HARD LANDING? SOFT LANDING? MAYBE JUST A FAST LANDING?

HEDGE FUNDS (Inception)	JUNE 2022	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-14.7%**	**-40.1%**	**8.4%**
Venator Select Fund (September 2013)	**-22.8%**	**-55.4%**	**6.0%**
S&P/TSX Total Return (March 2006)	-8.7%	-9.9%	6.0%
Russell 2000 (March 2006)	-8.2%	-23.4%	6.8%
S&P Toronto Small Cap (March 2006)	-13.4%	-14.2%	2.5%
S&P 500 (March 2006)	-8.3%	-20.0%	9.0%

ALTERNATIVE MUTUAL FUNDS (Inception)	JUN 2022	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-5.2%**	**-14.7%**	**-14.5%**	**0.3%**	**2.2%**	**5.6%**
B of A Merrill Lynch High Yield Index (August 2008)	-6.8%	-14.0%	-12.7%	0.0%	2.0%	4.4%

** As of June 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*

The worst start to the year, in broader markets, has been awful for our funds for a variety of reasons. The Income Fund has tracked the broader high yield index. A combination of modest leverage and the collapse of the convertible market (owing to a combination of a decline in the underlying stocks and an increase in the short-term risk-free rate) offset by the shorter duration of our bonds has led to this result. Running screens weekly, we continue to trade into more high coupon opportunities and have positioned the portfolio to a 10%+ forward yield.

On the equity front, the situation has been far more disappointing. Historically, we don't time markets or buy into "fads" unsupported by fundamentals (we stayed largely on the sidelines when it came to cannabis, crypto, excessive sales multiples in tech, and EV startups). We think this keeps us level-headed through ups and downs as we don't feel a need to keep a finger on the panic button since we don't own anything we see as "doubling in six months but dropping 90% in two years". In the broader market selloff, this has given us a shorter-term "false sense of security" as even our cheapest stocks have found their way to mid-to-low single digit earnings multiples – a stock that goes from 10x earnings to 7x earnings is still down 30% (for example, portfolio holding Wesco, expected to earn $14.60 this year, recently dropped from $145.00 to $105.00 in a "no news" week!). Furthermore, our companies have exceeded street expectations in a market full of high-profile misses, which, when combined with incredibly attractive post-market correction valuations, has kept us invested in these increasingly attractive investments. Compounding the issue is that our option-based hedge strategy has underperformed. This is because the strategy requires volatility, occasional reversals, to fully perform, and the market has gone straight down for six months leaving "premium" drag vs the net exposure of the portfolio.

These disappointing results are the result of overall market weakness and unfortunate sector allocation (no energy or defensive staples) combined with historically high in-sector correlations (sectors matter, companies don't in today's market). Four of our biggest "losers" of the year mentioned in previous letters (RingCentral, LoveSac, Uber and Inotiv) are lapping their competition with over two-times the growth of their competitors. But, with current valuations well below the comparables because of extreme declines in their share prices, they are given no credit for this performance and the market seems genuinely uninterested in what is causing this outperformance. We believe our investments represent great opportunities in that the companies have gotten better/stronger while their valuations have become much cheaper. For example, one earlier stage investment, a Canadian company called Nanalysis, recently announced a multi-year government contract that nearly doubles the size of the company to over $50MM in revenues, yet the stock is down over 20% this year!

WE DON'T HAVE MUCH TO OFFER IN TERMS OF STRESS RELIEF FOR OUR DIFFICULT START TO THE YEAR, BUT FOR A LIMITED TIME - INVESTORS WHO WISH TO INCREASE THEIR HOLDINGS, OR HAVE ALREADY INCREASED THEIR HOLDINGS IN 2022, CAN DO SO AT THE BEGINNING OF THE YEAR HIGH-WATER MARK. THIS MEANS INVESTORS WILL NOT PAY AN INCENTIVE FEE ON ANY NEW INVESTMENTS UNTIL WE ACHIEVE THE HIGH-WATER MARK SET AT THE END OF 2021.

