CANADA (non-resource): THE UNDISCOVERED COUNTRY

September was a fairly good month for stocks (with the exception of resource stocks which dragged down the TSX by 2.6%) with large cap techs performing particularly well on the heels of strong earnings from Oracle. The NASDAQ was particularly strong posting a 3.4% gain, and large-caps continued to outperform small-caps as the S&P 500 (up 2.5%) outpaced the Russell 2000 (up 0.6%). We managed a decnt gain of 3% (up 7.7% since our March launch), which was a bit of a relief given what happened the last time we faced a "third month of the quarter" (painful reminder: down 9% in June); the difference being some good news announcements for our companies in a normally "no news" month. As usual, we are optimistic heading into earnings season and expect the next eight weeks to provide some solid returns for the fund.

When people ask us about our asset mix by geography we always say that while we would normally expect two-thirds to three-quarters of our assets to be invested outside of Canada, the current split is about 50/50. The reason for this current situation is the extreme neglect that exists in the Canadian non-resource small-cap sector. Most retail/fast money has been invested in junior resource stocks (although some of the more speculative tech names have been getting increased attention as of late) and has left a number of high quality small-cap names trading at extremely low valuations. However, a side effect of this neglect is that it has also made these stocks extremely illiquid. While we don't like to divulge our investment names, we thought it wouldn't be offside to talk about our third largest position without divulging its identity; a market leader in power transformers which is our third largest holding. This small-cap ($50MM cap, $125MM revenues) has put up six consecutive record quarters (top and bottom line), is increasing its market share, is increasing its operating margins through economies of scale, and sells into attractive end markets. Revenue growth is stable at 30%, and unit volume growth is accelerating and stands at 22%. We have accumulated our position at the bargain price of 8.5x 2006 EPS and 5x our 2007 expectation.

We have finally caught up to our high watermark but won't be satisfied until all of our unitholders are comfortably in the black. Thus far, October has gotten off to a quick start for non-resource stocks. To that end, we continue to be underweight resource stocks (5% long) while maintaining a healthy short position in energy stocks (approximately 10%). The recent OPEC cuts make us more optimistic about our stance on energy stocks as we can't imagine anything being more bearish for oil prices than excess production capacity. While the "terror premium" has been previously estimated at $10.00-$15.00, we estimate that the "not enough supply to handle near-term demand premium" is likely $20.00-$25.00. It would appear that OPEC is just as addicted to high oil prices as we are to oil itself; but just as the price increase of the past seven years has been outside their control, so will the price decline.

Thank-you for your continued support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.