VENATOR
CAPITAL MANAGEMENT LTD.

THE MYTH OF MARKET NEUTRAL

As you may have gathered from the numbers below, we are very happy with our March performance as well as our quick start to the year. Both funds are performing well ahead of absolute and relative performance goals. The Founders Fund has done a good job keeping up with the faster moving US components of its benchmark despite considerably less than 100% exposure to the market on a net basis. The Income Fund is doing considerably better than its underlying 7% yield.

Instrument (Inception)*	March Return	Year-to-Date	Compound Growth
Venator Founders Fund (March 2006)	**4.5%**	**10.6%**	**13.1%**
Venator Income Fund (August 2008)	**1.7%**	**5.8%**	**16.9%**
TSX Composite (March 2006)	-0.2%	3.3%	4.2%
Russell 2000 (March 2006)	4.6%	12.4%	5.2%
S&P Toronto Small Cap (March 2006)	1.1%	0.6%	0.7%
S&P 500 (March 2006)	3.8%	10.6%	5.1%

*Estimated Performance

As part two in our mini-series of what we don't do, another risk management technique we keep coming across when talking to professional money managers and advisors is market neutral strategies. Some talk about how much they love them, some lament how their purchases of market neutral strategies post-2008 have caused them to miss the double off the bottom. In fact, it got to the point where we were considering opening our own market neutral fund, but decided that we wouldn't be doing anyone any favours with this option over a medium term investment horizon. The following is a brief summary of why we don't believe that market neutral strategies make much sense, and why many out there might not be as low risk as people think.

Most people usually go market neutral when it's too late. This is the number one problem with market neutral mentality. Anyone who bought a market neutral fund post-2008 can attest to this. Not making or losing money at all times just isn't a good strategy in a world where, over the long term, the general direction of financial markets is up.

Leverage Hurts. It is possible to make money with a manager that can generate "alpha", the problem is that you need to generate enough alpha to make a decent return when you are 50/50 long/short, either that or you have to use leverage, which is what most market neutral managers do. So now you are adding more gross exposure to reduce net exposure (100% long and 100% short is 0% net exposure but 200% gross exposure). Numerous market neutral or arbitrage strategies use 2-3x leverage (stock market neutral), 4-8x leverage (convertible arbitrage and merger arbitrage), or over 10x leverage (bond arbitrage, commodities, foreign exchange). The issue is that the more exposure you add the worse things can go wrong. Longs and shorts can move in opposite directions from time to time, the stock market can move substantially between Friday's close and Monday's open, or even shut down midday, and flash crashes can affect specific stocks but not the whole market proportionately. The reality is that during those "rare events" that seem to occur every six years, a 5% miscalculation can cause a 30% loss, leading to a more devastating margin call . . . it's always the levered strategies that famously go to zero.

Are you Beta (volatility) Neutral? If not, you are just fooling yourself. Long junior gold against short Barrick Gold is not market neutral. Long small cap stocks against a large cap ETF is not market neutral. Going long an oil drilling

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company against Encana is not market neutral. Basically, you are not market neutral when one side of the portfolio is significantly more volatile than the other side of the portfolio. In other words, your market neutral fund manager can be significantly long or short the market despite technically having net exposure of zero. The next time someone claims to be market neutral, be sure to ask if they are beta neutral as well.

Are you Liquidity Neutral? In other words, if things start to go horribly wrong, can you unwind both sides of the portfolio at the same pace? A lot of small cap long/large cap short strategies fall apart during periods of market stress for this reason. In market crashes small cap stockholders turn into "stuckholders". Fund redemptions can force selling into an illiquid market driving down these stocks on low volume, while large caps move on a more orderly basis.

Portfolio Concentration Defeats the Purpose of Market Neutral. The purpose of market neutral strategies is to provide low risk, low volatility returns. If your fund can take highly concentrated positions in stocks or sectors, or if it invests in highly volatile derivatives such as uncovered options or warrants, you may be able to generate good returns with alpha, but you may also be subjecting yourself to potential 10% drops. If one piece of bad news can materially impact a fund you aren't really risk neutral.

Basically, if you really want a true event neutral portfolio, you want a market neutral, beta neutral, liquidity neutral fund that uses relatively low leverage and is diversified. Oh yeah, and it needs to be able to put up consistent returns in excess of 7% after fees to be worth the trouble.

When we looked at doing a market neutral strategy ourselves, we concluded that despite what would have been some great historical numbers, the total performance would have been below the aggregate performance of the Founders Fund and that our portfolio concentration history (we commonly have positions in excess of 5%) would not have provided the low volatility that market neutral investors expect. I suspect that many market neutral portfolios that routinely hold 5%-plus positions would have similar problems over time. Instead we chose to adopt a systematic hedge policy, where we try to pair off specific risk factors in the long side of the portfolio. So far, it appears to be working.

We also concluded that our Income Fund is a better option for people looking for an approximately 7% return if they were willing to give themselves a 3-5 time horizon. Admittedly, what Mr. Market does over the short term can affect the volatility of the Fund. However, over the term of our bonds (which currently makes up roughly two-thirds of the portfolio), the market has no effect on these positions in any way whatsoever; as long as these companies stay in business, they need to give us our interest and principal back at maturity. I'll take that over market neutral any day.

We reserve the right to change our mind,

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

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