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While we may have hoped that with the end of Covid-related restrictions, 2022 would be a return to economic normalcy, it is now clear that the extreme market volatility that began in 2020 will continue for at least another year. Our strategy composite returned -15.87% net of fees in the first quarter (-15.62% gross) driven primarily by our Russian equity holdings. Excluding our Russian securities, our composite would have had a gain despite the decline in overall equity markets.

The world has changed more in this quarter than in any since the founding of the firm, even considering the start of the pandemic in 2020. The invasion launched by Russia and the ensuing sanctions and asset seizures will have ramifications in global trade for years to come even if there is a ceasefire in the near future. As you are reading this letter, I caution that you should pay attention to the date it was written as the geopolitical situation is still changing rapidly.

In previous letters, I have discussed how cognitive biases can color our perception including that of hindsight bias. The Russia-Ukraine conflict is a great demonstration of this hindsight bias and the difficulties of forecasting future events. The situation will seem to have been far more predictable in the future than it did while we were living through it. Among their other duties, forecasting is the primary responsibility of portfolio managers. When we are investing in an asset, we are predicting that the market has erred in the pricing of the asset and the future value of the cash flows the asset will provide is greater than what we are paying. For this letter, I described the evolution of my thinking at various dates during the quarter. In forecasting future events, it is important to incorporate new information and not be anchored to initial judgements. This current crisis has been humbling in how many surprises it has thrown along the way, ensuring that no one who has made public predictions has gotten it completely correct. Even those who correctly predicted Russia's actions may have been surprised by some of the events that followed, such as the severity of the sanctions or the effectiveness of Ukraine's determined military resistance.

Cornerstone Building Brands will be Taken Private

Our largest holding at the beginning of the year, Cornerstone Building Brands (CNR), was the target of a buyout by the private equity firm Clayton, Dubilier & Rice (CD&R). CD&R is the holder of approximately 49% of outstanding shares of CNR. The offer was reviewed by the management team of CNR and accepted. We have mixed feelings about this transaction. The price of \$24.65 offered by CD&R was 75% over the prior market price of \$14.09. This transaction gives us a great one-time increase in our capital that we can now invest in the current market's target-rich opportunity set. However, this offer still undervalues what we believe the business is worth. We feel that the fair value for the company is closer to the range of \$30-35/share.

Our Russian holdings: PJSC Sberbank and TCS Group Holding PLC

Russia has long been a source of interest for value investors due to the cheap valuation multiples to be found there. It has ranked among the cheapest stock markets in the world for many years. While we have had other Russian stocks in the past, currently we are only invested in two Russian companies, Sberbank and TCS. While known as being banks, in reality these two businesses are quickly diversifying into many other technology-driven lines of business.

Blue Tower has endeavored to be invested in companies that have pricing power and durable business advantages. Many of the commodity companies in Russia are less interesting to us for that reason, as companies without a competitive advantage cannot achieve returns on equity better than their cost of capital over the long-term.

Sberbank is the largest consumer bank in the country and is verging on being a banking monopoly due to their dominant position. Sberbank was formed from the Soviet state savings bank, Sberkassa, that itself was formed from savings banks that started in Imperial Russia in the 1840s. Sberbank has made great efforts to modernize their business through digital transformation, online services, and automation. This has allowed them to rapidly grow their business while decreasing the number of employees they require over time. They have expanded recently in non-financial businesses such as online retail, entertainment through things like Sberbank smart TVs, a rideshare app service, and food delivery. The recent sanctions have deprived them of their subsidiaries in the EU and UK, but over 95% of their revenues come from Russia, so this is not a major loss.

TCS Group is the Cyprus holding company for Tinkoff Bank which operates in Russia. Technically, the corporate parent is a foreign corporation to Russia, and their IPO was held outside the country which does shield them from some sanctions. The company has plans to expand internationally, but currently almost all their operations and revenues are based in Russia. Tinkoff became known through their credit card offerings and is now the second largest issuer of credit cards in Russia. They now have many other financial services including brokerage services, financial planning, entrepreneur business accounts, banking, point-of-sale lending, and small retail cash loans.

The exit of Western companies creates opportunities for both firms as the large software development and operation teams of each business will be able to fill in the niches left behind. For example, in past years when Splunk pulled their enterprise monitoring software from the Russian market, Tinkoff built their own product, Sage, which they began marketing to other Russian corporations as a new line of business. The exit of Visa and Mastercard will allow Tinkoff and Sberbank to introduce cobadged cards that use Mir payments for Russia and China's UnionPay for international transactions. As the current crisis will be tough for many businesses, it should allow Tinkoff and Sberbank to take market share from their weaker competitors.

