

THE NEWEST TREND IN TECH (*that no one is talking about*)

Instrument (Inception)*	February 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	3.4%	8.9%	11.5%
Venator Investment Trust (September 2007)	3.4%	9.1%	8.4%
Venator Income Fund (August 2008)	1.9%	3.7%	10.9%
Venator Select Fund (September 2013)	6.6%	15.5%	16.1%
S&P/TSX Total Return (March 2006)	3.2%	12.2%	5.5%
Russell 2000 (March 2006)	5.2%	17.0%	7.5%
S&P Toronto Small Cap (March 2006)	4.0%	11.9%	1.7%
S&P 500 (March 2006)	3.2%	11.5%	8.4%
Merrill Lynch High Yield Index (August 2008)	1.7%	6.4%	8.0%

The third act of a ridiculously strong first quarter for financial markets is yet to be written, but it is still worth noting that in the last six months we have seen both a 20% drop in broader markets, followed by a 20% rally, which is a stunning move for what is currently a steady economy with a stable outlook. There was no 48-hour market crash, currency crisis, bubble burst, financial crisis or really anything to rationally explain what we have recently witnessed. With earnings season largely behind us, corporate health can be characterized as neither weak or strong, and credit markets remain relatively unchanged. Thankfully, by staying invested throughout this rebound we have been able to participate in this market rally across all our Funds, as our year-to-date numbers indicate.

One area that we have profited from in recent years has been the convertible bond market and, specifically, opportunities within the technology sector. The recent structural evolution in the US convertible bond space has created an abundance of issues in the technology sector, which has created opportunities for both bond and equity markets alike. With good fundamental analysis, one can take advantage of various ways to profit from these largely ignored investment vehicles. Despite offering both debt-like characteristics (set maturity dates) as well as equity qualities (embedded call options), convertible bonds operate in a grey area where they are spurned by most debt investors (because they are rarely rated by bond agencies) as well as equity investors (because they are not in benchmarking indexes or eligible for many mutual funds). Despite being unavailable to the largest of market participants, here a few of the opportunities convertible bonds can provide:

- When a convertible bond is initially issued, the stock will experience temporary short-term weakness as arbitrageurs short the stock against their long positions in the convertible;
- If a stock underlying a convertible bond sells off, the bond might sell off aggressively as well when arbitrageurs adjust their proportionate positions, creating potential returns to maturity that are far better than 'vanilla' bonds would provide (and often with better balance sheets);
- Convertible bonds offer a better risk-adjusted way to synthetically own a volatile stock, with the \$100 price point at maturity providing downside protection over the life of the bond.

As previously mentioned, technology companies have increasingly taken advantage of this type of financing. This has occurred for several reasons:

- Since the conversion feature gets exercised at a 20%-40% premium to the current stock price, convertible bonds offer an opportunity to synthetically issue equity at higher than market prices;

- As an offset to offering the conversion feature, convertible bonds carry lower interest rates, offering the company an opportunity to issue debt at below-market interest rates, despite a lack of fixed assets or limited profit history;
- Since most companies engage in a synthetic *anti-dilution* transaction at the time of the issue, quite often the conversion will not materially increase shares outstanding, which allows the bond to act as nearly free money should the stock increase through the conversion price.

The recent proliferation of convertible bonds in sectors that have not traditionally offered these types of securities has allowed us to generate profitable returns across the Venator Funds during the past couple of years, with positions in companies such as Wayfair, Zillow, Palo Alto, RingCentral, Teledoc and Tesla/SolarCity being noteworthy examples. As it relates to Venator Income Fund, the increasing amount of opportunities that we have identified in the convertible bond space has allowed us to increase exposure to these instruments, while at the same time eliminating the dividend equity holdings within the portfolio. We believe that this move will have the effect of maintaining equity-like return potential moving forward, while at the same time curbing volatility.

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



Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

This commentary is intended for informational purposes only and should not be construed as a solicitation for investment in any of the Venator Funds. The Funds may only be purchased by accredited investors with a medium-to-high risk tolerance seeking long-term capital gains. Read the Offering Memoranda in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares. All stated Venator returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance.