OF BABIES AND BATHWATER

To the point, we had a very difficult month of June, with the fund dropping 9% versus a relatively benign environment for industrial small caps in general.

Our *Market Commentary* for the month is about inflation in the U.S., which we believe is far higher than is generally recognized by the market. We think the problem relates to our general points of view of inflation relative to what happens from a practical perspective. Home electronics, for example is one of the more "hidden" areas of "stealth inflation":

- Televisions: flat screen HDTVs may be down 50% in the past several years, but how many people would have paid more than $1,000 for a television in 1998 relative to the $3,000 "bargain" flat screens that are becoming main stream today.
- PCs: PCs are cheaper than they were 10 years ago BUT people are now buying laptops which are pretty pricey when you include software (including anti-virus which you didn't have to buy before). Let's not ignore the cost of hi-speed internet access while we are at it (an annual recurring cost). Also, a growing number of households have more than one computer; I haven't seen any specific studies, but I would imagine that the average household spends materially more on "all-in" computer costs than they did 10 years ago.
- A RIM pager costs more than your old day-timer, an iPod costs more than a walkman and we are now all paying two more phone bills per household (assuming he and she have cell phones).

As a former tech analyst, this stuff amuses me, but the bigger problems are outside of tech. The real problem (and we aren't the first to recognize this) is commodity prices pushing up the costs of everything. The market has been surprised by the lack of "core inflation" in the face of these commodity price increases, but we are seeing it big time. Anecdotally, we see a lot of companies popping up on our "growth" screens, but the reality is that they are anything but. The key question we have become accustomed to asking relates to unit growth vs. revenue growth; and we are coming across a lot of companies reporting better than 20% top-line growth, but have unit growth of less than 5%. For this reason, we think the Fed may be on the right track with regards to more rate hikes in the near future.

With the market weakness, we have been selling some of our more "stable" names; represented by inexpensive, but lower growth stocks that have exhibited little volatility, and increasing our stakes in weakening cheaper growth names, where weakening quotes on low volumes are creating buying opportunities. The fund is currently about 95% long and 37% short, with a 52/43/5 split between Canada, the US and cash on the long side.

Thank-you again for your support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.