March saw a retracement of our February gains, with the fund losing 5.6% in a market where Canadian small caps continued their recent trend of abandonment, while US stocks ended flat in an otherwise volatile month. For the first quarter the fund dropped 9.5% vs. a 10.2% drop in the Russell 2000 and a 5% drop in the TSX Small Cap Index. Given the difficult market performance (or to put it more bluntly, given that the Fund is down 10% this year) we thought we would focus our letter a little more on the Fund itself, and why we are optimistic on the Fund's prospects.

The first quarter of the year saw a disparity between our success rate in predicting our companies' financial results and the performance of their stocks. Out of over 30 positions in the fund (long and short) we had less than five go against us. Usually 25 "beats" would be able to greatly offset 5 "misses". That just hasn't been the case this year. Generally, good earnings expectations have allowed stocks to hold their ground, while missing causes the normal punishment. In one particular case, that of our Pet Valu holding, the company managed to top our revenue expectation by 10% and our earnings expectation by 30%, and we were rewarded with a 15% subsequent drop in the stock (the company does not provide guidance so we couldn't blame any forward-looking statements on the stock's decline).

As we have stated in the past, short term market volatility is generally bad for the Fund, and the market has been setting new records for volatility. Most of our companies tend to be poorly followed by the investment community, which gives rise to both the low valuations as well as low liquidity. These types of stocks tend to move well on news, but poorly during volatile periods in the market. When the market goes down, they sometimes lag, but eventually capitulate; often on very low volume. During subsequent rallies they will lag as well, as the lack of liquidity offers a poor way for people to get their money back into the market (but our more liquid shorts do rally, which hurts the Fund). As a result we would expect the Fund to perform better in a more muted market environment than the one we are seeing today. We expect the Fund to appreciate in all markets, but volatile markets require more breathing room than our monthly reporting affords us.

Canada has been a particularly challenging place to invest this year. We have found that liquidity has completely dried up in our sandbox of small caps (under $200MM in market cap). This has, in turn, scared away any buying, with complete disregard for valuations, growth rates and visibility. We have actually been shifting our assets more to the United States, where we are finding that good earnings can get attention even with a poor economic backdrop. Things can change very quickly in the markets. When you own a growing company, with limited cyclical vulnerability, and trading at 8x, money can be made fairly quickly on a move to a still inexpensive 10x earnings. We believe that a move to 10x EPS by Hammond Power could add 5% to the fund on its own (a realistic target given that we expect it to grow by over 35% this year).

To be completely fair, there have been places to make money (i.e. agriculture, solar) but we tend to shy away from highly cyclical names (unless we believe the cycle is early, and the stocks are cheap) or expensively valued high growth stocks as slight disappointments can cause crushing losses. We also shy away from "blind momentum" as it can turn against you quickly even if fundamentals haven't changed (The iShares China ETF was down 40% between late October and mid-March). We are trying foremost to Preserve Capital, and we believe that the Fund's positions are set up for that goal.

We appreciate your continued support of Venator Capital and believe your patience will be rewarded with the continued profitable outperformance that you have grown accustomed to in our short history. To this end, Steve and I have both recently made substantial investments in the Fund. The expected return on the portfolio's long positions is as high as it has ever been. If we can get one-third of this potential return this year it will be a very profitable one, despite the slow start.

Yours Truly

Brandon Osten
President, Venator Capital Management

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