THE WORLD ISN'T COMING TO AN END (ALTHOUGH IT'S PRICED TO)

HEDGE FUNDS (Inception)	SEPTEMBER 2022	YEAR-TO-DATE	ANNUALIZED
Venator Founders Fund (March 2006)**	**-9.8%**	**-39.2%**	**8.4%**
Venator Select Fund (September 2013)	**-14.7%**	**-53.4%**	**6.3%**
S&P/TSX Total Return (March 2006)	-4.3%	-11.1%	5.8%
Russell 2000 (March 2006)	-9.6%	-25.1%	6.5%
S&P Toronto Small Cap (March 2006)	-7.1%	-16.3%	2.3%
S&P 500 (March 2006)	-9.2%	-23.9%	8.6%

ALTERNATIVE MUTUAL FUNDS (Inception)	SEP 2022	YTD	1-YR	3-YR	5-YR	10-YR
Venator Alternative Income Fund* (January 2020)**	**-4.5%**	**-14.6%**	**-14.0%**	**0.3%**	**1.9%**	**5.1%**
B of A Merrill Lynch High Yield Index (August 2008)	-4.0%	-14.6%	-14.1%	-0.7%	1.4%	3.9%

** As of September 30, 2022*
*** Venator Founders Alternative Fund, which holds the same securities as Venator Founders Fund, is 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 Fed-induced market rout continued in September, which impacted global markets across the bond and equity spectrums. For the third month in a row, our own Funds gave up strong starts as the Fed commentary cooled any goodwill achieved through strong earnings. The economy is too strong, or so says the Fed, and we need to crush it. Too many people have jobs, demand is so high that people are willing to pay higher prices, borrowing costs so low that people are willing to borrow to buy and corporations to expand, housing prices must come down. The Federal Reserve appears to have lost all sight of leading indicators for the last two years and is squarely focused on lagging data. Even its own actions, an unprecedented thrice consecutive 75bp interest rate hike, should take time to work its way into the system, along with collapsing commodity prices, imploding shipping prices, a normalizing supply chain, and currency impacted lower import prices in the US. But if it didn't work in the two weeks between the last hike and the monthly CPI report, then let's go for another 75bps!!!

After a high headline but benign "core" inflation report for July, the August number flipped the script with a benign headline but high "core" inflation report. Our personal belief was that August numbers would show a second consecutive month of low core inflation and even lower headline inflation (thanks to energy prices coming down, which stopped this year's best subsector short of reaching its 2008 levels), but that wasn't the case. We still stand by our earlier prediction that month over month inflation should be near-flatlining into the fall, and that the inflation battle should turn into a "best of three" wildcard series (July/August/September) and hopefully not a "best of seven" series stretching into December. The one core inflation number that we don't see providing much relief is rent. Raising interest rates from 1% to 4% isn't making mortgages any cheaper and those costs will have to be borne by renters. If rent is the last inflation bastion standing, the Fed may have to reconsider their hike velocity sooner than expected (note that while Powell said that we shouldn't expect an easing of rates any time soon just last month, the "dot plots" released this month show the opposite with a willingness to lower rates below 3% once the inflation problem is solved).

Outside of cash, the safe havens have not proven safe. An inflation adjusted 8% loss on cash has been the "winner". Staples (i.e., Proctor & Gamble, Coca Cola), Grocery/Food, Gold, REITs, and GOVERNMENT BONDS, all joined the rout. A 10-year government bond has cost you 18% this year, and a 30 year has cost you 30%. Even a five-year government bond has cost you 10% this year and that's about as safe a loan as you can make. For REITs, a historical safety trade, the situation might be quite dire. All REITs "look the same". Proportionately, they all have $1B in equity, $1B in debt and a $60MM dividend. Over the next five years, as debt matures and refinances, the new cost of debt is likely to be reset 3% higher. Simply stated:

3% of $1B equals $30M – or half their earnings. This is the problem with higher interest rates meeting a desire to stall rental prices.

THE BIG DIFFERENCE THIS TIME: THE WORLD IS NOT COMING TO AN END

This is our third crash (personally it's my fifth if you include the 2000 tech crash and the 1998 Long Term Capital fiasco). The previous two, 2008 and 2020, were notably different in several respects. The two most important distinctions are that a) the world isn't expected to end this time around and b) the Fed is raising rates into a weakening economy when it would normally be looking to lowering rates at this point.

