

MACRO MARKET

Good riddance to 2007, a tough year for small-caps in general. The Venator Founders Fund was up 14.8% last year, which was pretty good considering the dismal performance of both the Russell 2000 and the S&P/TSX small cap index, which were down 2.8% and 2.9% respectively. In fact, since inception, the Founders Fund is up 52.9% despite negative returns for the S&P/TSX small cap index and a less than inspiring 5% return out of the Russell 2000. Having survived this dismal small-cap market, we hope things are going to turn up sometime in 2008, a bit of a contrarian call given that market sentiment towards small-cap stocks appears to be low point heading into January (the Russell 2000 was down 6% in its first week of 2006, while the S&P/TSX small caps were flat largely due to its large gold and oil component).

The stock markets are currently a tough place to navigate for us "bottom up" stockpickers (the process whereby we start by looking for individual companies and researching their prospects, as opposed to the "top down" strategy whereby you form an opinion on a whole sector and try to find the best prospects within that sector). While difficult markets tend to lead people to say we are in a "stockpickers market", we are seeing the exact opposite. We have seen strong upwards moves in infrastructure/contracting stocks, agricultural plays, consumer technology and solar stocks; strong enough that valuations of some stocks appear to be at extremely high valuations relative to historical norms (i.e. paying 17x earnings for Alberta-focused infrastructure companies staring down a six-year market opportunity). We are generally cautious with regards to these "rising tides lift all boats sectors" as valuations can get rather high for even the most mediocre of companies, and it's difficult to find absolute value, as all stocks tend to trade at relative values.

On the short-side of the market we see the same thing, with financials trading below book value (even the ones without material subprime exposure) and growing retail stocks trading below 8x earnings (even if their earnings miss by 25% they are still at a very reasonable 10x earnings). General aversion to small-caps has also increased the downside volatility of stocks, yet the upside volatility seems generally muted (a three steps backwards two steps forward effect).

We tend to be quite cautious about "chasing" either positive or negative momentum, and we generally require some expected valuation appreciation/contraction on top of fundamental improvement/deterioration, which has probably led to us being a little more selective than would be optimal. However, we do believe that there is some uncertainty from 2007 that we are able to put behind us as we move into 2008, which could help make things a bit easier going forward. One major variable that we have written about is the Canadian dollar, which appreciated substantially in 2007. We are fairly confident that we have seen the peak relative to the US dollar, and that we can stop worrying about its effect on our companies, which are strong enough to withstand a par dollar. While we still maintain our short position on the Greenback in order to eliminate the effect of currency on the portfolio, we have increased confidence in our Canadian portfolio with regards to US exports. We also think that stock valuations are starting to discount a possible US recession with regard to consumer discretionary spending, however, recent unemployment figures suggest that there could be another leg down in this sector (the first leg was housing prices).

We believe that lowered US demand will put continued downward pressure on base metals, which showed considerable weakness last year when you back out the effect of the US dollar. Interestingly, the precious metals appear to finally breaking out from their trend of simply inversely following the US dollar. We also continue our thus-far incorrect view that oil prices will come down due to deteriorating US demand and increased Canadian supply over the next

several years (if the US really wants to solve their oil problems they should divert \$100 billion from the war in Iraq, and just give it – not lend it – to companies developing the oil sands). We also believe that natural gas prices may have bottomed, but that this bottom could last two years. The US housing sector should continue to be a disaster for the foreseeable future, but banks with minimal exposure might be worth a look. Consumer technology stocks look pricey to us on the basis that people seem to be forgetting the “consumer” part of the equation; however technology stocks in general appear to be fairly valued.

Another thing to watch out for this year is whether or not private equity will return now that things are getting really cheap. If private equity is not as active in the first half of this year as they were last year, they will solidify my view that they were among the worst investors on the planet in the 2007-08 period. A year ago they were buying low growth retail, hotel and restaurant assets for north of 30x earnings, thinking that they could lever up enough to actually make money on a spinout. Somewhat predictably, the Blackstone IPO marked the height of that market. I would guess that if private equity funds had to mark their leveraged portfolios to market, they would probably be looking at losses in excess of 50% (hedge funds that invest in private companies have to write down investments when appropriate, but I am not sure of how private equity accounting works). Companies that they thought were worth over 30x earnings can now be had for 13x earnings, and while debt is a bit harder to come by now, these valuations should be too compelling to resist if they used a lower level of leverage now and levered up more later as rates come down. Their biggest obstacle could be trust, in that no one wants to sign a takeover deal where the buyer, based on recent activity, seems likely to pull out of the deal later. We shall see if the Sovereign Wealth Funds have more luck; but given that they seem to do their deals at a discount to the market, they are already proving themselves to be smarter than the private equity guys.

The fund itself remains quite defensively positioned from a valuation standpoint. Most of our companies are experiencing healthy growth and trading at less than 10x EPS. Our most expensive position, a recent addition to the portfolio called Digital Ally (NASDAQ:DGLY), trades near 20x earnings, but has a growth rate of 200%. We recently visited their headquarters in Kansas City, and believe that this company's in-car video recording system and video recording flashlight could be the next big things in law enforcement. We also continue to maintain our core holdings in Neo Materials, Hammond Power Solutions and Pet Valu, all defensive and inexpensive stocks with good earnings growth. These positions, all of which we have owned for over 18 months, combine for over 40% of the portfolio's NAV, which should give you a sense of our commitment to long-term investing as well as how concentrated our fund can become when we get to a certain level of conviction with regard to our investee companies.

If we have made one major mistake in the management of the Fund it has been on the short selling side. We incorrectly assumed that the market was oversold in mid-November and lowered our short interest to below 20%. We have since increased our short weighting above the 20% level, but we continue to have difficulty finding adequate Canadian stocks with which to hedge the Canadian side of the portfolio. Unfortunately, non-resource small-caps are somewhat illiquid in Canada and ETFs have too much of a resource weighting to properly hedge our largely industrial holdings. This is a major problem as we use short selling to hedge against the market exposure of certain long positions, rather than more uncorrelated positions.

We continue to remain confident in the outlook for the portfolio and its individual components, regardless of the macro-economic environment or the stock market. We believe that 2008 has the opportunity to be a very profitable year for our investors and we thank you for your continued support.

Yours Truly,

A handwritten signature in black ink, appearing to read 'BO', written in a cursive style.

Brandon Osten, CFA

President, Venator Capital Management