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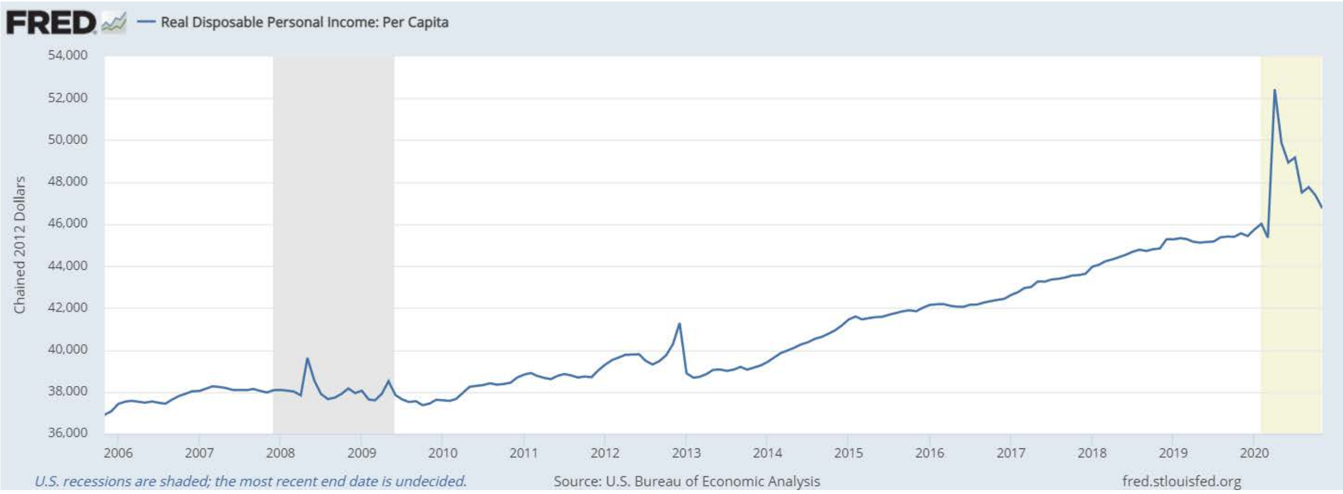
The extreme volatility of 2020 continued into the fourth quarter with our strategy recording a gain of 21.95% net of fees (22.31% gross) in Q4 giving a 2020 full-year return of 10.99%, net of fees. The biggest contributor to our performance this quarter was Joban Kaihatsu (Tokyo: 1782) due to a takeover bid that I will elaborate on further in this letter. 2020 has certainly been the most memorable for our strategy since we launched in 2014. I previously predicted in my email to investors at the end of February, that Covid-19 would set a record for the fastest vaccine development from point of virus discovery. This speed would be due to recent developments in biotechnology and how the virus would galvanize the world's resources to confront this novel deadly threat.

Russia was the first country to approve a vaccine with their Gam-COVID-Vac adenovirus-based vaccine in August. By the fourth quarter, we saw widespread distribution of approved vaccines begin in North America and Western Europe. With the virus sequence first published on January 10th, my prediction of unprecedently fast vaccine development proved correct.

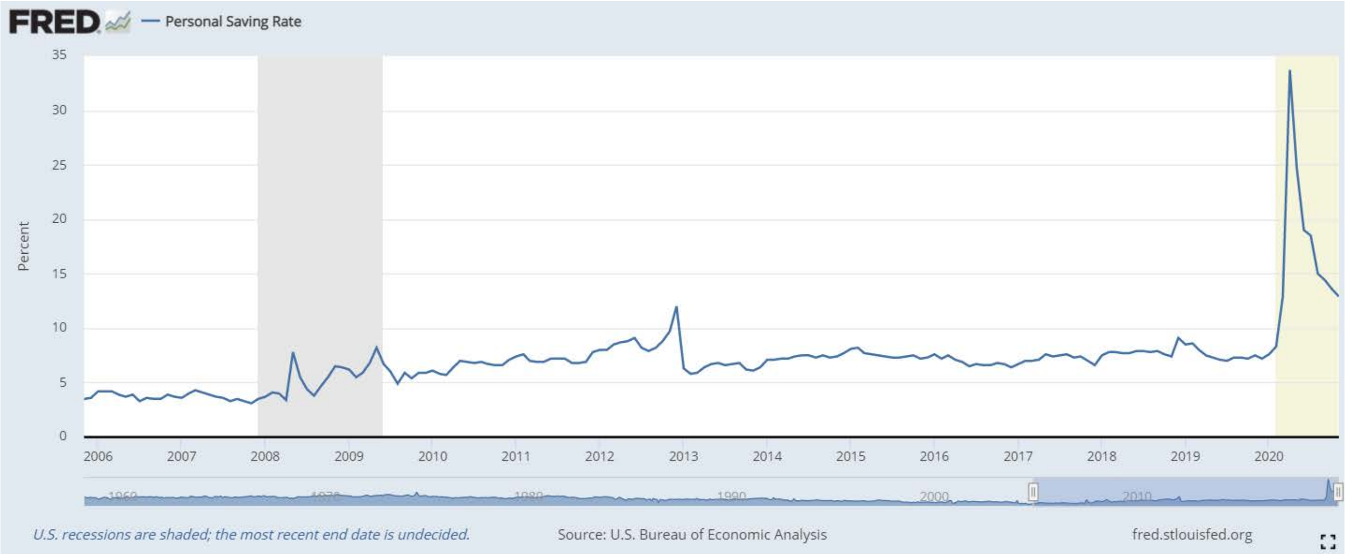
The distribution and approval of the vaccines along with the ending of the uncertainty in the outcome of the 2020 US election led to a great market rally in the fourth quarter. Investors were well rewarded to have remained fully invested throughout this political and pandemic uncertainty.

