VENATOR
CAPITAL MANAGEMENT LTD.

RULE #10: HIGH PRICES LOWER FUTURE RETURNS WHILE INCREASING RISK

Instrument (Inception)*	February 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**2.6%**	**1.9%**	**14.2%**
Venator Income Fund (August 2008)	**1.7%**	**3.5%**	**16.4%**
Venator Select Fund (September 2013)	**3.6%**	**-0.9%**	**-**
S&P/TSX Total Return (March 2006)	3.9%	4.8%	5.4%
Russell 2000 (March 2006)	4.7%	1.8%	7.7%
S&P Toronto Small Cap (March 2006)	5.9%	7.7%	2.4%
S&P 500 (March 2006)	4.6%	1.0%	7.0%
Merrill Lynch High Yield Index (August 2008)	2.0%	2.8%	11.5%

*Estimated Performance

It has been said that the current bull market (which began in 2009) is one of the most hated of all time. Basically, this is the opinion of a bunch of naysayers and crybabies who just couldn't see the value that the markets were offering up over the past few years. That being said, there are those who love the current bull market. These people generally didn't lose too much in 2008, or they are money managers who launched their funds in late 2008 or afterwards (many of which may have blown up in 2008 only to launch new funds that now have great 5-year track records but don't have 7-year track records).

To briefly recap the significant stages of this bull market, we point to three main surges we can generally identify from the past five years:

- **The "the world's not coming to an end" stage:** This was the first jump that occurred in the spring of 2009. People actually forget that it did in fact appear that the entire banking system was about to collapse, debt was not going to be refinanced, houses were going to be free, most governments were going to go bankrupt, dogs and cats living together...mass hysteria (RIP Harold Ramis, screenwriter extraordinaire).

- **The "hey there is some good value out here" stage:** This was the meat of the bull market. The point where it was safe to go back into the water. Where you could find a multitude of good companies with decent growth prospects and improving balance sheets offering up multi-year 15% gains without taking on a lot of economic or valuation risk.

- **The "Get me in this market now! I want to buy that company I read about in the paper this morning that was up 20% yesterday" stage:** This is the current stage we are in. Where we are projecting Tesla to outsell Honda (even though not everyone has a garage to put a power station in), where eyeballs without revenues are worth tens of billions, where technology companies are worth over 20x forward revenues, where sub-5% growth restaurant companies are worth over 25x earnings and where every M&A transaction is somehow a table pounding "tender to the bid before this buyer's shareholders force them to retract this insanely

expensive deal" while at the same time being materially synergistically accretive over the long-term making the acquirer a table pounding buy.

This last stage brings us to Rule #10 (again with the caveat that I can't remember if I wrote this myself or read it somewhere, it may be plagiarized, so I am not taking credit for it either way): HIGH PRICES EQUALS LOWER FUTURE RETURNS WHILE INCREASING RISK. Higher prices encompass more optimistic future expectations (or at least a higher expected probability of the most optimistic possible outcome being the actual outcome) while at the same time lowering the potential return should this optimistic outcome come true. Allow me to provide a couple of illustrations.

When we first started buying Boyd Group Income Fund in the $4.00 range we had a view that the company a) was capable of earning $0.40-$0.60 per share; b) could grow earnings organically by 10%+ going forward; and c) could possibly do some large acquisitions to accelerate that growth. We were getting good value on the base case $0.40-$0.60 in earnings per share at under 10x our earnings expectations. With regard to the other two things that we thought could happen, we were getting them for free because they were not built into the price of the stock. Fast forward to today where Boyd, with an acquisition program that exceeded our most optimistic expectations, currently sits above $30.00, over 7x where we started buying it. Now, had the Street built into its expectations two years of growth, several acquisitions and given Boyd a 25x multiple on these expected earnings, the stock would have been trading at something like $25.00 at the time, ruining most of the upside and increasing the downside should factors b) and c) not play out as expected. Our potential upside would have been less, and our potential downside greater.

Basically, the more assumptions you need to build into your future expectations, when coupled with a valuation that strays too far from the current financial state of the company, the riskier your investments become. This is what happens when your favorite company beats expectations yet the stock declines; it happens because the positive outcome was already built into the expectations for the company. Remember that just because overly optimistic scenarios aren't technically in published analyst expectations it doesn't mean overly optimistic expectations aren't built into the stock price; this is pretty much where high valuations come from.

Let's look at another example many of you can identify with: Google. This has been a great stock over the past year, up about 50%. Google currently sports an enterprise value of about $350 billion and trades at $1200 per share. Now what if Google, one of the great growth stories of our time, traded at 20x revenues five years ago. I can tell you that the stock would have been at $1,400. So after those five great years of growth, you would have lost money had you paid 20x revenues for Google! All because you paid too high a price for the shares, and despite the company realizing all of your hopes and dreams.

When I look back at the technology crash of 2000, I see some ominous parallels to that time. Valuations in excess of 20x sales for companies with market values in excess of $10BB and minimal profitability marked the top back then. Multi-billion dollar takeovers for early stage companies with lots of eyeballs and undeveloped business models were common (Mark Cuban may have ended up buying the Dallas Mavericks, but I don't think there is even a single line of code at Yahoo that originated from their takeover of his Broadcast.com). There will be survivors and long-term winners and they are probably the household names such as Facebook, Netflix and LinkedIn. But the odds of Workday (20x revenues), Zillow (15x revenues) and Splunk (20x revenues) turning out to be as good stocks as they are companies is, in my opinion, a low probability. In one extreme case, we have recently started short selling a small Canadian software company (by small I mean $0.00 in revenues, and this is not a social media company) that has somehow achieved a $200MM market cap.

As much as we have been talking about technology, it does not have a monopoly on the realm of high valuations

and high expectations. Restaurants, brand name fashion, industrial distributors, 3D printing and grocery chains all look very pricey right now. Even if official expectations are low, the market isn't paying 25x earnings for Papa John's Pizza because it actually expects the company to grow 2% per year; there are unwritten expectations built into that price.

Currently, with regard to the vast majority of stocks we see, the risk/reward ratio is not in our favour. We are adding very few new ideas on the long side of the portfolio, and have enough stocks that we consider to be good short sales that we currently find ourselves with no market-based ETFs in our hedge book. In our Income Fund, we are experiencing a similar low risk tolerance in that we are gravitating to safer positions as we don't believe that the risk/reward profile for most bonds fits our risk tolerances these days; we are less invested but in safer bonds.

Looking at my notes I see one other thing I wrote beside Rule #10: "don't force the issue; if the opportunities aren't there, you are just going to have to wait".

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

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