

RULE #6: YOU DON'T HAVE TO OWN 'EM ALL

Instrument (Inception)*	June 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	2.8%	13.1%	15.0%
Venator Income Fund (August 2008)	1.4%	8.1%	16.3%
Venator Select Fund (September 2013)	8.2%	25.8%	-
S&P/TSX Total Return (March 2006)	4.1%	12.9%	6.2%
Russell 2000 (March 2006)	5.3%	3.2%	7.5%
S&P Toronto Small Cap (March 2006)	7.0%	18.0%	3.5%
S&P 500 (March 2006)	2.1%	7.1%	7.5%
Merrill Lynch High Yield Index (August 2008)	0.9%	5.6%	11.3%

The rules we are looking at in this month's letter are pretty basic, but ones that should never be forgotten, and require special attention in a bull market where 70% of stocks look like a missed opportunity. Warren Buffet's baseball analogy is spot on: investing is akin to being at the plate with no called strikes (pitches in the strike zone that you don't swing at); you can wait forever for that perfect pitch and you don't have to swing at everything that comes at you even if it is in the strike zone.

In a bull market, everything looks like a good pitch. In hindsight, there are a ton of good pitches that you chose not to swing at. We often joke that we miss more great stocks than we get, because the math is simply that when you look at over 1,000 companies per year and invest in less than 100 of them, you are probably going to miss 500 stocks that go up and about 50 that go up a lot (you are also going to avoid some landmines too). There is really just no way around this.

Focus and conviction is important here. I would sooner have a 5% position that I know really well with a high level of confidence that it was going to double, than a 1% position that I didn't know very well that could go up 500%. It's not that I don't like the occasional home run, it's more that I hate strikeouts more than I enjoy home runs. Furthermore, you can hit the occasional home run without swinging for the fences. For example, we didn't need to swing for the fences when we bought Badger Daylighting at 10x earnings (an average 4% weight up 500% since we initially purchased it); but we would have been swinging for the fences had we purchased a very early-stage Amaya Gaming when we were first introduced to it at \$2.00 (up 1000% to \$20.00 on a recent, but would never have been more than a 2% weight given the risk profile). So yeah, we "missed it" but the monetary reality is that there is no penalty for "missing it" in the stock market, the only real penalty comes when you actually lose money.

In order to keep your discipline on rule #6, it is helpful to remember Rule #4: Most Stocks Are Fairly Priced. This rule generally holds true in relative terms. As a simple example, in any given industry the higher growth companies carry higher valuations than the lower growth companies. The market knows to pay up for quality, and discount low quality, the vast majority of the time. Yes, stocks can be volatile over shorter periods of time for no apparent reason, but generally speaking the market is a pretty good "ranking" mechanism.



That being said, from time-to-time, the market gets is wrong or is too slow to figure things out. Usually, this comes in the form of overestimating the likelihood of success for either an early stage company or a turnaround, an opportunity we like to exploit through short-selling. This can also come in the form of neglect, whereby a lack of liquidity or sell-side analyst coverage keeps a company at a low valuation for an extended period of time as it has difficulty finding the marginal buyer to increase its stock price (never forget that stock go up because a buyer is willing to pay more while a seller is unwilling to take less for his shares). This can also come in the form of the market not recognizing material changes in a business such as a material improvement of a company's future prospects (better than expected growth rate, earnings margins, or an accretive acquisition) or a material deterioration of the same.

This brings us to ex-pat and former-Canadian company Lululemon, a recently closed profitable short position in our portfolio (shorted in mid-2012 and mentioned in our March review). Lululemon is a case of the stock market failing to adjust quickly enough to the company's known deteriorating fundamentals. The problem was that all the problems the company was experiencing (product quality declines, negative comments from the founder, poor customer service) were considered one-time. That being said, competitors taking advantage of these missteps to build scale was not one time in nature. Once same store sales comparable numbers went negative, it was obvious that there was a problem in either consumer interest or geographic saturation. The street continued to hope that store expansion would save the company's growth prospects while paying little attention to the mounting risks in the business.

Personally, I think the company got a little too big for their britches (that pun actually was not intended, but I left it in once I figured it out). While we were increasing out short on the stock we were surprised to find out that the company gave up their Canadian listing (TSX:LLL) in June 2013, yet another mistake in a year full of them. The official line was that the dual-listing was a wasted \$95,000 per year, but at least Lululemon would always be relevant to the investment community in Canada should the US markets lose interest (something that is about two quarters away from happening now). On the most recent conference call it was announced that Lululemon would take a \$30MM tax hit to "repatriate" money from their Canadian bank accounts to their US bank account in order to buyback \$100MM+ of stock. I didn't bother to do any research on this one since we covered the stock, but couldn't they have avoided this \$30MM charge had they maintained their Toronto listing and bought the stock up here? Did they just spend \$30MM as a result of avoiding the \$95,000 per year listing? Did the departed CEO and soon to be departed CFO just cost them \$30MM? Only your corporate tax accountant knows for sure! \$30MM charge to repatriate cash from Canada to US for buy back. Should've kept the Canadian listing.

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

A handwritten signature in black ink, appearing to read "BO", is positioned above the name of the signatory.

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