THE YEAR IN PREVIEW

Instrument (Inception)	November 2019 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund* (March 2006)	**-0.8%**	**4.3%**	**10.5%**
Venator Income Fund (August 2008)	**1.0%**	**7.1%**	**10.4%**
Venator Select Fund (September 2013)	**1.2%**	**20.6%**	**14.8%**
S&P/TSX Total Return (March 2006)	3.6%	22.3%	5.8%
Russell 2000 (March 2006)	4.1%	22.0%	7.4%
S&P Toronto Small Cap (March 2006)	2.7%	9.9%	1.5%
S&P 500 (March 2006)	3.6%	27.6%	9.0%
Merrill Lynch High Yield Index (August 2008)	0.3%	12.1%	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***

The month of November continued the strong run for North American markets in 2019, with nearly all market sub-sectors showing strength despite some cautious data points. Capital continues to search for attractive opportunities in a low rate environment and investors have, perhaps, become a bit too comfortable with the longest bull run in recent history.

Venator Select Fund has performed well year-to-date, posting a 20%+ return, and benefitting from a barbell mix of mega-caps and micro-caps, as well as a largely unhedged portfolio.

Venator Income Fund posted another strong month with some convertible bond positions realizing on their equity optionality. Overall, the Income Fund has enjoyed a successful year, with a largely unlevered portfolio of short duration high yield and convertible bonds generating a 7% year-to-date return.

Our hedge strategy (Founders Fund & Investment Trust) has performed like a 'market neutral' fund (although that is not our intention), with the short-side of the portfolio eating into a good portion of the strong returns generated on the long-side of the ledger. This, in combination with recent market dynamics, has forced us to review our hedging strategy and to make some adjustments that are discussed in detail below.

THE YEAR AHEAD: LOTS OF TAKES, ONE BIG GIVE

The past fifteen months have been interesting times for the markets to say the least. A year ago, we were in the midst of the worst fourth quarter in the past 100 years, with the market down 20% from its intra-year highs by late December. The bounce back rally in 2019 was sparked by a potential, near-term, trade deal with China (that still hasn't happened), and the Fed shifting its policy stance from tightening to accommodating in the face of a slowing, but still growing, economy.

There are many negative market influences, and it's easy to be overly cautious, otherwise known as 'climbing the wall of worry'. Leading indicators for more cyclical areas of the economy, such as non-residential construction and capital spending, are rolling over. That said, markets have taken a recent shine to these names as 'value' quants have keyed in on low P/E or EV/EBITDA ratios. On the other hand, fundamental sell-side analysts continue to be more cautious, as we have observed more 'hold/sell' recommendations than 'buys', and target prices often below current prices. These analysts are sticking by the age-old adage that cyclicals are most expensive when they look the cheapest; quantitative models would have a more difficult time processing this not-so-quantifiable philosophy.

Within the technology sector, things are generally great. Cloud computing probably has another 3-5 years of outsized growth left, and the long-term winners are busy consolidating the sector. This intermediate term outlook has also led to out-sized valuations as the last of the 'generalists' pile into a market that we can now comfortably say is seeing

significant valuation premiums relative to the 2000 technology bubble. What will likely keep valuations high in the short-term is the prospect of mergers and acquisitions. Market leader Salesforce.com has continually set the bar in terms of valuation, currently trading in the 10x-15x forward sales range (despite trading at a significant discount to its takeover targets). The bright outlook for the market makes it a great place to look for investment opportunities, but let's not forget the old saying that 'oftentimes the best companies don't make the best stocks', largely because overly optimistic prospects might already be priced in.

Unfortunately, the resource sector continues to be a very difficult area of the market for us to get excited about. While we aren't necessarily 'perma-bears' in energy, we do believe that oil and gas technological efficiencies have turned former 'low lead time' production markets into 'just in time' markets, which means that long-term views cease to exist, and only short-term trading ranges are worthy of our attention. Copper, on the other hand, is one commodity that we do have a bullish longer-term view on *but* the problem is that the only two companies with attractive 10-year production profiles also happen to operate in very risky jurisdictions, which means you need to be opportunistic to discount the risk. Heightened risks associated with the US elections could also get the gold bugs fired up and the path of least resistance is likely up for the yellow metal in 2020.

US housing, especially the affordable or low-end segment of the market, remains our favourite long-term play. The big picture relates to pent up demand among millennials, who are finally starting families on a 5-7-year lag relative to the generation that preceded them. While housing starts and household formation have improved, they remain below long-term averages. As good as an ageing generation of boomers is for healthcare, ageing millennials represent just as strong and compelling a boon for housing, but with a little more short-term cyclicality, and a lot less regulatory oversight. This sector has been, and will continue to be, well represented across the each of Venator's equity mandates.

