VENATOR
CAPITAL MANAGEMENT LTD.

CONGRATULATIONS!!!

Congratulations are deserved all around to our faithful investors for sticking it out with us from our early days in March 2006, to our nearly five years in business as trusted guardians of your savings. In just under five years, the Founders Fund has gained 100% for our investors. It has been a bumpy ride, but the combination of a consistent medium-risk investing strategy and active hedging program has combined to produce superior returns with relatively low volatility, which is always the magical combination needed so that investors don't get "scared" out of the market at precisely the wrong times. All of Venator's Funds, along with the overall market, finished the year strongly, with all finishing at record highs; in other words, everyone currently invested with Venator has made money.

Instrument	December's Return	2010 Full-Year Return
Venator Founders Fund[1]	**8.0%**	**17.0%**
Venator Income Fund[2]	**2.1%**	**19.1%**
Venator Catalyst Fund	**4.0%**	**18.2%**
TSX Composite	4.1%	17.6%
Russell 2000	7.9%	26.9%
S&P Toronto Small Cap	6.8%	35.1%
S&P 500	6.7%	15.1%

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.*

I think it's safe to say at this point in time, people can put the 2008 financial crisis behind them and start looking forward to the next crisis. As we have pointed out in the past, there is no shortage of items that have led, and can lead to, substantial short term market drops. A quick internet search of market crashes yields a result of 10 such events in the last 25 years. Some of these were short-lived (2010's flash crash comes to mind), while some were more enduring (the NASDAQ is still over 40% off its high, while Japan is still down 50% from its all-time high in US dollars). However, what is often missed in the shuffle are the more sector-specific drops that wipe out the "hot" money, and a disproportionate number of investors in the process.

I have just finished reading "Fooled by Randomness" (Nassim Taleb, 2004) which addresses the issue of preparing for "rare events" which are, as we have continually stated, not as rare as people think. I highly recommend this book to anyone investing with financial professionals (Mutual Funds, Alternative Strategies, Brokers, etc.); if you are short of time, you need only read the first half of the book ("Part 1") to get the salient points. It does a great job explaining preparation for, and consequences of, rare events, which includes what happens to investors going into them (those most heavily invested in risk during good times are usually those with the best track records yet are also the most vulnerable) and the problems of selecting money managers after rare events (the sample size of funds to select from decreases dramatically, and new funds with often impractical back-tested models pop up to replace them).

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

Naturally, 2008 was a perfect example where strategies which saw some of the best multi-year returns were wiped out in a relatively short time frame. This spawned a number of new funds that were created between late 2008 and early 2010 that were able to benefit from the ensuing market rebound. I can only recommend that people search for funds that outperformed for the full year 2008 and the full year 2009 (I am aware that this excludes our Income Fund which was launched in July 2008). Funds that dropped 50% in 2008 and subsequently gained 100% in 2009 are likely invested in risk/beta rather than skill/alpha (let's just agree to call it luck), and may not be so lucky the next time they come face-to-face with the Black Swan (i.e. the financial crisis of 2008, the collapse of the Russian Ruble in the late 1990s, 9/11, the destruction of the planet Krypton, etc).

Taleb likes to think of it in terms of the probability of alternate scenarios, and the various magnitudes of those scenarios. He claims that we put too much weight on probability and too little weight on magnitude. For example, if we view the next year outlook for the market as a 70% probability that the market goes up 10%, but a 30% probability the market drops 50%, then our expected return is a loss of 8%. So should the investor be bullish given his 70% degree of confidence in a bull market, or bearish due his risk aversion to a possible market crash? He concludes that we would throw our money behind the bullish argument as we play the probability bull and generally ignore the magnitude of the improbable crash, even though the weighted average of our expectations suggests that we be cautious.

Thinking in terms of alternative scenarios of what we just went through would lead most to believe investors were all fairly lucky to come out in such good shape. Part of this is attributable to the broader collapse that occurred, creating a more coordinated effort to save the financial market than what you saw with a more sector-specific crash such as the tech crash. One helpful exercise for investors would be to think of what would have happened if China decided that 3% growth was enough and that their stimulus should be only half what it was; would you have fared so well if copper stayed below $2.00 or oil at $30.00? What if the US allowed Citi to fail? What if Germany allowed Ireland/Greece/Portugal/Spain to fail? What if the market rebound didn't happen until June; would Manulife, or Teck Resources (their creditors were closing in quickly) have survived? What would have happened if we were less hedged and our investors redeemed half their money (fortunately we have the best clients in the world and experienced virtually no redemptions)? Now we hear people of the down 50%/up 100% club claim that they were right all along! How easily people forget that the world was actually coming to an end. Here are the front page headlines from March 3, 2009s Wall Street Journal:

- Stocks Hit '97 Level, Signaling Long Slump;
- Dow's Plunge Below 6800 Comes as Investors Bet on a Sustained Earnings Downturn;
- Markets Shudder Across the Globe.

Believe me when I say that a harsh crash in the Canadian junior mining sector will receive little notice globally, and would even have a muted impact on the market-weighted S&P TSX Composite. In other words, there would be no bailout there. In fact, the real world (as opposed to the investing world) would welcome a retreat in commodity prices. Such a crash may have a disproportionately negative effect on many Canadian investors. We put the odds of such a crash occurring this year at 30% with a magnitude of 70% if it were to occur. But we think most are willing to bet on the 70% chance the rally continues.

At Venator, we do not engage in Black Swan-type investing (a strategy that calls for 85% of your money in T-bills and the other 15% in way-out-of-the-money longer-term options). This strategy can yield annual losses of 7%-10% in the absence of a rare event but payoff 100%+ when the rare event happens. Of course, the Black Swan of

Black Swan investing is that the rare event does not occur for 10-15 years wiping the investor out slowly over time (time intervals are the Black Swan of the Black Swan strategy). We prefer to make money most of the time and prepare for rare events by hedging through an active short selling strategy. We also have a disciplined willingness to miss any subsector bull market where we do not believe the fundamentals justify the hype (the current enthusiasm over rare earth elements is such an example) which helps us avoid bursting bubbles. I suppose the moral of the story is that investors need to continually revisit the age-old saying: hope for the best, but prepare for the worst. In the money-management business the former nearly always takes precedent over the latter, which can be a fatal error, and explains the high mortality rate of traders, funds and fund managers.

As I sit here on the first trading day of 2011 (in the US anyways) I can't help but notice the consensus bullishness that exists right now. It's as if the 100% rally off the bottom of the market never occurred and all the upside is still ahead of us. Even the hedge fund crowd has retreated with short interest statistics continually making new lows. The private equity side is getting ready to re-IPO recently public-gone-private companies before the ink has dried on their "going-private" transactions. China is buying everything under the ground, Americans are buying everything under the roof (mall traffic, e-commerce, stocks), but no one seems interested in buying anything under the sun (houses, cars, job hunters). I can in all seriousness say that I have not come across a real market sceptic in several months. About the only bearish thing anyone seems able to reference is that the bullish consensus appears too high.

Our own internal measure of bullishness vs. bearishness is our willingness to short stocks. At present, the fund is not short any ETFs as we are finding easier to invest our target short weighting in individual stocks. This raises a bit of a warning flag for us in terms of the optimism we are seeing in the markets. While the market overall appears inexpensive, we note that some very large pockets appear extraordinarily expensive while other large sectors appear inordinately cheap. So the average valuation may give market watchers and macro-mavens comfort, but from a bottom-up perspective opportunities abound on both the long and short side. Hopefully, we've got it right.

As always, we reserve the right to change our mind.

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.