The Counterintuitive Behavioral Phenomena of 2020

Typically, in a recession, we see a decline in real personal income per capita. For example, in March of 2009, we saw a decline of real personal income per capita to $37,603 from the March 2007 level of $38,268. By contrast, this current crisis has seen real personal incomes rapidly shoot up at the highest speed in decades. The CARES Act was the largest US government stimulus program in history and sent trillions of dollars into the economy. Workers who had not lost their jobs were still eligible to receive the stimulus payments and those who did become unemployed enjoyed enhanced unemployment benefits (which sometimes paid more than their previous jobs). The combination of direct stimulus payments and unemployment benefits caused household incomes to greatly increase on average. At the same time, this stimulus was insufficient to fully make whole tens of millions who had their businesses closed by lockdowns or who lost high paying jobs. This creates a highly unusual combination of rapidly increasing household incomes along with skyrocketing unemployment and delinquencies of mortgage borrowers and renters.



At the same time that disposable income was increasing, the opportunities to spend money have been sharply reduced. Bars and restaurants are closed across the country. Travel restrictions prevent foreign vacations. Work from home reduces the need to spend on commuting expenses. As a result, the savings rate dramatically increased to the highest rate ever observed in the US. The savings rate is usually slightly higher in recessions. Consumers are less willing to make purchases as they are cognizant of the elevated risk of losing their job and the difficult job market awaiting them should that occur.



These savings must find their way somewhere and during the first half of 2020, asset flows into money market funds have been the highest ever during any six-month period. Numerous stock bubbles have also been fueled in part by bored retail speculators depositing their money into brokerage accounts. With many sports events cancelled, casinos closed, and other avenues of entertainment restricted, many people have turned to financial markets for their entertainment. Daily volume in single-stock options averaged 17.3 million contracts during 2020, up 68% from 2019[1]. Stocks with entertaining narratives have had their prices bid up into bubble territory. These bubbles can be seen in the stock returns of unprofitable technology stocks and especially those of anything related to electric vehicles. In the below chart of a Goldman Sachs constructed index of non-profitable US listed technology firms, we can see that these companies have more than tripled since the beginning of 2020!

Tesla attracted a great deal of attention in 2020 with an astounding 730% gain in stock price. Enormous stock price gains and high valuations can also be seen in many other electric vehicle and battery component companies. Novonix, an Australian company which produces synthetic graphite materials for battery anodes has more than quintupled over the past 12 months and now has a market cap of AUD$981 against trailing twelve-month revenues of approximately AUD$4 million. Nio, a Chinese company which produces electric vehicles like Tesla, now has a greater market cap than General Motors. QuantumScape, a previously private battery technology company with a potentially revolutionary solid-state NMC-lithium battery design, announced a merger in September with a special purpose acquisition company (SPAC), Kensington Capital Acquisition. The SPAC gained 86% on the day of the announcement and its share price went from $10 on September 2nd to end the year at $84.45. QuantumScape is several years from having any marketable products, there are no guarantees that they can scale up their cells into a commercial product, and no guarantees that competitors cannot develop equivalent batteries, but their market capitalization has already reached a $18 billion market cap. It is certainly possible that their battery technology will revolutionize the electric vehicle industry, and it is these paradigmatic change narratives that are driving speculative momentum. A strong

[1] https://www.barrons.com/articles/stock-option-volume-exploded-in-2020-51610017270

argument can also be made that the new US Presidential administration and Congress will heavily invest in green technology and infrastructure as a form of stimulus. However, it is also a factor in these outsized EV stock returns that bored investors with excess savings want to invest in entertaining narratives, and potentially world-changing technologies fit that desire.

