VENATOR CAPITAL MANAGEMENT LTD.

MAKING A FASHION STATEMENT

Instrument (Inception)*	March 2015 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**1.0%**	**3.5%**	**15.5%**
Venator Partners Fund (July 2014)	**1.1%**	**3.2%**	**-**
Venator Investment Trust (September 2007)	**1.0%**	**3.4%**	**11.8%**
Venator Income Fund (August 2008)	**-0.6%**	**3.1%**	**15.1%**
Venator Select Fund (September 2013)	**-1.1%**	**-4.3%**	**31.3%**
S&P/TSX Total Return (March 2006)	-1.9%	2.6%	5.7%
Russell 2000 (March 2006)	1.7%	4.3%	7.6%
S&P Toronto Small Cap (March 2006)	-3.8%	-0.3%	1.0%
S&P 500 (March 2006)	-1.6%	1.0%	7.7%
Merrill Lynch High Yield Index (August 2008)	-0.5%	2.5%	10.0%

Investing over the short/intermediate term can be a lot like picking this fall's hot fashions. There are a multitude of factors that come into play when you are managing a portfolio of any size, the most volatile, and subjective, of which is valuation. So much of which is what rules the short term is the theme of the day, with the valuation/multiple telling you what's hot and what's not. Timing can be important (like when we shorted Equinox right before it was taken over by Barrick in what is now regarded as one of the more disastrous acquisitions in recent mining) and luck plays a role (i.e. you sell a stock because it hit your target, only to watch the stock fall after reporting a poor quarter you didn't see coming). What I am trying to say here is that the market is far better at pricing in what it thinks is going to happen than it is at predicting what will actually happen.

With all the "hot or not" noise we always need to evaluate risk/reward scenarios where investment outcomes, good or bad, can be ranked on a scale from science to faith, or fair to lucky. The key to maintaining perspective with regard to investment returns being influenced by the fashion of the day is to remember that the quality of the investment decision is not necessarily tied to its outcome (like winning a 10-1 odds bet where you successfully pick a number between 1 and 100; sure you made 10x your money, but you only had a 1% chance of being right). So with that onto the rankings:

6. Pre-revenue stocks: We call these coin flips and they come in many different forms. For our purposes, pre-revenue tends to be anything with less than $2MM in quarterly revenue. Early stage technology, blank check/high enterprise value rollups and junior biotechnology is the usual form these businesses take. Junior biotechnology is a complete coin flip: either the FDA approves the drug or the stock goes to zero; I would say that more than two-thirds of all single day +/- 50% movers in a year are junior biotechs reacting to an FDA ruling.

Early stage technology is only slightly less of a coin flip than junior biotech in that they don't need permission from a governing body to sell their product, but they generally need to create a market for it (in contrast, once the FDA approves a drug there is usually a big market waiting for it). Early stage technology usually ends badly but occasionally you can get a success story; I prefer to leave this sector to private equity/venture capital. The key is that, depending on Mr. Market's fascination with, and handicapping of, the technology in question, market values can easily reach into the hundreds of millions of dollars in an interim period, even when the most likely eventual scenario is that the stock ends up at zero.

5. Currencies: Currencies seem simple, but in reality they have little in terms of fundamental underpinnings. Only in hindsight can a winner be determined solely based on the outcome of the trade (unlike stocks where you can be right on your expectations but wrong on the more subjective determination of valuation. The relative valuations between currencies are correlated but not quite based on interest rate policies, money printing, and a general view of the economy. For example, even with oil in freefall, Canada likely has a better debt and deficit situation than the United States, yet the currency has recently been smashed by the declining oil price. Globally, the money printing race to the bottom has sent the US Dollar upwards despite them being first to zero interest rates. Currencies seem to be easily manipulated by central bank announcements, but with all the research I have read on currencies over the years I have never seen a currency target well justified (for example I have never seen a currency target based on a multiple of tax revenues, or analysis of total real estate plus natural resource value, or GDP divided dollars outstanding, or any other remotely tangible valuation metric). <u>When it comes to currencies, you can invest in fundamental direction (such as what has happened in the Loonie), but you can't put any concrete value on it</u>.

