

RULE #109: AVOIDING BUBBLES – YOU NEED TO ACCEPT LOOKING WRONG

HAVING THE CONVICTION TO KNOW YOU ARE RIGHT

Instrument (Inception)*	March 2014 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	3.1%	5.1%	14.5%
Venator Income Fund (August 2008)	1.4%	5.0%	16.4%
Venator Select Fund (September 2013)	4.4%	3.5%	-
S&P/TSX Total Return (March 2006)	1.2%	6.1%	5.5%
Russell 2000 (March 2006)	-0.7%	1.1%	7.5%
S&P Toronto Small Cap (March 2006)	0.3%	7.9%	2.4%
S&P 500 (March 2006)	0.8%	1.8%	7.1%
Merrill Lynch High Yield Index (August 2008)	0.2%	3.0%	11.4%

*Estimated Performance

To get to the point, we at Venator believe we are at some point in a bubble in the stock market. We do not use this term lightly. Bubbles are weird things, there is no way to really pick, or know, the top. Once you go into bubble land, there is still the possibility of huge gains to be made before it all comes crashing down. There are two types of bubbles we are concerned with:

- **Asset/Financial Bubbles:** this is what we experienced in 2007-2008. The asset was housing, which led to easy lending and excessive leverage, which led to a systematic crash given how much money and how many parties were involved. This is an admittedly simplistic explanation. We do not think that we are in this type of bubble.
- **Stock/Sector Bubbles:** this is what we experienced in 2000 (tech) and 2006-2012 (mining). Some of you may even recall the days of the "nifty fifty" when no price was too high for a blue chip. This is the type of bubble we are in, but the degree to which we are in it varies by sector, as stock bubbles usually do.

Let's start with the genesis of bubble psychology and stock momentum in general:

RULE #106: Investors should like a stock (or a house, or a pair of shoes) less when it goes up in price, but in the topsy-turvy world of the stock market they like it more.

It's like a reverse-sale; instead of advertising 20% off all items to get people in the stores, the media, brokers and fund managers are offering **20% more** to cause a Thanksgiving weekend-like stampede into the stock market. Also note, that unlike retail, where there may be only one pair of purple-spiked pumps left in the city, there are theoretically always shares available to buy in the stock market because it's easier to track down a current owner and offer them more for their share/shoes.

RULE #108: *A variation of Maslow's hammer, where in a bubble market everyone's excess cash (and unfortunately sometimes available borrowing capacity) feels like a hammer, and when they wield that hammer every stock looks like a nail. Otherwise known as the angry/panicked "get me in this market now" phone call most brokers have received over the past three months.*

You can just see the money move from stock to stock as every piece of news provides a fresh reason to buy or upgrade a stock. I am not even sure what got Ballard Power and Plug Power to add \$500MM in market cap each in less than a week (500% gain), but it wasn't anything done or announced by the companies (just some general and fairly non-specific support for alternative energy from the US government). It's not as though SunEdison or First Solar have been slouches either. Don't bother screening on financial metrics, just run a Google search for "public companies in sector XYZ", buy the one that hasn't moved yet and then wait for it to be uncovered on "Seeking Alpha" (or write the article yourself if you a feeling manipulative as Barron's has recently noted). I still remember back in 2000 when a company could move its stock up 20% in a day just by announcing that it was in the process of developing a Linux product for future release.

In a bubble, when you find the hot sector its "ready, fire, aim". Big Data? FIRE! Cloud computing? FIRE! Restaurants with store expansion? FIRE! The next Michael Kors? FIRE! Biotech? FIRE! It doesn't matter that the "aim" is off, we will do our due diligence later. Eventually we may/will discover that business intelligence vendor Datawatch doesn't have anywhere near the organic growth rate of Splunk; or that Sphere 3D had zero (\$0.00 for clarification) revenues in its last three reported quarters (to be completely fair they just acquired a company that has less than \$10MM in 2013 revenues for \$10MM in cash and stock) - the stock recently traded with a fully diluted market cap of over \$200MM, we repeat - zero revenues! We may remember that restaurants with sub-5% growth are too cyclical to trade in excess of 30x earnings over time. We may take note that Kate Spade isn't Michael Kors until it can prove that it can turn a reasonable profit. By the way, at this point pretty much all application software companies are "cloud computing", but that doesn't justify healthcare benefit management cloud company Castlight, with prior quarter revenues of only \$5MM, being worth over \$3BB on its IPO.

RULE #107: *In a bubble all target valuations gravitate to highest multiple on a poorly thought out "comp chart".*

The "comp chart" is a list of companies that are supposed to be similar to the stock in question that provide a guideline for what multiple similar companies should trade at. It's an analytical guideline for setting target prices. For example, if four companies with similar growth rates in the same sector trade at the same multiple of earnings, then the fifth company can be expected to trade at that multiple. This assumes "all else being equal", which it never is, and analysts tend to take liberties with the "all things being equal" assumption in bubbly markets.

