2019 IS BRINGING BIGGER CHANGES THAN USUAL

Instrument (Inception)*	November 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-3.5%**	**7.8%**	**11.5%**
Venator Investment Trust (September 2007)	**-3.6%**	**8.0%**	**8.3%**
Venator Income Fund (August 2008)	**0.6%**	**1.6%**	**10.9%**
Venator Select Fund (September 2013)	**-3.2%**	**10.8%**	**15.2%**
S&P/TSX Total Return (March 2006)	1.4%	-3.7%	5.1%
Russell 2000 (March 2006)	1.6%	1.0%	7.4%
S&P Toronto Small Cap (March 2006)	-4.0%	-15.2%	1.1%
S&P 500 (March 2006)	2.0%	5.1%	8.5%
Merrill Lynch High Yield Index (August 2008)	-0.9%	-0.1%	8.0%

The November correction wasn't kind to our equity strategies; however, Venator Income Fund had some notable wins that allowed it to buck the trend in debt markets. Corrections like the one we just experienced can be tricky things, with high-quality stocks dropping 20%+ for no apparent reason. When I say "high quality" this can mean smaller companies like long-term holding Skyline Champion Corporation, or blue chippers like Salesforce.com or Amazon.com. We were able to take advantage of the decline by purchasing some larger high-growth companies mid-month, and through the purchase of convertible bonds that had fallen with their underlying stocks. That said, the bulk of the equity portfolios remain intact as short-term market gyrations don't tend to cause massive swings in our portfolio positions.

With 2018 now largely behind us, I'd like to write about issues that we are tracking for the upcoming year. The market is always forward looking, and the following is a short-list of the macro issues that we are monitoring, which could shape parts of our portfolios over both the near and long-term as we build out our plan of attack for 2019:

THE END OF THE SUPER-LOW RATES: I don't think most people fully appreciate how big a tailwind markets have enjoyed in the form of consistently declining interest rates over the past 35 years, moving from near 15% to 1% over the period. Low interest rates increase stock market values (due to comparative rates of return) and housing prices (due to the low cost of carrying a mortgage), that much is well understood. It also naturally stands to reason that rising rates will have an opposite effect, but when it comes to investing, this doesn't tell the whole story.

Higher interest rates can have negative effects on the business of "financial engineering" which has, unfortunately, been a big driver of both public and private equity valuations as of late. In the public markets, companies have been using cheap debt to aggressively buy back their stock (in this regard, Apple has been copying a core IBM strategy) to boost earnings per share, a strategy that slows when the debt becomes too expensive.

The other financial engineering game that could come to an end is the proliferation of mergers and acquisitions, which are funded by debt. Truly strategic deals will continue to make sense, but just being "accretive" won't be enough as that accretion will be harder to achieve if the debt costs of closing the acquisition goes up. Of those deals that still happen, the increased cost of funding will necessitate a lowering of valuations. This is especially true of private equity valuations which are largely funded with debt; they can only pay up to the point at which the interest cost is covered by the operating profit; higher interest costs means that they will take on less debt to fund a deal, which results in less money to buy the target.

The longer-term issue is the ability to refinance debt that is already on the balance sheet. Not all companies are in position to free cash flow their way out of debt like Apple or IBM. Some companies, like Tesla and Netflix, have raised debt to finance aggressively negative free cash flow businesses. In less contentious situations are companies that can fund higher debt costs but not without a material negative impact on earnings. In the case of private equity companies, it is often the case that they run with maximum debt and minimal profits, a situation that turns into losses when the cost of debt increases.

DE-FAANGED: Back in our March and July commentaries (Wrong for a Year, Right for a Day; Some Cavities in the FAANGs) we talked about the ongoing PR and and executive exodus issues with Facebook, Apple's problems with selling phone upgrades, and the business model at Netflix. Many of these issues have now come to the forefront, with technology companies leading the recent market decline. While the market was largely in the "baby getting thrown out with the bathwater" phase, the super team that is FAANG might have to have to evolve into a new acronym. Specifically, the challenges facing Apple are not going away anytime soon, and you can already feel the growing concern for Netflix as Disney gets closer to full ownership of Hulu and the full launch of Disney+ streaming (rumoured to be initially priced at half of cost of Netflix).

