VENATOR
CAPITAL MANAGEMENT LTD.

NOT SO GREAT EXPECTATIONS (THE PROBLEM WITH OUR SHORT BOOK)

Instrument (Inception)*	August 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-2.4%**	**-1.8%**	**12.6%**
Venator Partners Fund (July 2014)	**-3.9%**	**-3.5%**	**0.0%**
Venator Investment Trust (September 2007)	**-3.2%**	**-2.8%**	**8.9%**
Venator Income Fund (August 2008)	**0.8%**	**12.1%**	**12.6%**
Venator Select Fund (September 2013)	**-2.3%**	**4.3%**	**18.2%**
S&P/TSX Total Return (March 2006)	0.3%	14.4%	5.1%
Russell 2000 (March 2006)	1.8%	10.2%	6.6%
S&P Toronto Small Cap (March 2006)	-3.6%	30.2%	2.1%
S&P 500 (March 2006)	0.1%	7.8%	7.4%
Merrill Lynch High Yield Index (August 2008)	2.3%	14.6%	9.0%

Earlier this year, in his first quarter letter, David Einhorn of Greenlight Capital called out the market's willingness to reward companies that "lower and beat", a phenomenon whereby companies lower their guidance and subsequently (sometimes only several weeks later) slightly "beat" this lowered guidance to the market's delight, causing the stock to increase beyond the initial stock price prior to the lowering of guidance. I will quote Einhorn directly here: "Impressively, there were 32 companies in the S&P 500 that earned less last year than was expected at the beginning of the year, and reduced expectations for 2016, while somehow managing to report positive surprises every quarter in 2015".

At Venator, we also noticed this phenomenon late last year, and internally coined the phrase "beating the miss" to describe companies that put out an earnings warning (often after the quarter end), and then, subsequently, beat that miss by a penny, sending the stock higher; sometimes higher than where the stock was prior to the earnings warning.

The poster child for this behavior is Lululemon, a former Venator short whose stock is currently at a two year high even though EBITDA has declined over that time frame and missed expectations. On December 9th, Lululemon warned that Q4, which was set to end in January, would miss expectations ($0.77 vs prior guidance of $0.86), sending the stock from $52 to $45. Fortunately, a month later they revised that guidance up to $0.79, sending the stock up to $57 (above the stock price when they were expected to earn $0.86), and, eventually reported EPS of $0.85, which then sent the stock up to $72. Through this strategic use of "lowering and beating" or "beating the miss", Lululemon managed to turn a slightly missed quarter into a 38% gain for the stock. One wonders what would have happened had they just maintained their guidance all along and missed the quarter by $0.01; I would guess the stock market would not have rewarded them with a 38% increase that day.

Walmart, our largest single short position, has performed a similar miracle with its stock only recently retreating from a 52-week high despite a 9% drop in profits from a year ago. When the company first shocked the street with a multi-year guide down, the stock fell from $66 to $58. But it has been able to "beat" every quarter since, and while earnings expectations are down roughly 10% from where they were when the stock was at $66, the stock has somehow managed to appreciate to north of $70.

In another similar situation, we have lost 10% this year on long-time short Fastenal. The neat thing about Fastenal is that they report monthly sales. Furthermore, they have missed analyst monthly sales models nearly every month in

2016. This also means that, when they report earnings, they really only miss sales expectations for one month, rather than facing the cumulative effect of missing three months' expectations. They have missed all three quarters that they have reported this year, both on the day they reported and relative to the expectations going into the quarter.

Getting back to the disappointing performance of our long/short strategy this year, I wanted to outline why the performance has been so poor and, at the same time, try to assure our investors that we still know what we are doing. In the long book, among investments that have made or lost us more than 0.1%, we have been "right" approximately 55% of the time. We have had two stocks cost us over 1%, but have had seven stocks make us more than 1%. Overall, the long positions have added up to over 7% worth of gains for the strategy. While this is below the market's performance overall for the year, it's actually a respectable result considering our conscious lack of exposure to mining and energy, which together account for the majority of this year's stock market gains.

The challenged performance of the long/short strategy, as you can probably surmise, has been the short book. We have been wrong 75% of the time this year in terms of stock moves. Furthermore, we accumulated all of these losses outside of the red-hot resource sector. In other words, we have fallen short of our expectations on the short side this year, materially underperforming the "everything-but-resources" sector. While the year isn't over yet, this is still a tough pill to swallow given our past success at short selling.