At the start of 2022, Russia was well-positioned to reap the benefits of rising commodity prices. With a positive balance of trade, cheap labor, and vast resource abundance, the ruble was also set to appreciate against the USD. Our aim was to use these two companies to gain exposure to the growth of the entire Russian economy. While it now appears that a contraction in 2022 is more likely, I foresee both companies becoming larger slices of a smaller pie in the Russian economy.

Predictions and Trades During the Crisis

At the beginning of the year, we considered an invasion of Ukraine by Russia as an unlikely event. The forces that were arrayed at the border of Ukraine were too few in number to easily overcome the Ukrainian military. The threat of the ensuing sanctions against Russia would be extremely costly for their economy. And while Russia has been involved in military conflicts in recent years such as with Syria, Georgia, and the Crimean annexation, Putin has tended towards being more cautious than to launch such a large-scale, destructive military operation that an invasion of Ukraine would entail.

As we monitored the situation, our thinking changed as it became increasingly apparent that war was a probable outcome. The deciding factor for us was the change in tone of propaganda coming from Russia towards militarism. On February 18th and 21st, we liquidated all of our Russian equities. On February 24th, as the invasion became a reality, the value of Russian equities dropped dramatically, with our former positions falling over 70% in a single trading session.

On February 25th, Western countries announced the sanctions measured against Russia as punishment for the military operation against Ukraine. The sanctions were less severe than expected with both Sberbank and Tinkoff excluded from the SWIFT bans. As a result, there was a minor rally in financial markets on that day. Many investors, including us, believed that the sanctions announced that Friday were the bulk of the sanction measures. Western nations had been holding consultations on the sanctions regime for several months at that point and many of these sanctions had been prepared in advance. The past pattern from Russia's operations in Georgia and Crimea is that the initial shock and uncertainty of war leads to a rapid selloff in equities which was then followed by a quick recovery in prices. We believed, at the time, that this pattern would be repeated for the 2022 crisis. Even if the shares went lower, we believed that the companies were then at low enough prices that we would have an outstanding forward rate of return relative to their prices several years into the future. Therefore, on February 25th we reentered our prior positions and brought our Russian portfolio weighting to roughly where it was when we liquidated. At \$4.40 for Sberbank and \$29.83 for TCS, we were able to buy far more shares than we liquidated a week earlier.

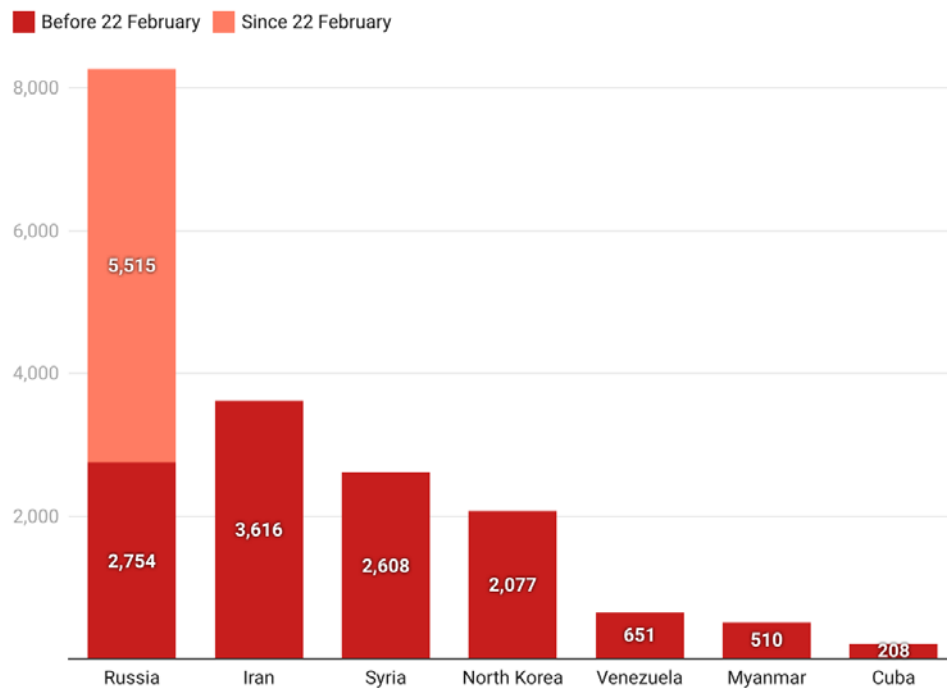
Our assessment about the future sanctions was incorrect, and the successive waves of sanctions were without any historical precedent.

