VENATOR
CAPITAL MANAGEMENT LTD.

THE INCOME FUND'S "EDGE"

The markets continued their 2012 comeback in February and we were fortunate to have had all of our Funds participate to varying degrees. As you may be able to deduce from last month's letter, Apple played a material role in our Founders Fund's gains, while our lower volatility Catalyst and Income Funds benefited from a generally rising market for both stocks and corporate bonds.

Instrument	February's Return	Year-to-Date	Since Inception[3]
Venator Founders Fund[1]	**8.4%**	**14.2%**	**97.4%**
Venator Income Fund[2]	**3.4%**	**6.3%**	**68.8%**
Venator Catalyst Fund	**1.0%**	**3.2%**	**59.6%**
TSX Composite	2.1%	6.6%	28.3%
Russell 2000	2.4%	9.6%	20.3%
S&P Toronto Small Cap	3.0%	12.1%	20.0%
S&P 500	4.3%	9.0%	21.1%

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.*
3. *The Venator Income Fund and the Venator Catalyst Fund have no benchmarks.*

This month we thought we would talk about our Income Fund, which has put up some very good returns with fairly low volatility, since shifting from a primarily equity-based strategy to a primarily bond-based strategy in early 2009. A big part of the success of this strategy involves what we would characterize as systematic structural mispricing in the non-investment-grade, or junk, bond market.

Many of you will recall the various legitimate criticisms raised against the credit rating agencies in the aftermath of the credit crisis. As bestselling author Michael Lewis eloquently outlined in his book, "The Big Short", the credit rating agencies brandish too much power over the credit markets despite several obvious biases and shortcomings. As some of you know, the credit rating agencies price all debt issues by giving them a quality rating which largely determines the yield/pricing of the bonds. Unlike stock analysts that rate stocks (Buy, Hold, Sell) and are generally thought to be biased in favour of companies from which their banks receive fees, credit rating agencies are viewed as independent - despite being paid by the issuer to write their reports.

A credit rating is a necessary precursor to pricing a financing. However, while the credit rating agencies are independent businesses, they are paid by the issuers, which puts them in a potential conflict of interest. To make matters worse, the people inside the agencies that rate these bonds are not considered the best and brightest on Wall Street. Now, as a general rule, I don't equate pay with skill/intelligence. But on Wall Street, pay does attract the brighter minds, and the credit rating agencies don't pay nearly as well as the investment banks or the money management firms (in "The Big Short", it was claimed that at the mortgage securities conferences you could generally identify the rating agency

VENATOR
CAPITAL MANAGEMENT LTD.

employees by those who were wearing the cheapest suits). Despite all these biases and shortcomings, credit rating agencies are still generally considered to be the word of law when it comes to bond prices. This is despite the mess that ensued from their action/inaction that directly contributed to the subprime mortgage crisis.

We recently went through the exercise of readying of our annual financials. When we prepare these documents twice yearly we have to create a chart outlining the credit ratings and maturities of the various bonds that we own. This chart is an accounting requirement according to our auditors. We always resent creating this chart as bond ratings are not the driving force behind our bond selections (for reasons outlined above). After all, there is no requirement that we create a chart outlining the number of BUY/HOLD/SELL recommendations on our equity positions. But we have to do it for bond holdings because people still think that published bond ratings matter.

This brings us to our competitive edge. No one would ever claim that ignoring stock recommendations is a competitive edge. It is fairly well-documented that good companies can be bad stocks and bad companies can be good stocks. But since bonds are expensive or cheap largely based on their credit ratings, you can gain an edge from doing your own work and ignoring credit ratings. With a little luck, the world will continue to pay attention to credit ratings, and misprice bonds accordingly. And hopefully, we will continue to make a lot of money off of this seemingly ingrained inefficiency of the bond markets.

Currently, the Income Fund is invested 100% in corporate bonds, plus 30% in high yielding stocks (generally yielding 4% or more). The underlying yield of the Fund is just over 8%, which we think is pretty good in the current market environment. The average duration of our bonds is less than five years, meaning that we are not as concerned with the dire outlook for long-term bonds/interest rates that you may be reading about in the papers lately (my personal favorite quote was by one manager claiming that long-term government bonds are currently offering return-free-risk, a twist on the normal risk-free-returns that they are supposed to offer).

One caveat is that the Fund, despite advertising its "income" component, does not currently pay out income to its investors due in part to the logistical challenges this would put on us, as well as the benefit we get from compounding returns. However, we do offer ways for investors to get money out on a regular basis if they are looking for an income payout component.

Thank you for your continued support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.