

THE STOP-LOSS: "A FALSE PROFIT"

February was relatively kind to the Venator funds, which continued their solid start to the year. Markets are "hanging in there" while they worry about great Scrabble words like "sequester" (68 points with the bonus for using all seven letters), and the prospects of criminals and comedians running Italy (how is that a change?). The shine has come off gold, while home and car building in the US continues to offer hope. We are fortunate to be positioned in the right places right now.

Instrument (Inception)*	February Return	Year-to-Date	Compound Growth
Venator Founders Fund (March 2006)	2.5%	5.5%	12.5%
Venator Income Fund (August 2008)	0.5%	3.6%	16.4%
TSX Composite (March 2006)	1.3%	3.5%	4.2%
Russell 2000 (March 2006)	1.1%	7.4%	4.6%
S&P Toronto Small Cap (March 2006)	-3.0%	-0.5%	0.6%
S&P 500 (March 2006)	1.4%	6.6%	4.6%

*Estimated Fund Performance

We recently welcomed a full time salesperson to help us with new interested investors, which has freed up more time for Steve and me to continue to search for new investment opportunities. Brian has taken us to a number of meetings to learn what others are looking for in an ideal investment portfolio. One particularly prominent investment strategy that people mistakenly perceive as useful risk mitigation appears to be the use of the "stop-loss". At Venator, we don't use stop-losses because they are a poor excuse for risk management, they de-value actual research, and because a true value investor cannot buy into the thesis behind a stop-loss when looking at new opportunities. We are going to dispel the myth of the stop-loss, and show that such a risk mitigation strategy carried out consistently would be harmful to an investment portfolio.

Firstly, it is important to know what exactly a "stop-loss" is. A stop loss means that if an owned position drops to a certain level (for example drops 10%) then a market order is triggered that forces the position to be sold, theoretically stopping your loss at a pre-determined price. This makes sense in theory, but the limitations of such a strategy means it would likely backfire from a practical perspective. While some might disagree, unless a fund has been up and running since mid-2008 you really would have no idea how stop-losses would perform when they absolutely need to. Let's go through the problems and contradictions of such a strategy.

PROBLEM #1: What a Stop-Loss Really Means

The first problem of the stop-loss lies in the definition itself. For a fund of any size, a \$1 million market order, triggered at the stop loss limit, is a really bad idea. Throwing a 100,000 share market sell order out on a \$30.00 stock is likely to drop a stock 5%-10% on top of the initial loss that triggered the sell order (unless you limit your investment universe to stocks that average 100,000 shares per minute). Sure, you could put in a sell limit of \$29.00, but in a market crash with limited liquidity, that's not really going to offer much protection because if the stock were to drop to \$28.00 you would be stuck with the stock since you were unwilling to sell below \$29.00. So much for "stopping your loss" at \$29.00; you are stuck in the stock like everyone else. If a stock missed their numbers and opened for trading 20% lower, no stop-loss can help you there.

In summary: a true stop-loss order can materially exacerbate losses in a fund, while a limit order would only offer protection in a mild sell-off with lots of liquidity and bids, but not a true market crash where you would still be holding the stock after a material fall, which brings us to our next point.

PROBLEM #2: Real Market Crashes

Think about this in terms of the "flash crash" experienced on May 6, 2010 when the market dropped 6% in five minutes only to recover in the next twenty. A true stop-loss would have likely triggered some fairly devastating sell orders into an illiquid market causing a portfolio to possibly drop over 10%. Some large cap stocks went virtually "no-bid" (some trades that went down to \$0.01 were famously reversed, but any trades within 60% of where the crash started were reportedly not reversed). The next time a portfolio manager tells you that they use fairly strict stop-loss strategies, ask how much they lost in the flash crash. If they are honest about it (i.e. "We lost 7% that day because our longs were sold"), you won't be happy with the answer.

In summary: in a market crash or short term flash crash where liquidity dries up, a stop-loss can create devastating and unnecessary losses.

Problem #3: How/When Do You Get Back In?

So if you get "stopped-out" and sell, do you get to buy another stock, or do you just have to stay in cash forevermore? Can you ever buy back the stock you sold (can you only buy it back lower or can you buy it back at a higher price which seems counterintuitive)? If oil drops \$10.00 per barrel and you get stopped-out of your Suncor position, are you really mitigating your losses if you can turnaround and buy some Petro-Canada (which is also down 10%) since you haven't actually lost money on that position? In fact, if everyone else had stop-losses then you might be buying each other's stop-loss sales; how does that make any sense?

Put another way, what is the point in stopping a loss in a stock when you can turnaround and buy another position highly correlated to what you just sold? How helpful is it to sell a stock that is down 10% and then take the cash and invest it in a new stock that subsequently drops 10% - you got stopped-out twice, but you are still down 20% on that money. If your risk management strategy allows you to reinvest the capital, you are really just fooling yourself.

In summary: if after executing a stop-loss you can immediately deploy that cash in another stock you aren't really lowering your risk.

Problem #4: What Constitutes a Loss Anyway?

Where is a stop-loss triggered from anyways? Is it a 10% loss from your cost base (if you manage two funds, does it get stopped out of one but not the other), or is it a loss from the stock's highest price since you bought it? Technically, it should be triggered from the latter, since new investors in a fund don't get the original purchase price of a stock that may have been purchased three years ago. If your model says that a stock is fundamentally broken once it drops 10% then it shouldn't really matter where you bought it, only that a 10% drop from any level broke the investibility of the stock (otherwise you might just be buying someone else's stop-loss).

In summary: your cost is a fairly arbitrary number, if you think a stock is uninvestible after falling a certain amount then the stop-loss should always be triggered from the stock's all-time high.

This brings us to our final and most important point about why stop-losses are utterly ridiculous for any self-proclaimed value or contrarian investor:

Problem #5: You Really Can't Buy Anything (Value Investor's Dilemma)

If you have a model which declares that if any stock you own drops 10% it is broken/uninvestible and must be sold, isn't your model basically saying that any stock down over 10% from its all-time high is broken and should not be bought? Any answer other than "that is exactly what it means" is a contradiction that invalidates the fundamental philosophy behind a stop-loss strategy. This basically means that if you fundamentally believe in the theory behind stop-losses than you cannot claim to be contrarian, unless being a contrarian constitutes buying stocks near their all-time highs. It also means you probably can't call yourself a value investor either, since most value investments are unlikely to be trading near their all-time highs.

In summary: it is a philosophical contradiction to believe in stop-losses yet claim to be a value investor or contrarian investor at the same time.

In conclusion, there really is no substitute for good research resulting in high conviction investing ideas (if you need to lower your overall market exposure you can always hedge). If your favourite stock is declining you need to do some more research and see if your thesis has been invalidated (sell it), or if the selloff represents an investment opportunity (buy more). True value investors believe that if you like an investment at \$10.00 you should like it even more at \$8.00. To sell simply because a stock has declined for no fundamental reason de-values your research and intelligence in favour of a black box/high frequency trading algorithm telling you what to do. In any case, if you can turn-around and reinvest your stop-loss proceeds tomorrow your plan won't reduce your risk at all.

We reserve the right to change our mind (although in this case I doubt we will).



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