

MID YEAR REVIEW

Instrument (Inception)*	June 2015 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	1.0%	3.3%	15.0%
Venator Partners Fund (July 2014)	0.7%	2.4%	9.9%
Venator Investment Trust (September 2007)	0.9%	3.0%	11.4%
Venator Income Fund (August 2008)	-0.8%	1.3%	14.2%
Venator Select Fund (September 2013)	1.4%	-5.0%	26.0%
S&P/TSX Total Return (March 2006)	-2.8%	0.9%	5.4%
Russell 2000 (March 2006)	0.8%	4.8%	7.4%
S&P Toronto Small Cap (March 2006)	-3.5%	1.1%	1.1%
S&P 500 (March 2006)	-1.9%	1.2%	7.5%
Merrill Lynch High Yield Index (August 2008)	-1.5%	2.5%	9.6%

As we approach the mid-point of the year, I thought this would be a good time to review where we might be in the market cycle, and how our Funds are positioned for the balance of 2015. Contrary to the financial press' attempts to sensationalize the current state of the market, this has been a fairly uneventful first half of the year. Implied volatility continues to bump along multi-year lows (both the TSX and S&P 500 are up less than 5% this year), interest rates continue to oscillate at all-time lows, currencies are more stable than they appear, and even the press' fascination with commodities seems to be losing its steam with crude oil not having materially moved since mid-April.

As always there are going to be some hotter and some cooler areas of the market in any given year. This year the hottest areas have been IPOs (even in Canada which is embracing the US model of floating only a sliver of stock as to ensure massive order books), and low internal growth companies focused on acquisitions using a combination of overvalued stocks and low yield debt. In the case of IPOs, they are structurally set up to succeed on day one, but structurally set up to struggle after week one as pre-IPO shareholders become perpetual sellers of the stock into the high expectation estimates as many of these companies masquerade as being higher growth than they really are. For the low-growth acquisitive companies, these companies are set up to succeed until they don't; this is largely the result of easy to beat low growth expectations coupled with increasingly difficult to meet acquisition expectations, both of which we believe will eventually be trumped by the ultra-high valuations of the group relative to their standalone growth prospects. The key to keeping your head on straight is to remember that all of these companies are being acquired for offers the sellers feel they can't refuse; and that they can't all be bargains if the majority are being bought at the highest price the sellers could get.

In terms of "cooler" areas of the market, the most obvious is yield-influenced equities such as REITs. While interest rate linked securities such as bonds have "hung-in" despite the constant threat of rate increases, as have debt-laden cyclicals and acquisitive companies in the face of less attractive financing/refinancing terms going forward, equity based securities purchased largely due to yield characteristics have not fared nearly as well. We will talk a little more about this below.

Outside of those two specific areas of interest it is tough to draw too many conclusions from such a benign market environment, so let's briefly discuss what we think of the current market. We see a lot of "chasing", and valuations seem to be losing their rationality or objectivity. There is too much corporate finance to be done, too much money

chasing hot deals, and too many analysts and portfolio managers afraid of missing what's left of this six year bull market. We see too much mediocrity being promoted on the basis that "they are going to do acquisitions". Comparable valuation charts are starting to change to inappropriate "comps" or disappearing entirely from analyst reports when valuations can't be supported by other market examples. "Risk factors" have been reduced to boilerplate items found in prospectuses rather than mentioning true analytical accounting or specific competitive or customer concerns. A recent study by the Financial Times/Bloomberg pegged the median recommendation of S&P stocks as being higher than late 1999 and pre-crisis 2008. Basically everything is "on the come", history is discounted entirely, and financial engineering trumps true growth. In short, the market is giving companies the easy path to prosperity and high valuations; acquisitions are easy, organic growth is hard - if you get the same valuation either way why bother with the high bar expectations of growth?

