VENATOR
CAPITAL MANAGEMENT LTD.

GO WITH THE "FLOW"

Cutting to the chase, August was a difficult month for our hedge funds, particularly the Founders Fund, which suffered a 6% loss, putting it at a slight loss on a year-to-date basis. Despite being less than 60% net exposed to equities over the past several months, the Founders Fund has performed in line with the US market summer decline, which has been very frustrating. The Catalyst Fund also suffered a modest decline, while the Income Fund was fairly flat and is up close to 9% on the year.

Instrument	August's Return	Year-to-Date
Venator Founders Fund[1]	**-6.3%**	**-1.1%**
Venator Income Fund[2]	**-0.2%**	**8.6%**
Venator Catalyst Fund[3]	**-1.0%**	**6.4%**
TSX Composite	1.9%	3.2%
Russell 2000	-7.4%	-3.0%
S&P Toronto Small Cap	3.6%	7.9%
S&P 500	-4.5%	-4.6%

1. *The performance of the Venator Investment Trust approximates the performance of the Venator Founders Fund. Return is for Class "A" units.*
2. *YTD of Fund is for Class "F" units net of distributions reinvested.*
3. *The Venator Catalyst Fund has no benchmarks.*

We have done a lot of analysis on the portfolio and have concluded that liquidity is completely drying up for stocks that trade less than $1MM worth of value per day (market capitalization is not as much of a factor). As a result, they are not moving up on good news, and still drop in the event of bad news. To this end, we have been lightening up on these positions, which now represent less than 25% of the Founders Fund (traditionally they have been over 60%). In any case, there is as good, if not better, value to be found further up cap.

In our recent letters we talked about the ultra-low valuations of certain high quality companies relative to their respective bond yields. We also hypothesised that if the low-rate environment continues (and we think it will), that these stocks could experience gains of 50%-100%. However, earnings are not enough. We look for what we call "unencumbered sustainable free cash flow" to prove the earnings to us. In a low-growth environment, where excitement will be tough to come by, and growth is difficult to project on a multi-year basis, free cash flow will enable companies to do great things to enhance shareholder value, such as:

- **Share buybacks:** Companies like IBM are not just doing traditional token stock buybacks. They are making material changes to their shares outstanding with plans to increase EPS by 25% over several years through share buybacks alone.

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- **Increase dividends:** We are seeing companies with excess cash balances increase their dividends, which serves to provide tax-efficient income returns relative to low yielding bonds. However, if Obama has his way, and the dividend tax rate increases from 15% currently to 40%, we would expect excess cash to move towards the other three items on this list, and would not expect much in the way of dividend increases going forward.
- **Pay down debt:** We are finding companies that are able to materially increase their earnings by paying down their high-rate debt with their low-interest cash. This serves two purposes: it lowers the risk of investing in the company, while at the same time increasing the earnings through the elimination of interest expense.
- **Make accretive acquisitions:** To the extent a company has a good cash balance, using low yielding cash to buy anything profitable is going to be accretive. Take HP's recent purchase of 3Par. In plugging the diminutive 3Par into its extensive network, we imagine that HP will likely increase 3Par's revenue by a factor of 3x-5x over the next two years, and that this will end up being a very accretive acquisition despite the lofty valuation paid. Guessing who is going to be taken over next is a low probability game, but knowing who is going to buy these companies in a manner that increases shareholder value is much easier.

For all these reasons we don't initiate too many new investments without significant unencumbered sustainable free cash flow, along with a plan to use it in one of the four manners described above (preferably the first three with a little of the fourth).

We have also stated that coming out of earnings season, when the reality of a low-to-no growth recovery sinks in, we would become more constructive on the market. As such, we have taken up a fairly large weighting in companies that we consider non-cyclical moderate growth vehicles, with the cash flow characteristics we have outlined above. IBM, Hewlett Packard and McKesson are stellar examples of this strategy. While their stocks remain neglected by the market, which may continue to impede the Fund's progress over the near term, we think big returns may be in store over the next 12-18 months; and at less than 10x unencumbered sustainable free cash flow, we don't think we are taking a lot of risk with this strategy (only the opportunity cost if they lag any market rallies given their recent status as low beta stocks).

Naturally, we are disappointed with the Founders Fund's performance on a year-to-date basis. Some changes have been made to accommodate the above strategy which has resulted in a little more exposure to the market (we are not hedging against these large-cap blue chips), others have been made to de-risk the portfolio, such as lowering our small cap weighting in the fund.

Yours Truly,

Brandon Osten, CFA
President, Venator Capital Management Ltd.

This is intended for informational purposes and should not be construed as a solicitation for investment in any of Venator's Funds. The Funds may only be purchased by Accredited investors with a medium-to-high risk tolerance seeking long-term capital gains. Read the Offering Memoranda in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares. All stated Venator returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance.