

YEAR IN PREVIEW

Instrument (Inception)*	November 2013 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	0.6%	28.1%	14.1%
Venator Income Fund (August 2008)	0.2%	13.1%	15.8%
Venator Select Fund (September 2013)	4.4%	11.6%	-
S&P/TSX Total Return (March 2006)	0.5%	10.8%	4.7%
Russell 2000 (March 2006)	4.0%	36.1%	7.4%
S&P Toronto Small Cap (March 2006)	0.2%	4.8%	1.2%
S&P 500 (March 2006)	3.1%	29.1%	6.8%
Merrill Lynch High Yield Index (August 2008)	0.4%	6.7%	11.4%

*Estimated Performance

We figured that now would be a good time to preview 2014. People start to think about their New Years investment resolutions (more of those below) around this time, and since our funds take in and let out money monthly, if we don't hear from you this month, then your Venator New Year doesn't start until February. Also, we didn't want to do a "victory lap" type year in review before the year was actually up, so we'll delve into what went right and wrong for us in 2013 next month.

So let's come right out and state the obvious:

- We are decidedly in a strong 5-year bull market
- This bull market is getting a little long in the tooth
- Interest rates are as low as they are going to go

This bull market started in the spring of 2009 in response to one of the worst and dangerous economic and stock market collapses since the Great Depression. To the extent the world did not actually come to an end, the market recovery to pre-2008 levels was entirely justified. To the extent we are continually reaching new market highs fuelled more by valuation/multiple expansion than revenue/earnings growth we can question the next move up.

Remember that multiples/valuations are more important movers of whole markets than growth and economic fundamentals. On an individual stock basis, companies can fundamentally make material changes that cause doubles and triples; these include a swing from a profit to a loss, accelerated growth rates and significant profit margin surprises. However, when whole markets move up or down 20%+ it generally does not coincide with 20% moves in GDP, or S&P 500 earnings growth. So you have to ask yourself what is more important: earnings growth of 3%-7%, or a move in the market multiple of 25% (from a current level of 16x earnings to 12x or 20x)?

When a bull market feels a little long in the tooth, market corrections tend to be more multiple related than anything. Sure, there may be a fundamental development that triggers it, but in a market correction, people

just decide that cloud computing software companies are worth 7x revenues rather than 12x, or that Amazon.com is only worth 50x earnings rather than 180x, or that Twitter is only worth \$10B instead of \$30B (because with less than \$1B in total revenues we can pretty much give a worthwhile valuation of anywhere between \$5B and \$70B on sentiment alone).

If you think I'm picking too much on bubble-like stock valuations, I will confess that you are correct. Amazon's paltry earnings and disproportionate multiple have a huge distorting effect on the market overall since it has such a large valuation. Put another way, a company with \$1B in earnings and a market cap of \$200B has a far greater influence on the overall market's gyrations than a company with \$3B in earnings and a \$25B market cap. This is how the S&P 500 and the TSX took such a drubbing at the hands of a relatively small sector back in 2000. Companies with hugely inflated valuations such as Nortel and Cisco have disproportionate effects on the market relative to their actual size.

I truly believe that market correction canaries in the coal mine are preceded by speculative excess, and that the more speculative areas of the market are where you need to look for warning signs. So when I see pre-revenue software companies' stocks come from nowhere to achieve \$100MM market valuations simply by virtue of existing and having a few lines of code (but no paying customers), or no growth companies triple in value because they have a new "big data" software product, or Bitcoins topping \$1200 per whatever backs the value of a Bitcoin, what I really see are warning signs. Not necessarily in our companies, but in sectors that have disproportionate effects on the markets, and can temporarily bring down everything around them.

So yes, I am looking for a significant correction at some point in 2014, but I don't know when, and I don't know what will trigger it, and I don't know if the market will move up on a "blow-off" top before retreating. However, that doesn't mean that I think the market will be down in the coming year. This brings up another problem in market forecasting. I can't remember where I read it, but I recall a study that pointed out that when the market goes up in a year, it almost always moves up more than 10%. Therefore, all these conservative forecasters who like calling for 4%-7% years in the market are almost always wrong.

RESOLUTIONS:

- **I will not chase the momentum:** This is a tough part of the market cycle for value investors. Everything is going up and you constantly feel like you are "missing it". The temptation is to "get in the game" but that's a good lead into eventual crushing losses. The guys who press their bets always end up losing half their winnings on the last roll/hand.
- **I will not try to time the market:** This just doesn't work. The temptation in a bull market is to buy for \$10 what you think is worth \$6 but you "know" is going to \$15 first. This is another good recipe for losing money. Buy only what you would feel comfortable owning if the market shut down for a year.
- **You don't need to own them all:** Stay focused; when everything is going up there are too many distractions.
- **Don't stop hedging:** It's worth leaving a little on the table now to ensure that you don't get hurt too badly when the really great opportunities arise post correction.
- **Remember that significant corrections occur approximately once every six years.**

At Venator, we don't really embrace volatility. But knowing that it's always lurking around the quarter, we can only prepare for it. We hope that we can continue to generate healthy returns without any stomach churning volatility.

As a quick reminder, we will be moving to our new office this coming weekend. Effective December 9th Venator Capital will be located at 2 Bloor Street West, Suite 901, Toronto, ON, M4W 3E2. Phone numbers will remain unchanged.

Wishing everyone a healthy & prosperous New Year!



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