THIS "RECESSION" WILL BE TIMID RELATIVE TO THE LAST TWO

Each bear market has a different trigger, and each has different impacts and durations. The way out of the last two, being the financial crisis and COVID bears, was simply an expectation that "the world isn't coming to an end". You looked for cheap stocks without solvency risks, rotated into them, and waited for the market to "calm down". Those were difficult times but yielded great opportunities. COVID would result in 90% drops in revenue for many companies and refinancing requirements, and the financial crisis was even more tenuous because credit markets shut down completely. The current bear market might feel like the world is coming to an end, but it isn't. Higher interest rates (even if rates hit 3%, this isn't very high by historical standards) and a growth slowdown does not pose an existential risk to most businesses or earnings. While the Bear narrative is now shifting to negative earnings revisions, creating a false sense of security around lower valuations, we would note that in 2009 the S&P500 broadly missed earnings expectations of $95 on the way to a $69 actual result, while returning 25%+ that year – sometimes bad earnings are implicitly built into the market expectations.

We would note this time is different in that the Fed is raising rates into a bear market/potential recession – something that has never happened before. But this is because it isn't trying to rescue the market from an existential crisis (9/11, financial crisis, COVID). The news cycle of the moment is highly concentrated on inflation and central banks' global response of rising interest rates. Rising rates are normally the tool to slow inflation by slowing demand. The problem this time around is that inflation has been a supply driven problem, so cooling demand isn't necessarily the best route to inflation destruction, which may very well take care of itself.

We wrote about the potential for supply driven inflation last spring after hearing companies talk about materials and shipping availability. (May 2021 Review: "Our own suspicion is that official inflation data is going to start to look somewhat worrisome as we move to year end, which could result in some not-so-friendly market commentary by the Federal Reserve regarding potential interest rate actions in 2022"). Nearly all product inventories were experiencing elevated costs throughout a scarce supply chain, whether it was at retail or for PVC pipe for industrial distribution. Boats, RVs and furniture had six- month plus backlogs. Employment shortages were rampant, as houses and construction were taking twice as long to build. Cars couldn't be built due to a lack of semiconductors from Asian shutdowns. It was everywhere and all at once.

Today, nearly all these inflationary situations are reversing fast. As with last year when we saw these issues six months before official numbers reflected them, this situation will take a bit of time to work through the system, but we suspect that that this deflationary impact will start becoming apparent on a month-over-month basis when July/August numbers are released. As Chairman Powell recently noted, when asked how the Fed is "going to bring prices down", the Fed's goal is not to bring prices down, if they stop going up, inflation goes away. Some deflationary items of note:

- Housing prices have leveled off/are starting to fall owing to higher mortgage rates and media headlines screaming "don't buy now".
- Used car prices are falling as well.
- Copper prices are 25%+ off the highs, which has a wide impact.
- Lumber is 50%+ off its highs, which will help housing/construction/furniture costs.
- Natural Gas (in North America) is 25%+ off its highs. Europe is in trouble (owing to Russian supply), but domestic storage is building towards seasonal norms.
- Oil is 10% off its highs, with the North American rig count (future production) rising in the current price environment - look for production growth, possibly into demand destruction, as we move towards year end.
- Shipping container spot rates are 50% off the highs, which helps all imported goods.
- Cotton is 25% off the highs – good for apparel.
- Retailers are stating they have too much inventory and are starting to return to their promotional/sale cadence.
- Wheat and Corn are 20%+ off the highs.

How can this play out near term? We think the Fed is committed to 50-75bs in July on route to a 2.5%-3% "neutral" rate. It's possible some of these deflationary inputs start to show in the July data, so you could get an "it's working" narrative on interest rates next month. But we suspect that it's the July numbers (released in August) that will start to show a major inflation slowdown (note that month-over-month is what matters here, year-over-year will still look bad) and with no Fed meeting in August, the September report will give us two months of lower annualized inflation between Fed meetings. At this point, you could have a combination of subdued inflation, a slowing economy (or recession), a bear market and midterm elections – we think the Fed signals it's either done or almost done at this point. With the Fed funds rate expected to be halted at 2.5-3% at that point, US mortgage rates will likely move back down to 5% (assuming the yield curve remains relatively flat, the historical spread between mortgages and treasuries is 2%) which will reignite housing market activity even if prices remain subdued, reinvigorating the consumer. With an endgame on interest rates, growth for those still growing with profit discipline should be back on the investment table (with apologies to former nosebleed multiples and high cash burners – those will likely not come back to former levels anytime soon).

