VENATOR
CAPITAL MANAGEMENT LTD.

FIRST DOWNS VERSUS TOUCHDOWNS

Instrument (Inception)*	May 2015 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**0.4%**	**2.3%**	**15.0%**
Venator Partners Fund (July 2014)	**0.1%**	**1.7%**	**-**
Venator Investment Trust (September 2007)	**0.3%**	**2.1%**	**11.4%**
Venator Income Fund (August 2008)	**-1.4%**	**2.1%**	**14.5%**
Venator Select Fund (September 2013)	**1.4%**	**-6.3%**	**26.4%**
S&P/TSX Total Return (March 2006)	-1.2%	3.8%	5.7%
Russell 2000 (March 2006)	2.3%	4.0%	7.4%
S&P Toronto Small Cap (March 2006)	0.3%	4.8%	1.5%
S&P 500 (March 2006)	1.3%	3.2%	7.8%
Merrill Lynch High Yield Index (August 2008)	0.3%	4.1%	10.0%

As many of you know I used to be a stock analyst for approximately ten years before venturing into my current endeavor here at Venator. I still remember some very well respected people assuring me that, while I was considered a very good stock picker, running a portfolio was a different game. Frankly, I think they were wrong. With the right investment-first (trading second) attitude, the only way to build a solid and long lasting investment portfolio is by picking good stocks for the long-term. If you do this well, the other mistakes become rounding errors.

One thing I definitely don't miss is the importance of individual quarters. I remember how overly important it was considered for a company to beat or miss $0.50 earnings estimates by one penny. I remember how the forward progress of a business could be derailed because of a 30% growth rate when the street was looking for 33% growth (never mind a whisper estimate of 35%). This type of micromanaging the development of a thriving business really causes you to lose sight of the larger opportunity.

Being too focused on the quarterly results vs the longer term opportunity is akin to being overly focused on first downs versus touchdowns. While you can definitely string together a bunch of first downs and turn it into a touchdown, a good QB always keeps looking downfield because the touchdown is the goal of the offense.

Private companies probably know this better than anyone. An entrepreneur realizes that a company's growth rates aren't predictable, and that slipping from a 40% growth rate in one year to a 20% growth rate the next year is not even remotely close to the end of the world; this probably has something to do with him not watching his stock drop 40%. Another entrepreneur might have a company experiencing some tough times and is pretty happy with their efforts to right the ship even if it is taking a little longer than expected, so long as they are comfortably making payroll. Again the private company management team has the ability to be patient enough to get it right, rather than be forced to work on the stock market schedule.

I am not discounting the fact that there are some definite advantages to being public. Namely, it is easier to get financing for capital expansion projects and acquisitions. And of course there is the ability to cash in on much more than a company's current cash flows (otherwise 1x earnings would be the default P/E ratio). But when the market is so focused on price and not necessarily thinking of value, it most likely has an effect on the direction of a business (is it worth the private company CEO's effort to "smooth" quarterly results out by worrying whether a deal closes on

June 20th vs July 5th?). In terms of lowering the quality of your product in order to placate Wall Street's desire for more growth or lower costs, one wonders if we would have to watch 20 seconds of commercials before watching a movie trailer on YouTube if Google was private (in effect being forced to watch a commercial before watching a commercial).

Warren Buffett is fond of saying price is what you pay and value is what you get. In a way, price is a distraction relative to the overall direction of the business. As long as you feel you are paying a fair, or less than fair price, then the direction of the business should be your only concern. Quarterly reports are definitely useful yardsticks in terms of determining a company's progress towards its potential (do private companies even care about quarters?), you just don't want to lose sight of the bigger picture due to immaterial fluctuations in a company's quarterly reports.

Of course you still have to be cognizant of when an investment becomes overvalued relative to its prospects. A major advantage of investing in public companies means there is pretty much always a buyer at the current price, even if a company's fundamentals begin to materially deteriorate (this is not always the case with private companies). When companies become overvalued it is usually a function of two things: the market is too optimistic about the company's prospects (ie the estimates are too high), or the market gets too enamored with justifying relative value (temporary assessments of value relative to other similar companies that may also be overvalued).

Of course in the context of managing a portfolio we do need to assess the market's reaction to our estimate of a company's quarter vs expectations. On cheaper lower growth companies this isn't as actionable an exercise as their quarterly results don't tend to dip too far from recent revenue trends, expectations are relatively low, and our margin of safety is likely significant. Growthier companies tend to carry more estimate risk and volatility around earnings reports due to the compound effect of future growth on current expectations.

As an analyst, a huge part of my job was figuring out which companies would beat the quarter and which would miss. When you think about this, it actually makes a lot of sense. For one thing, investors were always more interested in the high profile momentum companies than the deep value turnarounds. Everyone knows who the high quality growth companies are, and everyone has their own opinion as to the valuation of these companies (to the extent that they care about valuation), so the main place to add value on these stocks that people really care about is in predicting quarters. Therefore, on most of my companies I probably spent a disproportionate amount of my time working on my quarterly expectations. But when you are running a portfolio for the long-term, your efforts need to shift to the long term.

To illustrate a few recent examples of us getting "cute" with our quarterly models, just over a year ago we sold our Skechers stock at around $30.00 (for reference it is currently at $100). Basically, we were too concerned about the predictability of its second quarter numbers given that we couldn't figure out whether back to school inventory stocking for retailers was going to happen on the right side of the June 30 quarter end. This lack of certainty around the quarter, and our taking our eye off the bigger picture that caused us to buy the stock in the first place, caused us to miss a very profitable opportunity. The other mistake we made in this case was that when the stock started moving up, we allowed its recent past to hold too much influence on our decision to repurchase the stock (a psychological trading error known as the anchoring effect).

On the other side, we recently sold our Open Text prior to the release of their disappointing March quarter results (followed by some recent news regarding a very disappointing June quarter expectation) and avoided some substantial losses (sold in the high $60s, currently in the low $50s) due to our expectation of difficult near term results.

While the results of our quarterly analysis tends to be right more often than wrong, our biggest winners have been those where we weren't concerned with the quarters at all; we had our eyes on a bigger prize than the short term results. There is nothing like getting bogged down in the exercise of calling quarters to make you either sell too early or sell too late. Nothing makes the investing world seem more unjust when you get the analysis right but the direction

of the stock wrong (sometimes you get the quarter right but the company guides the wrong way anyways), even though you knew that the long term outlook ran counter to the short term results.

So if I was to tidy up this letter and put a bow on it, I would tell you that first downs are ok, but we are always looking downfield for touchdowns. We are willing to risk some incompletions along the way because we are patient and are trying to avoid interceptions. We will even punt every now and then by getting more market neutral when the opportunities just aren't there. Note that this isn't the same as swinging for homeruns and risking strikeouts; a touchdown is a calculated longer term process vs a home run swing which is more of an all or nothing proposition (strikeout, pop fly or home run, of which the home run is the least likely outcome).

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

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