

A YEAR (but really just a month) IN REVIEW

VOLATILITY CREATES OPPORTUNITY/SENTIMENT ISN'T REALITY

Instrument (Inception)*	December 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	-5.8%	1.6%	10.9%
Venator Investment Trust (September 2007)	-6.0%	1.5%	7.7%
Venator Income Fund (August 2008)	-1.1%	0.5%	10.7%
Venator Select Fund (September 2013)	-6.4%	3.7%	13.6%
S&P/TSX Total Return (March 2006)	-5.4%	-8.9%	4.6%
Russell 2000 (March 2006)	-11.9%	-11.0%	6.3%
S&P Toronto Small Cap (March 2006)	-3.5%	-18.2%	0.8%
S&P 500 (March 2006)	-9.0%	-4.4%	7.6%
Merrill Lynch High Yield Index (August 2008)	-2.4%	-2.4%	7.7%

A couple of our internal '*how to survive as an investment manager*' rules that I've always liked:

- **#1 thing to avoid: Don't have a down year in an up year.** It doesn't matter if you hedge, or whether you are market neutral, investors hate this type of result. As Gordon Gecko in "Wall Street" famously stated: "nothing ruins my day more than losses". That's probably better advice than 'greed is good'.
- **The best thing that you can do is have an up year in a down year.** While all three Venator Funds achieved this objective in 2018, it doesn't really feel like a 'win' given that we were up double digits several months ago. Fortunately, the performance of our Funds remains quite respectable relative to how North American markets finished the year.

December is typically a pretty quiet month. It tends to be light on news, 80% of Q3 results have already been reported, and investors are busy with holiday shopping and activities. Historically, the last ten trading days of the year also tend to have lower volumes and volatility. Admittedly, once Trump indicated a willingness to negotiate with China on trade in early December, we thought it would be smooth sailing through year end. Boy were we (and presumably everyone else) wrong! Some 2018 statistics courtesy of Goldman Sachs:

- For the first time in 70 years, the market was up 10% at one point, only to finish with a loss
- We started the year with a forward P/E multiple of 18.1 and finished at 14.4
- 57% of stocks ended the year more than 20% below their 2018 highs

After hitting record highs in Q3, the market started weakening into the fourth quarter as the trade war rhetoric ramped up, with confusion over Brexit compounding matters. Earnings season also seemed strong from our perspective with the notable exceptions of housing and Apple - both of which were looking at 'affordability' issues (we don't consider energy weakness to be a barometer because that is more of a supply issue than a demand issue). Both consumer/retail and business spending were also looking strong in Q4.

But then the Fed 'ruined' Christmas. I don't know why anyone would have expected the Fed not to raise rates, or to indicate that a couple more hikes are in order. Interest rates are still historically low, employment is historically high, wages are increasing, the consumer is spending aggressively, and businesses are spending. The decision by the Fed wasn't even remotely contentious; it was unanimous. It also didn't help that Trump was rumoured to be considering 'firing' his own appointed Fed president, even though he didn't have the authority to do so. To sum it

up, the market doesn't like the way the Fed is behaving and doesn't like the prospects of Trump wanting to put someone in place who would lower rates; also, high oil prices are bad for the economy and low oil prices are indicative of a weak economy. This all makes no sense! You can't have it both ways, and both sides of the same coin can't be bearish. It's called confirmation bias - when one looks, in hindsight, for the explanation of a market decline regardless of the actual data.

Of course, the algorithmic trading models all think that it makes sense because technical market moves always make sense! When everyone was ready to go on the Christmas break, the financial writers got all excited about a mildly inverted yield curve (the semi-unique situation where short-term interest rates are higher than long-term rates), and the computer algos gang tackled the markets. With algos now accounting for 80% plus of market volumes, they were ready to pounce on what is historically a decent predictor of a future recession, even if its record on timing said recession is very suspect (the market has been known to hit fresh highs post the inverted curve indicator). The other problem with algorithmic trading is that there are no contrarians in algo-land. In fact, for all the history showing that humans are notorious trend followers in investing (which leads to boom and bust cycles), algos are the ultimate trend followers and only exacerbate trends, which is how we were heading for the worst December ever, the worst Christmas Eve ever, and the worst three weeks of trading since 2008-2009 (the Russell 2000 was down 17% *on the month* at its low point). I would note that the simple explanation for algos being more aggressive trend followers than humans could be that the humans are the ones programming the algos, and the algos are using past human trading as an indicator of future performance, even though humans do barely any of the trading these days.

