VENATOR CAPITAL MANAGEMENT LTD.

FEELS LIKE MARCH 2000

The Founders Fund more or less tracked the market over the course of February, having a great 26 days followed by a disastrous final two days, and finished the month down 0.1% (closing unit price of $14.04), leaving the fund up 5.4% year-to-date. This marks the 12 month anniversary of the fund, which returned a solid 40.4% in its first year. Part of the reason for the fund's February weakness was a relatively low short position of 20% of NAV (vs. a more appropriate 35% relative to the market risk of the fund). While our short positions had successfully underperformed the broader market over the six month market rally, it had become a marginally losing proposition, hence the lower weighting.

The market started the month of March much like it finished February which was not a good sign, but is showing a little strength lately. The technicians who viewed the current bull market run as too long and over extended have kept a lot of buyers out of the market (as did extended margin debt) leaving little support for those taking their profits off the table (there are more people out there trying to protect gains than are underinvested). The severe market downturn occurred despite no major news or Fed commentary and the drop spared no market sector. In our opinion, this is a sign of speculative froth coming off the top of the market, rather than a change in fundamentals.

A large portion of the Canadian market feels a lot like the NASDAQ did in 2000. I am singling out the Canadian markets largely because the US market doesn't seem to be particularly overvalued relative to its current fundamentals (the future is always harder to see), nor is it anywhere near as speculative as the Canadian market. We have seen several speculative trends in Canada that concern us:

- Firstly, the Toronto Venture Exchange is increasingly seen as a "senior" exchange despite the exchange requirements being generally "looser" than that of the US "pink sheets" which is frowned upon by most major investment funds. I doubt if there are many investment funds in Canada that prohibit investments on the Venture Exchange.
- We have seen a marked increase in interest in the most speculative sectors (junior resource and junior tech) and large quantities of money flowing into the most speculative companies in these most speculative sectors (i.e. low grade resource companies in high risk geographies without enough resource to cover the capital costs of the project; recycled technology stocks from five years ago that have made no measurable business progress since that time).
- Crazy valuations are quite prevalent. Low growth/low profit technology companies are trading at 3x revenues (at least those that have revenues; we have seen quite a few $50MM start-ups), with little hope of improving the businesses' fortunes enough to hope that the current valuation reflects 20x 2009 EPS. On the mining side, we see valuation targets in excess of 1.5x NAV (this is the equivalent of the seller asking for $1.50 in exchange for $1.00) based on cash flow discount rates of 5% (in other words, no risk premium relative to a government bond), despite locations in some questionable countries (if you wouldn't buy a 20% Namibian bond, a 5% discount rate for a mine operation in Namibia or the Congo might be a little aggressive).

While we haven't done any specific studies on this, we would imagine that most investment professionals would agree that if you had two identical Canaidan companies, only one had 200MM shares outstanding and a share price below $5.00, and the other had only 10MM shares outstanding, the former would likely have a market value that was 25%-50% higher than the latter's.

To the point, we have seen a speculative environment that appears similar to what we experienced in technology in early 2000. To be clear, the valuations aren't quite as ridiculous as when we saw $1BB technology start-ups (today's similarly styled companies seem to top out at $300MM in market cap before people start questioning the fundamentals); but between mining and junior technology, we are seeing more of them in Canada. However, the

20 Eglinton Avenue West, Suite 1004, PO Box 2073 Toronto ON M4R 1K8 T 416.628.8198 F 647.477.2529 www.venator.ca

market seems to be optimistically expecting acceleration in growth rates (as opposed to continuations of a current trajectory) or counting on record levels of exploration success; and this is largely built into current stock prices, rather than offering material future upside. Again, we don't see the same level of speculative behavior in the U.S.

We think we are seeing the speculative froth come off of much of the market, which could result in a severe downturn in Canadian small caps. A mining company coming down from 1.5x NAV to 1x NAV will drop 33%, while an implied discount rate increase from 5% to 10% would cut valuations down by another 25%, suggesting many of these companies could easily fall 50% before being considered reasonably valued (we like to use 15% discount rates in our internal models). On the technology side, many of the "recycled" names will need to accelerate their growth rates from 10% to 30% (or do acquisitions without issuing a lot of shares) while increasing their profit margins from less than 5% to more than 10% to meet analyst estimates (and justify their target prices). Otherwise, many could fall 50% from current levels.

We continue to take advantage of the neglect in Canadian small-cap industrials. Indeed, a full 37% of our Fund is in Canadian industrial small-caps with no analyst coverage and all of these companies have healthy growth rates, good earnings margins, and either revenues or a market cap over $80MM; they also all have less than 15MM shares outstanding. This neglect is also resulting in us being overweight Canada (65%) vs. the U.S. (35%) which is well off of our 50/50 target. We continue to find interesting new ideas, but also continue to struggle to find room for them in the portfolio, which means we can handle more assets than we currently have under management without suffering any performance degradation, and that we could be more diversified in our holdings in order to reduce our risk levels.

We are also taking this opportunity to inform you of some good news regarding Venator Capital Management. Firstly, Venator has hired David Fisher to help with our multitude of stock screens. These screens are at the core of how we have found some of our biggest winners and I expect that running them more often should result in us getting involved with more opportunities earlier in their valuation appreciation periods. Also, we are in the process of opening an RSP-eligible fund this summer.

As Always, Thank you for your support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.