# TOUGH START ... BULLISH OUTLOOK

| HEDGE FUNDS (Inception) | MARCH 2022 | YEAR-TO-DATE | ANNUALIZED |
|---|---|---|---|
| **Venator Founders Fund** (March 2006)** | **-2.4%** | **-16.8%** | **10.8%** |
| **Venator Select Fund (September 2013)** | **5.0%** | **-18.4%** | **13.9%** |
| S&P/TSX Total Return (March 2006) | 4.0% | 3.8% | 7.1% |
| Russell 2000 (March 2006) | 1.2% | -7.5% | 8.1% |
| S&P Toronto Small Cap (March 2006) | 3.9% | 8.4% | 4.0% |
| S&P 500 (March 2006) | 3.7% | -4.6% | 10.4% |

| ALTERNATIVE MUTUAL FUNDS (Inception) | MAR 2022 | YTD | 1-YR | 3-YR | 5-YR | 10-YR |
|---|---|---|---|---|---|---|
| **Venator Alternative Income Fund*** (January 2020)** | **0.2%** | **-4.0%** | **-0.9%** | **5.0%** | **5.1%** | **7.1%** |
| B of A Merrill Lynch High Yield Index (August 2008) | -0.9% | -4.5% | -0.3% | 4.4% | 4.6% | 5.7% |

** As of March 31, 2022*

*** Venator Founders Alternative Fund, which holds the same securities as Venator Founders Fund, is now available as a Liquid Alternative Mutual Fund; it is eligible to be held in both registered & non-registered accounts.*

**** Performance data prior to January 24, 2020, relates to Class F Units of Venator Income Fund, which was distributed to investors on a prospectus-exempt basis in accordance with National Instrument 45-106*

This is not the start to 2022 we were hoping for. While we did experience one of the strongest earnings seasons in recent memory, relative to Street expectations, we found ourselves invested in the worst performing sectors of the market, which made our quarterly performance even more disheartening. Most of our dozen biggest detractors, year-to-date, reported indisputable “beat and raise” quarters and trade at attractive valuations relative to current growth prospects and backlogs. However, as we noted last month, we own too many “good houses in bad neighborhoods”, notably small-cap growth, technology and home-related goods. LoveSac, which we profiled in last month’s letter, reported earnings that exceeded expectations by over 200% ($2.00 vs an expected 55c) and raised expectations for 2023 to 30%+ revenue growth (vs 27% expected which the street thought was too optimistic to begin with), yet remains one of our larger year-to-date losses despite its 30% gain last month. In short, we have experienced a sector allocation problem this year vs a due diligence one.

As Morgan Stanley recently pointed out: the ratio of dispersion between vs within sectors remains elevated, now at the 91st percentile over 5 years. This means that sector allocation matters more than ever, while individual security selection has been rendered nearly irrelevant in today’s climate – sector picking vs stock picking. We have always believed that a great management team with a great product can manage their way through difficult times more easily than, for instance, a commodity company when the commodity is in decline. This usually holds true in the intermediate term, but for now, rising and falling tides are seemingly having the same effect on all boats, as LoveSac’s chart looks eerily similar to that of Restoration Hardware’s despite a notable divergence in the two companies’ growth fundamentals (we could say the same thing about a number of companies we own in terms of superior financial performance vs imploding competitors that have brought on a negative feedback loop “guilt by association” trade).

While rising interest rates had been the main concern for the first six weeks of the year, the conflict in the Ukraine supercharged near term inflation expectations and provided an escape valve in several corners of the market that are not sectors that we traditionally gravitate towards. Leaving several commodity trades aside, which have received a boost from the conflict in Ukraine, the specter of an accelerating rate hike cycle by the Fed has moved the market into defensive low GDP-growth staples and utilities, which are benefiting more from valuation revisions than brighter growth prospects. Rising rate anxiety has also penalized the high-growth, consumer discretionary and home related sectors that we have been overweight in this year. Furthermore, the rise in oil prices has caused a pause in the “reopening” trade, which has impacted several travel-related names that we own; I would note that Disney World attendance was quite busy this Spring Break - zero Disney Park Pass availability for March break with three hour wait times throughout Hollywood Studios.

That said, we are largely standing by our positions and our previously stated annual outlook. We are standing by our view that month-over-month inflation will slow into the summer, which will lead to a view that interest rate hikes will slow to a more gradual pace than what the market is discounting today – a good outcome for housing, growth and "reopening". In fact, we recently dipped our toe into the embattled homebuilding sector, as valuations have recently traded below tangible book value in some instances. We don't disagree that earnings beyond 2022 could be at risk, but sub-book value levels are a rarity only recently seen in the housing crisis of 2007-2009, and we don't see a "crisis" in the offing.

Of course, the Fed could get it wrong and overshoot the rate cycle. Interest rates have been the primary determining factor in valuations this year. The Fed should have started raising rates last summer when inflation started rearing its head. Not because the Fed was wrong to assume much of the coming inflation was transitory supply-driven rather than the more typical demand-driven variety, but because there was no reason to maintain such low interest rates at that point in the cycle. The economy could have easily absorbed a back half of 2020 50-75bp rate hike at the time. This rate hike policy is at risk of being compounded by pushing too far too fast over the next six months with some forecasters calling for an accelerated hike cycle to 3.5% by year end; if we thought this was likely, we might have to revisit our market views. Our current view is that the Fed will not raise rates beyond 2% by the end of this year and will not raise rates beyond 2.75% by the summer of 2023, which we see as a manageable scenario.

As stated repeatedly above, it has been a frustrating start to the year. We think we have done good due diligence on our companies and these companies tried to reward us with strong financial results and guidance. But between the narratives of persistent inflation (which we think will cool as supply chains rebound), higher interest rates (which we don't think should end up as high as the market is fearing), the Russia-Ukraine conflict (which we don't think will be a long-term material disruptive event), and higher energy prices (which we believe should moderate by the fall), our positions have suffered from forward looking macro theories that we believe will ultimately prove transitory or incorrect. Many of our companies' management teams agree and we are seeing open market insider purchases, a strong indicator whereby management is betting with their own money versus corporate buybacks when they are betting with shareholder money.

Our Income Fund has held up well in the challenging bond market environment that interest rate fears have created. Our short duration (under four years) has been defensive, and our overall yield is over 7.5% with a current yield in excess of 5.5%. We believe this fund could have a very strong remainder of the year once interest rate fears abate and we are on the lookout for better yields as the bond market weakens.

We reserve the right to change our mind!

Brandon Osten, CFA
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