4. Commodities: Like currencies, it is hard to put a tangible value on the price of gold, copper or oil. I would argue that 80% of the value of these commodities is derived from speculation about supply and demand. Oil and gas today is being driven by fears of an ongoing supply surplus. Copper is failing due to fears of a demand slowdown. The only reason we rank commodities as more tangibly valued than currencies is because we think bottoms are measurable at the marginal cost of production (we have yet to figure out how to measure tops). When prices slide below this level, which isn't always easily observed, supply gets crunched and the commodity starts moving up.

It's important to reiterate that the market is far better at pricing in what it thinks is going to happen than it is at predicting what will actually happen. Peak oil supply is not happening anytime soon, but the incorrect assumption that it was going to happen in the next ten years was enough to send oil prices to $140/barrel. The US Dollar is not losing its status as the reserve currency any time soon, contrary to popular thinking five years ago. Fertilizer supply is not going to lose its cyclical nature because people are eating more meat, an incorrect theory that sent Potash and Agrium to all-time highs. The end of the dismantling of the Russian nuclear stockpiles did not lead to a shortage of uranium. This last one is probably the best example of how the market has a way of pricing in what it thinks will happen without accurately predicting what will happen. Uranium was never truly in a shortage situation. Yet the price rose 500%+ in anticipation of a shortage that never came. If you made money buying uranium stocks count yourself in the "better to be lucky than good" crowd because you made a lot of money even though your thesis proved to be completely wrong.

3. The High Multiple Stocks: I initially had these as standalone categories but the tying thread was the high multiple so we bunched them together. High valuations are indicative of one paying for something that is not currently there, whether it is a future acquisition, future growth, future cost cutting or future products; when you are paying a high multiple of operations, the expectation is that something good in the future will happen that is going to bring that valuation down while the stock is going to go up.

- **High Growth Expensive Stocks:** This is the stock market junkie's favorite category. These are the companies that are always in the news with everyone talking about what a great company it is and a few people talking about how expensive the stock is. This is where we find Tesla, Amazon, Netflix, GoPro, Workday, Lululemon and the like. It's also where we used to find Cisco, Nortel Networks, Krispy

Kreme Doughnuts, SodaStream, Heely's and Coach. When they keep growing at a fast clip these stocks can keep up with the growth rate and produce sizable gains thanks to the miracle of compounding. But when the growth stalls . . . look out below. Thanks to the *reverse-curse* of compounding, taking down all of your current numbers by 10%, your forward growth rate by 10% and your multiple by 30% can result in some pretty devastating losses. The winners are always known in hindsight and the losers are quickly forgotten (when is the last time you thought of Heely's). Maintaining future growth expectations of a high growth retailer or technology company can be an exercise in the frustration of fortune telling, especially without the buffer of a reasonable P/E multiple (say 25% premium to the P/E multiple of the market because you usually have to pay something extra for growth). These stocks tend to be volatile high wire acts, but generally have great companies behind them. When you see a hot IPO, chances are it falls into this category.

- **The High Multiple Roll-ups:** We view these as a little more risky than the first category as they are not necessarily in control of their own destiny. When the prices of acquisitions are too high do you risk disappointing the market by not making any, or do you sacrifice your discipline by overpaying? It's a tough question because if you are a low growth company that can't acquire anything your stock could very well suffer a major correction if acquisitions are the expectation. One factor that can help is a high valuation coupled with low interest rates as it makes pretty much everything accretive if bought with debt, stock, or cash from a previous financing. The one time you can run into major problems is when your acquisition strategy is dependent on your high stock price; in other words you are always issuing stock to do the acquisitions. Once your lower stock price kills the accretive nature of your acquisition strategy you are likely on a spiral to 10x-12x earnings which could be a precipitous drop depending on your starting point. What makes these stocks somewhat unpredictable is the high multiple, where you are often paying a premium for something that would likely trade at a discount without the expectation of acquisitions.

