

THE IMPORTANCE OF BEING HEDGED

The Venator family of funds had something of a mixed month, despite some relatively strong markets. The Income Fund had the strongest month, posting a solid 5% gain, while the Catalyst fund also posted a nice 2% gain. However, the Founders Fund suffered a slight loss despite net exposure to the market of 70%; we made the right market call, but the long side of the Fund just refused to get going along with the broader market.

| Instrument | August's Return | Year-to-Date |
|--|-----------------|--------------|
| Venator Founders Fund¹ | -0.8% | 33.4% |
| Venator Income Fund² | 5.0% | 27.4% |
| Venator Catalyst Fund³ | 2.2% | 8.8% |
| TSX Composite | 2.1% | 20.0% |
| Russell 2000 | -0.3% | 14.5% |
| S&P Toronto Small Cap | 2.8% | 26.2% |
| S&P 500 | -0.3% | 12.8% |

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 has no benchmarks.

The last twelve months have been a shockingly volatile time. The markets have had no fewer than five 15% moves in twelve months and in aggregate we have seen this market move down 50% from its peak and then jump 50% from its bottom (which still puts the market down over 20% in the past twelve months). Being hedged, the Venator Funds have moved with considerably less volatility than the overall markets, with the Founders Fund down 5% over the past twelve months and both the Catalyst (up 15.6%) and Income Fund (up 6.4%) up during that time frame, with all of the Funds up since January 2008.

While this latest market bounce has “bailed out” a number of financial experts numerically, their risk profiles have been disastrously exposed. Be wary of the fund that dropped more than 50% last year and are up 100% this year to get you even because they have been exposed as “levered long” funds (whether they use actual leverage or just synthetic leverage with higher beta investments), and not the hedge funds they advertised to be. What you may not know is that a number of these funds may have been taking outsized risks in this market rebound more out of concern for getting back to their own high watermarks (where they can start taking performance fees again) than out of concern for their clients' money.

Truth be told, this rebound represents a chance for investors to learn a valuable lesson and shift their recovered capital into more hedged instruments, because these market crashes have occurred stunningly often over the past 20 years:

- The Crash of 1987: Black Monday was just the beginning of a two month 30% market crash.
- The Mini-Crash of 1998: In the summer of 1998, the market corrected by 20% and many small cap issues fell by more (the Russell 2000 fell by 37%), spurred by the Emerging Market collapse.
- The Tech Crash: The Dow only lost 38%, but the Nasdaq is still roughly 60% off its high.
- The Everything Crash: That was a 54% drop from its October 2007 peak.

For those of you who lost track, that is one major market correction every five years on average. In this current incarnation, we are all fortunate that everything came back. But if you were in the “hot” sector that didn't come back (i.e. the aftermath of the Tech crash), you could have suffered a more permanent loss of capital. This is the problem with leveraged long funds masquerading as hedge funds. When you lose money without leveraging, you keep your stocks so that if the market does come back you still own them and can come back with it. When you use leverage, you get margin calls and have to sell your stocks as the market goes down; the result being that you are no longer “in the game” for the hopeful rebound.

Hedge funds that hedge, on the other hand, can keep you in the game the whole time, and protect you in the event of a sector rotation. This is useful because simply being able to hold onto all of your tech stocks in 2000, or your natural gas positions today, would not have allowed

you to recoup losses during the current rebound. To be clear, none of Venator's Funds are marketed as "market neutral". Rather, we constantly analyze the risk that we believe exists in the markets in general and with our stocks in particular, to determine what our appropriate hedging policy should be.

At this point, the stock market, in our opinion, has fully recovered from its previous fall. While stocks are still down roughly 20% over twelve months, the stock indices are price indices, not value indices. With all the stock and debt issuances in the past eight months, the surviving companies generally have overall market values that are roughly equal to where they were last year. Any differences between last year's valuations and this year's valuations can be more than accounted for by lower growth prospects going forward.

So now that the market has, in our opinion, fully recovered, where do we go from here? We are concerned that the market has priced in an economic rebound that is far from a foregone conclusion. What we see is a much lower base of economic activity currently, and a lower growth rate over the next five years.

One of our short sales, Fastenal Co., represents much of what we see wrong with the market today. Fastenal is a leading distributor of fasteners (that high growth market known as threaded screws to us laymen) and other such consumables to contractors. Now, Fastenal's sales have been declining at a relatively healthy 20% clip this year, with no real signs of improvement on their monthly sales reports, but a good sign of deteriorating margins on their quarterly reports. The Company trades at 30x current year earnings, which everyone thinks are depressed owing to "bottom of cycle" perceptions. However, what is more pertinent is that FAST trades at 26x next year's expected earnings and 25x 2011 earnings. These numbers assume 6% revenue growth and 10% earnings growth per year over the next two years. The point is not that the expected growth is aggressive, which it probably is, but that at 25x earnings the Street seems to be factoring in a fairly significant beat to these earnings (it bears mentioning that FAST trades at over 20x its best earnings year ever in 2008). Contrast this with another one of our shorts, Donaldson Company, a leading manufacturer of air filters. Now, DCI has fared slightly better than FAST, with sales dropping only 17%. However, with a July year end, they are one of the early ones to give next year guidance. On their recent conference calls, they guided that next year's revenues and earnings are likely to drop from this year's levels, along with margin guidance that suggested that analysts were getting too aggressive in their cost cutting/margin improvement expectations. Naturally this data sent the stock lower.

The point is that expectations for a return to growth, which appear to be expected for nearly every company in 2010, could run into a brick wall of reality next January/February when companies begin issuing their 2010 outlooks. If those 5% revenue growth/15% earnings growth forecasts come down, then we could see a pretty hefty market correction of 10% to 20%. It's important to remember that we are not necessarily talking about a deteriorating economy, we are talking about a rationalization of expectations, which could result in a 10% reduction in earnings expectations, and a further 10% reduction in the market multiple for a combined 20% drop. We are about six months away from this happening, which is supposedly how far in advance the market predicts these types of things, so the market could start getting a little choppy right about now.

The point of this whole exercise is that we still think you need to have a hedged strategy in this market (or at least some bonds in order to ensure a return of principal). Be wary of the hedge fund that was down 50% last year but is up 100% this year, because clearly they are a hedge fund that does not hedge. We believe the current rally was one of exceedingly cheap valuations in contrast to reasonable expectations, while the potential for a drop may be due to high valuations coupled with unreasonable expectations, which is a pretty bad combination for the market.

Thanks for your continued support,



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President, Venator Capital Management Ltd.

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