Russian Sanctions

As of April 8th, there were 8,269 sanctions placed on Russia¹, making it by far the most sanctioned nation in the world.

¹ Data from Castellum.AI (<https://www.castellum.ai>)

Russia Is Now The World's Most Sanctioned Country



Source: Castellum.AI • Created with Datawrapper

Some of the sanctions placed on Russia have been done through the fundamental infrastructure of the central bank cooperation. The Swiss-based Bank of International Settlements (BIS) suspended Russia from the organization on March 10th. It is noteworthy that the BIS remained neutral even during World War II. Even during war, the central banks of the Axis and Allied countries were able to remain connected to each other through the BIS.

In addition to the government sanctions, exits from the Russian markets by around 600 Western companies have had a huge impact. Russian officials have threatened these companies with possible seizure of their assets within the country, but nothing concrete has moved forward. Russia has promised that they will be announcing counter-sanctions against unfriendly countries in the near future.

The sanctions included the freezing of Russia's foreign reserve holdings within countries in the EU, NATO, and several US allies (roughly half of their total reserves). These sanctions attacking central bank assets are unprecedented with only the Taliban after its takeover of Afghanistan having had a similar treatment. Prior to this, central bank obligations were seen as sacrosanct. Now that they have been shown to be vulnerable, countries will be less willing to trust foreign currencies and foreign reserves. And trust is the fundamental basis of global trade. These sanctions were applied due to a military invasion. However, the same sanctions logic could be applied towards internal issues such as countries accused of violating human rights. This will likely lead to more dedollarization of trade and deglobalization. We should expect more countries to transact with each other in their own currencies. Even Saudi Arabia, the original source of the petrodollar system has considered pricing some oil sales in Chinese yuan. Countries will try to relocate critical parts of their supply chains within their own borders and stockpile necessary raw materials and commodities. This deglobalization and stockpiling behavior will be a strong inflationary pressure in the years to come.

Russia in the near-term will be able to avert financial disaster as their main exports are an absolute necessity for Europe. The Centre for Research on Energy and Clean Air (CREA)² estimates that Russian companies have received approximately 29 billion euros in payments for energy exports since the start of the war on February 24th. It will take European countries years to find alternatives for Russian energy. In the meantime, they are forced to buy energy imports from Russia or suffer the dire economic, public health, and social consequences of a continent-wide energy shortage.

Longer-term, these sanctions will be very harmful for the Russian economy. Russia is very dependent on foreign imports for many of its industries, especially automobile parts, airplanes and their parts, and semiconductors. Many manufacturing plants have had to cease production due to shortages of components. It will not be trivial for Russia to find alternatives for its supply chain. They will greatly deepen their trade relationships with India and China which will alleviate some of these issues over time.

While the US and EU countries have said that these are temporary sanctions, they have not given clear criteria for the removal of the sanctions. Sanctions often last much longer than people expect at the time. The sanctions applied in 1974 on the Soviet Union by the US over the Refusenik issue³ were not removed until 2012! It would not surprise us if many of these new sanctions remain in place for longer than a decade.

The breakdown of trade due to war and sanctions will in the near-term cause a huge threat to the food security of the entire planet. Russia and Belarus are 2nd and 3rd largest exporters of potash fertilizer. Russia and Ukraine together comprise 30% of the world's wheat, 20% of corn, and 80% of sunflower oil exports. China has halted their exports of potash fertilizer and is still dealing with the fallout from their swine flu epidemic. Additionally, there are several countries, including the USA, dealing with unusually bad droughts this year. We may be entering a perfect storm of energy and food shortages leading to a global famine, primarily affecting Africa, the Middle East, and South Asia. These shortages will also have second-order effects on civil strife and social disorder. It may be that the trade disruption and subsequent food shortages cause more deaths globally than the violence of the actual fighting.

Moscow Exchange Trading and our Frozen Russian ADRs and GDRs

Our investments in our two Russian equities are in the form of an American depository receipt (ADR) for Sberbank and a global depository receipt (GDR) for TCS Group. Due to Western exchanges and clearinghouses suspending trading and settlement support for Russian securities, we have been unable to trade these securities since March 2nd. While Sberbank is clearly a majority state-owned Russian corporation, TCS Group has tried to make the argument to exchanges and clearinghouses that they are incorporated in Cyprus with an independent management and increasingly international shareholding base and corporate footprint. Therefore, they argue they should not be held to the same trading restrictions that are affecting other Russian securities. Hopefully, both companies can resume trading soon on Western exchanges.

