DO VALUATIONS MATTER? (YES, THEY DO)

Instrument (Inception)	May 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund* (March 2006)	**-1.8%**	**7.7%**	**11.2%**
Venator Income Fund (August 2008)	**-0.9%**	**3.9%**	**10.6%**
Venator Select Fund (September 2013)	**-3.7%**	**13.1%**	**14.9%**
S&P/TSX Total Return (March 2006)	-3.1%	13.4%	5.4%
Russell 2000 (March 2006)	-7.8%	9.3%	6.8%
S&P Toronto Small Cap (March 2006)	-4.2%	5.8%	1.2%
S&P 500 (March 2006)	-6.4%	10.7%	8.2%
Merrill Lynch High Yield Index (August 2008)	-0.9%	7.9%	7.9%

***** Venator Investment Trust is also available as an extension of the Founders Fund strategy; its monthly performance mirrors the Founders Fund, and it is eligible to be held in both registered & non-registered accounts***

May wasn't the greatest month for markets but let's not fret too much as the year could still be characterized as being off to a strong start. That said, in the span of nine months we have gone from excessive worry due to a trade war and the end of an accommodating Fed, to a belief that there would be no trade war (sending the market back to its highs), and now justified concerns over a worse than expected trade war with China and Mexico (with Canada finding itself in a trade war with China as well). It's also worth noting that the never-ending saga that is Brexit has moved from the 'temporary' to the more 'intermediate' category. Perhaps the most telling of the canaries in the coal mine is the recent surge in the 'flight to safety' instrument that is low/no yield government bonds, as well as the slight resurgence in the 'uncorrelated' asset known as Bitcoin.

Probably about once a year, we pontificate as to whether our value (or even relative value) bias is a strength or weakness. It's always a worthwhile exercise to look back and evaluate stocks that we might have sold too early, stocks that we own that aren't moving up in value, stocks that we are short selling, and stocks that we didn't buy at all. Valuation isn't everything, but it's an important consideration in all our investment decisions. If you believe that a fundamental tenet of investing is that a company is worth the future value of its cash flows, or, in some cases, the amount someone else would pay to acquire it, then it is important to consider the current valuation of the company. Carl Icahn once said that everyone knows who the great companies are, that's why they have such high valuations. I would note that the great companies also tend to come with high expectations, which can prove to be a handicap for future returns. This is presumably why it has been said that good companies can end up being bad stocks and vice versa.

Howard Marks noted that the stock market is the only market in which increasing prices make products more attractive to potential buyers (largely due to Fear of Missing Out, or FOMO) – which is both funny and true. In retail, Thanksgiving is when all the sales start, and sales ramp hard as the discounts escalate, with the media focusing on $300 flat screen door buster deals. In the stock market, we only get excited about buying stocks when they are up, debating how 'early' we are in the eventual price escalation as analysts fall all over themselves to *increase* their target prices which, in turn, *increases* demand for said stocks. This isn't just theoretical as you tend to see more financings (selling new stock to the public) near all-time highs, and almost never see them near all-time lows. In comparison, if your wireless service provider were to double the price of your data plan, you would be looking to switch service providers; but no one is looking to dump stocks when the valuation doubles (in the absence of a commensurate change in fundamentals).

I recently read an article where a (presumably) momentum investor suggested that he/she focused on the higher quality companies and paid little attention to valuation because it was the most known factor of an investment. I can see how this would *seem* true in the world of professional investment management, as nearly all investment research

contains earnings estimates and P/E or EV/EBITDA ratios, with data aggregators focusing on quantitative rather than qualitative factors. Institutional investors are generally keenly aware of the valuations at which their companies trade. That said, in my opinion, the *vast majority* of market participants have no idea as to the valuations of the companies they own, which makes knowing this information a long-term competitive advantage in investing. ETFs and technical algorithmic trading, which are believed to account for over 75% of all trading volume, have no concept of valuation; it isn't even a consideration in their investment strategy. I would also posit that your typical Amazon, Facebook, Disney, Netflix, Google, Lululemon, Nike, Colgate, McDonalds, Starbucks, CIBC, Barrick Gold, Suncor, Bell Canada, or Canopy investor does not know the P/E, EV/EBITDA, growth rate, market capitalization, profit margins, or relevant valuation metrics of these top-of-mind and widely held investments. The core fundamental investors, largely institutional, that currently make up a very small percentage of the investment landscape, are the only ones that look at valuations, which makes technicals, money flows, and high-level fundamentals (Icahn's previously noted comment that everybody knows who the good companies are) all better known quantities than valuation.

This quote, from John Kenneth Galbraith (which I lifted from Howard Marks' recent book 'Mastering the Market Cycle'), is a great one to keep in mind during extended bull markets and when witnessing near-record valuations:

"When the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

Today, we are starting to see circa-2000 valuations for "software-as-a-service" (SAAS) companies. Back then, when really good companies typically traded at 10x *revenues*, and great companies traded at 20x *revenues* (!), we learned the hard way that despite their *'greatness'*, they weren't able to sustain such lofty valuations. I would also note that '*greatness*' back then was defined by 70% to 200% growth rates, as compared to the 20% to 50% growth rates that we see currently. At least back then, the extremely high growth rates left a glimmer of hope that these companies could grow into such extreme valuations within a reasonable time frame, something far less likely with the substantially lower growth rates of today. Will today's investment environment end the same way as the 2000 bubble for tech stocks? Time will tell; but probably yes (where 'probable' means more likely than not, but not definitely).

We are also seeing crazy low valuations in the toxic retail sector. Every year, Q1 results seem disappointing due to 'weather' (because it almost never snows in February/March); but then the Christmas selling season somehow manages to set new records. We are currently on the hunt for low valuations in this sector as Amazon's foray into apparel has slowed dramatically and retailers finally appear to have their online act together.

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

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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