Healthcare seems to always be a great place to invest - it's a classic positive-sum game. When demand for chemotherapy declines it's because a new, more effective, and possibly more expensive, therapy has emerged. You don't even need to take binary FDA risk for drugs to make money, although sometimes you must take some reimbursement risk. We are somewhat fearful that drug pricing could come under fire during the lead up to the US election campaign. While the whole 'billionaire tax' narrative will likely fade away, Trump seems as interested in taking drug prices down as any of his prospective Democrat opponents. As such, we expect the narrative to hold down the drug sector leading up to US elections and would look to other corners of the healthcare space for opportunities.

Without question, the US election is going to dominate the narrative in 2020. Regardless of whether you think Trump will get re-elected or not, the bottom line is that the US election is a 51%/49% proposition and the polls of the day will likely fire up volatility to levels that most recent market participants will have a difficult time recalling. A Bloomberg nomination could go a long way to easing fears, but to the extent Elizabeth Warren remains the front runner for the democratic nomination, we would expect heightened market volatility leading up to the election.

The 'BIG GIVE' that keeps this market afloat and rising is, of course, money flows. Capital desperately looking for a home in a low rate environment has continued to find its way into large cap ETFs (represented mainly by the S&P 500 or SPYs). The S&P 500 has been, without doubt, the best broad market to be invested in among established markets over the last five years. We believe that this has been largely a function of familiarity vs fundamentals. Even poorly performing companies have benefited from money flows, including heavyweight components such as Apple, whose stock has more than doubled in the past four years despite an EBITDA *decline*; and Walmart, which has seen its stock double over the last seven years despite an EBITDA *decline* of 10%, suggesting they are still losing the war against Amazon. Multiple expansion among mega-cap companies has vastly outpaced their respective fundamental improvements, suggesting that money flows are the predominant driving force in the market.

Interestingly, money is also pressing hard into other esoteric parts of the market. Private investments have become increasingly popular in an environment where investors want to avoid any 'mark-to-market' risk and/or negative price swings in the accounting value of their assets. This probably makes some sense for groups like pension funds, where liquidity isn't very important, but even private equity funds have shelf lives and the recent failure of many high-profile IPOs is showing that eventually you will need that public 'mark' if you ever need the capital. This recent post IPO

weakness is telling us that the private markets would rather pay for the psychological benefits of not seeing investments move anywhere but up (a sliver of a recapitalization at a higher valuation can mark up the whole investment in the private world, while private funds don't tend to readily reduce the equity value of an investment for pesky things like missed quarters). Within debt markets, we have also seen a move towards private debt funds that provide loans/financing that the big banks can't make (which sounds better that saying that the big banks *won't* make them, even at 10%+ interest rates), ignoring the saying that the worst loans are made in the best of times.

VENATOR'S YEAR AHEAD

With respect to Venator Income Fund, we expect that its strategy will remain largely unchanged during 2020. The Fund will continue to hold its outsized position in convertible bonds because even though they tend to be lower yielding, they offer outsized optionality and lower credit risk than your typical mid-rated bond investment. It's difficult to find what we deem to be good/safe yields in the current environment, so we don't mind taking the lower coupon associated with a convertible bond and getting our upside through the underlying optionality of the stock. The two negatives to this approach involve taking a lower coupon, and accepting some mark-to-market risk, as convertible bonds tend to be more correlated to stock movements than non-convertible bonds. However, the offsetting benefits are improved credit quality, greater time-adjusted upside potential, as well as tax efficiency compared to our more traditional high yield bond positions.

In the case of Venator's long/short strategy (Founders Fund & Investment Trust), we will continue to shift its hedging strategy towards index-based options. Several years ago, we determined that our hedging strategy, focused primarily on shorting individual stocks, had been a net benefit to us from 2006-2015, with the bulk of our short sale losses coming from either pair trades or ETF positions. At that time, we reduced the negative impact of ETF short positions by building a more diversified portfolio of company specific short positions. While this strategy helped us avoid recent down years in the market (2015 & 2018), it also prevented us from capitalizing on some potentially lucrative years too (2016 & 2019). The reality today is that the market is dominated by ETF money flows, which has made it nearly impossible to create an alpha generating diversified portfolio of company specific short positions.

Given current market conditions, we have made the decision to shift the nature of our hedge model towards one that focuses primarily on downside protection via options. While options will represent the bulk of our hedging program moving forward, we will also continue to selectively short individual stocks which, in combination, will hopefully return the performance of our hedge book to its better days of 2006-2015. In short, we believe that our proprietary options strategy can both minimize losses and potentially generate profits during up years for the market, under certain conditions. An additional benefit to this change in our hedging program relates to the long book; specifically, we will be able to dedicate even more of our resources towards the long side of the portfolio, which has been much stronger than our recent performance would suggest.

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

On behalf of the entire team at Venator Capital Management Ltd., wishing you a happy holiday season, and a healthy and prosperous 2020!

Brandon Osten, CFA
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