

THE END OF EXPENSIVE OIL

Despite some turbulence in the markets, we are quite happy with how the first half of the year has gone. Our Founders Fund is up nearly 12% thus far, while our Income Fund set an all time high, sitting up 10% year to date.

Instrument (Inception)	June's Return	Year-to-Date	Compound Growth
Venator Founders Fund (March 2006)	-0.6%	12.0%	11.0%
Venator Income Fund (August 2008)	1.4%	10.0%	15.8%
TSX Composite (March 2006)	1.1%	-1.5%	2.7%
Russell 2000 (March 2006)	5.0%	8.5%	2.8%
S&P Toronto Small Cap (March 2006)	-2.1%	-7.9%	-0.2%
S&P 500 (March 2006)	4.1%	9.5%	3.1%

Let me preface this months commentary by asking you not to hold this fairly unpatriotic letter against me. But the bottom line is that money knows no boundaries, and it is our belief that 10 years of Canadian stock market outperformance came to an end last year (TSX -10% vs the S&P500 up 11% in the last 18 months) and that as commodity markets have reached the end of their bull market, Canadians are going to need to look to new and less familiar places for future returns.

Canadian markets finished 2010 with a solid decade of outperformance. This was fueled both by the emergence of resource starved emerging economies, as well as a banking structure that avoided the problems faced by the US and now Europe. But we are going to have a tough time outperforming without resource market outperformance. While we recently wrote about our bullishness for the intermediate term outlook for natural gas, our projected prices of \$4.00-\$6.00 are nowhere near recent highs of \$14.00. Consequently, we are quite bearish on oil, which is too far from its high of \$140 after too long a period of time (2008) to believe that it will be coming back any time soon.

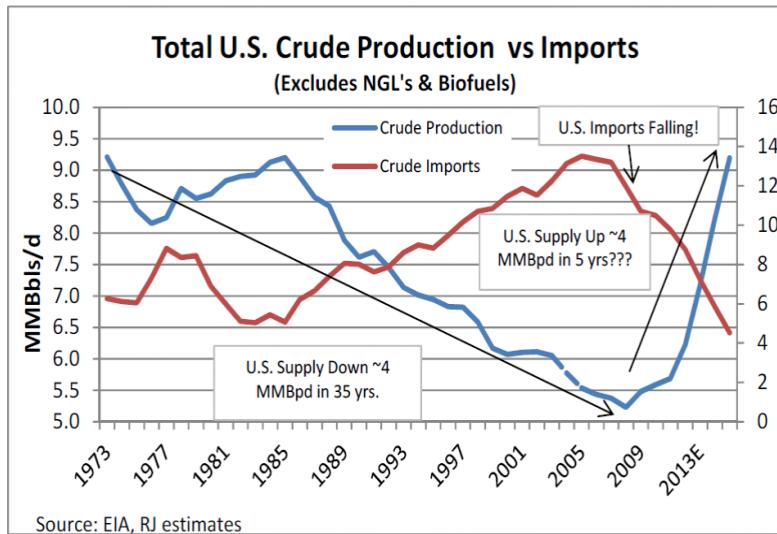
Remember "Peak Oil"? That was the recycled theory that we would run out of oil in the next 60 years or so, which fueled the oil bubble (yes, it will look like a bubble when oil eventually hits \$30.00). Peak oil peaked as a traffic term on Google Trends in 2005 and 2008, but has declined since, probably for the next 25 years. To give you a sense of the history of peak oil I offer up the following quotes:

- "Total future production limit of 5.7 billion barrels of oil, perhaps a ten-year supply" - 1914, U.S. Bureau of Mines
- "Reserves to last only thirteen years" - 1939, Department of the Interior
- "We could use up all of the proven reserves of oil in the entire world by the end of the next decade" - Jimmy Carter in 1978
- BONUS QUOTE: "Natural gas storage numbers are nearing all-time highs, and supply growth is as high as it has been in recent history as new technology is opening up huge shale gas fields...Natural gas could realistically fall from a current level of over \$11.00 to \$5.00" - Venator Capital Management, May review 2008.

Like clockwork, Peak Oil theories come back into vogue every 25 years or so, and are proven wrong over the next five, and then disappear. The latest source of Peak Oil's disappearance is a combination of a slowing global economy coupled with shale fracking technology (yes, the same technology that swapped a Malthusian theory of gas shortages in 2007-2008 to the current endless supply theory, knocking prices down 80% in the process). Shale oil

appears to be on track to mirror the experience of its natural gas cousin, having gone from a \$120 cost per barrel pipe dream, to a \$60-\$90 cost per barrel reality. US domestic shale oil reserves are estimated at anywhere from 800 billion to 1.8 trillion barrels. With scale (like with what happened to the gas market), I could see this cost per barrel metric falling into the \$30's, possibly in as soon as five years (using gas fracking cost declines as a reference). The bottom line is that US and global oil production is actually increasing, that US oil production is expected to keep increasing, and that it is not uncommon to find predictions of the US becoming a net exporter of oil within the next

ten years (feel free to read that statement again). This is what logically happens when you combine declining demand (economic and conversion of trucks from diesel to gas) with increasing supply. Energy independence, that long standing American dream, may become a reality in ten years thanks to vast, previously uneconomic, shale reserves. The best part: there is nothing OPEC can do about this other than open the spigot and crush oil prices to below \$50.00 in order to discourage shale investment. These recent Iranian embargoes will have a very short term effect on oil (especially with Iraq ramping back up); the longer prices stay high, the sooner shale resources will be developed.



