

IT'S NOT DIFFERENT THIS TIME

The Venator family of funds had something of a mixed month relative to the severe market bounce experienced in March, with the Founders Fund (and Investment Trust) experiencing solid gains, while the Income Fund and Catalyst Fund managed fairly flat returns. In any case, we are satisfied that all Funds are up on a year to date basis, versus comparable indices which were all still negative at month end.

Instrument	Monthly Return	Year-to-Date
Venator Founders Fund ¹	7.4%	9.7%
Venator Income Fund ²	0.1%	4.2%
Venator Catalyst Fund ³	-0.4%	2.2%
TSX Composite	7.4%	-3.0%
Russell 2000	8.7%	-15.4%
S&P Toronto Small Cap	3.1%	-4.8%
S&P 500	8.5%	-11.7%

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.

After a difficult six-month period in the markets, and a few hard bounces upwards, the debate on where we are headed going forward has many conflicting views. We try not to time the markets, but we definitely keep our ears to the ground in trying to determine market sentiment. We also try to keep our heads about us in times when sentiment moves from incredibly bullish to incredibly bearish on a weekly basis. While the world was coming to an end for the first two weeks of March, many are now saying the bottom has been put in after a two-week 20% rally. Of course, this happened at least once before in the past six months, and was subsequently proven completely wrong. What complicates things is that the markets are considered a “discounting mechanism” that is always forecasting/guessing six months in advance.

Let’s preface our market views with our economic views. Our belief is that the economy will not recover for quite some time, but should stabilize relatively soon. We are running our strategy on the assumption that after a possible 10% fall in GDP from the top, the market will hit bottom, but unfortunately is unlikely to show a lot of growth going forward as credit markets unwind, unemployment stabilizes at a fairly high level, productive capacity remains too high, inflation remains low (a function of excess productive capacity offsetting the currency printing presses), operating margins continue to be under pressure, and the consumer keeps saving. As a result of this view, we continue to position the fund in the value camp rather than the growth camp, as we believe value is always value, yet growth will be unreliable.

“It’s not different this time” has proven to be a reliable investment strategy for decades. As an analyst, this thesis caused me to publish a negative report on the internet sector at the height of the internet bubble. It also led to our negative view on oil and agriculture last year. As explained below, “it’s not different this time” has either positive and negative connotations depending on what sectors of the market, or what specific stocks you are looking at.

10x P/E will be considered cheap again: Our view, supported by history, is that good companies tend to trade at over 10x earnings over time. In fact, the market P/E at the trough of all bear markets from 1920 onwards managed to stay above 10x earnings in all but one decline (1980–1982 where the trough P/E was 8.5 and interest rates were well over 10%). The advantage this current situation has is that interest rates are already low, which is suggestive of an appropriately higher P/E ratio than 10x. In other words, a P/E rebound already has a fairly good head start on other bear markets of the past due to the extremely low rates we are seeing today. Also, what we consider decent quality corporate debt trades at a yield just below 10%, which is also indicative of a market where good companies deserve P/Es in excess of 10x. The wild-card here is the ability to accurately forecast those earnings. In a difficult economic environment, we are faced with the bear-chain of unemployment plus higher savings begets lower revenues begets higher spare capacity begets lower operating margins. That being said, to the extent you can build in fairly extreme worst-case scenarios and still come out at less than 10x earnings, you should do just fine. *It's not different this time!* Portfolio holdings Glentel, Pet Valu and Allion Healthcare are prime examples of where we expect substantial gains to 10x P/Es in businesses where we are very confident in our expectations.

Book Value will be worth Book Value again: There are a lot of cheap stocks out there by virtue of decimated earnings power in the current recession. Like a lot of people, we were out there looking for companies whose market values were below the cash on the balance sheets. While we found a few, too many of them had commitments for that cash, were losing too much money, or had operations that were large relative to the cash balances (the risk being that a slight downturn in fundamentals could wipe out the cash). Where we found some even better opportunities was in profitable companies trading well below the value of their working capital (net liquid assets). To the extent that a company can convert working capital to a source of cash in a low growth environment (working capital is usually a use of cash in a growth environment), there can be a significant amount of untapped value, and you get the earnings and fixed assets for free. We believe that profitable businesses will trade back up to their book values (or at least the value of their net working capital). *It's not different this time!* Portfolio holdings that are seen benefitting from this are Skechers, Celestica and Soapstone Networks.

Debt will be considered a viable option again: In the first year of business school, students are taught that debt is cheaper than equity. Simply put, it is cheaper to use debt for growth than to dilute your shareholders. Of course, if your stock trades at astronomical multiples and interest rates are high, then the opposite would apply (which is why you saw a lot of 2000-era tech mergers happen for shares rather than cash). That being said, companies that have debt and more than adequate cash flows to service it should probably trade at the aforementioned 10x earnings. However, we do believe that there is a high likelihood the corporate debt interest rates go up when they rollover, so we need to be mindful of how much debt a company can pay down before the debt does roll. If you can find a good stable company with strong free cash flows trading at well under 10x earnings, there is probably some good money to be made. *It's not different this time!* We believe that recent portfolio addition Owens-Illinois fits this bill.

Oil will go down on lower demand: Many of our readers will know that we have been bearish on oil for quite some time. While oil prices have fallen quite precipitously over the past year, we believe there is another 50% drop in store and fully expect oil to trade in the low-\$20s within the next twelve months. Every data point coming out on oil is extremely bearish and on a forward-looking basis the world is producing, or can produce,

way too much supply relative to foreseeable demand. While the bulls point to OPEC cuts and a reinvigoration of demand, we point to low OPEC capacity utilization (currently at 80%; you can run out of spare capacity, but once its built you can't take it back) and full Chinese storage capacity (they don't have room to store any more oil). To put this in perspective, if non-OPEC production shrinks by 1% per year and OPEC production increases 2% per year (so total oil supply keeps track with a 1% increase in GDP per year going forward) we are 10 years away from having to worry about production capacity! Closer to home, the cumulative US crude inventory build over the first three months of the year is now closing in on 40MM barrels. To put this in perspective if you had consecutive bullish draws of 500K barrels per week *every week for the next year and a half* you would only be back to where inventory levels were at the end of 2008. The best play on oil right now may be buying storage tank manufacturers as the world is running out of room to store excess inventories (right now approximately 80MM barrels is floating around on tankers looking for a storage tank to offload into). Another issue could be what happens when Obama is dictating strategy for US automakers. Given his proven propensity for radical government interference in private enterprise and ill-advised populist policies I can imagine the government forcing 50% of GM production into hybrids/electrics, and offering massive tax incentives to consumers to buy them, which could lower oil demand even further (frankly, OPEC should look at buying GM and selling Hummers for \$5000). In commodities, productive supply capacity is more important than demand and productive capacity is currently way too high. Oil cycles traditionally bottom at the marginal price of the current productive barrel, which is around \$25.00. For the past 50 years oil stocks have *always* bottomed with the oil price. *It's not different this time!*

We continue to have confidence in our holdings despite the market uncertainty. Most of our companies reported Q4 earnings that exceeded our expectations and we are sticking by our "buy-and-hold" strategies with these investments. We believe the fund is adequately hedged to maintain day-to-day volatility at a relatively low level. We believe our holdings are both undervalued stocks and defensive business models. Finally, we believe the outlooks for our investee companies remains bright, even in the face of a difficult economic backdrop.

Yours Truly,



Brandon Osten, CFA

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