

THE ART OF PICKING THE BOTTOM

Getting to the point, the Funds hung in there in an otherwise difficult month in the markets (especially in Canada). The Income Fund and Catalyst Funds kept up their steady climbs, while the Founders Fund gave back a little bit of its stellar start to the year (Apple, a big winner for us thus far and still our largest position, has been down in 16 of the last 19 trading sessions which isn't helping). We are feeling pretty good about our start to the year.

Instrument (Inception)	April's Return	Year-to-Date	Compound Growth
Venator Founders Fund (March 2006)	-1.0%	17.9%	12.2%
Venator Income Fund (August 2008)	1.4%	9.4%	15.8%
Venator Catalyst Fund (January 2008)	0.4%	4.2%	11.7%
TSX Composite (March 2006)	-0.6%	3.8%	3.7%
Russell 2000 (March 2006)	-1.5%	10.7%	3.2%
S&P Toronto Small Cap (March 2006)	-3.8%	2.0%	1.4%
S&P 500 (March 2006)	-0.6%	11.9%	3.6%

I need to preface this commentary by saying that we are not resource experts at Venator. Our gross and net resource weightings tend to be extremely low by Canadian standards; in fact one of our main selling points to investors is that we offer portfolio diversification away from the Canadian-focused financial and resource exposure that many of you would find in your brokerage accounts. That being said, we have been known to pontificate on various natural resource markets from time to time, and recently we have been turning our focus to the decimated market of Natural Gas.

There is a saying in our industry: the market can remain irrational longer than you can remain solvent. When you are running a fund with other people's money this statement becomes doubly relevant as investors can pull their money well before the thesis plays out. The point is that, regardless of any inclinations to suggest that long-term investing is the way to go, timing does have to be a factor when picking a bottom.

The first step in trying to pick a bottom is looking for an unsustainable situation. In commodity markets, this is easy to spot: the price of the commodity simply falls below the marginal cost of necessary production. When this happens, producers halt new projects, and eventually you get an acute shortage and an eventual spike in prices. Unfortunately, bottoms can be tough to time. It can take years for a copper mine to deplete its production to the point where new productive capacity is needed. But for the most part, a natural resource price bottom will self-correct when production eventually falls due to a lack of new production replacing old depleted production. *Natural Gas is the current market where we think we have found an unsustainable situation brought on by impossibly low prices.*

Let's take a brief but high level view on what has transpired in the gas market over the past six years. Back when gas was at \$13.00 there was an acute fear of a shortage in North America. The fear was so great that companies were building natural gas liquid (NGL) facilities to take in overseas NGLs and "re-gassify" it for use in North America. This is a fairly expensive process (liquification, shipping, re-gassification), hence the high price of domestically produced dry gas. Then the recession hit and, more importantly, investors discovered the rising production of shale gas. The next thing you know US natural gas reserves have gone from 125 years to 250 years due to the perceived abundance of shale gas. So much for those NGL plants (the talk now is about retooling them so we can liquify our gas and send NGLs overseas where natural gas commands 3x the domestic price). Couple this surplus supply argument with one of the warmest North American winters on record, and you have natural gas prices sitting at a 10-year low. That pretty much covers recent history so let's get into some unique "must know" attributes of the gas market.

All commodities have characteristics that are unique to them; in the case of natural gas, it is important to focus on the unique aspects of shale gas. Shale gas tends to be higher cost than conventional gas on an "all-in" basis, but at 25% of current North American production is the necessary marginal supply, so this is what we base our bottom price analysis on. What you need to know about shale gas is that upfront costs are high (it costs anywhere from \$3MM-\$8MM to drill a horizontal multi-stage well) but once you are going, production costs out of an existing hole are very low. The other problem with shale gas is that production decline rates are very steep; as an example, Haynesville shale production decline rates have been shown to be 80% in year one, 34% in year two, 22% in year three etc.. Put these last two characteristics together, and you get the two biggest inputs to determine pricing and timing of a gas bottom. We estimate that, due to high cost of drilling shale gas, a gas producer should require at least \$4.00 per mcf to consider punching a hole in the ground and getting a decent rate of return; and given the high rate of decline of these shale wells, gas prices are unlikely to remain below these levels for more than two years before we run into severe shortages.

Two other very important factors you need to know about natural gas is that prices are seasonal and the prices you see in the news are local. Overseas, you can routinely get \$5.00-\$10.00 for natural gas that goes for \$2.50 here. Also, prices are seasonal, as anyone who looks at their gas bill in the winter and compares it to the summer will tell you. This creates a bit of a problem in that you can't really buy today's price for a longer time frame than this month (with spot prices at \$2.30, January 2013 prices are still north of \$3.00). There is no way to buy-and-hold spot natural gas without your own storage facility. The closest you can come is buying stocks in gas companies.

So let's briefly discuss some other factors that you might see in the papers and various brokerage reports you might come across:

Let's start with the popular bull argument. To be frank, we don't buy into the most popular bull arguments. Everyone recognizes that natural gas is currently oversupplied and prices are low. When this happens it makes sense for power suppliers to make the relatively quick and cheap move from coal to natural gas. The problem with this argument is that as coal prices respond by coming down, it's just as easy to switch back and kill this argument. The other big bull argument that has been in place for years is the record natural gas vs. oil price spread. The debate is based on equivalent energy units suggesting the amount of energy you can get from gas is way too cheap relative to the amount of energy you can get out of oil. But the reality is that the two aren't always readily substituted, so I have never bought into this argument either.

Looking at the bear case, these points tend to be more relevant, which is why gas prices are so low now. As we mentioned earlier, thanks to the economic development of shale gas, it is unlikely that we will run into a shortage of natural gas that can't be fixed with higher prices (maybe \$10.00 as an upper sustainable limit) which provides a long term ceiling on prices (we would note that we have approximately 700 years of potash reserves in the world, but that minor fact has not prevented agriculture bulls from calling for a shortage of that resource). The real issue is that natural gas storage is nearly full. In theory, spot natural gas could hit zero if storage facilities become full in that the marginal mcf of production simply has nowhere to go. This is not a joke. The possibility of \$0.00 spot natural gas prices is very real and I would peg it at 15%. But remember that natural gas is seasonal, and I would peg the January contract price's chances of falling below \$2.00 at less than 10%. The January contracts are the ones that matter.

Our final issue with resource markets in general is the public company problem. Public companies think they need to do two things to keep their stocks moving: they need to show production growth and they need to show reserve growth, so to some extent they will keep punching some money losing holes in the ground. The other problem is that many producers hedge their production out for a year or two. By our calculations Encana loses money at gas prices below \$3.00, but they are fairly well hedged partly into next year at much higher prices, so they are going to keep producing at close to their scheduled pace until the hedges run out and this could delay supply shortages. But at least the growth capital won't be there until prices rebound.

But by far the biggest determinant of picking the bottom is widespread production and development budget cuts. This is the Trump Card of the bottom picker and it's happening now. Almost every gas company has stated that they will be curtailing future development given the current price environment. It could take some time for the current production, the weather and the hedges to run their course, but with the production cuts taking place now, we can be no more than 18 months away from a march into the \$4.00-\$5.00 range and stock markets tend to look forward 6 months.

Now you still have to buy the right stocks. To us the right stock means intermediate size companies with either decent balance sheets, good assets (i.e. their own processing plant), and a large plot of land that would be considered strategic to a potential acquirer. Finally, you want to minimize the chance that they will need to raise equity in the next 18 months, because the whole argument falls apart if your company doubles their shares outstanding while you wait.

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



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