

The Bears (or at least the Correctors) reared their heads in November. On rumours of another Federal Reserve rate cut, markets tried, but failed, to stage a rebound during the final week of the month. This probably will have the same effect as the last two cuts – a two day rally followed by a fresh market bottoms, a brutal technical indicator known as lower lows and lower highs. This bounce helped US stocks recover half their monthly losses, but Canadian stocks stayed near their monthly lows as commodity prices weakened, the Canadian dollar dropped 10% off its highs (which should have been a good thing), and the normally stabilizing factor of Canadian banks didn't help. Small-caps continue to underperform the market with both the Russell 2000 and the S&P TSX SmallCap index down from their January 1<sup>st</sup> start. The Founders Fund was not able to avoid the turmoil, dropping 3.4% on the month, putting the NAV at \$14.80 and the year-to-date gain at 11.1%. In our opinion, the horrible November market is going to leave a lot of stocks open to tax-loss selling, followed by the normal "window dressing" period, which we expect will lead to extreme volatility in December.

At this point, we are starting to look past 2007 and into 2008 with regard to our macro outlook and our investment allocations. It is difficult to see things getting better for the US financial and housing sectors next year (the fact that investors are continually trying to catch the bottom suggests we are not there yet); the flood of new houses coming up for sale on foreclosures should continue to put a lid on new home prices and new homebuilding, while we are having difficulty seeing where the banks are going to get their profit growth from outside of trading and deposits (and just because Goldman didn't take a writedown, doesn't mean they shouldn't). That being said, US manufacturing could pick up with a weaker US dollar (at least when it comes to engineered products where the competition is largely European). We are still unsure of what happens to the US consumer; with the absence of creative, bank-created credit instruments, it's difficult to say where the US consumer draws the line between perceived necessity and luxury.

The Canadian markets are a little more segmented so it's difficult to develop a macro view. However, we remain cautious on the resource sector as recent events such as the indefinite delay of Novagold's core project illustrates how escalating capital costs of resource projects could make many of them uneconomical. Novagold had an experienced partner who decided that it would be uneconomical to throw real cash at the project; unfortunately most of the junior/intermediate exploration and development-stage stories don't have a "parental figure" holding the reigns and as such are relying on the less-than-independent investment bankers, analysts and engineering firms to approve the economics of their projects. Of course, the paradox here is that if these projects don't get off the ground then commodity prices could stay high for quite some time. This would suggest that investors would be wise to stick to producers first and explorers (of the early stage, highly risky variety) second, while avoiding development-stage at all costs.

The Loonie seems to have settled back to par, which is where we believe it belongs. The stock market appears to be in the process of marking down retailers and manufacturers, however the adjustment is always more painful than expected as lower gross profits (even if gross margins remain the same) get spread upon a static selling, general, administrative and leasing cost base. For example, we estimate that a typical retailer running with pre-tax margins in the 15% range could expect to see earnings drop 30% in the event that they can adjust their prices and cost of sales to maintain their current gross margins.

With so much uncertainty in the economic realm today, we are somewhat unwilling to try and catch bottoms. The large cap market is still up on the year despite materially worse prospects for the next twelve months than those in place at the beginning of 2007 (remember Merger Mondays, private equity LBOs and "buy the dips"?). The Fund continues to increase its concentration in what we would characterize as inexpensive, growing, highly-profitable companies that we believe will not be materially affected by potentially negative economic factors on the horizon. The portfolio currently has over 40% of NAV invested in four stocks, with another 20% invested in four additional names. The Fund is currently 100% invested on the long side. Remember, we try to be fully invested on the long side at all times, and use the short-side of the portfolio to mitigate market risk. In other words, we don't use "market timing" for our investments. The markets are simply too volatile for us to risk a month's worth of returns for a day of market timing (i.e. the NASDAQ gained nearly 5% on November 29<sup>th</sup> and 30<sup>th</sup>; if you sat out those two days you missed 50% of the YTD gains!).

As always, we are primarily focused on our investee companies. While increased portfolio concentration is generally considered to be an increase in the risk of the portfolio, we believe that the factors driving these exceptional investment opportunities will insulate them from market turmoil in the coming year. When the market is doing well, it is easy to spread the portfolio a little thin with a lot of "starter" positions. This more diversified approach would normally lead to higher market correlation and a strategically larger short weighting to offset this market risk. However, the more concentrated situation we find the Fund in now should lead to less market correlation and as such our short position currently stands at below 15%.

With the Holidays quickly approaching, I would like to thank you for your continued investment in Venator Capital Management. Investing your savings is a great responsibility and not one that we take lightly. We appreciate your support and continue to strive towards our goals of capital Preservation, Appreciation and Performance. If you have any questions or concerns I am always available to via phone (416-628-8198) or email (Brandon@venator.ca). On behalf of the team, have a safe and happy Holiday Season.

Yours Truly



Brandon Osten  
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