

THE BULL CASE VS. THE BEAR CASE

The Venator family of funds all managed to finish in record territory despite the January selloff. We saw increases in all of our funds, which are more defensively positioned than they were in the latter half of last year.

Instrument	January's Return	Year-to-Date
Venator Founders Fund ¹	4.7%	4.7%
Venator Income Fund ²	0.1%	0.1%
Venator Catalyst Fund ³	3.4%	3.4%
TSX Composite	-5.4%	-5.4%
Russell 2000	-3.7%	-3.7%
S&P Toronto Small Cap	-2.9%	-2.9%
S&P 500	-3.8%	-3.8%

1. The performance of the Venator Investment Trust approximates the performance of the Venator Founders Fund. Return is for Class "A" units.

2. YTD of Fund is for Class "F" units net of distributions reinvested. *30.1% refers to the since inception (August 2008) return of the Fund.

3. The Venator Catalyst Fund has no benchmarks.

Without a doubt, this will be the third interesting year in the market in a row. As January showed, you can't take your eyes off your money for a second nowadays. No matter how confident you are of your companies beating estimates, they can still go down after last years' run-up. In one of the most glaring examples of this phenomenon, portfolio-holding Sketchers preannounced BLOWOUT Q4 earnings (revenues of \$380MM vs. expectations of \$320MM, with earnings more than doubling expectations), only to see the stock sell off 10% over the next two weeks. That being said, companies do seem to be exceeding expectations for the most part, and normally this is good for the markets.

The bull case is quite convincing. In fact, we can find quite a few reasons to be bullish on the market from both fundamental and valuation standpoints:

- Most companies have a good shot at exceeding full-year earnings expectations if you believe the economy is in recovery mode. While expectations are admittedly high, that hasn't prevented many companies from putting up huge earnings beats in Q4 2009. We would imagine a similar scenario playing out in Q1 2010, where prior year results represent a fairly low hurdle to cross.
- Most companies are operating in a very lean fashion after last year's expense reductions and at the same time are unconvinced that a growth recovery is in the offing. Therefore, we would expect to see expense growth trail revenue growth in a recovery scenario, which could lead to strong earnings.
- Despite the recent market run, we have not seen a lot of inflows into equities in general. Instead, most of the money has been finding its way into increasingly low yielding bonds. This would suggest that as we get closer to that low-yield tipping point, we could start seeing equity inflows which could take this market higher. However, we would point out that despite last year's rally, there still appears to be a healthy amount of retail skepticism out there.
- For many larger-cap franchises (i.e. Proctor and Gamble, Coca-Cola, Intel, Microsoft, Johnson and Johnson) which make up a substantial chunk of equity indices, valuations remain very low relative to interest rates. If you believe in the Fed Model (which states that P/E multiples should trade at the inverse of the 10 year treasury rate), then you would have to concede that the IBMs of the world deserve to trade in excess of 20x earnings today, while most of these staples trade in the low-teens P/E multiple.

That last point admittedly suggests a narrow rally in quality blue chips. Furthermore, the first three points are reliant on cyclical recovery, because economic stabilization would not be enough for companies to exceed current expectations, which are clearly expecting some degree of growth in 2010.

Regarding the bear case, allow us to first point out that last year's markets were up sharply despite the fact that companies, for the most part (including the estimated earnings for the S&P500) missed their beginning-of-year earnings targets by a wide margin. We point this out to illustrate that this year's market could be down even if a cyclical recovery was strong enough to allow companies to exceed current year expectations:

- Expectations may be running a little too high in 2010. Specifically, many analysts seem to be projecting the early year/easy comparison growth into the back half of the year, which could prove to be a costly mistake. Specifically, Q4 growth could fail to materialize once the easy comparisons are over, which would suggest that...
- Expectations may be running a little too high for 2011. As the market shot up 65%, which was unjustifiable based on 2009 numbers (which missed expectations), analysts ratcheted their numbers for 2010 in expectation of a cyclical recovery. However, the 2010 numbers still weren't good enough to justify the P/Es we were seeing for economically sensitive sectors. Therefore, we are seeing targets based on fairly aggressive 2011 and even 2012 expectations. If Q4 2010 doesn't show some solid growth over Q4 2009, we could see a significant ratcheting down of 2011 and 2012 expectations.
- Capacity utilization remains low. It is difficult to raise prices when whole industries are operating well below capacity. This could significantly impact the cyclical profit recovery thesis. Without higher prices, companies will have a difficult time achieving the earnings growth in excess of revenue growth that is currently priced into the market.
- Cyclical expectations remain high. As we alluded to above, we are surprised by the expectations we are seeing for the more cyclically sensitive companies out there. On average, we are seeing revenue growth expectations in the range of 8%-12% and earnings growth of 15%-25% for each of the next three years. Furthermore, many of these companies trade in excess of 17x those 2012 numbers, suggesting that these companies are expected to exceed those seemingly high expectations.

Note that the key inflection point for the bears will be Q4 2010 results, which will confirm whether or not the stimulus-infused strong numbers we will see early in the year are a function of an easy comparison with the first half of 2009, or the start of a new growth phase in the economy. Of course, quarterly models may see problems coming early, which could cause the market to derail much sooner. But if Q4 does show growth, the bears may have to capitulate to some degree as we will no longer be talking about if there is a true cyclical recovery, we will be arguing over the degree of strength.

We didn't point out that bull and bear cases to confuse everyone. Nor did we put them out there to suggest any indecisiveness on our part. We did it because if you are going to be long or short (as a hedge fund we do both), you really need to know both sides of the argument and assign some internal probability metric to each case.

Your Funds are positioned more conservatively than in the recent past. The Founders Fund is only 55% net invested (100% long, 45% short). The Catalyst Fund is less than 50% net invested, holding a combination of cash and low correlation equity securities. The Income Fund is 140% invested with close to 90% in shorter term (3-5 year) bonds and 50% in non-cyclical, high yielding equities. Overall, we consider equity and bond markets to be fairly valued to overvalued, hence our conservative equity exposure and shorter term bond exposure. We remain cautious for the time being, and hope to gain more conviction one way or the other as we move towards that critical Q4 2010.

Thanks for your continued support,



Brandon Osten CFA
President, Venator Capital Management Ltd.

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