On the first point, short memories may allow us to forget the very real threats to the global economies that existed in 2008/9 and 2020. In 2008/9, the entire financial complex was at risk of complete collapse. Major financial institutions either failed outright or needed the government to intervene in rescues or forced mergers (Countrywide, Lehman, Bear Stearns, Morgan Stanley, Merrill Lynch, Fannie/Freddie, Washington Mutual, Greece, General Motors, Manulife). Pensions were imploding, insurance companies weren't going to be able to payout policies, and houses were being abandoned because speculators couldn't afford the payments on third houses they should never had bought (renting wasn't the institutionalized market it is today). Bonds couldn't be refinanced, and default bankruptcies were a real threat across the corporate landscape. For investors the playbook out of this was to exploit the opportunities presented by the financial markets in "too big to fail". Think of IBM at 5x earnings. In some cases, you could buy companies trading below the cash value on their balance sheets like Skechers, which bottomed out at $4.00 when it had $6.00 per share in cash and $12.00 per share in working capital. In bond land, you were looking for bonds trading at 60c on the dollar with hard asset coverage that were set to mature near term. If you wanted to go further out on the risk curve, emerging growth companies, like Lululemon, traded at 7x earnings.

In 2020, far fresher in everyone's minds, the world was again coming to an end. Populations all over the world were living under house arrest. Government bailouts of businesses and individuals were the norm. And even with this help, many businesses faced a greater risk of bankruptcy than in 2008/9. Restaurants, movie theaters, retail stores, airlines, hotels, amusement parks and even hospitals were barely allowed to operate. A restaurant had to pay rent but could only operate at one-third capacity, and the government was paying people more to stay home than to go to work. There were two playbooks to outsized gains at the time. You could invest in the "work from home" themes, such as video calling (Zoom), internet retail (Amazon), and home improvement/furnishings (Home Depot). Or you could pick the survivors and take the plunge into beaten down retailers (Aritzia) and hotel companies that traded well below the franchise or asset values of the businesses (Wyndham Hotels).

In 2022, we have a unique situation in that the markets are acting like there is a crisis even though there is not. That there isn't one would suggest that the opportunity set is more widespread. Inflation is high, but we believe it will ultimately prove to be transitory (depending on whether you define transitory as six months or a year; we don't think it is "multi-year"). The Russian aggression staved off a return to normalcy, although much of economic fallout (apart from European gas price effects) has dissipated quickly. In energy, Russian exports only fell by 400,000 barrels (vs a 3-million-barrel expectation). Fertilizer prices, after an initial bump, have not sustained gains either. Finally, China is sending LNG to Europe, as the excess they have received from Russia is too much for them to use! The current situation is more like the tech bubble of 2000, where a minor rising rate cycle collided with a bubble in a specific sector of the market.

This brings us to our second point, that the Fed would normally not be raising rates into a slowing economy, and this is what gives rise to the "this time it's different" cries. To be fair to the Federal reserve, sub-1% should be reserved for calamitous events such as 9/11, the Great Financial Crisis, and COVID-19 – the last three great cut cycles. The economy was rebounding as of last summer, and they should have taken the opportunity to gradually move rates up to 3% over 18 months instead of going from 0-4.00 in ludicrous mode. Give people a little time to decide if they want to pay a 4%-5%-6% mortgage rather than pricing them out in two months, especially in a market where supply is tight already and where 30-somethings need houses. Forcing people into the relatively new institutional single family home rental market is not the answer to the housing supply crisis. Raising rates into a weakening (even if still strong) economy is somewhat unprecedented.

THE GOOD NEWS

Considering the coordinated actions of Central Banks around the world and the ongoing conflict in Europe, we suppose the conclusion of "the world is not coming to an end even though it's priced to" will have to suffice. At the very least, that's enough to make us believe that things will be OK, that great companies can still be great stocks, and we should see the same great value = great opportunities paradigm that financial markets have been enjoying for over 100 years. But a few more specifics are probably in order.

In a vacuum, I5% interest rates are not an absolute impediment to "growth multiples". Indeed, most of the bull market of the 1990s happened with rates between 5-6%. The market is trying to figure out which companies did well, partially or completely, because of the favorable rate environment of the last 10 years. Once it becomes apparent who the real great ones are, those companies will separate from the pack.