Copper is also in a fair bit of trouble. China's next phase of moving from an infrastructure build-out-based economy to a consumer-driven economy is not a good thing for copper even if China engineers a gradual growth slowdown. That being said, we still believe in our previously published theory of a collapse in China's growth rates due to: a) a horrible demographic situation brought about by decades of the famous one-child policy (think Floridian retiree-to-worker ratios), b) a domestic balance sheet that is far worse than expected (in a controlled economy the municipal, provincial and bank debts are actually national debts), and c) civil unrest caused by crony-capitalism rivaling that of Russia (and widespread censorship that isn't really working). China's stock market, down over 60% from the top and nearly 20% over the last year, would appear to agree with us.

Lest you think that gold stocks would be a good place to hide, allow me to point out that lower copper prices are very bad for gold producers. For many gold companies, copper is a by-product of mining gold that brings the cost of production down materially. We have seen some "gold" companies where as much as 50% of the economics is dependent on copper by-product production. So when you find a "low cost" gold miner, be sure to ask what the cost of mining the gold is without copper; you may find that the costs are as much as \$500 an ounce higher. As further evidence of the tied-at-the-hip nature of gold and copper in gold miners, we would note that two of the premier gold companies out there, Barrick Gold and Freeport McMoran have made major copper acquisitions in the past several years. The bottom line is that the effect of \$2.50 copper coupled with \$2000 gold would likely cause many gold stocks to decline. If you want to bet on gold vs the economy, bet on gold, not gold stocks.

Financials, the other support beam of the Canadian market, aren't likely to rally in our view. We really don't follow the financial sector (we don't even dabble, as we do in the resource space). That being said, poor resource markets mean less investment banking and trading activity for the banks. Tightening the mortgage rules for our buoyant real estate market is not going to help either. Dividend yields will hold them up, so we forecast a prolonged period of stagnation for this market (assuming that we are right on everything we said above).

THE PROBLEM WITH CANADIAN STOCK MARKETS

After ten years of neglect in the non-resource, non-financial space in Canada, the US just has better companies. We have sat back and allowed ours to be acquired, or have stunted growth through a severe lack of funding interest, or pushed them into the US with US headquarters relocations and US listings. In fact, we recently ran a screen for Canadian headquartered companies outside of resources and financials (only 352 companies) with market values above \$200MM (155 companies), revenues in excess of \$100MM (138 companies), that trade more than \$500,000 worth of value per day (84 companies). If we eliminate subjectively chosen companies that no longer feel compelled to do their financing activities in Canada (i.e. Molson Coors, Lululemon, SXC Health, Open Text, etc.) we end up with a rather thin universe of 75 companies with a combined market cap of \$342 billion (one-third of that market cap resides in the top 5 of Canadian National Railway, BCE, Thomson Reuters, Telus and Rogers). That is out of 1,500 total listed companies being worth \$2 Trillion dollars. Put another way, your typical domestic large cap money manager or broker has very few places to go outside of the traditional resource and financial sectors in Canada.

While US companies have record free cash flows, corporate Canada is not nearly as healthy (or at the very least, our free cash flow numbers are so far below reported earnings as to render resource earnings numbers relatively meaningless). Two things our junior and intermediate resource companies do extraordinarily well is issue stock and burn cash, diluting shareholders and killing the majority of the shareholder value their powerpoint presentations claim they will create. Without rising commodity prices, this greater fool's game will end, because either the companies get desperate and dilute the value out of you, or they run out of cash, or they turn into shell companies with decent amounts of cash (this would be the smart move in most cases, and it allows upper management to maintain their jobs and salaries).

It's time to look further afield for your investments. Venator takes pride in its ability to provide investors with a diversification tool away from the resource and financial vehicles that tend to dominate the typical Canadian investment portfolio. Be careful out there.

See you on the 19th!!!

(If you haven't already heard, we have rented a 400 seat theater to present a sneak preview of the third installment of the Batman trilogy "The Dark Knight Rises". We are almost sold out as we are only looking to fill one-third of the theater in order to ensure a good seat for everybody. Please let us know soon if you would like to attend.)

Thanks for your support,



Brandon Osten, CFA
President, Venator Capital Management Ltd.

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