VENATOR CAPITAL MANAGEMENT LTD.

A BASKETBALL IN A HAYSTACK

The markets got off to a strong start for the year, and our Funds were not left behind. Good news is welcomed and bad news is being shrugged off. Gold is going up with the markets. The financial glitterati of the world are promising to keep rates low indefinitely. Previous causes for alarm such as debt ceilings, near bankrupt nations and runaway deficits are not a hindrance to these markets. And "risk-on" is apparently a good enough reason to blindly and stupidly buy long-term risky losers - witness the strong move by the Euro last month - beta is the name of the game here. A number of factors are telling us that the market is getting too complacent here, but we don't want to sit out the rally either. So our Funds are currently aggressively invested in conservative securities.

Instrument	January's Return	Year-to-Date	Since Inception[3]
Venator Founders Fund[1]	**5.3%**	**5.3%**	**82.1%**
Venator Income Fund[2]	**2.8%**	**2.8%**	**63.5%**
Venator Catalyst Fund	**2.1%**	**2.1%**	**58.0%**
TSX Composite	4.4%	4.4%	20.4%
Russell 2000	7.1%	7.1%	17.5%
S&P Toronto Small Cap	8.9%	8.9%	16.5%
S&P 500	4.5%	4.5%	16.1%

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 Income Fund and the Venator Catalyst Fund have no benchmarks.*

Currently, our biggest position in our Founders Fund is Apple Inc. We are not proud of this. After all, we pride ourselves in finding needles in haystacks, and Apple is more like finding a basketball in a haystack. That being said, we aren't about to let a good investment get away. We can run all the stock screens we want and still not come up with 65% growth, 45% ROE and huge free cash flow at 10x earnings with market leadership in an emerging technology market. Besides, Apple is one of the greater "early stage" opportunities we have come across (more on this later).

First, let me explain some very basic things about Apple from a research perspective. Apple is a very efficiently followed company. There are numerous newswires and analysts covering the company from all angles (I get about 200 pieces of information on Apple per day). But its products are few and simple. Judging from the monstrous earnings "beats" Apple regularly announces, it's fair to say that everyone knows Apple and no one knows Apple. We like to pride ourselves on having informational advantages on most of our investments, but with Apple we can at least say we are not at an informational disadvantage, which, given the investment opportunity here, is good enough for us.

The other thing we like is that it is simple to understand from an analytical standpoint. They have very few product lines and very few accounting lines. We count 8 lines in their most recent income statement and 20 lines on their balance sheet (not including "total" lines). They also provide ample segment information on granular product line sales, units and margins. We love supplemental information but hate accounting complexity. Yet another reason to love Apple.

Back to my point of Apple being an "early stage" growth company, a statement that seems hard to believe given its $425BB market cap. It might surprise some people to know that Apple has very low market share in its two main markets: cell phones and PCs.

- In the past twelve months Apple sold just over 93MM iPhones vs 1.9BB cell phones sold worldwide putting its market share at 5%. Now some might argue that Apple is approaching 20% of the 500MM smartphones sold last year, or that Apple dominates the market for $500+ smartphones. But this misses the point. A consumer gets a 3Gs free and will soon get the original iPhone 4 free. Over time, this opens up the entire 1.9BB unit market.
- In the past twelve months Apple sold 18MM out of a total 340MM PCs for market share of 5%. Now some might argue that Apple dominates the market for $1000+ PCs at home, but this again misses the point, as Apple is already starting to penetrate the corporate market (web interface cloud computing makes this easier than any time in the past) and drop price below this $1000 level (while others are increasing prices with expensive ultrabooks while phasing out cheaper netbooks). Again, the world is wide open for Apple.
- The tablet market IS the iPad market. So while Apple dominates with 75% market share (there is a units shipped vs. units sold debate here), we need to find a different way of looking at this category given its newness and rapid growth. So let's add up iPads (40MM units) and Macs (18MM units), versus PCs, eReaders and Tablets (340MM, 11MM and 55MM respectively). This gets us to 15% market share assuming that no one would own both a PC and a tablet (a conservative assumption) but note that this is a category definition that puts Apple firmly in the sub $1000 PC category (the cheapest iPad costs $500).

So Apple has market shares ranging from 5% to 15% depending on how you want to look at things. Apple's 5% cell phone market share compares with Nokia's 30% and their 5%/15% PC/PC+tablet share compares to Microsoft's 75%-90% (we use Microsoft because PC sales are more about the operating system than the hardware for our purposes). Anyone want to bet against Apple tripling its market share (15% cell phones, 15% PCs, 45% PCs plus tablets) over the next several years? That could put earnings at $150 per share with over $300 per share in cash. In other words, Apple is potentially trading at under 3x 2016 earnings or under 1x net of cash.

The law of large numbers just doesn't apply here. Not just because of its low market share, but because of its vertical integration. Apple only seems big because gets the combined margins of Microsoft, Dell, Nokia and Best Buy on all direct sales of its products. This allows them to realize more profits per unit while being able to underprice the competition, which needs to split margin with their partners at each link in the chain. Therefore, we think market share is the better way to look at things as they have structural ways of keeping profit margins high (unless Microsoft buys Nokia, HP, Best Buy and maybe Intel).

Additionally, the timing seems right. Apple is chock full of catalysts this year. They have major product refreshes coming in all their product lines. They are putting a push on education/textbooks six months before school starts. They are in the process of finishing a full rollout to the last carriers that they haven't "allowed" to carry iPhones (including some big ones in China). They have a potential new product line in televisions (which is potentially more like iPhones for Apple than iPads as there is no risk of cannibalizing and existing product line). We think we will see a dividend or buyback which, although immaterial, will likely be viewed positively by the Street. Finally, we view a number of features gaining traction creating an increased cross-selling effect; these features include Siri (which gets exponentially more useful with scale), and iCloud (which gets more useful when you have more Apple products).

