BRIDGING THE "GAP"

Instrument (Inception)*	August 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**8.4%**	**19.7%**	**12.7%**
Venator Investment Trust (September 2007)	**8.4%**	**19.9%**	**9.6%**
Venator Income Fund (August 2008)	**1.6%**	**2.3%**	**11.2%**
Venator Select Fund (September 2013)	**13.9%**	**33.2%**	**20.4%**
S&P/TSX Total Return (March 2006)	-0.8%	2.3%	5.7%
Russell 2000 (March 2006)	4.3%	14.3%	8.7%
S&P Toronto Small Cap (March 2006)	-0.5%	-3.1%	2.2%
S&P 500 (March 2006)	3.3%	9.9%	9.0%
Merrill Lynch High Yield Index (August 2008)	0.7%	1.9%	8.4%

With the end of the summer upon us, the current bull market in the United States is now believed to be the longest in modern history, without a 20% downward move for almost 10 years. This is an amazing feat considering where it started in 2009 amidst a financial collapse that brought down some of North America's largest financial institutions. While the initial phase of the rally was met with caution and a degree of disbelief, it became something of a self-fulfilling prophecy when a strongly rebounding equity market allowed financially troubled companies to recapitalize their way back into solvency.

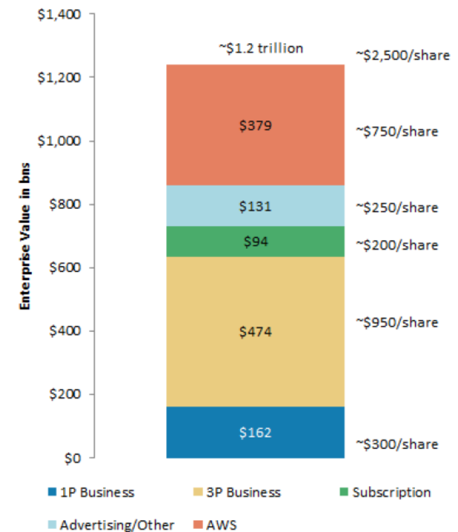
The middle phase of the bull run had been called the most hated bull market of all time due to a lack of participation by scorched retail investors and active portfolio managers alike. ETFs, which are dispassionate to history and forecasts by nature, experienced a period of substantial outperformance.

This current euphoric stage of the bull market was at first sparked by the election of Donald Trump, whose economic and tax policies lifted all boats (say what you want about the President's social graces, he has been undoubtably good for the American economy and financial markets), which was then followed by the notable consolidation around 'household name' technology stocks. It is my personal belief that one of the reasons why this high-tech bull market has more staying power than the one experienced in 2000 is the familiarity that investors have with *most* of today's stock market champions.

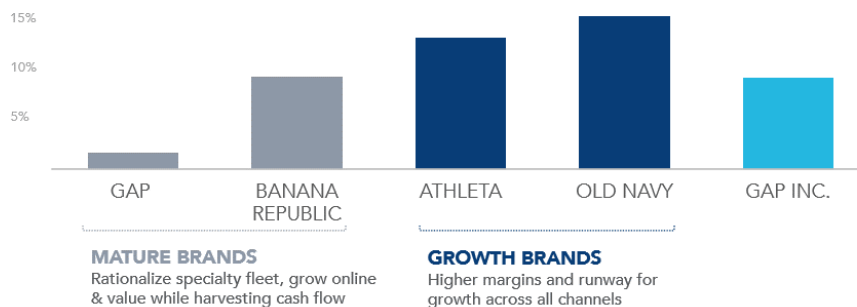
In 2000, investors crowded into mega-cap technology names like Microsoft, Cisco, EMC, Intel, Oracle, SAP, Nortel and JDS Uniphase and, apart from Microsoft, by-and-large had no real idea what these companies did (routers, microchips, storage servers, databases, ERP software, fiber optics, etc.). Today, the market is crowding into names where investors *believe* they know exactly what the Company does, which makes the decision process easier. Shareholders today have direct interactions with Apple (iPhones and related services), Amazon (online shopping), Google (search engines, android phones and YouTube), Microsoft (PCs, Xbox, and Office), and Facebook (Facebook, Instagram and messaging) - comprising the top five companies in the S&P 500 by market cap. We can also put Netflix (video content streaming) into the mix to complete the 'FAANG' acronym.