So what is our outlook for the rest of the year? We don't really like to time the market, but we always have a view and currently that calls for some low volatility weakness ahead. The various Federal Reserve equivalents around the world value stability above all else. At this point I think they would take stable weakness over jumpy gains so that's where I think we are headed. We believe it will be difficult for GDP+ growth companies to maintain 'growthier' valuations. That being said we are positively predisposed to organically growing companies that build cash (since they don't spend it all on acquisitions) because in many cases they trade at similar valuations to the consolidator growers who do spend all of their cash flow on acquisitions. We continue to have a bearish outlook for oil (Exxon remains our largest short and we are back on our crude short), and have become somewhat negative on our outlook for gas as production costs have declined which could result in renewed oversupply; and we don't view gold as protection against anything in particular. We are concerned about longer term bonds, as despite recent weakness they still exhibit the ultra-low-rate characteristics we call return-free-risk, and in fact the long bond ETF is one of our larger shorts.

Finally, a quick word on our individual Funds:

Venator Founders Fund / Partners Fund/ Investment Trust: So this strategy has managed to keep up with the broader markets thus far. The returns this year have been split fairly equally between the long positions and the short positions. While there has been a few material adverse developments in the portfolio, they have been offset by our winners. Going forward we remain optimistic as we have found some good value in several large positions that have yet to materialize. The strategy currently has a below normal 50% net long exposure to the markets, but is also running with very low statistical correlation to the market (estimated weighted component beta of 0.10). As is typical, the strategy is currently invested in just under 30 companies on the long side, with the top 10 positions making up about 50% of the portfolio, the largest of which are Entercom Communications, Spectrum Brands, Concordia Healthcare, Callidus Software, and Halogen Software. Offsetting this is just under 20 short positions, the largest of which are the long-term treasury bonds, oil, Exxon, and the S&P 500.

Venator Income Fund: Thus far in 2015 this Fund has managed to keep up despite some severe weakness in two healthcare REITs in the portfolio, and one oil-and-gas infrastructure company (which despite fixed-fee, long-term contracts has been the baby in bathwater). We have held onto two of these positions that give us 10%+ yields. The yield market is still on shaky ground which is why we have kept the vast majority of our bonds inside of 2020 maturities in order to mitigate any general bond weakness. The Fund is currently carrying a yield-to-maturity of just over 7% and a yield-to-worst of just over 6%. We continue to have a one-third stock, two-thirds bond split, but have added some "SPACs" to the mix (sidebar: SPACs have been around for a while but are relatively new to Canada. You are effectively giving a proven management team a blank check to find an acquisition. The good news is that if they can't find one within two years, or you don't like the deal they find, you can get all of your money back). We remain optimistic that we can hit our mid-to-high single digit return targets for the Fund in 2015.



Venator Select Fund: This Fund got off to a rough start in January (down 8.4%) and has gradually been making its way back into the black. With its concentrated portfolio, wins and losses tend to be amplified and we have had several 2% hits to the Fund (20% drops on 10% weights). Nonetheless, this being our "best ideas" Fund we remain optimistic. Our largest position, Entercom Communications, is a near 25% weight in the portfolio, while our second largest position is a near 20% short position in Exxon. We are also carrying over 20% of the portfolio in two SPACs, as these offer very attractive risk-return trade-offs.

Overall, I would characterize our current mindset as being the very cliché "cautiously optimistic". Cautious on the market, but optimistic on our holdings. While we see potential weakness ahead, we think that low expectations coupled with some very gradual change will keep volatility manageable which should allow us to be diligent and patient.

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

A handwritten signature in black ink, appearing to read "B. Osten".

Brandon Osten, CFA
CEO, Venator Capital Management Ltd.

This is intended for informational purposes and should not be construed as a solicitation for investment in any of the Venator Funds. The Funds may only be purchased by accredited investors with a medium-to-high risk tolerance seeking long-term capital gains. Read the Offering Memoranda in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares. All stated Venator returns are net of fees. It is important to note that past performance should not be taken as an indicator of future performance.