

## WHO WILL BLINK FIRST?

Again, we are happy to report that all of Venator's Funds were up in the month of July, although keeping up with this rampaging rally while being defensively positioned is proving increasingly difficult. Of note, the Income Fund hit its one year anniversary with a 12-month 10% gain versus the market's 6% loss. Equally impressive is that this Fund was never down more than 10% despite being 100% invested through the crash that characterized the first six months of its mandate.

Instrument	July's Return	Year-to-Date
Venator Founders Fund <sup>1</sup>	5.8%	34.5%
Venator Income Fund <sup>2</sup>	4.3%	21.4%
Venator Catalyst Fund <sup>3</sup>	-0.5%	6.5%
TSX Composite	4.0%	20.0%
Russell 2000	8.8%	11.4%
S&P Toronto Small Cap	3.8%	19.7%
S&P 500	7.4%	9.3%

- 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 events of the last year have left our minds spinning and I regret that I am having difficulty creating a unifying thesis from all the data we are currently processing. Is there a real recovery in the offing or is this a bear market rally? Can inventory restocking be enough to lead an economy out of recession? Can earnings keep bouncing back while revenues go down? Can China keep the commodities markets afloat when the restocking is done? Will Obama fire Bernanke in January? Can the Presidency survive healthcare reform?

Our big problem right now is that we are not sure that we see the ingredients for a sustainable market rally (the current rally has been abrupt, but has not yet proven sustainable). To get one item out of the way, we understand the underpinnings of the current rally. We fully understand that investors were quite under-invested. We understand that companies have cost-cut their way to proving they can earn good money despite 25% revenue drops. We get that six-to-nine months from now quarterly earnings results will anniversary with the disastrous Q4 2008/Q1 2009 results, which will have the effect of showing increased earnings on relatively flat revenues. It is this last statement that saw the Founders Fund move from 50% net long to 70% net long back in March. But even while we were doing it, we were fully cognizant that cost-cutting was not the road to sustainable economic growth, and that annual revenue growth rates moving from negative to flat, just because year-ago numbers were an easy comparison, was going to easily translate to earnings growth in 2010.

The problem is that the Armageddon expectations that the market had built in several months ago have turned into growth expectations in 2010. By and large, we see forecasts of 5% revenue growth and 15% earnings growth across the board. A big part of this is that companies are operating so lean, that any revenue growth should result in substantially greater earnings growth, as businesses move from record under-capacity to less-than-record-under-capacity. To have sustained recovery, we need a better jobs picture (or higher capacity utilization leading eventually to more jobs), a better capital spending picture, a better home equity picture, and a lower savings rate picture. The question is, "who will blink first, the suppliers or the customers?"

This question is at the heart of our own market views. If the American consumer is going to start spending again, then emerging economies can start selling us more stuff, they can resume their consumption of commodities, and companies can hire people to handle the excess order flow. Unfortunately, a country at 65% capacity utilization isn't going to have much need for higher

capital spending for a while (nor new jobs with the average work week running at 33 hours – lowest level since 1964; we first need to see increase in hours worked), nor can we look for an increase in domestic infrastructure outside of government stimulus plans (which we believe could be at risk of being curtailed or cancelled if the powers that be decide that emergency measures put in place in March are no longer needed). Without an increase in consumer demand we are looking at a stagnant economy, which will not bode well for markets in 2010. If the current market rally is anticipating a late-year economic rebound, will another Fall collapse be a predictor how growth expectations are going to go down the toilet in the spring of next year?

There are some other ominous signs on the horizon as we look towards 2010. Here is a non-exhaustive list of other worrisome items that could become monthly commentaries soon:

- **Debt Refinancing:** No one seems to have incorporated the fact that companies are generally rolling their debt 2% higher than their prior rates, which will hurt earnings.
- **Commodities Can't Cut Costs:** We understand that corporate earnings are beating expectations because of lower costs despite lower revenues, but commodities prices don't have costs to cut; they just have the weaker revenues in the form of lower demand.
- **Bernanke vs. Summers:** The markets will not be happy if Obama replaces the well respected Bernanke with a less independent Summers.
- **The Health Tax on Businesses:** It will be interesting to see what small businesses do with their employee bases once they start paying additional payroll/healthcare taxes on a per employee basis.
- **The New Gen-Y Tax:** I don't expect a positive reaction from Gen-Y (ages 20-30) when those that believe they are healthy enough to not need healthcare insurance are forced to spend several thousand dollars per year as health coverage becomes mandatory under health reform.
- **China's Demographic Nightmare:** I am not sure why we never read anything about this, but in about ten years China's demographic situation is going to be worse than the disaster that has been Japan for the last ten years. Chalk this up to the country's famous one-child policy coming back to haunt them (the fertility situation is even worse given the male-female imbalance).

Despite the current market rally, and a possible next leg that the technicians are universally calling for, we are staying cautious. All of our portfolios are positioned quite conservatively in terms of both asset allocations and underlying investments. Now is not the time to be taking chances unless you are trying to time short-term, but violent, market moves. My experience with bull markets, as well as rebounds from market crashes, is that they tend to occur with sustainability when economic times are good. This is not the case today. Capital preservation and appreciation are our foremost considerations right now. Opportunities for outsized performance will come to the patient.

Thanks for your support,



Brandon Osten, CFA  
President, Venator Capital Management Ltd.

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