THE ONLY OBJECTIVELY UNDERVALUED OPPORTUNITY

To review, last month was fairly disappointing for our Hedge Funds, where our cautious stance towards the markets led to mere 1.4% gains in an otherwise strong month for the markets. However, our Income Fund experienced a strong 4.7% move as the mid-yield markets continued to strengthen.

Instrument	July's Return	Year-to-Date
Venator Founders Fund[1]	**1.4%**	**5.5%**
Venator Income Fund[2]	**4.7%**	**9.3%**
Venator Catalyst Fund[3]	**0.7%**	**7.4%**
TSX Composite	4.0%	1.3%
Russell 2000	6.9%	4.8%
S&P Toronto Small Cap	4.1%	4.2%
S&P 500	7.0%	-0.1%

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.*
3. *The Venator Catalyst Fund has no benchmarks.*

The market has, as we have written about in the past, moved from the "benefit of the doubt market" of 2009, to the "show-me" market. Long-time readers will recall that we doubted both the extreme negative sentiment of early 2009, as well as the expectations for a multi-year cyclical recovery in late 2009. While others were cheering the strong economic results of Q1, we were lamenting how far below 2008 levels they were, the strength over 2009 being the result of easy comparisons rather than true cyclical growth. With 2011 growth being revised downward, it's fair to say that the market is coming to grips with a medium-term low growth future.

A medium-term low growth future (possibly lengthened by the negative Chinese demographic rollover that should begin around 2016) carries some heavy implications for macro investment themes going forward. The first of which is that we expect interest rates to remain low for quite some time. Simply stated, there is no reason to raise them. This brings us to another point; we don't think inflation is on the horizon either. Market experts used to talk about excessive monetary stimulus resulting in runaway inflation, where now they are laying odds on deflation.

Macro themes can be very powerful. Technology, emerging markets, gold, oil and financials (shorting) have offered a number of ways to make very significant returns over the past twenty years with very little regard to individual stock picking. Macro money making can be much easier and more profitable than working to find those hidden gems that we spend most of our days attempting to pick out of the market haystack. Playing it safe with our Income Fund (bonds and dividends) is a great way to hide out

for hopefully 10% returns in uncertain times, but you aren't going to find any macro double themes in the higher quality, medium-term bond markets.

So if we don't believe in medium term economic growth (cyclical or otherwise), but we do believe continued low interest rates, can we make an educated guess as to the next big macro theme? Here at Venator, we have been looking into blue-chip, (relatively) non-cyclical companies trading at significant P/E discounts to their bond yields. Indeed JP Morgan, in a recent bullish report for the market overall, noted the historically wide divergence between investment grade bond yields and their stock earnings yields (the inverse of the P/E ratio). Without getting into a lot of mathematical detail, stocks historically trade at a lower earnings yield to their respective bond yields (i.e. stocks are more valuable than bonds; equity is more valuable than debt). As noted in JP Morgan's presentation, P/Es have never been this low (13x earnings, or an earnings yield of 7.5%) when investment grade bond yields were below 5%. The presentation theorized that today's investment grade bonds yielding below 5% suggest that their respective stocks should trade above 20x earnings (an earnings yield of 5%).

As a specific example, we have noted in the past that we are fans of IBM. IBM not only trades at a cheap P/E, but as an admittedly low growth company, it has one of the best track records of building shareholder value through smart acquisitions and tax efficient share buybacks. When IBM recently set a goal of doubling its EPS in the next five years, a full 80% of the growth target was expected to be achieved through cost cutting, acquisitions and share buybacks, leaving little at risk in terms of organic growth. IBM currently trades at about 11x earnings, while its 10-year bonds yield roughly 4%. Now if IBM were to trade at an equivalent earnings yield (a P/E of 25x), IBM would trade at $280.00 (currently IBM trades at $130). However, if we were to put our "rose coloured glasses" on, and took IBM's guidance to double earnings within five years (to roughly $20.00 per share) at face value, and if the bond yields were to remain stable, IBM's stock could hit $500.00. Anyone following the markets for the past 10+ years will readily admit that crazier things have happened than IBM trading at 25x earnings. Besides, with the stock currently trading at around 11x earnings, we are not taking on a lot of risk to achieve these potential rewards.

Skeptics will note that cheap is generally not a great reason to go long by itself. However, we would note that, in retrospect, cheap was the only reason to buy the 2009 rally, as economic numbers are currently showing that a sustained multi-year return to average growth would have been an incorrect thesis. We would also note that the theory that applies to mega-cap non-cyclical stocks in terms of valuation appreciation potential does not work for small caps. This is because smaller companies' debts tend to trade at yields closer to 10%, as opposed to the 5% yields we see on large caps. This means that smaller cap companies are more fairly valued in the 10-12 P/E range, even while we are talking about large-caps potentially trading in an 18-25 P/E range. It also means that we could see record large-cap outperformance over the next several years.

What could turn this thesis on its head? Investment grade bond yields could go up to 10%. This would crush the bond market by 25%-30% and make a 10x P/E the norm. However, we would remind you that we expect government bond yields to remain low, and we would suggest that a 10-year IBM bond really isn't much riskier than a 10-year treasury bond in our view.

As one can deduce from this communication, we have been shifting some assets into larger cap, low P/E names. Also, given what we believe to be a somewhat safer profile than our typical small-cap investments, we are not hedging very much against these positions. We still have relatively low net equity exposure across all of our Funds for now (the Founders Fund is the highest at 60%). But we are

opportunistically adding to these larger-cap positions in an unhedged fashion (we recently bought some Hewlett Packard shares post the CEO-scandal meltdown).

Yours Truly,

Brandon Osten, CFA
President, Venator Capital Management Ltd.

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