VENATOR
CAPITAL MANAGEMENT LTD.

ZERO PERCENT RATES HAVE TO END SOON (there, I said it)

Instrument (Inception)*	July 2015 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**-3.8%**	**-0.7%**	**14.4%**
Venator Partners Fund (July 2014)	**-4.1%**	**-1.8%**	**5.0%**
Venator Investment Trust (September 2007)	**-4.0%**	**-1.2%**	**10.7%**
Venator Income Fund (August 2008)	**-2.7%**	**-1.4%**	**13.6%**
Venator Select Fund (September 2013)	**-5.2%**	**-9.9%**	**21.3%**
S&P/TSX Total Return (March 2006)	-0.3%	0.6%	5.3%
Russell 2000 (March 2006)	-1.2%	3.5%	7.2%
S&P Toronto Small Cap (March 2006)	-6.4%	-5.5%	0.4%
S&P 500 (March 2006)	2.1%	3.4%	7.7%
Merrill Lynch High Yield Index (August 2008)	-0.6%	1.9%	9.4%

Half-way through earnings season we have had 16 companies report (nine of our longs and seven of our shorts), nine of which beat our expectations, three of which met our expectations and four of which missed our expectations. That's actually a pretty good batting average, but alas as you can tell, we did not have a good month. Our biggest loss came from one of our companies that was unable to resolve a known past regulatory issue (encompassing operations from 2010-2013) and decided to go to court; a bad piece of news given that the company had publicly disclosed a range of expected settlement outcomes (the worst of which the company could easily afford) based on their year of negotiations with the FTC. While we view what happened as very unlikely given the range of probable outcomes for that case, as we have said in the past: sometimes improbable things happen (this is basically the sales pitch that keeps the insurance industry in business).

With our core strategies relatively flat year-to-date we feel very confident going forward. We invest in value and for the long-term. As we have always said, you get to buy companies at value prices precisely because they are unloved or unknown, and you can't expect these companies to jump to whatever you deem to be fair value the day after you are done buying. Put another way, if everyone loved it you wouldn't have been able to buy it at that value in the first place.

Stanley Druckenmiller made a speech earlier this year (forwarded to us by one of our investors) whereby he warned that, in his opinion, when the party ends it will end badly. One of the main themes in his thesis is the unsustainable level of easy credit the Federal Reserve and their global counterparts have made available to businesses today. It is tough for us to disagree, which is why we have been so defensively positioned for the last year.

While the whole of the speech was interesting, there was one particular snippet that grabbed my attention. Basically (and I am paraphrasing here), *he questioned how the Federal Reserve could put rates at zero and hold them there for five years, something they had not done for roughly 100 years, when the current state of the economy and capital markets is in nowhere near the worst shape it has been in during that time.* This is a very basic but fantastic point he is making. You could even shorten the criticism by simply asking why would you ever have zero interest rates with the stock market pushing an all-time high and non-investment grade bond yields plumbing all-time lows (with historically covenant light terms)?

It seems the low rate mission is nearing completion, and furthering this policy might prove especially damaging since the benefits of low rates are not being accomplished, and the uses of funds are being recycled into an economic merry-go-round. At a basic level, low rates are supposed to accomplish one thing economically: encourage investment. Basically if you are going to get no return for holding cash, and/or it will be exceedingly cheap to borrow money, naturally you should try to get a higher return on your money by investing it in a new factory, productive employees or capital markets. While the first two of these things happened with varying degrees of success (resulting in sluggish GDP growth), getting money into capital markets has been the standout success. This is why we have capital markets at all-time highs, yet capital spending, employment and economic growth are not at levels you would expect.

So why have low rates not had the desired effect on capital spending, employment and economic growth? It's because this economic cycle has been largely corporate finance driven. It's been about mergers, leveraged buyouts, stock buybacks and dividends. These things don't exactly expand economic activity, only capital market valuations. Merger synergies cut jobs and factories in order to increase capacity utilization, leveraged buyouts cut companies to the bones (most LBO companies we look at have relatively little organic revenue growth), and "returning money to shareholders" in the form of buybacks and dividends doesn't expand businesses. You see, in this cycle where low rates have created cheap debt, or at least no incentive to keep excess cash on your balance sheet, why hire employees when it's easier to borrow money to buy back 10% of your stock or increase the earnings of your business by $100MM for $1.5BB in debt that only costs you $60MM in interest expense? *I don't think the Fed actually envisioned a market where buying took such immense priority over building when they decided to hold rates down after the market had largely recovered by 2011*.

Based on what has happened, which we don't think is about to change with regard to hiring and capital investment, the only thing that low rates is going to do is push more investors into this long-in-the-tooth bull market, and therefore the Fed is risking the negative consequences of their easy-money policies (namely more people throwing money at capital markets in front of a crash) without the core economic benefits they are hoping for (namely higher employment and economic growth). This means it's time to throw in the proverbial towel on low rates because at this point you are just risking greater and greater capital market losses when the party does end.

And no, raising rates by one-quarter, to one-half of a percent isn't going to change my opinion. Given where they are now in the market cycle, you probably need to raise rates by 2%+ to get to a reasonable level of 3%-4%, which is probably where we should be given where financial markets stand today.

For those of you who may not have noticed, North American markets are currently flat for the past twelve months in their local currencies. I think this is because, generally speaking, people are looking for organic growth which is proving increasingly scarce. Corporate finance activities benefit those undertaking them. But organic growth is contagious: it pulls suppliers, pushes customers, spurs innovation, and gets the competitive juices flowing. The Fed is just going to have to find another way to achieve its growth goals. Maybe if they raise rates, and in so doing eliminate the main ingredient to financial engineering activities we have been seeing over the past several years, corporations will be forced to seek out organic expansion to keep their stock prices up. It's counterintuitive but with rates already at zero, it's pretty much the only option left.

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

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