VENATOR
CAPITAL MANAGEMENT LTD.

IT LOOKS LIKE A BULL, BUT SMELLS LIKE BULLSH…

The Venator family of funds had a solid month with respect to their investment mandates. The Founders Fund managed to perform in-line with the overall markets despite being only 66% net long, while the less volatile Income Fund also managed healthy gains. The Venator Catalyst Fund managed a small gain due to its underinvested position, but it's worth noting that the cautious nature of this fund allowed it to post a small gain last year, so hopefully it can be forgiven for missing a chunk of the current rally.

Instrument	Monthly Return	Year-to-Date
Venator Founders Fund[1]	**9.7%**	**20.3%**
Venator Income Fund[2]	**3.7%**	**8.0%**
Venator Catalyst Fund[3]	**1.5%**	**3.8%**
TSX Composite	6.9%	3.8%
Russell 2000	15.3%	-2.4%
S&P Toronto Small Cap	9.6%	4.2%
S&P 500	9.4%	-3.2%

1. *The performance of the Venator Investment Trust approximates the performance of the Venator Founders Fund.*
2. *YTD of Fund is net of distributions reinvested. The benchmark of S&P/TSX Income Trust is no longer relevant as the Fund is now comprised of a high proportion of bonds.*
3. *The Venator Catalyst Fund was has no benchmarks.*

Being a contrarian is considered something of a badge of honour in the investment community. Everyone wants to think they are a contrarian but few truly are. I don't like the term contrarian. Frankly, I prefer the term "independent thinker". I can tell you that when I worked under Eric Sprott in the late 1990's he was a long investor in a bull market (his Markets at a Glance columns used to end with his signature "We Remain Bullish!"); in late 1999 he turned into a contrarian, shunning the bull market and buying beaten up resources. This was a contrarian trade at the time, but one that turned into a momentum trade from 2003-2007. The point is that independent thinkers can be both contrarian, and ride momentum depending on the circumstances, and this is how we like to model ourselves. This is in stark contrast to momentum investors, who like to wait for a clear trend and then pile on. They tend to be the last to get in on a trend and the last to get out, but have great rides in between (the longer the cycle the better).

Here is a collection of correct independent thoughts we have had over our short history:

- April 2006: "We believe (there is a) commodity bubble forming"
- August 2006: "Oil is Cyclical" (yes, that was a contrarian opinion at the time); "the new cyclical low for oil (is) about $30.00"
- November 2006: "we are shocked at the valuations we are seeing for public LBOs", "private equity will eventually disclose their share of disasters"
- December 2007: "we believe that lowered US demand will put continued downward pressure on base metals"
- December 2007: "(private equity) were among the worst investors on the planet (in 2007)…if private equity funds had to mark their leveraged portfolios to market, they would probably be looking at losses in excess of 50%"
- April 2008: "(Agriculture) is a very crowed trade for what is historically a very cyclical …market"
- May 2008: "Oil…we find ourselves unable to jump on this bandwagon"; "Natural Gas could realistically fall from a current level of $11.00 to $5.00"

We our bringing this up only because recent market volatility and economic uncertainty will make independent thinking a necessity for investment success in the current market. Groupthink would have had you too long going into the crash and too short (or underinvested) coming out of it. Last month we wrote about great values to be found in the market, where great returns could be made with a minimal amount of risk. That being said, we were unprepared for the force of the indiscriminant market rally of April, and are now shifting our attention to the short side, where a number of stocks have come back too far and too fast.

The big problem as we see it is that corporate America cannot cost-cut their way to growth and prosperity. We can appreciate that first quarter earnings were generally not as bad as feared due almost entirely to better than expected cost controls, but we would also note that revenues were generally as bad, or worse, than feared, and rarely better than expected. This is not a good sign. Thanks to the cost cutting measures, profit margins are still near peak levels, but revenues potentially have further to fall, and it's difficult to put a P/E on a shrinking business. All companies can't cut spending but hope no one else does. All companies can't lay people off yet hope unemployment doesn't get worse. All companies can't build up free cash flow to pay down debt while hoping others keep up capital spending, just as we can't hope for the savings rate to go up (in order to get the housing market going again, and improve credit quality) yet hope consumers keep spending. If corporations and consumers alike are going to keep spending less, then we have more negative earnings revisions in store for us. While in the short-term cost cutting is good for the investment markets by propping up earnings and cash flows, in the longer term it could end up prolonging the recession, as cost cutting typically results in both lower corporate and consumer spending which at worst could result in further negative revenue revisions, and at best delay a return to growth.

While we still think there are great values out there (the Fund is still close to 100% invested on the long side), we are also starting to find a number of stocks that look extremely overvalued. Restaurants and retailers appear to be pricing in a return to peak margins *in addition* to a return to growth rates of 2007; there are industrial companies trading at over 20x *last year's* earnings (again looking for a return to previous record revenue and margin levels, and assuming the forward growth prospects are as good as the growth prospects of last year); oil stocks are pricing in a return to $80.00+ oil despite one of worst supply-demand gluts in twenty years. The level of optimism toward cyclicals appear overblown to us given our above concerns and our thesis that while the economy will stabilize over the next 12 months, we may not see the economy return to meaningful growth rates for the next several years, leading to some long-term overcapacity and a general lack of meaningful pricing power.

As we stand, our hedge funds remain more aggressively net long than they have been in the past. However, we have taken some money off the table in our more risky (i.e. cyclical and turnaround) investments. We have also consolidated our long holdings in some of the laggards and cheaper stocks (think IBM). As you can surmise from the above commentary, we are also starting to look at new short candidates again. The Founders Fund is about 105% long and 30% short, while the Catalyst Fund is about 40% long. The make-up of our Income Fund hasn't changed much; it's still close to 50/50 equity/debt, showing a current yield of close to 10%, unhedged, and for the most part unlevered.

Thank-you for your support,

Brandon Osten, CFA

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20 Eglinton Avenue West, Suite 1004, PO Box 2073 Toronto ON M4R 1K8 T 416.628.8198 F 647.477.2529 www.venator.ca