VENATOR
CAPITAL MANAGEMENT LTD.

RULE #35: FEEL FREE TO CHANGE YOUR MIND

Instrument (Inception)*	August 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**4.7%**	**21.0%**	**15.7%**
Venator Partners Fund (July 2014)	**4.3%**	**5.8%**	**-**
Venator Income Fund (August 2008)	**1.3%**	**10.8%**	**16.3%**
Venator Select Fund (September 2013)	**7.8%**	**29.3%**	**51.4%**
S&P/TSX Total Return (March 2006)	2.1%	16.9%	6.5%
Russell 2000 (March 2006)	5.0%	1.8%	7.2%
S&P Toronto Small Cap (March 2006)	2.5%	17.9%	3.4%
S&P 500 (March 2006)	4.0%	9.9%	7.7%
Merrill Lynch High Yield Index (August 2008)	1.5%	5.8%	11.1%

As the summer winds into autumn we continue to wonder if we are in the autumn of this nearly 6-year bull market. It's normal to gain outsized confidence that a long bull run like this can give you. It's also normal to attribute outsized performance to skill rather than increased risk tolerance that comes from overconfidence. It's not so normal to be looking over your shoulder when you are cruising downhill with no imminent danger around you. That being said, as anyone who has spent a day in our offices can attest, we at Venator can hardly be characterized as "normal".

One year into our Select Fund strategy (high risk, unhedged, highly concentrated portfolio), we find this Fund up over 50%. In a bull market this should be our best performing Fund. These kind of returns will have their comeuppance at some point, because where there are great returns, there is always great risk. Fully realizing this, we have bought a substantial amount of index put options which should serve to protect the Fund in the event of a more than 6% drop in the market between now and year end. We would like to take this opportunity to thank our early investors in this Fund. *Noting that the Select Fund has reached a critical mass sooner than we had expected, September will be the last time we will accept investments at the current minimum of $500,000. Beginning on January 1st, the minimum investment for this Fund will be increased to $1MM.*

Our Partners/Founders strategy has also had a decent run this year. Like the Select Fund we have chosen to buy some insurance against a possible decline in today's very complacent investment landscape. To that end we have purchased put options for this strategy as well, although not in as great a proportion given that this Fund is typically only 65% net exposed to the market anyways (a function of our systematic hedge model).

And finally, our Income Fund has had an ok summer as well, nearly doubling the performance of the high yield market. However, given the nature of the underlying securities (bonds and low volatility/non-cyclical stocks) we have chosen not to buy protective hedging instruments for this Fund at this time.

Rule 35: "Feel Free to Change Your Mind" is one of my personal favourites in investing. We get heavily invested in our companies in terms of time, research and relationships. As long term investors (as opposed to shorter term traders) this rule requires special attention. Actions that come from changing your mind can be accomplished fairly quickly with "buy" and "sell" orders so you need to take advantage of this characteristic of investing without abusing it through excessive trading.

When fundamental changes happen to our companies, competitive landscapes or regulatory environments we have a number of questions we need to ask. The primary question is whether or not the original reasoning behind the investment is still valid? In light of the changed circumstances, does the investment no longer represent good value? Is the investment thesis not playing out as expected? It is always important to remember why you bought the company in the first place.

This past spring, we had to let go of long-time holding Hanger Inc., which had been a nice triple for us since we initially bought the position in early 2008. We liked the base business (prosthetic and orthotics fitting centres) but were smitten with this amazing technology they had invented to help stroke victims with foot drop (a condition causing a fairly immobilizing limp). We thought the technology was great, the economics even better, and the road to commercialization was easy given they already dealt with 30% of all victims in the US. While Medicare reimbursement had been delayed on several occasions we still believed approval to be a free option for Hanger as it did not appear to be built into the stock price. Meanwhile, cracks were starting to appear in the business relating to industry-wide reimbursement delays for prosthetic devices in general. But we held steadfast, believing that approval for reimbursement for this new technology had the potential to more than triple the stock over the next several years. However, earlier this year a study suggested that gait speed, a primary measure for foot drop victims, had not improved substantially with Hangers technology (other advantages were ignored) and therefore Medicare would not be pursuing reimbursement. So the original reasoning behind the investment was no longer valid, and the investment thesis did not play out as expected. Regardless of how we felt about the base business we had to sell the stock, step back, and take another look at another time.

This brings us to ***<u>Rule #36: "If your thesis is broken then close the position"</u>***. We covered our Redknee short this past month after the stock dropped 20% following disappointing financial results. While the stock was slightly higher than it was when we first published this position, we made money as our conviction in our call allowed us to continue to increase our short position as the stock rose (in the end our average cost on the position was over $5.00 per share). Our thesis was that Redknee's financial position was getting stretched by what we characterized as aggressive revenue recognition relative to collectability of those revenues (mainly through the use of rising "unbilled receivables", which in our experience is always a red flag). With the release of its most recent quarter in August and the subsequent decline in the stock, it would appear that our thesis has now been accepted by a large contingent of former fans of the stock, as the company continued to burn through tremendous amounts of cash from operations (over $55MM in the past nine months despite non-GAAP positive EBITDA and minimal capital expenditures). This situation was bad enough for the company to announce near term restructuring charges of around $20MM, not something you typically see in a thriving, healthy business.

So why did we cover the short? Because the sell-side analysts who refuse to give up on this stock despite nothing but missed expectations, managed to raise Redknee approximately $75MM in front of two really bad quarters (usually when a company accepts this much financing in front of two bad quarters, investors tend to question the bullish theses outlined by the company and the analyst community, although the analysts are still sticking by this one for some reason). This $75MM is the difference between a $55MM positive net cash balance and a materially negative net cash balance which would have brought solvency into question and likely sent the stock south of $2.00. It also bought the company time and money to do their restructuring.

Suffice to say, this story played out way closer to our thesis than the sell-side research community's, which failed to even acknowledge these risks in any meaningful way, despite our mapping the whole situation out for them a year ago. But the roughly $75MM financing killed our thesis by buying the company more time to right the ship, and with a low sales multiple it is possible that the ship can be righted before the company runs out of cash again. So we will be sitting on the sidelines for now. To quote Keynes: "When the facts change, I change my mind. What do you do, sir?".

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

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