VENATOR CAPITAL MANAGEMENT LTD.

NAVIGATING OBAMA

All the Venator Funds gave back some of their January gains during the market's February chapter of the worst bear market of our generation, yet all of our funds remain up on a year-to-date basis.

Instrument	Monthly Return	Year-to-Date
Venator Founders Fund[1]	**-4.1%**	**2.2%**
Venator Income Fund[2]	**-2.3%**	**4.0%**
Venator Catalyst Fund[3]	**-0.7%**	**2.7%**
TSX Composite	-6.6%	-9.6%
Russell 2000	-12.3%	-22.1%
S&P Toronto Small Cap	-7.5%	-7.7%
S&P 500	-11.0%	-18.6%

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. Benchmark: S&P/TSX Income Trust (monthly return -10.2%, YTD return -12.1%).*
3. *The Venator Catalyst Fund was has no benchmarks.*

Pessimism abounds, and daily data doesn't help. There are few brightspots out there, and even so-called defensive stocks (i.e. Coca-Cola, McDonalds, Procter & Gamble) are showing that they are anything but in this harsh environment. While our companies have been largely beating their earnings estimates and guiding above consensus expectations, the subsequent gains posted in the days after reporting have usually been given back in the following weeks. That being said, our hedge funds have the least amount of net market exposure than they have had through this bear market, so that we can get more reliant on the individual characteristics of our companies and less correlated to market moves in general.

While those who know me know I have some pretty strong opinions (I don't consider the label "opinionated" to be an insult), I have largely left politics aside in these writings. That being said, after 100 days in office, a stimulus package, the announcement of a potentially additional $2 trillion in undefined stimulus, and a budget that appears designed to destroying the current healthcare system in the United States and choking off private sector job growth, we have to start figuring the implications of at least four years of an Obama government.

The first thing we noticed about the initial Obama budget proposal is the attack on healthcare. The President appears to want to take away from certain aspects of the current system (insurance/HMOs, home healthcare, hospitals and biotech) and stick it in a "slush fund" to be put to some form of Universal Healthcare later on. It almost amounts to actively trying to make the system materially worse so that the government will have no choice but to "nationalize the system" at a later date. With the exception of cutting back on the fat margins of home healthcare providers, we believe that the other proposals are overly populist proposals that show a complete lack of understanding of the workings of the healthcare system. Hospitals and insurance companies are barely profitable right now. The pharmaceutical industry only looks as profitable as it does because their profits don't reflect the billions of dollars spent by junior biotech companies that don't get through all of the FDA's trails (big pharma tends to acquire the better biotechs only after these entrepreneurial companies look like they are going to go all the way). The fact that the FDA is so stringent is why other countries effectively rubber-stamp drugs that have been approved by the FDA; in other words, the US is effectively subsidizing the rest of the world's drug expenses. If Obama really wanted to cut healthcare costs, he would start by capping on the amount that people could sue for medical malpractice (which costs on average over $40,000 per doctor) and limit what patients could sue for (which would avoid excessive radiology imaging for fear of getting sued for missing a brain tumor when someone comes into the ER with a migraine). But something tells me that limiting the right of Americans to sue wealthy doctors is not the direction Obama wants to go in (Bush tried and failed to put a similar measure through).

The next part of the budget that concerned us was the $500BB deficits running through the end of the forecast period in 2019 (after the Iraq exit). We would really worry about the devaluing of the US dollar if we didn't think that other governments were going to have to do the same thing. We would also be thinking about buying commodities if we didn't just exit a period of productive capacity build-out of supply in front of a collapse in demand. No, what we are really worried about is paying for excessive public sector spending at the expense of private sector spending through the excessive tax increase proposals placed on families earning over $250,000 per year, many of which are small business owners and primary job creators in the US. The combination of lifting investment taxes, lowering deductibles, increasing income taxes and proposing to eliminate the tax deductibility of mortgages (which likely won't pass) could have the effect of choking off private investment in America.

We would criticize both the stimulus package and the Geithner's $2 trillion slush fund, but we really can't figure out where any of that money is supposed to go! Some of it appears to be going to electronic medical records (with great fanfare), and some is apparently going to alternative energy, and some is going to infrastructure, but those items are much less specific than they sound (as an analyst that used to cover electronic medical records I can tell you that this technology has been purchased by most doctors who desire to use it).

Despite these concerns, we note that Obama's plans still need to pass through Congress, which fortunately has all of the old school corruption, lobbyists and special interest groups to slow the pace of change. That being said, Obama clearly has strong ambitions for change. Like Bush before him, a central form of government promised during election time does not appear to be part of the plan, as Obama is arguably moving further to the left than Bush moved aggressively to the right. Unfortunately, as much as the previous administration had its issues, I believe that the market was far more comfortable with the Bernanke/Paulson ticket than it is with the Geithner/Frank ticket (Bernanke is either keeping his distance from Obama/Geithner/Frank or vice versa).

THE STRONG WILL GET STRONGER

While we don't believe that the current administration is going to help lift us out of this recession quickly, we do believe that by the end of this economic train wreck, the strong will be stronger in terms of market dominance, even if the temporary result is only a larger slice of a smaller pie. Unlike prior recent recessions, the weak won't be able to weather the typical 12-18 month 5% drop in business levels. The destruction of the credit markets will destroy the over-levered companies without the free cash flow to retire debt, as interest rates will likely balloon from 5% to 10% in the case of "Tier 1" companies, and from 10% to 20% for everyone else. Additionally, the search for stable vendors will result in the disappearance or absorption of the "mom and pops" that still litter the economic landscape. The survivors will be characterized by healthy balance sheets, strong free cash flows and increased market dominance, and will ultimately prove to be great investments as they strengthen their market dominance through this difficult economic cycle.

Some of these companies' stocks are already experiencing the anticipated longer term benefits of these market conditions. Companies like Best Buy and Bed, Bath and Beyond have seen their stocks hold some respectable valuations in light of the anticipated market share gains that come from the bankruptcy of Circuit City and Linens 'n Things respectively. Meanwhile, portfolio holdings such as Hammond Power Solutions appear to be benefiting from current market conditions as they get increasing levels of business from customers in the process of consolidating their vendors, as well as benefitting from competitive bankruptcies. Finding the beneficiaries from these factors isn't easy; big companies aren't necessarily safe (i.e. Circuit City) and small companies can benefit from these factors.

While we believe that our companies are on the right path to being the emerging winners in this downturn, we are constantly faced with the dilemma of whether to try to sell now and buy back later (and possibly cheaper) or to stay the course with portfolio holdings that continue to grow their earnings, even in the current economy. We have rarely been disappointed with our companies' financial results, but valuation compression is where the portfolio has fallen short. As such we are more hedged than we have been in the past (100% long, 60% short, 40% net long) and will rely on the strengths of our individual companies to outpace the overall market as they have consistently done for the past several years.

Thank-you for your continued support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.