VENATOR
CAPITAL MANAGEMENT LTD.

# THE CASE AGAINST ETFs

January was another good month for the Founders Fund which posted a 5.5% gain, putting the fund up 40% since its March ’06 launch (unit price $14.05). North American markets finished up approximately 2% for the month although they took different paths to that number. Here in Canada markets started off weak and spent the rest of the month recovering, while technology lifted US markets early in the month and those gains were gradually given back. The markets would have finished flat for the month were it not for the last two trading days which saw big gains across the board. We saw several trends that continue to intrigue us:

- People want to invest in technology, but quarterly numbers are not showing robust growth in the sector, and valuations aren’t particularly cheap.
- Oil continues to show a dangerous trend of weak fundamentals (supply-demand) followed by market manipulation (retaliatory OPEC cuts); we see this as a bearish trend as excess production capacity is not a good thing for oil prices.
- Large caps continue to be favoured over small caps; even on the most volatile of days, the Russell 2000 seems to underperform its larger counterparts.
- The Canadian dollar continues to decline in the face of rebounding oil and gold prices.
- The Fed doesn’t appear to be under any pressure to move rates.

As usual, we are looking forward to earnings season. The fund is currently fully invested and we are doing research on a number of new ideas generated by our recent screens. This will hopefully result in a strong finish to what has been a successful first year for the fund.

This month we are turning our attention to the growing, and increasingly crowded, market for ETFs (which stands for Exchange Traded Funds). Originally, these units were designed to track Exchange returns (hence the name) but new ETF instruments have been built to track market indexes (i.e. S&P), sub-indexes (i.e. S&P mid-cap), sub sectors (i.e. oil services), commodities, emerging markets and increasingly esoteric corners of the market. The idea behind these instruments is that they are passively invested funds designed to track some portion of the market that investors might be interested in while removing the effort and responsibility of actually picking the stocks. Because of the “passive” nature of these instruments (which simply invest in the underlying index with the same component stocks) they don’t need to hire a research team and can offer a lower fee structure. These instruments are marketed on the basis of the argument that actively managed funds underperform the market by approximately 2%-2.5% on average whereas an ETF is going to track the market (less their lesser management fee). Here is our problem with this argument:

- Obviously, actively managed funds are going to underperform the market by 2-2.5% on average. Actively managed funds *are* the market, and *on average* they are going to perform in-line with the market before management fees and underperform by their management fees.
- The marketing fails to mention that passive ETFs will *always* underperform the market by the management fee since there isn’t any flexibility to beat the market (although some ETFs are using leverage to match the markets *assuming* they go up over time).

Of course as an actively managed fund we could be perceived as being somewhat biased. However, it seems nonsensical that you can be forced to continue to own a fundamentally imploding business just because it's in an index (think Bre-X after Barrick said there was no gold there). Of course, there are also many active fund managers that can continually beat their index; the point being that with a good money manager, you at least have the potential to meet or beat on index. With a good hedge fund, you may even make money in a down market (no chance of that in an ETF).

Now that I am done extolling the relative advantages of actively managed portfolios, we are going to talk about the real problem with ETFs. These funds continue to suck liquidity out of the market. The $400BB ETF market continues to grow ($50BB raised last year alone), buying stocks but never selling them. While this is not yet much of a problem on the large cap side, it is starting to have an outsized effect on the liquidity of smallcap companies (i.e. under $1BB in market value). This is in large part because smallcap companies often have CEO/founders/VCs that still own a significant chunk of the float. So when a smallcap company goes though a certain market value hurdle that makes it eligible for an ETF, you can get a 5% further reduction in the float (i.e. a $100MM company where the pre-IPO shareholders still own 50% of the shares outstanding; ETFs may end up buying 2.5% of the shares as it moves through $100MM). This can cause continual upward pressure on emerging companies as there is less stock to buy, and less eligible sellers to sell (of course this works in the other direction as well when we are not fighting with as many shares to sell when something blows up, but since we expect our stocks to go up, this factor hurts us more than it helps us). This can be problem if a company hits a small-cap, technology, software, and growth ETF radar screen all at the same time. The problem here is that ETFs don't concern themselves with trivial characteristics like earnings, cashflow, book value, growth or any of the other things active managers look at. Therefore, when an announcement is made, fewer shares available for trading are having a greater effect on share prices.

That being said, we employ the use of ETFs for short hedges. It is an easy way to hedge out market risk if we can't find enough companies that we are comfortable shorting. Unfortunately, we are not the first ones to employ this strategy and ETFs are getting increasingly expensive to "borrow" due to the proliferation of hedge funds employing a similar mentality.

As some of you may have noticed, we don't like to reveal our positions in general. However, recently we have been quoted in several press publications as being invested in certain Canadian positions, namely Neo Materials (NEM), Belzberg Technologies (BLZ), Pet Valu (PVC) and Hammond Power Solutions (HPS.A). These stocks all represent what we look for in our ideal investment candidates, namely 15%+ EPS growth, valuations of 10x forecast EPS or less, non-cyclical growth stories; they are all core positions in the fund (5%+ weight). The fund remains nearly 100% long (30 positions) and we have dropped our short exposure to 25% (12 positions); the long side of the fund remains weighted 60% Canada vs. 40% International. Our biggest problem right now is trying to find room in the fund for new names that we are discovering (which is a nice problem to have).

Thank you for your support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.