If the stock goes through your target, they just throw some higher priced companies on (or drop some lower priced companies off) the "comp chart" in order to justify a target increase. If you are a software company that's getting a little expensive, just get an analyst to put Workday (20x 2014 revenues) on your comp chart to drag the target multiple up (kind of like what the market did when justifying mining companies that traded in excess of 1x net asset value - I still get a chuckle out of that one - this junior gold company may cash flow \$500MM over the life of the mine, and we think you should be willing to pay \$750MM for that because that's what others trade at; a financial version of "if all of your friends jumped off a bridge would you?").

As an example, we recently read a report on Enghouse Systems. Now, Enghouse is a very good consolidator of companies, but currently has an organic growth rate of about 0% (I don't think any analysts disagree on this point, given that management admitted as much on its most recent conference call). Yet somehow/someway Salesforce.com (the de-facto leader in cloud based applications with three consecutive 25%+ organic growth years behind it) snuck onto a recent comp chart for Enghouse. These companies couldn't be more different. Enghouse is a high earning, low/no organic growth consolidator, while Salesforce.com is a high growth/low earning cloud-computing leader. That being said, Salesforce.com has a way of increasing multiples on a comp chart which no doubt helps the Enghouse investment thesis since it trades at a sky-high 30x earnings considering its lack of organic growth (note that I fully understand the bull case for Enghouse, and that the company is very good at what it does, namely consolidate other software companies and maximize cash flow in short order; this is not a commentary on the quality of Enghouse's business, it's a commentary of the stupidity of using inappropriate comps to justify higher targets). Recent research reports similarly contained comp charts for former Venator holding Datawatch (organic growth of less than 10% prior to a recent acquisition), which contained Splunk (50% growth) and Tableau (90% growth); at least they are in the same big data space, but what give the latter two their premium valuations is their growth. So either Datawatch isn't competing very effectively resulting in a lower growth rate, or they have yet to prove they belong in the same zip code as Splunk and Tableau (again, not a commentary on the quality of Datawatch management or products, just a commentary as to how targets get pumped up so easily when you are chasing a high flying stock).

Lest you think I am relying too much on my technology analyst past (I was a sell-sider with a lot of sell/hold recommendations in the midst of the 2000 bubble), I can tell you that the entire Restaurant sector is just a pile of companies playing leap frog over each other on the comp chart, each one dragging up the others valuation. Industrial HVAC companies and distributors look pretty rich at 20x-30x earnings given their sub-10% growth rates, but they comp well against each other. Fashion companies (not the retailers) are in the same rising boat; however, don't you dare put Coach on my comp chart.

A closely related problem is the common commentary that Company ABC is "the next" XYZ (company XYZ is a wildly successful company trading at a high multiple). Kate Spade is the next Michael Kors, every biotech is the next Intercept, every biotech consolidator is the next Paladin Labs, every cloud computing company in the next Concur. But maybe Kate Spade is the next Coach, maybe Lululemon is the next Urban Outfitters, maybe Workday is the next Ariba (this isn't as far-fetched as it sounds), maybe without any paying customers it's a little early to claim that Sphere 3D is the next Citrix, or that CHUYs is the next Chipotle.

Let's just ask why the street is always trying to goose comp charts at the high end? In most cases, the low end is probably the better comp series. When I think of the Canadian software low-organic growth consolidator set (Enghouse, Constellation, Open Text, Redknee) I think more of Oracle (13x earnings) than anything else. Frankly, I prefer to run comp charts against growth rates, not simply some high-flying, kind-of related sector the company is trying to tell you that it's in.

One final argument against the bulls in the bubble that is heard every time. The bulls say buy the clear-cut long term high quality winners and you will be fine. Of course the long term winners are most easily identified as the high growth market leaders with the high valuations that you read about in the paper every day. That is fine in theory, but buy these companies near the top of the bubble at your own risk. For as promising as Twitter, Workday, Tesla and Kate Spade look, stocks that get knocked off of very high perches take a long time to recover. Probable long term winners in 2000 included Cisco (still down 70% from the top), Sun Microsystems (bought by Oracle after a steep decline), Nortel (Bankrupt) and YAHOO! (still down 60%). Maybe you get lucky and get the next Amazon, just don't forget it took TEN YEARS for that winner to recover to its 2000 high.

RULE #109: AVOIDING BUBBLES: YOU NEED TO ACCEPT LOOKING WRONG (over the short-term), HAVING THE CONVICTION TO KNOW YOU ARE RIGHT!

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



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PS, as you might have guessed we are short some, but not all, of the companies mentioned in this report, including Splunk, Workday, Castlight, Redknee and Sphere 3D among others.

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