will recent cuts hold prices up, or remove the fear of supply shortages given the extra production capacity?
- **The Loonie:** It was actually down last year (show of hands: who predicted that?). Interestingly, the decline accelerated as the Greenback was losing ground to the Euro. The problem here is that the two largest industrial/service economies (Ontario and Quebec) were getting hurt by the higher dollar. These economies need the dollar to decline to do well. If resource prices continue to weaken off of their mid-summer peaks, how far does the dollar have to weaken before the industrial/service economies are doing well enough to pick up the economic slack?
- **The Greenback:** There are too many currencies to measure against here. Between the housing collapse, the potential fallout to the consumer, the Fed under pressure not to raise rates (see below), China loosening up currency controls, countries starting to peg oil against the Euro (oil was down more significantly in the rest of the world), it would seem that the fundamentals suggest a further decline, as do money flows. The only question is how low can it go?
- **The Fed:** Everyone seems to think rates should come down, but we tend to forget that current rates are actually pretty low in every historical context except the most recent (which was an overreactionary knee-jerk reaction to 9/11 on the back of the tech wreck). The real question (and it's a boring one) is will the Fed move rates at all this year?
- **Gold:** As a currency it's probably the easiest way to play the decline in the Greenback. As a commodity, I don't like to speculate. But with the financial community easily able to fix the production-demand shortage by selling a fraction of their estimated holdings, the imbalance appears to have been artificially created by the financial markets, rather than genuine market forces. Of course gold stocks trade at premiums to NAV with low discount rate assumptions and aggressive price assumptions, and if the greenback is the primary reason for gold's ascent, then mining costs are going up too. Is Gold a commodity or a currency? Either way you are probably better off with the commodity than the stocks.

- **Base Metals:** People generally expect base metal prices to come down because they have been on such a run and have started to show signs of weakness. However, we note that production-demand imbalances (or at least tightness) are real. So if commodity prices are likely to come down over the next five years, but remain tight over the next three, how far can prices really fall if at all? Does the collapse of US homebuilding negatively affect demand? Do you buy the producers which trade at good discounts to NAV (assuming base metal prices stayed within 50% of current levels, which no one seems to be assuming)?
- **Tech and Vista:** It seems a forgone conclusion that the upcoming Vista release is going to be a shot in the arm to a technology sector that has been struggling for the above-average growth expected of it. The only bearish thing people are talking about is whether the upgrades are going to come up front or whether people will wait for the less buggy second generation and upgrade in 2008 (in our opinion, this amounts to degrees of bullishness). Will software vendors take advantage of the new capabilities of Vista, prompting a wave of upgrades? Will the hardware guys get a shot of adrenaline as Vista will provide the first required upgrades in over five years?
- **The US Consumer:** "Never bet against the US consumer" has been a warning that has proven prescient for a long time. That being said, the current situation in housing (caused in part by recent Fed action mentioned above) is considered potentially unprecedented by some market watchers. Supply is still too high and demand too low. We tend to be leaning towards the more pessimistic opinions which suggest that the typical American does not yet fully appreciate the loss of value to their home (you always think that yours is better than "typical" until you have to put it up for sale), nor are they prepared for the mortgage rate resets over the next 24 months. That being said, America is the land of creative credit, where the financial system is the best in the world at "farming-off" credit risk through the use of securitization and other derivative investments. However, in the end someone has to pay. Assuming the housing market remains flat-to-down, what will crack first: the consumer or the financial credit?
- **Emerging Markets:** We don't keep close track of emerging markets because they are somewhat "uninvestable" by our standards (language barriers, local knowledge barriers, information flow barriers, accounting barriers, and that many foreign markets only require semi-annual reporting rather than quarterly). The only question that comes to mind is: is there enough domestic demand in these markets to overcome potential housing-related consumer weakness in the U.S. which would put a crimp on exports?
- **Private Equity:** The world is awash in cheap excess liquidity (yet people keep clamoring for lower rates). The recent trend of buying up public companies at significant premiums of over 20x cyclical-peak earnings suggests that there is too much money looking for a home, and that private equity, is no longer more discriminating than its public counterpart (due to the "outdated" concept of the illiquidity discount). The question here is how does it end: does the first disaster sink a private equity fund, or is the debt attached to the deal so big that it jumps the risk premium on private equity debt enough to sink the entire market (this question may not be answered for a few years)?
- **Income Trusts:** Income trusts are now down about 10% from where they were before the "Halloween Massacre". The math on the tax-shield expiry suggests they should be down 20% (while excess business model impact to certain sectors such as energy suggests that the sell-off should be a bit worse). Are people betting that a 10% sell-off is enough to attract private equity (even though long term earnings prospects just declined by 30%)? Are people hoping that the Liberals will talk about a six-year extension to the tax holiday (seemingly built into current valuations)? Are mathematically challenged investors are so hungry for yield that they are willing to exchange future capital losses (low tax rate) for income distributions (high tax rate) over the next three years? A longer term question: will companies maintain their payout ratios when the tax shield expires (despite the point that distributable cash flows are generally less than free cash flows)?

Most of these questions suggest that results could go either way for each of these factors, but that there are reasons to be skeptical or cautious. However, some questions seem to lend themselves to distinctly bullish conclusions (i.e. the technology question is either neutral or bullish) or bearish conclusions (i.e. the answer to the question of the U.S. consumer seems neutral or bearish). Now we have to state our normal disclaimer that we are a "bottom-up" stock picking fund, and that there are others better equipped to deal with these issues than us. Although, with regard to commodities, we are still quite certain that cyclical pricing lows are represented by the marginal cost of production (which is well below current commodity prices across the board); while difficult to time, this does seem to be a historical truism that the financial world appears to have largely forgotten.

While 2006 was a very good year for us (33.2% return over the 10 months since launch), we are actually more optimistic about how the fund is currently positioned than we were last March. This is largely attributable to owning many of our names for over six months, and our increasing comfort with their fundamentals, business drivers and management teams. Furthermore, many have had nice upward moves due to financial performance but have yet to experience the valuation expansion that can provide the bigger and faster lift. Several of our largest positions we would characterize at not-particularly-seasonal, not-particularly-cyclical growth companies trading below 10x earnings. We remain under-invested in commodities, as we continue to have a difficult time finding companies trading at valuations below their net asset values based on our required rate of return (15%) and "safety cushion" target prices for the underlying commodities (think $40.00 oil). The fund remains nearly 100% long (25 positions) and 35% short (15 positions); and 60% Canada vs. 40% International.

Happy New Year,

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