I would expect Amazon to remain at the forefront of *everything*, and Microsoft to get increasing levels of respect (Microsoft doesn't get the same level of attention that Apple, Amazon and Google enjoy). It also wouldn't surprise me to see the continued ascent of Tesla (also talked about in detail in our March review) as is moves to sustained profitability over the next several quarters. Finally, business/cloud technology is showing no signs of slowing down, as witnessed by strong quarterly earnings out Salesforce.com and Workday.

There is more out there than technology, but consumer technology, for whatever reason, always gets the limelight. As such, there will continue to be market leadership out of the technology names that best capture the imagination, but we could see a changing of the guard as we move into next year.

OIL AND THE FIFTH STAGE OF GRIEF: Long-time followers will know that we have ranged from bearish to skeptical on oil for the past several years. Our longstanding thesis is that oil is unlikely to rebound to $100 per barrel barring a major war in the Middle East, and that its cyclical price is likely to be in the $20-$70 range for the foreseeable future. The bottom line is that the US is now self-sustaining in terms of oil production and, as with shale gas, can turn the taps on and off in short intervals, with $30 as the breakeven cost. I believe that commodity watchers have finally begun to accept this reality given recent increases in production and pipeline capacity coming on next year.

Canada has a unique problem with an easy (but seemingly not so easy) fix. For those of you that haven't been following closely, Canada is getting less than half of the marked price of a barrel of oil and there are two main reasons for this. The first is that the US doesn't need our oil anymore! Historically, Canada would pipe its Alberta produced oil into the US, which would take all it could get. Now that the US doesn't need it, Canadian oil is stuck in Alberta, which brings us to the second reason. Since the US has historically taken all the oil Canada could give them, we never bothered to build out an efficient transport mechanism to the east coast of Canada, along with international markets. In short, the US no longer wants/needs our oil, and we can't get it to markets that do. Frankly, it's a ridiculous situation that could be alleviated by building the required pipelines, but our Canadian parliamentarians can't seem to make it happen, even though it should probably be *the number one priority* in terms of the economic well-being of the country.

TRUMP ON TRADE (he is not wrong on this issue): The Trump Trade War has dominated the headlines, and while Canada and Mexico caved somewhat, the big whale is China. While we are generally free market people, and therefore have a knee-jerk negative reaction to moves away from free trade, I must concede that Trump has a good

point when it comes to unfair trade policies regarding China. As has been discussed in the issue of drop-shipping goods purchased online (drop shipping is the practice of moving goods directly from the manufacturer/distributor in China to the final retail customer in the US), Chinese sellers of goods receive favorable post-office rates vs US shippers, putting US distributors at a competitive disadvantage in many cases *when selling the same good to a US citizen*. This is, in part, because in certain instances China is considered a third-world country due to a large impoverished population that brings its per capita economic statistics down to level that puts them on par with middle-Africa on some trade conditions. Of course, this is ridiculous because many of these Chinese businesses are well capitalized, richly funded, and have educated work forces. While Trump may go too far sometimes (often?), some trade conditions have a long way to go just to even the playing field.

While we all think lower prices are generally good for the economy, having the USPS lose money on drop-ship goods, subsidized by higher prices charged to US businesses doing the same thing, is just the US subsidizing Chinese profits, which makes no sense. Obviously, there are many more angles to this, not the least of which is intellectual property theft. Having a major economic power like China get the benefit of being treated like a third world nation from a trade rules perspective is a situation that should never have gotten to this point in the first place.

THE CONTENDER? I am not a huge follower of US politics, focusing instead on economics. That said, I am amused by the entertainment factor that Trump provides. For those that want him out of the Oval Office, the Democrats need to come up with a credible alternative, and there currently doesn't appear to be any high-profile candidates on the horizon. As those of us in Ontario have learned, if the incumbent is hated by enough of the people, you can trot out any candidate within weeks of an election and still win. But I get the sense that there are still too many Trump supporters out there to hope for a default win by a relative unknown to move the swing vote. It will be interesting to see in which direction the Democrats head.

Overall, we remain optimistic heading into the new year. As mentioned, we made some 'growth' additions in our equity mandates over the past month, taking advantage of the market weakness. We were also able to take advantage of the situation with Venator Income Fund and are currently looking at a higher projected yield than we have seen in months.

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

On behalf of the entire team here at Venator Capital, I'd like to wish you and yours a Happy Holiday season – and a healthy and prosperous 2019!

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