VENATOR
CAPITAL MANAGEMENT LTD.

RULE #22: DON'T LET VOLATILITY SCARE YOU OUT OF A GOOD INVESTMENT OPPORTUNITY

Instrument (Inception)*	April 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**5.0%**	**10.4%**	**15.0%**
Venator Income Fund (August 2008)	**1.6%**	**6.6%**	**16.5%**
Venator Select Fund (September 2013)	**5.0%**	**8.7%**	**-**
S&P/TSX Total Return (March 2006)	2.4%	8.6%	5.8%
Russell 2000 (March 2006)	-3.9%	-2.8%	6.9%
S&P Toronto Small Cap (March 2006)	4.0%	12.2%	2.9%
S&P 500 (March 2006)	0.7%	2.6%	7.1%
Merrill Lynch High Yield Index (August 2008)	0.7%	3.7%	11.3%

*Estimated Performance

Last month we talked a bit about segments of the market getting a little frothy and how we were shorting the hype machines of the last six months: big data, cloud computing, restaurants, etc. OK, I didn't actually know these stocks were going to get hammered in April, we were just lucky enough to have done the right thing at the right time (more on RULE #26: "Timing is Impossible" below).

Sometimes stocks are just overvalued. You don't need an actual catalyst other than the disappearance of the marginal buyer of a stock to send a sector down. When the tech market started collapsing in March of 2000 it would be another two quarters until any important companies actually started missing earnings.

That being said, when things get frothy, they also get volatile. Watching Venator shorts Splunk and Workday, both great companies by the way, get hammered by nearly 40% each on no news, can create opportunities (beyond just covering the short position as we did with Splunk). Volatility is scary. It's tough to buy a stock that is dropping 5%+ per day for no reason and on no news. Sell side target prices are dropping daily as the "Comp Chart" valuations fall (as though the only way to value a stock is by looking at other stocks RIGHT NOW with no regard for history); a little sidebar here: we recently saw one analyst refuse to drop his target on a cloud computing company on the basis that the stock dropped 20% on no news, this despite that the analyst community continuously raising targets on no news. This brings us to:

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The hype sectors are hyped for a reason: they have very promising prospects. We like cloud computing, medical devices, big data and 3D printing. It was just that expectations and valuations were running a little hot. But when things get volatile, opportunities are created. When stocks are dropping 40% for no reason other than momentum investors getting out, there are going to be a few gems that get into buying territory. We have found it best to make a shopping list of stocks we would like to own if they got down to a good price. This check-back in the technology market brought some stocks very close, but they didn't quite cross the line (Salesforce.com and LinkedIn came awfully close though). So either my levels are wrong or we aren't quite done with this selloff yet. This brings us to Rule #26:

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<u>RULE #26:</u> TIMING IS IMPOSSIBLE. YOU CANNOT DO THE RIGHT THING AT THE RIGHT TIME CONSISTENTLY. IF THE STOCK WASN'T OUT OF FAVOUR YOU WOULDN'T HAVE GOTTEN THE OPPORTUNITY TO BUY IT IN THE FIRST PLACE

This is an important rule. It must be recalled when volatility is at its peak and stocks break through the prices on your shopping list. You may be right tomorrow, but you probably will not. The key is that you are now getting the chance to buy a great company at a sale price. You need to have conviction in this belief. Momentum investors would take a different view since at this point momentum would truly not be in the stocks' favour. But if the stock wasn't in the midst of getting hit down to your levels you wouldn't be getting this opportunity. This is what you want: a validated great company that everyone fundamentally loves coming down to a valuation that is reasonable. It is rare that you get to buy truly great high growth companies at reasonable prices.

Now if you are still scared, you can always hedge your bets (this is what a hedge fund is supposed to do). You can maintain your short position in overvalued stocks while buying those in a same sector that are now reasonably priced (this is called a pair trade). As the sector weakens further, you can close your short bet while maintaining your long investment and possibly buying more if the long investment has come further down in value.

<u>BONUS BERNANKE SECTION</u>

I recently had a chance to hear former Fed governor Ben Bernanke speak at a luncheon hosted by the Economic Club of Canada. For the sake of brevity I will simply give you the two interesting takeaways from his speech and subsequent Q&A (these are my interpretations of what was said).

<u>How the Fed looked at overvalued assets/bubbles:</u> This was of interest to me because I have always wondered how much the moves of the stock market influence Fed policy. I now have my answer. Basically, the Fed asks the question: if this overvalued asset class came back down to a reasonable level how many people would be affected? If the scope is small and the types of people being hurt aren't critical to the system (think wealthy high tech VCs holding onto post IPO stock), then there is less of a need to interfere, support or manage the situation. So generally, the stock market matters, it just depends on the potential scope of the problem. Think Fed lack of action in the 2000 tech wreck vs the Feds involvement financial collapse of 2007-2008. Although it does seem as though the Fed is having trouble letting go of its 2007-2008 role right now.

<u>How the Fed looks at its forecasts when determining policy:</u> Basically, he said that the forecasting models change based on the new information they receive in economic data, and they adjust their forecasts accordingly. This is classic. If you ever wondered why it seems as though the Fed just reacts to the news of the day it's because that is exactly what it does. That clears up everything.

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

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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