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January 20th, 2023

I am happy to report that the Blue Tower Global Value returned 13.76% net of fees (14.09% gross) in Q4 2022 and 4.12% net (5.31% gross) for the year as a whole.

Please review your individual account statement to see the returns on your account as it will differ from the composite return. The sanctions on Russian investments, which prevent us from buying or selling Russian stocks, caused a dramatic increase in the internal dispersion of returns for our composites. Accounts that were opened after March 2022 will not own any Russian assets and will instead have a larger weight of all the remaining positions in the strategy.¹

The main cause of our outperformance this year was due to four of our portfolio holdings² being acquired or taken private this year at significant premiums to our purchase prices. As so many of the companies we invest in are high-quality businesses trading at very cheap prices, it is unsurprising that others decide they want the entire company for themselves. Two of the acquisitions were management buyouts and two were acquired by larger companies.

The last three years have seen the world enveloped in multiple overlapping crises beginning with the Covid-19 pandemic. It would have been impossible for any macro strategist to have accurately predicted at the beginning of 2020 how the next three years would have gone, especially the beginning of the largest war in Europe since the Second World War. In the midst of the chaotic environment, we have performed well with a three-year annualized net return of 14.1%. The MSCI ACWI global equity index returned 4.0% annualized over the same period.

Environments like this lead to more stocks being mispriced relative to their fundamental values. This is not only due to the intrinsic value of companies changing rapidly due to fundamental changes in the world, but also due to price changes from investor capital flows and fund liquidations. For small and nimble active managers like us, these are rich environments for bargain hunting and building portfolios of excellent investment opportunities.

Instead of trying to forecast macroeconomic factors far into the future, it is a better use of our research effort to focus on individual securities. When there are macro surprises, it can be a good time to revisit securities we have researched previously that may not have integrated the new information yet.

¹ Additionally, we will not be able to adjust the weighting of Russian stocks to account for deposits/withdrawals of existing investors. Although Sberbank shares increased in price this quarter, the ruble weakened against the dollar eliminating most of this gain in dollar terms. Therefore, Blue Tower investors without Russia exposure had a better performance than our overall composite this quarter.

² Our four acquired holdings were Cornerstone Buildings Brands (NYSE:CNR), Swedish Match (Stockholm:SWMA), LeoVegas (Stockholm:LEO), and Shinoken Group (Tokyo:8909)

Russian Sanctions May Discourage Future Financial Flows to the West

2022 will be remembered as giving one of the worst one-year returns for the “60/40” stock and bond portfolio. Investors may now be tempted to rotate more heavily towards bonds to take advantage of the higher rates now on offer, but I believe they will be disappointed by their real returns.

After the beginning of the Russian military operation in Ukraine, Western governments not only took the unprecedented move of freezing the central bank reserves of Russia in their countries, but also carried out sanctions against wealthy Russian citizens. As of November 30th, 2022 there were over 8,000 individual sanctions announced against Russian citizens in relation to the war in Ukraine³. These asset freezes were usually done without due process under law and targeted almost all super-wealthy Russian citizens, regardless of their having any official government position or provable influence over government policy.

In recent years, wealthy investors in emerging market countries have been persistently moving their savings to wealthier countries with more reliable rule of law and property rights. The country receiving these financial flows will see increases in the value of real estate, strengthening currency, and reduction of real bond yields. The country which is experiencing the flight of these financial flows will in turn have a weakened currency. This leads to a strange effect where, through the forex and treasury markets, consumers in developing countries are subsidizing the consumption of citizens of wealthy countries.

Now the property rights advantage of Western economies has been put into doubt. While it may seem justifiable today to target Russian oligarchs due to the human tragedy unfolding in Ukraine, other ultrarich investors in emerging market countries fear that they could be next. What if a few years from now the US and its allies find themselves in conflict with Saudi Arabia or China? If these emerging market investors were hoping to have a safe haven in Western countries when their homeland goes into political crisis, they may find that their assets in the West are frozen at the exact moment they need them most. In addition to the private investors of these countries, their governments may also have concern. As of the end of November, China currently holds \$870B of US government debt (down from \$1069B at the start of 2022).

