SIX MONTH REVIEW:

BE CAREFUL WHAT YOU WISH FOR…

Firstly, August was a good month for the fund, which was up 7.4% in a good market for small caps. We continued to benefit from a good earnings season, and remain confident that several of our stocks should continue running up as their market exposure increases over the next several months. The end of August marks the end of a difficult first six months for the fund, which showed a small gain of 4.6% since inception on March 1. In other words, we are only narrowly meeting the first of our three goals of "*Preservation, Appreciation, Performance*". When you start a fund you are essentially hoping for two things: a) the market goes down and b) you go up. This is the best way to differentiate the fund and raise some capital. With regard to our area of focus (industrial small caps) this has been the case so far with the fund showing positive performance during a negative period for small caps. After six months, we are quite confident in the funds' positions, make-up and strategy after several months of finding our footing. This being the case, we are offering a more comprehensive view of the fund than usual, so you can get a better understanding with regards to how your money is working in the current market environment.

<u>Benchmarking</u>:

As you may know, our real benchmark is 0%; either we make money or we don't: NO EXCUSES. That being said, we know that many of our investors are expecting us to do better than the TSX (because we are Canadian), while a number of our investors are expecting us to outperform the NASDAQ (due to my history in technology). However, neither of these are particularly accurate benchmarks, especially the TSX:

- **TSX**: the TSX index is over 70% weighted to financials and resources. We have close to zero net resource weighting and no financial services weighting. The TSX is not a well diversified index (and the Canadian market is not a particularly diverse market in general); we like to think of the Founders Fund as offering a good diversification option for Canadian investors.
- **S&P 500**: This is a little better, although still not hitting the mark. None of our long positions are large enough to be included in this benchmark (although some of our short positions are).
- **NASDAQ**: Getting pretty close here by virtue of an overweighting in technology (52%; we are not quite that high), yet still diversified by industry with a relatively low weighting in resources (2%). However, this is still a market cap weighted index, disproportionately leveraged to Microsoft, Intel, Dell, Cisco, Oracle, Google, Ebay and Qualcomm. Again, we are not large cap investors, nor do we necessarily look to overweight technology.
- **Russell 2000**: Now we're talking. The Russell 2000 is pretty close to the mark as a highly diversified index of companies ranging in market cap from $200MM to $2BB. This is still above our sweet spot, but it tracks overall small cap sentiment.
- **Russell Microcap**: As good as it gets! Highly diversified with 2000 companies (the smallest 1000 in the Russell 2000 plus the next smallest 1000 companies). Market caps ranging from $60MM to $600MM. Indicative of "under the radar" (and likely illiquid) opportunities that we find ourselves invested in.

That being said, we need to take into consideration that the Fund tends to be 20%-40% short as well (which suggests that our performance should approximate 66% of the index performance); while we like to think we are going to make money on the majority of our short positions, we also short companies to “hedge-out” market specific risk as well. We also need to consider that approximately 50% of our positions are Canadian non-resource microcaps, for which we can’t find a benchmark.

This brings us back to our original point: that there is no perfect benchmark given the make-up of the Fund, although the Russell Microcap can give a sense of overall market conditions for about 50% of the portfolio. Over the short-term, it is very difficult to escape the weight of the overall market, but over the longer term, we expect our companies to differentiate themselves as excellent investments. We have charted our monthly performance below against the aforementioned benchmarks for your review:

VENATOR FOUNDERS FUND PERFORMANCE													
	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	2006
TSX			3.6%	0.8%	-3.8%	-1.1%	1.9%	2.1%					**3.3%**
Russell 2000			4.8%	-0.1%	-6.4%	1.3%	-3.2%	2.9%					**-1.2%**
Russell Micro			4.5%	-0.6%	-5.8%	-0.4%	-3.6%	2.6%					**-3.6%**
S&P 500			1.2%	1.2%	-3.1%	0.0%	0.7%	2.0%					**1.9%**
NASDAQ Comp			2.7%	-0.6%	-6.4%	-0.3%	-3.7%	4.4%					**-4.2%**
Average			*3.4%*	*0.2%*	*-5.1%*	*-0.1%*	*-1.6%*	*2.8%*					*-0.8%*
Venator			**0.9%**	**6.7%**	**-2.8%**	**-9.2%**	**2.4%**	**7.4%**					**4.6%**

As can be seen in the above chart, the past six months have not been kind to small caps. We also had a disastrous June (more on that later), which didn’t help. Overall, while the fund is up slightly, we are still below our “high watermark” of $10.77, meaning that some of you are in the red, and we won’t be satisfied until all of our investors are comfortably in the black.

Portfolio Concentration:

There are many schools of thought on this topic and we are admittedly still trying to find the right mix. We know of one fund manager that just owns four stocks! We know another that has a goal of finding the top 10 stocks and just go with a 10% weighting in each. Yet another considers anything more than a 2% weight in a single position to be too risky. Finally we know of another very successful money manager with over 150 positions based on the theory that if you are confident you will make money on it, you make room in the portfolio.