Of course, the algos don't know everything, and there was one super-unique factor of this market drop that had fundamental investors, like us here at Venator, piling onto the carnage at precisely the time they didn't want to. Investors who were previously up on the year quickly had the tables turn on them in mid-December, slipping into negative return territory. These investors, both retail and institutional alike, had realized investment gains when we were all having a good year but were now staring at a tax bill, on top of what was now a negative return year. This caused what can only be described as the most aggressive tax loss trading in years. When this was over, we saw a pretty substantial rebound, including the largest ever one day point gain in the Dow Industrial Index – ON CHRISTMAS WEEK!!!

This brings us to another one of our investment management rules: *volatility creates opportunity and sentiment isn't always/often reality*. We found ourselves on both sides of this rule in late December, reluctantly exiting loss positions (hopefully for only 30 days), but also trying to take advantage of buying opportunities on the other side. In fact, the Founders Fund went from +40% net invested entering December to nearly +70% net invested by the end of it. As you would expect with this type of market decline, some silly opportunities have presented themselves in the last two weeks:

- **Fedex Corporation (FDX):** Down roughly 40% in three months, the company recently put out a good quarter with a bad guide. While e-commerce volumes continue to expand, Amazon Air has cast a competitive pall over the courier space (we also own the stock and convertible bonds of the company from which Amazon is leasing its planes). Fedex emphatically stated that its US business is on fire, but that Brexit and China trade talks have stalled growth in their international business. That said, overall business growth is still expected.
- **The Children's Place, Inc. (PLCE):** Down roughly 40% in three months, Children's Place has recently encountered some 'problems' that other companies would like to have. Still growing and ahead of the curve on retail location consolidation, Children's Place is currently dealing with the short-term issues associated with competitor bankruptcies. These issues include enhanced online order growth for which they were unprepared (they are currently shipping too many orders from stores, which is less profitable than shipping from the overburdened distribution centers), as well as the negative impact of clearance pricing by competitors who are in the process of closing stores. That said, at less than 10x earnings with multiple years of market share growth ahead of them, the recent turmoil created an opportunity.

- **The Stars Group, Inc. (TSGI):** Yet another tax-loss selling victim, the owner of PokerStars and acquirer of Sky Betting got crushed earlier in the year when new buyers of a financing '*discovered*' a two-year-old, \$850 million decision against them in Kentucky. That decision, however, was reversed on appeal last week - yet outside of a 7% upward move in the stock price for approximately one hour post the announcement of this material news, the tax loss selling pressure was too much to overcome. Trading at 7.5x earnings with some strong secular growth tailwinds (hello legalized major sports online betting in North America), the opportunity was too great to ignore.

Those who are familiar with Venator and the way in which we manage capital understand that we are not market timers. While someone who attempts to time the market *might* be able get it right two or three times in a row, it's next to impossible to do consistently over time. And, I have yet to read about the investor who successfully called eight out ten material market reversals. As fundamental investors, we generally view a market decline as an opportunity to buy high-quality businesses at valuations that haven't been available for some time. In the case of Fedex Corporation (FDX), the company hasn't traded below 9x forward EPS estimates over the past 18 years (we only looked back to 2000), and the only two times that it traded below 10x earnings were at annual low points where it averaged over 14x in those years. The market can only discount what it *thinks* will happen, which often is not what *actually* happens; after all, the market has successfully predicted nine of the past five recessions. This latest move could make it ten for five!

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

Wishing you a happy, healthy and prosperous 2019 on behalf of the entire team at Venator Capital Management Ltd.



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