THE FED IS NOT YOUR FRIEND: MAX FEAR = MAX FRUSTRATION = OPPORTUNITY

HEDGE FUNDS (Inception)	APRIL 2022	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-11.2%**	**-26.1%**	**9.9%**
Venator Select Fund (September 2013)	**-16.9%**	**-32.2%**	**11.4%**
S&P/TSX Total Return (March 2006)	-5.0%	-1.3%	6.7%
Russell 2000 (March 2006)	-9.9%	-16.7%	7.4%
S&P Toronto Small Cap (March 2006)	-6.4%	1.4%	3.6%
S&P 500 (March 2006)	-8.7%	-12.9%	9.7%

ALTERNATIVE MUTUAL FUNDS (Inception)	APR 2022	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-4.6%**	**-8.4%**	**-6.5%**	**3.0%**	**3.9%**	**6.4%**
B of A Merrill Lynch High Yield Index (August 2008)	-3.6%	-8.0%	-5.0%	2.6%	3.6%	5.2%

** As of April 30, 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*

Right to the point, this year has been awful for us thus far. We are talking Financial Crisis awful and COVID awful. Each bear market is different than the others. This one, which has found us invested in the least favored areas of the market – small cap growth and technology – has hit our funds disproportionately hard, which is partly why our broader based index put options haven't helped us as much as we would have thought. Small cap growth is now 30% off its highs with more than half the NASDAQ down over 50% from its highs. The Fed rate scare has sent bonds plummeting as well, with even intermediate "risk-free" government bonds off 10% and longer dated bonds down around 20%. While we aren't backing off our thesis that inflation will start to level off in the summer, and the Fed will need to reassess the cadence of its tightening cycle by year end, the market is clearly assuming something far worse. Of course, the market was assuming zero interest rates forever last summer and trading these assumptions in periods of high volatility is a more profitable exercise than correctly predicting what will actually happen; at least in the short term (shorting the zero-rates-forever/valuation - doesn't-matter trade last summer would have caused a 30%-60% loss by October in many cases). Now the market is assuming an incompetent Fed, a deep recession and stagflation. As with last summer, it might be difficult for the market to see anything other than a worst-case scenario until month-over-month inflation actually slows down or until the Fed clearly articulates what its target "neutral" rate is.

POWELL AND THE FED SHOULD BE INSULTED

Clearly the market is signaling that it thinks the Fed has no clue what it is doing. The consensus is that the Fed should have hiked rates earlier and is now afraid that it will go too fast and too far in its attempt to correct this mistake. There is no shortage of headline grabbing fear mongers saying, "I could see a 100bp hike" or "I think rates could go to 6% by next year". We still stand by our thesis that month-over-month inflation will abate by the summer, and rates will settle in the 2.0-2.5% range by year end with the Fed becoming more measured in their narrative, with an ultimate goal of 2.5%-3.0% rates. With a current flat yield curve of 3% and 30-year mortgage rates at 5.5%, this 3% target seems to be built into expectations. But this is only what we think should happen and not what will happen. The market is clearly betting that what will happen is that Fed will crash the landing. Our personal belief is that the Fed is data driven and the inflation data will get better leading to slower rate hike cycle in the fall.

A key current debate concerns how much the Fed can do given much of the inflation is supply driven vs demand driven. The Fed's actions are designed to halt inflation by tapping down demand. But it has no control over the supply chain issues and employment mobility that is largely responsible for today's inflation. Going from a six-month waiting period for a car to a four-month waiting period isn't going to get Ford to lower pricing for an F-150! This is why the market is rightfully concerned that the rate hike cycle will not be able to cool prices even if it slows demand, and the Fed could find itself "pushing on a string", which would result in the dreaded stagflation scenario.

That the Fed always wants a "soft landing" would suggest a more measured rate hike cycle and a hard look at the monthly data to give an excuse to slow it down. But the consensus is that the Fed will overshoot the mark and that there is a good chance of a recession. We would also note that the financial markets are increasingly psychologically emotional in times of stress and that the click-and-trade incentivized media never helps matters. A 40% chance of recession sounds much more ominous than a 60% chance of no recession.