Of course, this doesn’t take correlation into consideration. You can have 50% of your portfolio spread amongst 100 oil stocks, but in the end you would have 50% of your money riding one thing, oil (or gold, copper, homebuilders or any other highly correlated market sector or commodity). In Canada, many people think they have diversified portfolios, but in reality have all of their money riding on maybe four investment segments: energy, metals, financials, and income trusts (actually two segments: resources and interest sensitive investments).

Our Fund is probably too diversified, in my opinion. We categorize our weightings based on the following criteria:

- **2-3%:** This weighting would generally be considered a “starter position”, a “middling position”, or a “speculative position”. Roughly 35%-50% of the portfolio.

- **3-6%:** This would be considered a core position. This is our real comfort zone and represents roughly 35%-50% of the portfolio.
- **7-10%+:** This would be a "special opportunity". We have had three of these. Roughly 10%-30% of the portfolio.

I suppose that since we have gone to a 10%+ weight on three separate occasions, ultimately we would like to have the confidence that certain individual positions are so far above the crowd in terms of risk/reward that we can form on a highly concentrated portfolio. Therefore, ideally we would like to find 10 positions at a 10% weight each. Only time will tell as to whether we can find 10 such positions.

We aim to be 100% long at all times. Our philosophy in this regard is that if we can't find 20 stocks (out of over 15,000 in our target universe) that we think are going to go up regardless of the market environment, we just aren't looking hard enough.

Shorting/Hedging (including Market Timing):

We aim to be about 20%-40% short at any given time. The majority of our short positions are companies where we believe there are fundamental problems not recognized by the market. Other short positions will generally consist of "hedges" that offset long positions which we believe have good relative valuation characteristics (i.e. resource stocks, growth stocks trading in excess of 16x earnings). Occasionally, we may also bet against certain sectors where we don't have enough knowledge to bet against a specific stock, as we did with the US Homebuilders ETF earlier this year.

We may also use shorting as a market timing mechanism from time to time. This can be accomplished through raising existing short positions or by shorting broader market indexes. We prefer this to selling our long positions, which we believe will go up regardless of the overall market environment. It is important to note that when shorts go down, it creates cash for the fund (although in inverse is also true), allowing us to increase our long positions; for this added reason, we believe we have the right strategy here in terms of market timing.

A final note on shorting is that is has proven difficult to "borrow" stocks at reasonable rates (you need to borrow a stock from a holder before you can short sell it into the market). This has caused us to miss out on a number of promising short positions. Essentially, we are unwilling to short sell a security were the borrow exceeds 3%, or the borrow plus any dividend exceeds 5%, which has cut our universe down dramatically.

A Word on Volatility:

Looking back on the first six months of the fund, wish we had kept closer track of the day to day performance of the fund. When we launched, I was told by other fund managers to not let the volatility of the fund give me daily heart palpitations, and that daily moves in excess of 2% were "normal". While you wouldn't know it from the monthly performance figures (below), the Fund exhibits very little volatility on a day-to-day basis. I am going from memory here, but I would guess that in approximately 120 trading days, the Fund has maybe moved in excess of 3% once or twice, and has moved in excess of 2% less than 10 times; I would also estimate that the Fund moves more than 1% less than 65% of the time. Even the month of June, our wildest month thus far, was really just a long series of -0.5% to -1.5% days with very few "up days" in the month.

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Venator			0.9%	6.7%	-2.8%	-9.2%	2.4%	7.4%					4.6%

Interesting, the most volatile days in the market tend to be the most uneventful days for the Fund. The reason for this is because major up days in the market generally has the "fast money" scrambling to get in quickly on more liquid names, coupled with short covering, while generally ignoring less liquid stocks. This basically causes our less-liquid longs to do nothing, while our shorts move against us. If the Russell 2000 is up over 2% in a given day, chances are the fund is not doing particularly well.

<u>Market Commentary – Oil and Gas</u>:

As a public service, we are spending a little extra air time on this topic since many of are investors are so disproportionately invested in it elsewhere. Working here in Canada, it's impossible to "ignore" the energy market. Fortunately, after nine years as an analyst at Sprott Securities, I dare say that a little understanding of this market did sink in through osmosis. We are not averse to investing in this sector, however, for a number of reasons, we are not planning on significant investment in this sector at this time for a number of reasons:

- **Oil is cyclical**: the most experienced of resource experts say that you buy the resource when it is trading below the cost of production. While new oil pools are getting more expensive to extract (i.e. oil sands, deep water), they are still only at $30.00 per barrel. This suggests a new cyclical low for oil of about $30.00, well off of today's prices (but above prior cyclical lows of $12.00).
- **Gas is cyclical too**: There is logic behind the historic 6x-8x oil to gas price ratio. It relates to costs of extraction and rig rates. We believe that this ratio will likely be restored at some point, and that the current excess spread exists only because the "terror premium" doesn't seem to apply to gas to the same extent.
- **Supply and Demand appears "balanced"**: It would appear that oil inventories are at healthy levels, demand is stable, and OPEC (not the most trustworthy of organizations) seems to believe that the world is currently oversupplied. In the next five years we should see increased production out of Canada, Russia and Iraq. The fear of production shortages due to Middle East unrest will not likely go away, but we don't believe that such shortages would be long lived. Furthermore, if those bullish on the oil sands really believe that there is as much oil there as in Saudi Arabia, there should be no fear of long-term supply shortages whatsoever (an interesting paradox here: how do you believe in the massive potential supply of the oil sands and long term supply shortages at the same time).
- **Substitutions to the rescue?**: There is a truism in technology: it takes longer than expected to permeate society, but when it happens, adoption is faster than you thought. When I started using the internet in 1992, I thought everyone would be "online" by 1998; but it was the 1998-2003 time period that created near pervasive penetration. Digital cameras just completed the same cycle and HDTV is currently undergoing a similar cycle. In a similar vein, while electric cars and fuel cells appear to be coming on rather slowly, we imagine that in 15-20 years we will hit a point where the vast majority of automobiles sold will be "alternative energy" vehicles (check out Lexus' new electric Tesla with a 250 mile range, 0-60 in four seconds, and a top speed of 130mph to see how far this technology has

