VENATOR CAPITAL MANAGEMENT LTD.

INTRODUCING THE WORLD'S MOST POWERFUL DAY TRADER and
WE HAVE FOUND NEXT MICROSOFT (you won't believe who it is)

Getting straight to the point, the Fund lost close to 10% in January to finish with a NAV of $13.79. Painful, frustrating and annoying would be some of the adjectives I would use to describe the month. Another appropriate description might be reminiscent. Indeed, the market activity of the month reminded us of the disastrous month the Fund experienced in June 2006, when the Fund dropped by approximately the same amount, despite a lack of news coming out of our investments (two pieces of news released in January cost the Fund approximately 0.5%). The anatomy of January 2008 and June 2006 were also similar in that our less liquid small caps remained at their monthly lows, while the market (and our more liquid mid-cap shorts) rebounded sharply in the last week. That month proved to be a bottoming point for the Fund, which gained nearly 40% over the following six months. We simply needed to get past the market turmoil and let our companies "speak for themselves" with their financial results. We believe this will be the case once again while we await the launch of earnings season over the next eight weeks.

Ben Bernanke proved all of his critics right last month, placing two "panic" trades in the market. We all get a bit jittery when markets are collapsing and it can cause a short-lived case of "itchy trigger finger". However, that the Fed cut rates twice (within ten days) after learning that the first cut was probably unnecessary makes this Fund manager nominate Bernanke as the "World's Most Powerful Day Trader". For those who missed all the action, the Fed came into work on the Tuesday following Martin Luther King Day, looking to calm the waters of a market that appeared on the brink of collapse. Indeed international markets cratered throughout the Monday US holiday for causes that were at the time unknown. The Fed came to the rescue with a 75 point cut, which turned what was looking like a crash into just another bad day in the market. I had no problem with this action, my problem is with what happened afterwards.

Several days later it came to light that a young trader at Societie Generale (SocGen) had lost $7BB on bad market bets, and the ensuing trading relating to this loss, and subsequent unwinding of said loss, was the likely cause of the Monday turmoil in the market. In other words, the Fed was a little too quick on the trigger (it's unlikely they would have cuts rates that deep that quickly one week before their scheduled meeting had they known the market turmoil was due to a bad trade made in Europe). So what does the Fed do? It cuts another 50 points at their regular meeting! This, despite that the only information they received between their surprise cut and their scheduled cut was that the first surprise cut was unnecessary, at least as it pertains to the economy. Put another way, Bernanke & Co. are more focused on playing the stock markets than watching the economy. This massive cutting of rates will not spur a new round of home buying, nor will it magically get rid of the over-levered bad debt now plaguing the financial sector. It can however further devalue the US dollar, making oil, food, clothes and other imported products more expensive to the consumer. Someone needs to tell this man that stock market corrections are a normal and healthy thing.

Outside of the Feds ill-advised actions (we are a bit bitter as the cuts definitely hurt the Fund in the month, as our shorts rebounded while our longs lagged), it was an odd month. Short covering rallies occurred in the obvious defensive sectors of retailers, restaurants, financials and homebuilders, while those worrisome low growth sectors of infrastructure, healthcare and technology were among the worst places to invest. Sarcasm aside, the market has been briefly turned on its head, yet troubles clearly remain. Mortgages still can't get paid, retailers are still putting out horrible results in a saturated market for shopping destinations, and no one is eating out (apparently even McDonalds isn't cheap enough to entice families out of the dining room).

Of all the amazing things that happened in this odd month, perhaps the most amazing revelation was that Microsoft is still Microsoft -- who saw that coming? Apple's numbers were underwhelming as big gains in iMacs were not enough to offset flat iPod sales and significant subscriber shortfalls for the iPhone (high unit shipments brought out channel stuffing concerns after AT&T came out with lower than expected subscriber activations). Then Google missed for the second time in the last four quarters. Now Microsoft is about to take over Yahoo, giving it the largest captive user base on the internet (I don't care what any contrarian says, this was incredibly smart in terms of the target, timing and price). Say what you want about Yahoo's inability to "monetize" its captive audience, it's probably better than MySpace, YouTube and FaceBook will ever achieve. And say what you want about Apple's "phenomenal" track record of innovation (the Mac has been around for twenty years, the iPod is their <u>only other</u> tangible financial success thus far), Microsoft has proven their ability to extend their market reach time and again (the Xbox being the latest success, relative to Apple's thus far failed iTV foray into the living room;). Microsoft is more recession-proof, more international, and has more price control than any other technology company out there; and now they have Google shaking in its boots (despite what they might say, they have been unable to meaningfully extend their market reach outside of search, and Microsoft is about to become the dominant internet portal in terms of internet user attention). There can be no denying that Apple and Google are both great companies (we actually

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bought some Apple when it got below $120.00), but the time has come to give Microsoft it's due after what can only be characterized by five years of disrespect. At $28.00, Microsoft can be had for 14x earnings. You can get a little extra return buying Yahoo stock, but why risk the EU's anti-trust stalling; whether it goes through or not Microsoft will likely be back at $36.00 by year end.

It's always difficult to report such poor results to our unitholders, regardless of market conditions. That being said, the Fund is not designed to escape the short-term trappings of the market given our use of selective short selling, rather than an outright market neutral hedging strategy. Our positions are largely non-cyclical, or not economically sensitive in the current environment. They are also, in our opinion, quite inexpensive; although in the short-term any stock's valuations can be knocked down to unreasonable levels regardless of its growth rate (the most egregious of these would be represented by our investment in Sangoma Technologies which trades at 9x earnings despite its 80% growth rate). If our Companies start posting disappointing results relative to our expectations for them, we would be concerned. However, since this is not the case, we will be patient, if frustrated. While we may have mixed up our stock allocations during the month, this shuffling has only served to increase our expected returns without a significant increase in risk.

Yours Truly

Brandon Osten
President, Venator Capital Management