Developed Western economies are running large deficits and have large national debts. The US deficit is well past \$1 trillion and the national debt is over \$31 trillion. Japan and the EU countries are also heavily indebted. In the past, with the dollar being the global reserve currency, this was not a huge issue as foreign investors would need to purchase dollars and US government treasuries to facilitate trade. However, the growth of China as well as other emerging market economies has made the US economy a smaller portion of global GDP over time and helped drive some efforts to dedollarize trade over the past decade. This dedollarization of global trade will accelerate in part due to these Russian sanctions eroding confidence in dollar and Eurozone reserves. As an example of this, the Saudi minister of trade announced at Davos this week that they are willing to negotiate trade settlement agreements in currencies other than dollar, greatly undermining the petrodollar system.

If there is less demand for the dollar, then it will be more difficult to fund US deficits. If there is insufficient demand for purchasing treasuries, the US government may purchase the debt in order to keep yields under control. Already the largest holder of US treasuries is the Federal

³ <https://www.atlanticcouncil.org/blogs/econographics/russia-sanctions-database/>

Reserve with a balance of \$8.5 trillion⁴ which far exceeds the amount held by the largest foreign holder, Japan, at \$1.1 trillion⁵. If deficit spending forces the government to buy ever larger amounts of its own debt, this is in effect monetizing the debt and would likely lead to higher inflation rates. Highly indebted governments have limited tolerance for high interest rates as the higher interest will cause a ballooning of the deficit. Therefore, holders of government treasuries would receive bad inflation-adjusted returns.

I am not predicting an imminent economic cataclysm, and I believe that the dollar will remain one of the most important currencies in global trade. It is unclear when these economic developments will play out, but I consider them likely over the coming decades. Over this long-term time horizon, I believe our strategy of investing in a global basket of outstanding businesses at bargain prices will continue to do better than the traditional “60/40” portfolio.

Update On Our Russian Investments

While there have been public discussions in Russian government committees about potential mechanisms for investors from “unfriendly” countries to liquidate their investments, at this time there are no concrete plans to implement any of them. Our view remains unchanged from our previous letter that the most likely outcome is that we will be able to liquidate our shares at the market price after the military conflict in Ukraine ends. This is a volatile situation, so almost anything is possible.

Unlike our Sberbank ADRs which have been converted to local shares, we still have no changes in the status of our investment in TCS Group. As a Cyprus corporation, TCS is unaffected by the new Russian law banning foreign depository receipts. However, the London Stock Exchange continues to prevent trading of the global depository receipts (GDR) on their exchange. The USD-equivalent price of TCS Group on the Moscow Exchange and the pricing of our depository receipt at Interactive Brokers can be seen in the table below.

	London GDR price @ Interactive Brokers	MOEX Price (Rubles)	GDR price in USD based on MOEX ⁶
TCS Group	\$3.19	2676P	\$39.21

Price as of January 20th, 2023

Value Spreads Remain Wide

In our Q2 2020 letter, I discussed the extreme valuation spread between the most expensive and cheap deciles of the US stock market. While there are always going to be cheap and expensive

⁴ https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

⁵ <https://ticdata.treasury.gov/Publish/mfh.txt>

⁶ Ruble/USD exchange rate based on IBKR market close rate of January 20thth, 2022: 0.014652

stocks in the market, the spread between them is not constant and varies with time. This valuation spread was extremely high regardless of whether one was using price-to-book or price-to-earnings. Since then, value has been making a comeback. Since the end of Q2 2020 to the end of 2022, the Russell 3000 value⁷ has had a cumulative return of 42.5% vs 13.4% for the Russell 3000 growth index.

Despite the recent comeback for value, there is still far to go before things get back to the historical normal. AQR, an investment management firm, created a composite valuation metric which combines five valuations measures (book-to-price, earnings-to-price, forecast earnings-to-price, sales-to-enterprise value, and cash flow-to-enterprise value). By their metric, the current global market is still trading at a wider value spread than 94% of the time since the beginning of 1990.⁸

Historically, value stock outperformance has been due to their multiple expansion as undervalued stocks return to fair value. With the spread this wide, however, value can outperform just through normal cash flow generation and capital return to investors. Therefore, we can expect the performance of the value factor to be good in the coming years even if the value spread stays at its current elevated level.

We believe that our strategy will continue to deliver great results over the long term, and we will endeavor to navigate this difficult environment to the best of our ability.

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.

⁷ Russell 3000 is a market-capitalization weighted US equity index maintained by the Russell Investment Group. The value version includes the segment of stocks with lower price-to-book ratios and lower expected growth rates. The growth segment has the higher price-to-book ratios and expected growth rates.

⁸ <https://www.aqr.com/Insights/Perspectives/The-Bubble-Has-Not-Popped>