A SKEPTIC'S GUIDE TO INFLATION

Considering the strong finish we experienced in December, we were rather pleased with our January performance, especially our Income Fund considering the recent stagnation in the bond markets.

Instrument	January's Return	Year-to-Date
Venator Founders Fund[1]	**0.6%**	**0.6%**
Venator Income Fund[2]	**3.2%**	**3.2%**
Venator Catalyst Fund	**-2.0%**	**-2.0%**
TSX Composite	1.0%	1.0%
Russell 2000	-0.3%	-0.3%
S&P Toronto Small Cap	-0.7%	-0.7%
S&P 500	2.4%	2.4%

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.*

We wrote a bit about stealth inflation several years ago (May 2006). At the time, interest rates were a bit higher and we were only worried about it to the extent that others were not. Our infatuation at the time was with the discrepancy between reported revenue growth and unit growth. Our issue was with how many growth companies weren't really growth companies. This situation is creeping up again. Even through the rebound many companies seem to be receiving growth multiples based on short term earnings growth through cost cutting and price inflation, while unit growth is much more stagnant. This has kept the fund on the value side of the market rather than the cyclical side. It has definitely been difficult to keep up with a cyclical rebound when you are largely invested in value stocks and are, on average, less than 70% net exposed to equities--but somehow we pulled it off.

In any case, we thought we would revisit this idea of stealth inflation for several reasons that should be of concern to you--on an investor level, as well as on a personal level. As an investor, you need to be concerned about rising interest rates if the various Fed-equivalents ever fess up to real inflation (rather than the fantasy numbers they throw out there). Rising rates are generally bad for investors over the long term.

Aside from the most obvious forms of inflation including commodity (oil, copper) and food inflation, here are a few other stealthier forms of inflation that consumers and investors may not be aware of. These little corporate adjustments are partly responsible for some of the better financial results investors are seeing out there; but all we see is illusory growth numbers.

- **Aspirational brands:** While some high-end brands have chosen to stick with only the highest income brackets, some are increasing their offerings of items at lower price points (I'm looking at you Ralph Lauren). Even luxury brand Coach is letting less expensive models dominate their product line-ups. The issue here is when do the high end consumers decide that these brands are no longer exclusive enough, killing the image as an aspirational brand. In the meantime, it's worth noting that these prices (and quality) have not been deteriorating to help out

the high net worth consumer, but rather to make these less expensive (but still pretty expensive) products reachable for others in a form of middle-class inflation.

- **General retail pricing:** Retailers don't have to raise prices to raise prices. They just have to tighten up inventory and lower markdowns. Most of you will have noticed fewer markdowns (in both number of items and the percent of the markdowns) as well as fewer inventories on both sides of the border. Over the past ten years, branded manufacturers have been able to increase margins by opening their own stores (keeping the retailer margin for themselves). On the flip-side, retailers have been increasingly shifting to private label brands (which are often, but not always, lower quality items than the branded names). Both of these games have been more or less played out at this point.

- **Food packaging and quality:** One of the dollar stores in the US (which we are short) has been constantly asked how they will counter inflation in materials and freight (this particular dollar store chain still keeps everything under $1.00). The answer was that they don't have to carry any particular item and could always mess with the product mix, quantity or quality. This retailer openly admitted to lower quality packaged food and lower quantities which was a bit surprising to us. Ice cream may have more air injected into it, paper rolls may not be as tightly rolled, paper may not be as white, pens may not have as much ink in them. I am just waiting for the day when we open a 6x4 inch bag of chips and only find four of them in there. Supposedly, the dimples are getting bigger on the bottom of bottles and tubes, because how many people would really notice a subtle decrease in shampoo quantities?

- **Airlines:** We all know that filling up the family truckster has gotten increasingly pricey over the past decade. But another thing to take note of is that everyone is turning a profit now, including airlines. As anyone who has booked an airline ticket recently is fully aware, the cost of the surcharges and taxes (some of which used to be buried in the price of the ticket) can add up to more than the cost of the ticket itself.