While the stock prices of large US corporations have been shooting up in 2020, international equities have been mostly left behind. Some of our Japanese investments still trade at low earnings multiples and negative enterprise values. Additionally, our stocks in Europe have not yet recovered to their pre-Covid highs despite reporting strong numbers throughout 2020. There are many stocks out there which remain not just cheap relative to overvalued bubble stocks, but even in absolute terms.

EZCORP

While I made a correct prediction about vaccine development, my predictions about EZCORP in my Q2 2020 letter were far less accurate. Normally in an economic crisis, demand for subprime credit is elevated and counter-cyclical companies such as pawn shops have their best years. As a result of the disposable income increase previously discussed, we have instead seen sharply declining demand for subprime credit. Pawn shops have seen loans repaid by customers and much of their inventory purchased, sending cash on hand to extremely high levels as pawn service charges plummet. Compounding this issue for EZCORP in particular was that the rollout of their digital Lana app saw very low adoption by customers. EZCORP has performed terribly in 2020 and the company has responded by replacing the previous CEO, Stuart Grimshaw, with a new CEO, Jason Kulas.

The company currently trades at an extremely depressed valuation. The company has a market cap of $258 million against inventory of $98 million, cash on hand of $305 million, long-term debt of $251 million and pawn loans outstanding (PLO) of $134 million. Using the multiples of inventory and PLO of recent acquisitions in the pawn shop industry, it seems likely that EZPW could command a price 2x to 4x the current share price in an acquisition scenario. We will continue to remain invested to see if the company can be turned around with its new leadership. Our position in EZCORP should also be observed in the context of our overall portfolio. If we were in a business environment where lenders like EZCORP were far more successful, we would expect our other more cyclical holdings to be doing poorly. Additionally, as Joban Kaihatsu shows us, patience with very cheap companies may be rewarded once a catalyst comes about.

Joban Kaihatsu

On November 13th 2020, Joban Kaihatsu announced that two of the company's managers had put together a plan to take the company private through a management buyout. In this transaction, the company's managers offered to buy shares in a tender offer. The management must get 2/3 of the shareholders to tender their shares otherwise the transaction will not proceed. The tender offer was originally priced at 7800¥ per share which, although ~30% above the previous market price, was less than the net cash and marketable security portfolio of the company (roughly 8500¥ per share). It is quite a remarkable thing for the management of a highly profitable company to attempt a takeover at a price less than liquid net cash and securities. Since they can use the company's cash and securities portfolio to pay back their acquisition debt, the buyers were in effect paying a negative amount of money for ownership of the company. While these management buyout attempts are usually immediately successful, the low takeover price and the large amount of the company's float in the hands of investors unaffiliated with management make it more difficult for the takeover to gain investor acceptance.

A Seychelles-registered hedge fund, Black Clover Limited, apparently took notice of the attempted buyout at this low price and decided to purchase a large position in the company. As of the most recent filings, Black Clover had bought 12.3% of the outstanding shares.

As it only requires 1/3 of the shareholders to block the transaction, Black Clover's large position makes it less likely that the management will be able to complete the purchase assuming Black Clover decides not to tender.

After the tender offer was announced, the shares traded at prices over the tender offer price for several weeks. Presumably, investors realized that the tender offer was unlikely to be completed at the original low price and investors were speculating that the company will be purchased at a higher price in the near future. These speculators were proven correct as the original tender offer was supposed to conclude on December 28th, but the management extended the offer until January 25th. On January 22nd, the management announced that they were extending it again to February 25th and raising the tender offer price to 9000¥.

We have sold some of our position shortly after the tender was announced, but we still hold most of the shares that we possessed at the beginning of November. The situation with Joban Kaihatsu remains fluid, and I look forward to discovering how this interesting situation plays out.

2020 has been a year of accelerated change for many people, and my life was not an exception. I am happy to announce that my wife Katie and I were married in December, and we now look forward to building our future together.

I appreciate the faith and confidence that all of Blue Tower's investors have placed in the strategy during this challenging year. I always enjoy hearing from you and hope that you will contact me with any questions.

Best regards,

Andrew Oskoui, CFA

Portfolio Manager