SECTORS GRABBING OUR ATTENTION

This brings us to the interest rate sensitive housing sector. The rise in mortgage rates is shutting down the existing home market and mortgage refinancing, which accounts for most of the mortgage application market that CNBC likes to highlight as a presage to a housing collapse. A contrarian thesis is that these rising rates have played right into the hands of the homebuilders in the near term. Homebuilders, scarred by the housing crisis, have been underbuilding for more than a decade, causing an acute shortage of new homes built, exasperated by supply chain shortages. Homebuilders are still reporting strong results, strong margins, long backlogs, and minimal cancellations. While prices are likely to cool off causing some margin compression, the problem remains: if you own a house and try to sell it, you still need to buy a new one in a tight supply market, and you need to trade in your 3% mortgage for a 5.5% mortgage – few people are going to do this unless forced to by a life event like moving cities (for job or tax reasons) or divorce! With some homebuilders trading 30% below book value and less than 4x current/peak (?) earnings, we are at trough valuations two years before a possible trough. We would point out that homebuilders appear to be more protective of their book value and margins than they were in 2007, turning away long lead time new orders to ensure healthy profit margins and utilizing land options rather than holding too much land inventory on their books. Even if builder earnings drop 50% in the next several years (We don't think they will), as long as they can improve book values, these stocks look like "no brainer" buys, even if we are early on the investment. We have started buying select homebuilders in the last six weeks.

The other sector that has been oddly painted as rate sensitive is the former "can't lose" Software-As-A-Service (SAAS) space. This is perhaps because zero rates were viewed as an excuse for sky high valuations last year, so that thesis has been reversed. It may also be because they have all been bucketed in the hated "COVID beneficiary" camp. The WCLD cloud computing ETF is off over 45% (!) from its November highs after rallying 35% last summer. In a market that has seen the recession "flight to safety" trade benefit low growth staples and utilities, why should the market turn against the SAAS sector, which is effectively a collection of utilities with monthly billing, unregulated pricing, above average growth, and clean balance sheets. While valuations largely deserved to come down, owing to circa-2000 tech bubble highs, there is a point where these business models should be recognized for the durable and secular growers that they are. For us, that means 20x earnings or 5x sales (representative of 20x the 25% after tax earnings margins a good SAAS business should be capable of at a 10%+ growth rate). Even in most dire scenarios, we would expect Salesforce.com's earnings to outgrow that of Proctor & Gamble over the next 15 years.

One area of market strength we have not invested in, to our detriment, is the defensive staples. While recession resistant in nature with some pricing power, watching them experience 20%+ multiple expansion without any material increase in forward expectations doesn't seem right in a rising rate environment. Many of these stocks have gone from 52-week lows to 52-week highs in the past eight weeks in the flight to defensives. During recessionary times, we would expect better business performance out of this group as their businesses are resilient and an expectation of lower rates to end a recession should rightfully help these stocks, but this isn't the case today. In a market where the narrative has moved away from "long duration assets" (meaning that you need to hold for a long time before you earn 100% of the market value of the business), paying over 20x earnings for low growth Walmart, Colgate or Coca Cola is a very long duration investment. We would suggest that Microsoft, Google, and Amazon are likely to earn back their market values in a shorter time frame.

STOCK FUNDS HIT BY COLLATERAL DAMAGE (FUNDAMENTALS INTACT/VALUATIONS LOW)

Most of our companies still expect 2022 to be better than they were thinking six months ago. Could their prospects deteriorate in 2023? This is possible, but far from certain. Some of our stocks are growing at their healthy pre-COVID rates but are being treated as pure-COVID beneficiaries. We have seen a significant “guilt by proximity” problem whereby COVID-benefiting competitors imploding around our companies have dragged them down by association. We have seen several companies suffer precipitous drops immediately following competitor misses and warnings, while, thus far, our investments’ growth prospects remain undiminished. Our biggest loss last month was a pre-clinical pharmaceutical contract research firm that was down 40% (!) in large part because a competitor has warned twice in the last several months, with each warning causing a 15%+ one day drop in our investment; our company beat earnings estimates and has seen four insiders purchase shares since mid-February which triggered a short lived 25% rally in the stock; we think management has greater long-term designs on the stock than six weeks!