Without doing a comprehensive study, one can probably deduce that the cost of living has quite possibly doubled over the past ten years despite government statistics to the contrary. As we anecdotally illustrated above, we are seeing acceleration in pricing for food, clothing and travel. Only shelter is more affordable in the US, but not necessarily in Canada where housing prices have held up. Margins are high, yet prices are increasing. Protecting margins is paramount for corporations today, so either margins have to come in, or spending does, or we just accept quality deterioration. In any case, you are being inflated whether you realize it or not.

The big red flag of inflation is the overseas estimates. While North America and Europe have become accustomed to deluding themselves about the true nature of current inflation, other regions are much more forthcoming. Particularly alarming is the full recognition by both China and India of inflation in excess of 5%. If these two engines of emerging market growth continue their recent efforts to try to rein in inflation, we could see a serious slowdown in global economic growth.

On a more personal level, you need to be concerned about the eroding value of purchasing power of your savings. I would suggest that investors probably need to target at least a 5% annual return in order to keep up with what I believe is the current true rate of inflation, so cash and GICs won't cut it. Unfortunately, with rates low, you need to take a little risk to get there. Our Income Fund has a target yield of 8% which may be able to keep you there. Our Founders Fund is invested predominantly in stocks, which may become necessary as an inflation hedge because companies raise prices with inflation which should, in theory, allow investors to keep up.

Staying ahead of inflation is no easy feat. Commodities, specifically gold, is a place where many say to go. However, commodities are different than commodity stocks. The problem with commodity stocks is that in an inflationary environment their costs of production go up, just like any other company. Therefore, the profit margins can't improve unless the underlying commodity outpaces cost inflation. In the case of junior mining, you have the triple whammy of

higher interest on the debt to get the mine started, as well as the higher ticket on the operation's initial start-up costs, plus the increased cost of production. Basically, you would be better off buying a producing mine, with its debt and start-up costs behind them, than an early stage exploration company if hedging inflation is your goal. Oil and gas makes a little more sense since they can produce every time they punch a hole in the ground, so they are generally able to match their capital costs with production, resulting in a better inflation hedge than a start-up mine. Without growth in the underlying resource of an operator, owning the actual commodities is a better theoretical inflation hedge than operating resource companies; magnified by the point that resource companies' reserves have finite lives.

Industrials can be better inflation hedges than they generally get credit for. But you need to either buy cheap (earnings yield below bond yields) or buy true organic (unit) growth to stay ahead of the curve. Corporations which have the ability to raise prices in line with inflation are as good as any resource company as an inflation hedge (if not better as a resource company as no ability to control prices). But like all stocks, rising interest rates are historically a major impediment to rising stock markets. This is why you want to buy cheap, debt-free, true growth companies that are in control of their own pricing.

That being said, some people we have come across have suggested that rising interest rates could be good for stocks initially as there is such a wide dispersion between longer term treasury/investment grade bond yields (sub-5%) and investment grade earnings yields (above 7%). The theory is that that rising rates, which would most definitely hurt bond prices, would force investors into stocks until yields found an equilibrium, which could send high quality stocks up 20%-30%.

Speaking of cheap, debt-free, true growth companies with pricing power, every now and then you find something that gets you really excited. We bought this rather large but high growth company back in early 2009 that had been hit hard by the market crash (down over 55%). They had some great new products coming out and actually never missed a quarter through the recession. While the company continues to grow at 60% and has had significant supply shortages in its most recent quarter (demand exceeding supply), we were recently able to pick up more of this company at approximately 10x current year earnings (net of their cash) after they topped earnings estimates by an astonishing 20%. We can't tell you the name of the company but our internal target price on this $340.00 gem is about the price of an iPad.

As always, we reserve the right to change our mind.

We are excited to announce that effective March 1, 2011, we will be adding CIBC World Markets Inc. as an additional Prime Broker to our Funds. Feel free to contact us if you'd like more information.

Yours Truly,

Brandon Osten, CFA
President, Venator Capital Management Ltd.

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