² https://crea.shinyapps.io/russia_counter/

³ Jackson–Vanik amendment to the Trade Act of 1974

In the meantime, it is more difficult to determine the value of our shares. In normal times, arbitrageurs will balance the value of shares on different trading venues. If a company's ADRs trades at a higher value than the shares on the domestic market, an arbitrageur can buy local shares, convert them to the ADR, and sell them for a profit (or the same process in reverse). With the cutting of the financial linkages between the Western markets and Russia, we are now left with the pools of liquidity between countries for these shares, isolated from each other.

The Moscow Exchange had the longest shutdown of trading in its modern history as the exchange suspended operation on February 24th following the commencement of military operations by Russia in Ukraine. Since then, the Moscow Exchange has begun a phased reopening with different asset classes and groups of shares reopening for trading by domestic participants (foreign traders are still banned from participating).

We are now entering a bizarre new world where shares of the same class are no longer fully fungible. The price of shares is now determined not only by the value of the underlying business but also by who owns them and where they are traded. Our depository receipts are frozen in the United States and in London, but if they were shares on the Moscow Exchange and we were investors with legal residency in Russia, we would have an unrestricted ability to trade them. Still, we can get a rough approximation of the value of our holdings by looking at the current prices of these shares in the Moscow market. As our client agreement states, we agree that our custodian, currently Interactive Brokers, gets to determine the valuation of security prices for the purposes of calculating account fees and strategy performance. It is interesting to note that if we could realize the current Moscow prices for our current holdings, we would have a net gain in Russian shares for 2022.

	ADR/GDR price @ Interactive Brokers	DR Ratio	MOEX Price (Rubles)	DR price in USD based on MOEX ⁴
Sberbank	\$0.52	1:4	143.72₽	\$7.16
TCS Group	\$3.193	1:1	3274.50₽	\$40.80

All prices as of April 8th, 2022

On March 28th, J.P. Morgan filed notice that they had resigned as the depository for the Sberbank ADR⁵. Ordinarily, Sberbank now has 60 days to declare a successor depository⁶. The ordinary process is complicated now by the current sanctions regime and restrictions on foreign investors in the Moscow Exchange. On April 6th, the Russian State Duma passed a bill calling for all foreign depository receipts of Russian companies to be dissolved and converted into local Moscow Exchange shares. This does not affect companies with Russian roots that are legally foreign corporations such as TCS which is based in Cyprus despite having most of their operations and revenues within Russia. The bill must still be passed by the Federation Council and signed by President Putin before it can become a law.

⁴ Ruble/USD exchange rate based on IBKR market close rate of April 8th, 2022: 0.012461

⁵ <https://api.markitdigital.com/jpmadr-public/v1/cms/document?cmsId=0473e1795c8e4f61a1095525713279f8>

⁶ This is specified in the amended deposit agreement for the Sberbank ADRs.

https://www.sec.gov/Archives/edgar/data/1474274/000119380517000487/e615933_ex99-a.htm

This situation is still rapidly developing and uncertain. We believe the most likely outcome is that the ADRs will be converted into local Moscow Exchange shares in the near future, and foreign holders will be allowed to liquidate their shares at a later date.

Impacts on our Future Investment Moves

This experience with Russia may lead one to ask whether they should invest in emerging markets at all or just invest in developed markets like the US instead. The headaches of regime risk are an unfortunate cost of dealing in these markets. However, there are benefits of diversification as the pains to emerging markets are often uncorrelated to more developed markets. Companies in these markets can often have high growth prospects while still being valued at a reasonable multiple. Additionally, the occasional crises that emerge in these areas often create liquidity holes where stock prices experience free-fall as there are no buyers willing or able to support their prices. In situations like that, active investors can buy assets at huge discounts to fundamental value from forced sellers.

Recent US sanctions have banned American investors from making new investments in Russia. Therefore, we plan on liquidating our Russian portfolio companies as soon as they are unfrozen and we are able to receive a reasonable valuation for them.

I appreciate the trust that my investors have placed in Blue Tower during these overlapping historic crises. While we focused on the economic ramifications of the current situation, we should also remember the suffering being felt by those in Ukraine. There is rarely a bad peace that is worse than continuing war, and I hope all sides can come to compromise on a ceasefire.

Best regards,

Andrew Oskoui, CFA

Portfolio Manager

Disclaimer: This commentary does not represent a recommendation to trade any particular security, but is intended to illustrate Blue Tower's investment approach. These opinions are current as of the date of this commentary but are subject to change. The information contained herein has been obtained from sources believed to be reliable but the accuracy of the information cannot be guaranteed. Past performance is no guarantee of future results.