SOME CAVITIES IN THE FAANGs DRAGGING ON THE TECH BULL RUN

Instrument (Inception)*	July 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-0.9%**	**10.4%**	**12.0%**
Venator Investment Trust (September 2007)	**-0.9%**	**10.6%**	**8.8%**
Venator Income Fund (August 2008)	**0.2%**	**0.7%**	**11.2%**
Venator Select Fund (September 2013)	**-2.3%**	**16.9%**	**17.6%**
S&P/TSX Total Return (March 2006)	1.2%	3.1%	5.8%
Russell 2000 (March 2006)	1.7%	9.5%	8.4%
S&P Toronto Small Cap (March 2006)	-1.0%	-2.7%	2.3%
S&P 500 (March 2006)	3.7%	6.5%	8.8%
Merrill Lynch High Yield Index (August 2008)	1.1%	1.2%	8.4%

While Venator Income Fund remains a model of stability (it's flat on the year, but stable in a rising yield environment), our equity strategies took a small step back in the last few trading days of July. In fact, each of our Fund strategies was headed for record all-time highs until Netflix and Facebook ruined the party for growth stocks, and tech-focused growth stocks specifically. That said, we are in a bifurcated market where the *'haves'* trade at nearly unprecedented valuations, while the *'have-nots'* are completely ignored and trade at depressed valuations, reminding me of early 2000.

The market is learning that stocks don't go up in straight lines in excess of their growth prospects forever. That's the issue with stocks being driven primarily by money flows - fundamentals are ignored. To be clear, the fundamentals of many '*in-favour*' companies (such as Facebook or Netflix) are the envy of the media and technology world; however, they might not be as good as their respective stock prices suggest. Carl Icahn once said that everyone knows what the great companies are, that's why they are so expensive (implication being that great companies aren't necessarily great investments, which Warren Buffet has also stated).

One tool with which we have had some recent success involves screening for stocks whose share price has either grown faster than or slower than the underlying business. Interestingly, some bearish analysts on Netflix pointed out that, prior to its recent correction, the stock had run up nearly 100% on the year despite immaterial increases to long-term street estimates. Although, this is a typical characteristic of 'hot' sectors.

We believe that what happened back in 1999-2000 can be illustrative of the danger of valuations becoming materially disconnected from fundamentals. At that time, great growth companies with strong fundamentals such as Oracle, Cisco, Dell, EMC, Intel and others imploded well ahead of a fundamental slowdown later that year (the slowdown was, in part, because financing dried up for early stage tech companies that were buying all the tech infrastructure). It took well over a decade for these companies to repair themselves, while dozens of other market darlings never did, such as Nortel, JDS Uniphase and Sun Microsystems.

One characteristic of the current tech bull market rhyming with history rather than repeating it involves today's fascination with more consumer-focused technology (Google, Apple, Facebook, Netflix, Microsoft) vs yesteryear's concentration in business-centric technology (SAP, Oracle, EMC, Nortel, Cisco). While cloud software has received a lot of attention, this has been largely a new media driven rally, with most of the FAANG stocks deriving a large chunk of revenues from advertising. Even Amazon's growing advertising business is gaining a lot of notice lately and is expected to be more valuable than its product selling business within a few years, if it isn't already.

This brings up unique revenue saturation and product quality issues that we haven't seen before. Namely, companies aren't fighting for a growing pie of technology infrastructure spending, but for a greater piece of a less dynamic pie of advertising budgets. Complicating matters is the old school problem of how many ads can you throw at your users, and the conflict of sacrificing the user experience (ad load, privacy) for the benefit of the advertising revenue stream.

The recently fallen angel that is Facebook is a great example, as it's the poster child for many of these issues. The stock has fallen precipitously, due largely to an admission that privacy issues need to be addressed with some adjustments required to its advertising feed model, which could negatively impact both expenses and revenues. Furthermore, it's reaching saturation in terms of how many ads it can throw at an Instagram or Facebook feed. It's worth noting that there was a falling out with the founders of its market leading WhatsApp messaging application over user privacy and monetization of the platform (although we would note that the founders were somewhat naive if they thought Facebook was going to pay them $19 billion for the platform and never monetize it). Advertisers are growing skeptical of the value of 'impression advertising' online and Congress is looking into privacy issues in social media (easy legislative fixes could include users having to opt-in to data sharing rather than the complex process of opting-out; and setting browser defaults to 'privacy mode' - but neither of these are likely to happen).

All of this said, Facebook has already tipped its hand in terms of showing us its future. It appears that its longer-term business plan involves more Instagrams and Whatsapps, whereby the company will grab popular media apps with a lot of users, but under-monetized platforms, and plug them into its superior data mining and advertising engines. This isn't as sexy as developing an internal, ground-breaking product or the next big thing, but it works.

Facebook, however, isn't the only FAANG stock facing the issue of deteriorating or diluted product quality as it gets bigger. Less prominent and/or material examples include Google search results being increasingly dominated by ads disguised as legitimate search results or by products for sale gaming the search algorithms, and YouTube (owned by Google) even makes you watch ads for ads in some cases (think of ads in front of movie trailers or weight loss products). Amazon ads within Amazon.com bias product searches and third-party sellers that push their way to the top of the list with lower prices, but higher shipping costs (pro tip: always click the prime button, otherwise double check the shipping costs). Much of this is done in the name of mining for personal data for advertisers (leading to the joke: I bought one vacuum cleaner and the internet thinks I am starting a collection!).

Another less intrusive example would be Apple making you pay more for processing power that you don't need, simply to help fuel a massive increase in features that you don't use. Not many people have changed their iPhone usage habits in years. The only reason people voluntarily update is because feature bloat slows down their old phones and eats up their battery life, even if usage remains unchanged. Netflix is also increasing prices to afford its exploding internal content programming (and associated multi-billion-dollar cash burn) of shows and movies you don't watch (although it is worth noting that they have a strategy that basically states that each individual user needs to watch a limited amount of Exclusive Content to maintain their subscription, which is different than the typical media content strategy of trying to get everyone to watch the same thing; you need a lot of programming to ensure that everyone is watching the requisite 10-20 shows to maintain their subscriptions, especially when everyone is watching a different combination of those shows out of a pool of 1,000 shows).

As stated earlier, we are in a bifurcated market where the *'haves'* trade at nearly unprecedented valuations, while the *'have-nots'* are completely ignored and trade at depressed valuations, reminding me of early 2000. But that's OK because there was money to be made back then, even on the long side of the tech market. The key was looking for

the neglected companies of high quality and low valuations (not unlike what happened in Canada in the non-resource space over the last eight years). We feel that we already have a few such names in our portfolios in the form of companies like The Gap Inc. (GPS), Wesco International Inc. (WCC), and Bluelinx Holdings Inc. (BXC); in addition to opportunities in high growth companies that have only recently been discovered by the broader investment community, such as Skyline Champion Corporation (SKY) and Biolife Solutions Inc. (BLFS).

While shorter-term bouts of volatility similar to what we have witnessed over the past week is unsettling, we are well hedged in the event of a continued, longer-term market selloff. The bottom line is that while certain parts of the market are overheated, the economy remains stable. Overall, this creates a good environment for us to find opportunities, especially within neglected corners of the market.

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

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