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April was a very strong month for the Fund, which managed to move ahead with the markets on the heels of big moves in a few select portfolio stocks. We gained 9.6% on the month vs. a blended benchmark gain of 3.8%. Rest assured, with the Fund still down 0.8% this year, we are working hard to find the right balance between risk, reward and hedging to ensure that we can take advantage of some of the compelling values we are seeing out there, without exposing the Fund to excessive market risk.

The Fed has finally come near full circle and dropped rates back down to 2%, about the same level that Greenspan saw fit the post-tech bubble but before the knee-jerk 9/11 rate cut. Without another geopolitical disaster, this is probably as low as we go. Accordingly, we have likely hit a near-term low in the US Dollar. Dollar-bashing has been a popular and justified trade over the past several years, but it has gotten rather crowded and we believe the dollar is poised for a short-term reversal against the Euro, which has yet to reduce interest rates to account for their slowing economy (they have been more concerned with fighting inflation). We also think that this reversal could knock a lot of steam out of commodity prices which, as far as market sentiment is concerned, are priced in US dollars, making the ensuing drop likely headline fodder in North America for the balance of the year.

We do not believe that there is any point to cutting interest rates further (if there was even a point in cutting them this far in the first place). Let's look at some of the main influences behind the rate cuts and why we think they aren't having any effect on these sickly facets of the US economy:

Housing: The only way the housing market is coming back is if banks start offering 110% mortgages again. Yes, people were buying \$1MM dollar houses when lenders were offering \$1.1MM of financing, but this practice is dead for now. Now that Americans are actually faced with the prospect of putting \$100K down for a \$500K house, the affordability factor has dropped considerably, which has nothing to do with interest rates or house prices. That you can't find anyone to back the mortgages is almost a red herring when compared to the sales pitch of "I will lend to an extra \$100K to move in" vs. "you have to come up with \$100K to move in".

Manufacturing: It's time to accept that America is done as a manufacturing economy. Only the most automated of manufacturers will survive which won't do much for jobs. Focus on making the non-exportable industries stronger such as trucking, retailing, restaurants, printing, infrastructure and healthcare. You will never see the dollar at the point where labour is competitive with the Rimini, Rupee, Peso or whatever Eastern European country you choose.

Lending: The problem isn't the cost of the product, it's the perceived quality. The only thing rate cuts are accomplishing is bringing treasuries to a yield of near-zero, while lesser quality corporate yields remain quite high. Investors are not going to buy what they perceive as cubic zirconia over diamond rings just because they're cheaper. So as long as non-government debt is perceived as high-risk, people will stay away. These markets need time to heal and for investors to appreciate the underlying cash flows of corporate America; rate cuts are not making the difference.

We do like the more creative levers the Fed is pulling to deal with specific pain points in the economy. Having JP Morgan buy Bear Stearns was a great transaction in that Bear's shareholders got the shaft, but Joe Lunchbox, with money deposited in the once-formidable institution, was spared. Protect Ma and Pa's life savings, forget the shareholders, forget the debt holders; I have no problem with this.

The real problem with the US, which the rate cuts and the ensuing falling dollar have exacerbated, is that inflation has gotten out of control. We do not believe the Fed is only concerned with the popular "ex-food and energy" numbers; we believe they are very concerned about those two categories. Once they give up on the hopeless factors mentioned above, they will realize that food and energy represents a greater threat to cost of living than does the interest portion of a mortgage payment. We listen to a lot of conference calls. Menu prices are going up at restaurants while apparel prices are going up at retailers. Inflation is everywhere and needs to slow down. Letting the dollar float a bit without aggravating its fall with rate cuts is the fastest and best way to do this once you accept that a low interest environment won't fix housing, manufacturing or lending for any extended period of time.

We fully believe that this is it for rate cuts, and fully expect the Greenback to move closer to par with the Euro vs. the latter's current 50% premium. This could cause as much as a 20% near term rise in the battered currency, which could cause a similar 20% drop in commodity prices (as quoted in US dollars) over a very short period of time. Commodities have moved too far too

fast recently due largely to American speculation, leverage and fast money looking for the next commodity trade (energy to base metals to precious metals to agricultural commodities). That commodity trades have kept creeping into more esoteric assets, the whole “own real assets” thing has gone too far in our opinion. To the naysayers may we note that an ounce of gold doesn’t grow into two ounces, acquire other ounces, or pay dividends. Two commodities we think are particularly susceptible to drops include:

Gold: We think gold is the most susceptible commodity to a dollar rally, largely because it’s the primary commodity to be pegged to the dollar without any real fundamental supply-demand underpinning to support it; but also because it’s a market where high leverage is commonly employed. Fundamental (non-financial) demand for gold is well below supply. While people believe that demand out of China and India will be strong, we believe those countries would rather build tanks to store oil, than vaults to store gold. As gold falls, we do not believe that American speculators, who have bid it up to hedge inflation, will think to hold their gold and short the Euro; they will just sell their gold.

Agricultural Commodities: This has definitely been a too far too fast story in our opinion. The agriculture bull market has moved from a story on page 7 of the business section, to page one of the business section, to the front page of the paper in less than a year (there are about two front page articles a week). That is a very crowded trade for what’s historically a very cyclical and weather-sensitive market. While the world wants more meat, the cattle herd surplus is as high as it’s been in years. Yes, high food prices are causing shortages amongst the world’s poor, but that is a pricing function, and government regulation/restriction function, more than it is a supply/demand function. Amazingly overlooked in the whole agriculture mania are several crucial fundamental factors: food is a renewable resource (crops have seeds, animals reproduce), there is no current or future shortage in fertilizer reserves (and production can be brought on quite quickly by the current manufacturers), and the crop season is highly weather dependant (try arguing it’s different this time against that factor); actual food demand only goes up by less than 5% annually. The agricultural move has been spurred largely by artificial factors that have affected pricing more than fundamental factors that have affected supply and demand. Some of these factors include government suppression of exports, pointless bio-fuels and the allowance of speculators into a market that was designed to keep them out (Barron’s had a great article on this subject in early April, warning that regulators are looking at closing those loopholes).

Oil and copper, to name two other commodities, have weekly inventories, political, and shortage vs. substitution factors leading us to believe they will only drop to the extent that the dollar trade would dictate (all else being equal). But valuations can drop if investors increase their required rate of return on a company-specific finite resource pools. Unlike the technology boom, the commodity boom is more price-related than volume/demand related. These prices can drop dramatically (probably about 30%) without any disruption to expected supply in gold, copper, food, uranium, coal, or oil.

These are fairly contrarian calls, and we will always reserve the right to change our minds, but we have been hedging our few resource positions to carry a market neutral weight in energy and a net short position in gold. We believe that we are likely past the turmoil phase experienced in the beginning of the year. While the economy may stay weak for some time, good companies can now rise on their own merits instead of being dragged down on macro-economic concerns as was the case earlier in the year. This is a period where individual stock selection can be crucial, as rising/lowering tides aren’t going lift/sink all boats anymore, although certain sectors are still likely to move in tandem. The Fund is currently fully invested on the long side, with a 50/50 split between Canadian and US companies. We are over 45% short right now as well, with nearly all short positions in the US.

Yours Truly,



Brandon Osten
President, Venator Capital Management

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