come). Within 5-10 years beyond the early adapter stage (which can last a while, we are assuming 15 years in this case), these vehicles will represent the vast majority of vehicles coming off the assembly line (the more sustained high oil prices are, the quicker this happens). Transportation represents 50% of oil demand, a proportion that is not expected to decrease by 2030 (source EIA).

- **Peak Oil, Peak Demand:** While some people think we are at "Peak Oil" production today, we don't subscribe to this theory. Increasing production from Iraq, Canada, Russia, and offshore sources leads us to believe we are not there yet, and that the skeptics, who point to "peak oil" in 2030, may be right. Transportation represents 50% of oil demand, a proportion that is not expected to decrease by 2030 (source EIA).If we are correct in our above comment that fuel cells, electrics and at least hybrids will start to dominate new car sales by 2025, "peak oil" supply could coincide with "peak oil" demand.
- **Where's the starting line?:** Let's assume that I don't know what I am talking about (which might not be a bad assumption), and everyone else is right in saying that growing demand from China and India will force oil prices up over time. I agree with this statement in that they will force *the cyclical range* of prices up. I am now on record (for what that's worth) as saying that the new cyclical low for oil is $30.00, way above historical cyclical lows. While the theory that oil prices will go up over time may be correct for all the reasons stated by oil bulls, you need to ask yourselves whether or not current oil prices are the proper starting point for that argument.

To be clear, oil is not my specialty. There are others that know the oil market better than we do. While we wouldn't dare try to pick the top of oil prices in either timing or levels, we are confident in our belief that we are closer to the highs than the lows on a forward basis. We are confident in the following statement:

Oil IS cyclical; it is NOT different this time; and the cyclical low is likely NEAR the $30.00 per barrel it costs to find and produce new pools.

It is also worth pointing out that most of the oil stocks we see are not cheap. While we hear people who clearly don't know much about oil come on CNBC and say they are overweight oil stocks because they trade at 10x earnings, they seemingly fail to consider that many oil companies have less than 10 years of reserves (and declining production profiles to boot). Most oil companies we see require $65.00 oil in order to be valued at 1x *undiscounted* net asset value (NAV, the total value of their reserves). In contrast, we are finding copper stocks that trade below NAV assuming copper prices of $1.10 with current prices over $3.30 (good luck finding an oil company trading below NAV based on $25.00 oil).

We are investing selectively in oil. We are investing in companies with "extraction upside", in other words, companies whose reserves will likely go up materially through the use of technology applied to known resources. We are firm believers that if the oil is there, oil companies will find a way to get it out of the ground. We are also investing in selective energy services. Specifically, those dependent on "activity" and not dependant on pricing leverage (i.e. not drillers, who are dependant on day rates, which are dependant on oil prices to an extent). Activity levels should remain at record levels for as long as oil remains above $40.00, even if pricing does not. We are short the XLEs (U.S. energy ETF) as a "pair trade" on our energy related positions.

While our skepticism has likely cost us some near term performance, we are not too bent out of shape about it. Even if oil were to go to $100 from current levels of around $70.00, this will not result in the same performance oil-related stocks achieved as oil moved from $15.00 to $75.00 over the past several years. In other words, oil's best days are likely behind it, and we look for investments where the best days are in front. Rest assured, the Venator Founders Fund will remain a good diversification tool for those of you with a lot of money invested in energy through your brokers or other funds you might own.

The Founders Fund Today:

As of today, the fund is fully invested on the long side and about 33% short. Of our long positions, approximately 45% is invested in U.S. equities. We are currently looking to lower the number of positions we are carrying (currently 23) and concentrate the fund to a greater extent on some of our better performing names. We continue to look for new ideas, but confess to having difficulties finding ones that we like better than the names we are already invested in.

The current weakness in the market, coupled with the slowing of the U.S. economy has us looking for "oversold" stocks while keeping a watchful eye on sensitivity to weakening economic indicators. This is creating a delicate balance between inexpensive parameters based on trailing financial results, and future prospects. Therefore, we continue to focus our efforts on defensive, non-cyclical growth companies or operating-leverage-based turnaround situations.

Thank-you for your support

Brandon Osten, CFA
President, Venator Capital Management Ltd.