Getting practical about the lower input costs mentioned above, we will once again reference LoveSac, our sectional sofa innovator (who last month reported 55% order growth, while nearly every other home furnishing retailer is negative order growth). Outside of labor, major cost inputs include lumber, cotton, shipping, advertising, and rent. All these factors are working in its favor so that, according to management, if they were accounting/selling on a last in/first out basis (as opposed to the more typical first in/first out basis), gross margins would improve from 50% currently to 65%!!! All else equal (which it wouldn't be because they would likely pass on some of these savings to their customers) this would take projected EBITDA margins from 11% to 25% and EPS from $3.30 to $7.75. We suspect several companies will have the potential for similar gross margin improvement, even as sales slow owing to similar factors.

TOUGH TO TIME THE BOTTOM, BUT IT'S LIKELY TIME TO BUY

Our biggest mistake this year (aside from thinking we could side-step our own warning about inflation and a rise in interest rates through avoidance of elevated valuations and interest rate sensitive sectors) was assuming that great companies that maintained their greatness would be fine, or at least their stock prices would be if we bought them at reasonable valuations. We suppose it's a mistake we keep making and will always make because, historically, these companies eventually reach new highs to the extent they push forward through cycles. We have little doubt that nearly all our companies will be experiencing record revenue and profits within two years. We try not to own stocks of companies which have no control over their own financial destiny (this is part of the reason we historically have not been overweight commodity companies), or companies that ride the economic cycles with near GDP-growth rather than doing something special on their own path (GDP++ growth). Our companies continue to perform as evidenced by their financial results and guidance exceeding expectations. But the shorter-term fate of the stocks of these outliers is the same as their competitors, who are imploding around them. No one is asking "why" these companies are doing so well against faltering competition, everyone is just trading them down with the competition, with the market simply assuming no differentiation between companies and giving no consideration to what makes them (and their financial results) unique.

We don't believe that markets can be successfully "timed" through multiple cycles, we just look at whether investment opportunities are cheap or expensive relative to a macro/sector outlook and shift asset allocation accordingly. We have been stunned by our stocks' declines this year given that we thought we had avoided super-cyclical businesses, speculative early-stage businesses, businesses without a near-term outlook for profitability, bubble-like valuations, investment fads, and companies that received outsized temporary growth from COVID.

With many of our stocks down substantially, despite undiminished prospects (many of our companies have recurring revenues, reoccurring revenues, or extended backlogs), our portfolio looks as inexpensive as we have seen since 2006. Note, this is based on prospects, rather than hindsight. With hindsight, both 2008/9 and 2020 were cheaper given that the world seemed like it was coming to an end, which is not the case today. Financial institutions are not at risk of bankruptcy this time around (except crypto-related banks, if you can call those banks in the traditional sense), and no one expects to see 90% year over year revenue declines as we did with COVID (restaurants, hotels, movies, retailers, airlines). If the labor market is going to be weak, an uptick in unemployment from 3% to 4.5% is minor compared to those two events.

The so-called "margin-of-safety" is high right now. You can find select homebuilders at 0.5 book value and 3x earnings – even if earnings fall, there is still a lot of upside to book value (even if land value goes down 30%!). You can buy construction and industrial distributors for less than 5x earnings. You can find the occasional 20%+ growth company at 5x-10x earnings.

Some copper stocks are trading below 0.5x net asset value. While we realize that some earnings expectations could come down, these valuations provide a good buffer for companies that are currently operating with sustainable margins and have pricing power.

Regarding our Income Fund, the current yield-to-maturity is now over 11% due to some tax-loss harvesting of our convertible bonds and switching into some higher yielding securities (for homebuilders' balance sheets, land value would have to drop over 60% for the debt to be at risk in many cases). With terms to maturity mostly less than six years, there is limited interest rate duration risk. All the companies in the fund are public which gives them added security in terms of refinancing debt when the bonds we own mature. While we are utilizing some leverage to achieve this yield, we note that approximately 20% of our investments mature within 18 months.

We reserve the right to change our mind!

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