Did I mention that the stock is exceedingly cheap based on current results? We expect Apple to earn over $45.00 per share putting it at 10x earnings. This is cheaper than the market as a whole and cheaper than lower-growth technology companies such as IBM and EMC. If I were to back out $100 in cash per share, we are below 8x earnings for a company where everyone wants what they are selling and has relatively low market share in its markets, as we have already established. But let's go one step further and compare Apple to the pending IPO of Facebook.

Like many people, we went through Facebook's recent preliminary prospectus cover to cover. Whether we invest or not, Facebook will be an important company going forward, will have an effect on other companies we watch, and may spawn additional investment opportunities for us to potentially exploit. For our purposes, we are going to assume the Facebook's market value hits $100BB on the IPO, as there are enough people that don't actually look at valuation in detail and think they are getting the next Google. *(As a side note, Google carried a valuation of $23BB at its IPO, had half the revenues, and was in year five of its existence, as compared to Facebook currently in its eighth year - Google was five times larger than Facebook when they both turned five. Facebook is about to get two-thirds of Google's current enterprise value despite being one-tenth of the size, but I digress).*

Getting back on track, what we are really trying to do here is illustrate just how much runway Apple has in their future market opportunity versus a similar growth profile with a similar market value (Facebook at one-third of Apple's enterprise value is as close a comparable as we can find given no one else with a market value over $100BB is growing as fast as Apple).

Facebook is coming public with $3.5BB revenues and $1BB earnings after tax with revenue growth of 88% versus 2010, but surprisingly only 55% in its most recent quarter (more on this in a second). At $100BB Facebook will be valued at 100x trailing earnings, or 50x-70x forward earnings depending on how much weight you put on their Q4 growth.

In terms of market penetration, at 850MM+ users, Facebook has about 50% of its addressable market penetrated (internet users outside of China), demonstrated by new user growth which has slowed dramatically recently. We would note that the Facebook opportunity is mainly about how much advertising they can get out of their existing user base, not how many new users they can get. However, at 27% of display ad market share, they may already be reaching a point of saturation - 50% user penetration spending 50% of their time on Facebook equals 25% display ad spend.

Looking at the most current developments, despite all the hype, we believe that Facebook's Q4 would have been a considered a complete disaster for the stock if it was already public. While the company had consistently posted 100% growth for a number of consecutive preceding quarters, Q4 growth was "only" 55%. Based on history relative to Facebook's normally seasonally strong Q4, we believe people would likely have expected 100% growth, or Q4 revenue of $1.4BB versus the $1.1BB actually reported. *(Put another way, Q4/Q3 2011 dollar growth was only $177MM (+19%) versus $264 last year (+56%). It is very odd to see a hyper-growth company report lower sequential dollar growth from one year to the next).* But getting back on point, Facebook's 55% revenue growth in the quarter was lower than all but one of Apple's last seven quarters.

Looking at the future opportunity and market share, as noted above, Facebook now has 50% of its addressable market signed up. Its Internet display advertising business may be reaching the point of saturation within its advertisers' budget base (although online advertising is a growth market) but its mobile market revenue is just starting. This is duplicative in terms of users but incremental in terms of ad revenues. But recall that Apple has only hit about 5%-15% of its potential user base so we would suggest that while Facebook's ramp on existing products (facebook.com) plus readily observable opportunities (Facebook mobile) is about 2x-8x, Apple's (PCs, cell phones, tablets) is 6x-10x.

The mystery that will drive Facebook is how far can they expand the empire (think gmail, Android and youtube.com for Google). Given Facebook's internet-within-an-internet model it is difficult to surmise the ultimate opportunity. On the one hand, limiting yourself to a subset of the internet has its limitations; on the other hand, you get to control 100% of your corner of the internet, allowing you to capitalize on captive areas such as payments and games within their ecosystem. There are even rumors that they are looking at building their own cell phone.

But Apple has demonstrated an ability to come out with new products too. Furthermore, I would place a higher probability on new product success for Apple because Apple's customers pay for products, whereas Facebook's customers don't. In other words, I place higher odds on the success of an Apple TV than a Facebook cell phone (that being said, I would place a decent chance of success on Apple branded steak knives given its rabid fan base). People are finding more uses for iPads everyday (i.e. credit card/iTunes terminal for self-checkout at restaurants and retail stores). Most people don't know this, but Apple has yet to really make any material money off of iTunes; it costs a lot of money to approve product and maintain the iTunes/App store.

Apple's earnings are about 30x that of Facebook, but its enterprise value is only going to be 3x larger. Its growth rate is similar, if not superior, and its runway on existing products is at least as great. The one advantage Facebook has is that investors are buying into visionary Mark Zuckerberg, but Apple investors are still going to be in a wait-and-see mode on the innovative capabilities of Apple absent Steve Jobs.

The mystery is why does Apple stock stay so cheap relative to the market in general, other mature technology companies, and other high growth consumer product companies? Part of it has to do with its size in that it takes a lot of money to move Apple's stock. Algorithmic trading doesn't allow for a lot of volatility either. Its weight in the various market indices tends to keep it anchored to daily index movement in general. But from our perspective, this provides more opportunity for us, and you, to make money in what I would characterize as a relatively low volatility fashion given how dynamic a company it is.

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

Thank you for your continued support,

Brandon Osten, CFA
President, Venator Capital Management Ltd.

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