Of these six names, I would say that most investors likely know exactly what the primary driving business of their investment is in five cases, the exception being Amazon, which is not really an online shopping business that your typical investor perceives it to be. Even if investors have heard *about* Amazon Web Services, many probably don't know exactly what it does (a circa 2000 investor in Cisco could probably have told you that they make routers, without really knowing what a router was).

To illustrate this point, a recent research report out of Morgan Stanley calling for a $2500 target price on Amazon pegged the retail business (Amazon selling you stuff directly) at 'only' $300 per share, 40% below the Company's peak 2000 stock price. In other words, what a typical investor is likely paying $2000 for, is only worth $300. The point here is not whether Amazon's stock is a good investment (it's been an amazing investment thanks to these newer business lines), or that Amazon investors might get burned because they don't know what they own. Instead, it's simply illustrating that sometimes investors don't fully understand the value of their own investments, especially when there are component pieces of a business that dwarf the more commonly known name brand.



This brings us to The Gap, Inc. (GPS), an iconic retailer that we believe is misunderstood by the market. Just as Amazon (the stock) is not really a company that sells you stuff directly online, The Gap, Inc. is not just "The Gap" name brand - an admittedly stale, no growth business. In fact, "The Gap" generated almost none of the $1 billion in net income of The Gap, Inc. In a 'once only' presentation by management at a conference last year, they revealed profit margins by division, a disclosure that they have not updated since. Among the surprises were that "The Gap" brand is barely breakeven, Banana Republic (believed to be a troubled brand) was quite profitable, Athleta (one of the fastest growing retail concepts in the US right now) is quite profitable, while Old Navy (one of the fastest growth off-price retailers in the US) generated most of the corporate profits:



In other words, The Gap, Inc. is far more than just "The Gap" brand. You could shut "The Gap" down tomorrow and it would have an immaterial effect on the profitability of Old Navy, et al. To an optimist, "The Gap" brand represents $1.00 in EPS potential should management prove capable of achieving 10% operating margins within the division (like Banana Republic). That is $10.00 per share of potential value to be unlocked on a $30.00 stock, based on our thesis that "The Gap" brand is currently valued at nothing within The Gap, Inc.

In fact, without "The Gap" brand, The Gap, Inc. would still be earning $2.50 per share, but would be growing revenues by more than 10%, making it one of the faster growth retailers in the US. The closest comparables to Old Navy are Ross Stores, Inc. (ROST) and The TJX Companies, Inc. (TJX), both of which are consensus "buys"

trading at 20x earnings, with lower than 10% growth rates, and less room for future expansion. While Banana Republic may be a drag on the overall growth rate of The Gap, Inc., Altheta's approximately $1 billion business is growing faster than higher-end direct competitor Lululemon. It's not hard to imagine a *Gap-less* The Gap, Inc. trading at 20x earnings, or $50.00 per share, vs $30.00 today.

To bring it back to square one, the point is that it isn't always apparent what comprises the value of a business, despite the familiarity one may have with the brand. In the case of Amazon, many people wrongfully attribute the financial success to a part of the business that has negligible value to the Company overall. Conversely, in the case of The Gap, Inc., investors are being overly complacent towards the stock due to the stagnation of its namesake brand, even though it's largely immaterial to the Company's overall profitability. As silly as it sounds, just going through the process of changing the corporate name from The Gap, Inc. to Old Navy Inc. could cause the stock to go up 50%!!!

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

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