To cite a more familiar example, it has been illustrative to watch portfolio holding Walt Disney, a mega cap that should be providing stability in uncertain times, fall 20% last month largely because Netflix is losing subscribers. Streaming is still a small part of Disney’s business and accounts for none of the business's earnings. Meanwhile, the Parks segment is booming with extended lineups in expanded parks during off weeks despite record high pricing (apparently the “everyone will be spending money on travel” thesis doesn’t apply to Disneyworld and Disneyland). Disney had 27% corporate-wide operating margins pre-Disney+ and will likely achieve that level again once the streaming platform is built out (Disney+ margins should settle at a similar level to Netflix’s operating margin, if not better, given its focus on less but higher quality established franchise content). At an eventual 25% operating margin, Disney can earn in excess of $10.00 per share by 2025, way above current street expectations. Within several years, Disney will be reduced to Experiences (Parks and Cruises) and Content (streaming and movies) with obvious cross-capability synergies; its current treatment as a streaming company independent of financial results is a narrative that can change quickly.

We accept that general multiple contraction has caused some weakness in these stocks, but some of the moves we have seen are beyond extreme given that we try to be mindful of not overpaying for growth in order to avoid extreme share price declines owing to valuation compression alone. Thus far, we have only had a handful of companies report their earnings for the first quarter. We have been pleased with the results and they were well received by the market. As earning season closes out over the next few weeks, we believe that we should see an increase in the number of potential doubles from these levels and that the current environment is opportunity rich for hunting for outsized gains.

INCOME FUND HIT BY RATES, CONVERT/ARBs (BUT FORWARD YIELD IS THE BEST IN YEARS)

Our Income Fund has been hit with the bond markets. The convertible bonds, we had been so fond of, have suffered from the falling stock and bond markets, where the fall in “risk-free” government bonds has created a higher benchmark for yield for even net debt free company bonds. We have started to shift back to higher coupon issues as we would rather get our investors the monthly coupon if the yields to maturity for “normal” bonds and convertible bonds are equivalent. That said, if we see a “chance to convert” or a potential takeout target (which would send a discount bond to PAR), we are holding onto the convertible bond. The yield to maturity of the portfolio is approximately 8% now with a current annual coupon yield of 6%.

We would point out that the high yield bond market has fared considerably better than it did during the last two market meltdowns. This is largely because today's weak markets do not pose an existential risk to businesses, as they are largely interest rate and comparative return driven. Generally speaking, no one is expecting widespread bankruptcies this time around, unlike the early days of COVID or the financial crises. What makes this correction different is that it is being led by Fed’s expected increase in interest rates. This has driven government bonds significantly lower vs the “flight to safety” rise in government bonds that accompanied the last two crises. Instead of competing on the basis of safety/quality, this time around the corporate bond market is competing on absolute interest rate returns.

If there is one area of enhanced risk in the corporate bond market, it lies with the credit of private companies. Private equity historically flies close to the sun when it comes to leverage and often takes on enough debt whereby the interest expense wipes out nearly all the profit of the business. Any slip in business prospects (revenue slow down or cost inflation that cannot be pushed through), coupled with higher rates on maturing debt, could be catastrophic and result in sponsors abandoning their companies to the debt holders which tends to only benefit the first lien lenders, generally term loans and not bonds. Public companies, in contrast, have easier access to equity markets to refinance their balance sheets to the dilutive detriment of the equity holders. We have shifted our own bond holdings accordingly to avoid this risk.

This is the fourth time we have gone through this exercise. The first was the financial crisis in 2007-2008. The second was the final quarter of 2018 when the Fed hiked rates from 1% to 2.5%. The next was COVID and now we have a Fed rate hike cycle again. But we would note that, after ten years of relative calm, there have been three major market checkbacks in the last four years. Historically, these have always been great opportunities for us, but every downturn has its unique characteristics and have called for different strategies. Even this current one saw the Russian-Ukraine conflict benefit commodities while negatively impacting an already precarious inflation and supply chain situation. This happened at a time when a post-COVID reopening economy was set to loosen the supply chain constraints through year end. That said our 12–18-month outlook still calls for a fall in inflation, a reopening economy, supply chain relief, and a hopeful resolution in the Ukraine. Let’s hope the Fed doesn’t muck it up.

We reserve the right to change our mind!

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