- **Low Growth High Multiple Stocks:** These stocks have always fascinated me. They tend to be unspectacular but stable profitable companies with good brand names or highly regarded management teams. There is a positive "aura" around these companies where their high multiple seems to dictate the perceived quality of the business when the relationship should be the other way around. Plus you have the benefit of low expectations that won't disappoint the market; it's probably easier for Coca-Cola to maintain its -2% growth rate (20x earnings) than it is for Google to maintain its +15% growth rate (17x earnings). But just when I think it doesn't make any sense to pay so much money for so little growth Warren Buffett and 3G go ahead and take out perennial 0% grower Kraft Foods for 25x earnings and the cynic in me thinks: I thought those guys were "value" guys. Outside of a takeover, I always try to ask myself: how can I make money on a low-growth company trading at an above market valuation? Often you are reliant on corporate finance-type transactions (buybacks, dividends, mergers) since multiple expansion becomes less likely at higher prices. What it comes down to is that there is more valuation risk than business risk, and I view the former as far less predictable than the latter. If I own Coke, I am far more concerned about the company experiencing a multiple contraction to 15x (a 25% drop in the stock) than I am with whether they grow by 1% next quarter instead of -2% (which would have an immaterial effect on its valuation). We like to think that if a company executes on its business plan, the company will be more valuable in the future without having to worry about valuation, which translates to buying stocks cheap.

Incidentally, between these three categories I would tend to favour the first one. If I am going to pay up valuation-wise, better to do it for the high grower that can grow into its valuation than the low grower that can't without some external (i.e. corporate finance related, bull market) help. With its below zero growth rate, it would be difficult to have a tremendous amount of confidence in Coke's ability to recover a 25% multiple correction in a reasonable amount of time without a bull market behind it. But if Google can continue to grow at something resembling its current growth rate, a 25% drop in its multiple would take less than two years to recover in its stock price. Best to stick with companies with more control over their own destinies.

2. Fundamentally sound, non-cyclical value stocks: This is what we consider our specialty when it comes to equities. When you can find good earnings growth with little macro-economic exposure trading significantly below market multiples you likely have a winner. The beauty of buying into lower valuations is that future improvements to the fundamentals of the business are not built into the stock price. Growth becomes a positive surprise, as does profit margin expansion and the occasional acquisition. Your margin for error in these situations can be substantial. Low expectations coupled with a low valuation is what we view as a low risk-high return situation. You can always get it wrong as fundamentals can unexpectedly worsen, but you definitely increase your odds of being right, and it is unlikely that you will lose money from a change in the fashion of the day; what you are buying is already out of fashion (hence the low valuation) and waiting to come back into fashion, because high quality-low valuation companies are the black leather jackets and blue jeans of the stock market: they always come back into fashion eventually.

1. Corporate Bonds: This instrument, a specialty of our Income Fund, is probably the most "fair" instrument around. If the company underlying the bond is still around when the bond comes due, we get all of the interest and principal we are owed. Our return is certain. There is no valuation risk to maturity. As we are fond of saying: when we buy a bond we are making an "over/under" bet on the company remaining solvent. Regardless of what happens to the stock market or the bond market, if the underlying business is still in business, we will get our expected returns without exception. It's so damn simple there is nothing left to say in this regard (and our Income Fund's returns prove the thesis quite emphatically).

The order of this list is how we look at investments on the risk spectrum. Our Income Fund, which has generated the steadiest returns among our fund family, is invested predominantly in our number one ranked category for return predictability. Our equity-based hedge funds, on the other hand, are invested predominantly in the number two category, with investments from the other less predictable/higher risk categories sprinkled in opportunistically. So far, our chosen focus areas have served us well, and we think they will continue to do so in the future, because black leather jackets and blue jeans will always come back in style.

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

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.