VENATOR
CAPITAL MANAGEMENT LTD.

POLARIZED WITH FEAR

February was much kinder to the Fund than January, as earnings season propelled the Fund to a 6% gain. This may not look so stellar in light of Canadian markets being up 5% for the month, but it's worth noting that we estimate that our Canadian holdings were quite flat during the month, as we received only one earnings report, and we are not invested in the resource plays that drove the Canadian markets higher. On the other hand, we estimate that our US holdings, many of which have reported earnings at this point, gained over 10% in what was another down month stateside for the markets. We can only hope that the Canadian earnings season is as kind to us in March as the US earnings season was to us in February. Rest assured, with the Fund still down 4% this year, we are working harder than ever to find the right balance between risk, reward and hedging to ensure that we can take advantage of some of the compelling values we are seeing out there, without exposing the Fund to excessive market risk.

We have talked about the "polarized" nature of today's market briefly before. In reviewing the 2007 markets there was clearly a sense of "haves" (represented by agriculture and certain other commodities, large cap technology, and infrastructure) and "have nots" (such as apparel retailing, financials, small caps and anything real estate related). Lots of "year in review" articles would typically say that the exclusion of one or two stocks/sectors would have had dramatic effects on the year end performance of certain indices. Without getting into statistics, it has been widely publicized that the TSX Index, which showed a healthy return of 7%, would have been flat without Research in Motion, Potash of Saskatchewan and Alcan. The meager performance of the S&P500 would have been close to +10% excluding the financials, while the strong performing NASDAQ would have looked fairly mediocre without Amazon, Apple, Google and the aforementioned RIM.

We believe that the markets views are currently getting even more extreme, and consequently more volatile, in the current environment. The bottom line is that right now an investment theme appears to be either incredibly bullish, or incredibly bearish. It's not like the technology bubble, where other sectors would suffer from neglect as all the money went to technology stocks. Right now it's not neglect but sheer negativity that is leaving the have-nots (financials, real estate, retailers) behind. Even small caps in general fall into this category of negativity as people are afraid of illiquidity.

The commodity boom is a large one that continues to have legs. Unlike the technology bubble, which saw investors hopping between variations on a theme, the commodity bull has multiple disparate themes to play on. Investors can hop from commodity to commodity (i.e. wheat to gold), or from stock to stock (i.e. Barrick to Deere). What is increasingly fascinating is the move out of stocks and into the commodities themselves. For those of you that haven't noticed this, it actually makes tremendous sense. Now that all commodity producers are effectively above their cost of production, the leverage to increasing commodity prices is not what it was, and with much of the rise attributable to the deteriorating dollar, foreign producers whose costs are in their local currencies aren't getting the full benefit of these commodity price increases (Canadians know this all too well). Furthermore, companies leveraged to the commodity boom (i.e. mining companies) are still companies with all the associated risks that came with them; the potential returns are not what they once were but the risks are pretty much the same. We think this direct play on commodities can continue for a while as there are so many that can be rotated in and out of (oil, gas, copper, wheat, corn, cattle, etc.), while equities may continue to lag as a way to play commodities.

However, we note that people need to beware of the bubble. Speculative investing in the underlying commodities can create a "Double Bubble" (unfortunately already trademarked by Tootsie Roll, otherwise we would grab it). The first bubble is created by too much fast/speculative money driving up the physical commodities, which have historically been moved by supply and demand for the commodity rather than speculative investment (in this sense we are currently in somewhat unchartered waters). The second bubble is created by the stocks benefitting from this getting full benefit (financials and valuations) as though this were a supply and demand theme rather than an investment theme. For example, if the speculative money comes out of gold (it is currently estimated that near 20% of gold demand is financial investment related in the form of ETFs, hedge fund holdings, etc.) and it drops back to $600, then your typical gold stock is likely to fall by 35% on lowered future cash flow expectations, plus an additional 30% on the valuation as is moves from 1.8x its Net Asset Value to 1.2x its NAV.

Here at Venator, we are getting increasingly bullish on our own prospects, even if we are a little concerned with where the markets appear headed. We are not in the current "hot areas"; valuations always seem stretched to us (which is the result of being hot), volatility is extreme and you can lose too much money from a valuation/sentiment drop even if earnings meet expectations. As we are fond of saying, we prefer that the momentum comes to us. We are, however, in neglected areas such as small caps. You can buy some great growth really cheap, especially here in Canada. We are also growing increasingly confident in our short positions, where low growth, highly valued companies seem like much better bets when private equity is shut down. There is no room for even the most immaterial error when you have low/no growth yet trade over 25x earnings, and there is almost always some error in every report. Iron Mountain (IRM) represents just such an opportunity and we recently re-shorted it after exiting that position last year (we note that Warren Buffett has recently exited his position in this stock as well). The Fund is currently fully invested on the long side, with a 50/50 split between Canadian and US companies. We are over 30% short right now as well, with nearly all of these in the US. Finding suitable shorting opportunities in Canada remains difficult, as Canadian industrials seem to be carrying fairly low valuations as worries over the Canadian dollar have taken their toll. Without the hype, we can't get the valuation cushion we like in our short candidates, even if the fundamentals are weak. Rest assured, we will keep looking, as we would like to increase our hedge positions to further hedge out market risk.

Yours Truly

Brandon Osten
President, Venator Capital Management