Our biggest problem is that we have been shorting some fairly expensive stocks, with very low growth and secularly challenged growth prospects (i.e. the aforementioned Walmart and Fastenal, as well as Energizer and Enghouse which are outlined below). Over the short term, missing or exceeding expectations is more important than looking at what those expectations are telling you about the quality of the company in the first place. When you are a growth challenged business, clearing really low bars can become fairly easy. Conversely, when your growth expectations aren't very dynamic, it is also more difficult to miss earnings by significant amounts.

Energizer Holdings Inc. (the battery company), which has seen its stock increase in price by 40% in the past twelve months, despite a 10% drop in gross profits, has been another frustrating short position in the portfolio. I could understand the price increase if the stock traded like a growth challenged business, but Energizer currently trades at a premium multiple of 20x current year earnings. We admittedly misread the market when it turned out that, in the short term, this pronounced deterioration in fundamentals was worth that great an appreciation in the value of the business.

Similarly, we keep awaiting the day when the market begins to recognize that, in the technology sector, flat-to-declining organic revenue growth is not worth a premium multiple. And yet, we live in an investment community in which Enghouse Systems commands a premium multiple to Google, Microsoft and Oracle. Management can fearlessly state that organic revenues were up or down 2% in a given quarter, knowing that such a low bar has been set that negative financial reports are rarely felt by shareholders. While I understand that the company is expected to grow through acquisitions, I also understand that the cost of these acquisitions is excluded from the street's assessment of the cost of its "growth" strategy. It's tough to make money shorting a company that is effectively reporting quarters that can't be missed!

We recently initiated a new short position in Edgewell Personal Care. We have followed this company for years as it was the parent that Energizer Holdings Inc. was spun out of (which was followed as part of the due diligence on Spectrum Brands, owner of the Rayovac family of batteries; a long position in the portfolio for quite some time). The main reason that Energizer batteries was spun out was because management believed that the secularly declining battery business was holding down the value of the rest of the business. The irony is that since the spinout, Energizer is up 40% while Edgewell is down 20%. Every one of Edgewell's businesses declined last quarter. Furthermore, nearly half of its business is dedicated to the increasingly competitive "wet shave" business, where the main incumbents, including Proctor & Gamble's Gillette brand and Edgewell's Edge/Schick brands, are under fire from fast rising

discounters Harry's and Dollar Shave Club. Despite these shrinking revenues, Edgewell enjoys a premium multiple in excess of 20x earnings.

To be clear, we are not shorting these companies because we think they are simply expensive relative to their flat-to-declining growth rates. Low growth staples can hold premium multiples for a long time in a low rate environment, and financially engineer their way to investor gains through buybacks and dividends (think about tobacco and soft drink companies). Instead, we are shorting companies with what we believe are materially challenging issues that the street is choosing to completely ignore, all the while holding valuations up and applauding consistency and reliability in financial results (even if they are reliably declining).

Generally, we like to go long low expectations and short high expectations, putting potential surprises in our favour. This approach has worked well in the past, however, valuations today are causing a different result which, so far in 2016, has hurt performance. The problem we are encountering is that high valuations don't mean high expectations, as they have in the past. Ultimately, the long/short portfolio holds a good mix of businesses that offer both growth and value, and while some of our low-growth value longs have not kept up with our low-growth expensive shorts so far this year, we remain optimistic. By way of example, Entercom Communications continues to report solid organic growth, and I would argue that the long-term outlook for its business is currently better than Energizer's. But alas, at less than 8x free cash flow, Entercom has not yet received the multiple appreciation we expected; while companies like Energizer, Edgewell, Walmart and Enghouse are trading as if, one day, they are going to exhibit some kind of growth leadership. Frankly, I would be shocked if any of these companies were able to exhibit three consecutive years of GDP+ organic growth in the next ten years.

While it has been a tough year to date in our long/short strategy, we remain patient with our portfolio holdings and investment style. Over the years, investors in the strategy have, by and large, also demonstrated patience during times such as this, and have thankfully been rewarded for it. Separately, we are pleased to report that Venator Income Fund is having another strong year!

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

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