There is no wave of bankruptcies coming. Most companies can survive a slowdown. Some will clearly be in better shape than others. In oil and gas, the past year has given them a wonderful opportunity to repair their balance sheets through debt paydown in a previously over levered sector, even as prices retreat to pre-Russia-Ukraine levels. For other companies not as fortunate, the opposite is true. If you have too much debt and too little free cash flow, the likely refinancing of debt 3% higher over the next five years could be materially problematic, Value-to-EBITDA be damned. Sidenote: this will be especially problematic for many private equity holdings that have little-to-no free cash flow after interest payments.

Negative earnings revisions are coming but that doesn't mean stocks are going down. This has been a consistent commentary by the more pessimistic market forecasters. Higher rates, a stronger dollar and a likely recession equals negative earnings revisions, which means stocks will go down. How soon we forget (or don't bother to look up). Most recently, 2020 earnings were a disaster that missed expectations by one-third, but the market went up nearly 20%! Going into 2009, the S&P500 "bottom up" (analyst forecasted) earnings estimate was over $90.00. By the time 2009 was done, earnings came in under $57.00 (a miss of over 35%) and the stock market rallied 26%. The market even rallied a further 15% in 2010 when earnings still failed to clear the $90.00 bar! One would like to think the market rallied because the P/E got too low, but the truth is that it finished between 18-20x earnings in both years (a bit above where we are now).

Bond Yields are offering compelling (recent) historical return potential. *Our own income portfolio is currently yielding over 10%.* High Yield Bond yields have moved up faster than any other time in recent history, excluding 2008 and 2020. Total 12 month returns on high yield bonds have historically ranged between 7%-17% after such a violent move. We have seen some very high yields for what we would characterize as some very safe bonds. One of note is Forestar, which is the land ownership feeder and spinout from DR Horton, the number one homebuilder in the United States. Most of their land is pre-2020, so it is very likely worth more today than what is being carried on the balance sheet. By our own estimation, this land would have to drop by over 50% for the bonds to be impacted (remember this is largely land selected by the premier homebuilder in the world for future development). These bonds yield over 9%; they aren't government bonds, but they are damn close in our estimation.

"In the real word, things generally fluctuate between "pretty good" and "not so hot". But in the world of investing, perception often swings from "flawless" to "hopeless" – Howard Marks

We think this quote sums up the last twelve months pretty well. It's amazing to think that a year ago, people thought that a zero-rate growth environment would last forever and you couldn't pay enough for 2030 estimates, even if the product hasn't been developed yet. That money losing start-ups were worth billions. That money making growth companies were worth 30x revenues. That high yield bonds were priced below 5%. That people bought near zero yielding 30-year bonds. That some foreign bonds carried negative interest rates. That meme stocks and worthless meme-cryptocoins were worth billions.

Today, the market thinks that interest rates of 4-5% are the harbinger of doom. That a less than two-year retreat in housing prices will destroy household spending, even though the vast majority of homeowners have their mortgage rates locked-in for 30 years in the US. Today, the market thinks prices must come down for inflation to come down (you don't need deflation to get rid of inflation, just a year of flatness). Microsoft's growth rate of better than 10% isn't good enough anymore even though Proctor & Gamble's 2% growth rate gets the same earnings multiple. Stock charts rule and fundamentals have been devalued. It's easier to look at a chart for 10 seconds than to study the notes to financial statements for an hour, and that's a big reason why stocks can be incredibly volatile, often in the opposite direction of

fundamentals, if they happen to find themselves with the wrong comp set. That markets have declined, while earnings estimates have held up, is informative. Stocks have underperformed their earnings growth, and that is a market ripe with opportunities (even if earnings were to miss expectations by 5%-10%).

Obviously, this market was not the one we bargained for back in January. While in many cases, our companies have had better years than we expected, this, along with reasonable valuations, has provided little defense against an aggressive bear market. Having, in some instances, the only companies to exceed expectations in their sectors has been a poor defense against overwhelming negative sentiment. As in 2008 and 2020, we are always looking to cycle into better upside opportunities as stock prices and bond prices decline, and this time is no different. Sometimes the best forward opportunities are in stocks we are already positioned in (we have one company currently sporting a 40% growth rate that is at 3x expected forward earnings), and other times we need to move out of existing holdings and move into better opportunities as the portfolio is always evolving. While the market is acting like its 2008/2020, the reality just isn't that bad – in that sense "this time is different".

We reserve the right to change our mind!

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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