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I am happy to report that the Blue Tower Global Value composite returned 13.78% net in Q1 2024 (14.05% gross) which exceeds the gain seen in broad market indices so far this year. Sanctions have frozen our Russian investments, leading to high levels of dispersion among accounts in the composite, so please rely on your account statements for your individual investment performance.

With strong contributions from Meta Platforms, Enova, and Georgia Capital, our performance in this quarter was not driven by any one stock. Sentiment in Meta continues to improve due in large part to the AI boom which has benefitted the major tech giants. Enova and Georgia Capital remain undervalued for the same reasons explained in our previous letters focused on those companies. The gains in those companies have largely been from organic growth, with the discount to fundamental value remaining intact.

Daniel Kahneman (1934-2024)

We are saddened that this quarter saw the passing on March 27th of economist Daniel Kahneman who was awarded the 2002 Nobel Prize in Economical Sciences for his work on prospect theory[1].

His prospect theory explains how humans are biased towards taking risks that have high-impact, low-probability gains, and are biased against taking risks that have high-impact, low-probability losses. This behavior of risk seeking towards improbable gains and risk aversion to improbable losses are greater than what one would expect from rational utility-maximizing decision making.

Furthermore, people value the impact of a gain or loss from a set reference point. The emotional impact of a loss is far greater than the emotional impact of an equally large gain. A chart (figure 3 below) is taken from Kahneman's original paper demonstrating the shape of a hypothetical utility function from a typical person's reference point.

These behavioral biases can help explain the existence of gambling in lottery tickets and some of the existence of the insurance industry.

[1] Kahneman, D., & Tversky, A. (1979). Prospect Theory: An Analysis of Decision under Risk. Econometrica, *47*(2), 263–291. https://doi.org/10.2307/1914185

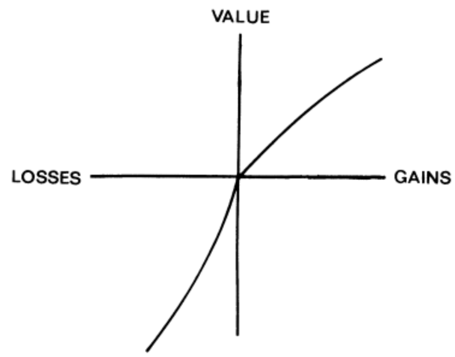

FIGURE 3.—A hypothetical value function.

In addition to prospect theory, he made great contributions to psychology with his work on hedonic psychology, behavior psychology, and cognitive biases. His 2011 book, *Thinking, Fast and Slow* became a major bestselling popular science book.

Replication crisis

Psychology research has been mired in a quagmire as it becomes clear that much of the peer-reviewed discoveries in the field cannot be replicated by others carrying out the studies. Much of psychology research came under question in recent years due to this replication crisis, and this includes many of the studies that were cited in *Thinking, Fast and Slow*[2]. However, Kahneman's work in prospect theory remains well-supported and has been replicated in subsequent studies.[3]

In 2015, a research collaboration led by Brian Nosek of the University of Viginia found that only 39 out of 100 replication attempts of previously published research studies was successful.[4][5]

This undermines the credibility of the field and suggests that many conclusions of this research fail to reflect reality. Several causes may explain this including small sample sizes, pressure to publish positive results, p-hacking, and HARKing (hypothesizing after results are known).

HARKing is a bad research practice, in part, as without a clear hypothesis to expect the outcome of a study in advance, the result is much more likely to be due to pure chance. Truly understanding a phenomenon requires an ability to predict its outcomes in advance. P-hacking, also known as data-dredging, is when data is subjected to a series of different statistical tests

[2] https://replicationindex.com/category/thinking-fast-and-slow/
[3] Ruggeri, K., Alí, S., Berge, M.L. et al. Replicating patterns of prospect theory for decision under risk. Nat Hum Behav 4, 622–633 (2020). https://doi.org/10.1038/s41562-020-0886-x
[4] Baker, M. Over half of psychology studies fail reproducibility test. Nature (2015). https://doi.org/10.1038/nature.2015.18248
[5] Open Science Collaboration ,Estimating the reproducibility of psychological science.Science349,aac4716(2015). https://doi.org/10.1126/science.aac4716

and different combinations of variables to find correlations. The tests that show significant results are shown in the study and the other tests that fail to show significance are ignored. Studies that fail to prove a hypothesis are less likely to be published. Small sample sizes can give a significant outcome just by pure chance.

As a result of problems like these, reforms have been made to the psychology field: improved transparency in research practices and data availability, studies are publicly registered before data collection, larger samples are used, robust replicable practices are emphasized in study design, and open science initiatives are more common.

Prospect theory helps explain Blue Tower's typical investments

Some of the investment opportunities that Blue Tower seeks out can be better understood through the cognitive biases described by prospect theory. These cognitive biases dealing with probability help explain why the opportunities to invest in these undervalued companies exist at all.

Investors have irrational aversion to low-probability, high-magnitude losses and an irrational attraction to low-probability, high-magnitude gains.

Companies that have idiosyncratic, low-probability, high-magnitude risk can be described as "ugly ducklings." These are companies where there is an aura of dread surrounding them.

> Hypothetical Example: Imagine an initially fairly-valued company has just become the defendant to a large class action lawsuit. Based on the facts of the case, there is a 90% chance the company will win the case. If they lose, they will go bankrupt, and if they win, they return to their initial value. In a rational world, the company should drop 10%. Often in the real world, a company in this position will drop 50% or more. If that happens, then an investor after the drop would have the opportunity to make an investment that will give them a 90% chance of doubling their investment or a 10% chance of losing their investment. Of course, in a real-world scenario, we will not have these exact probabilities given to us and must deal with rougher approximations and nuance.

An example of an ugly duckling which is currently in the Global Value portfolio is Charles Schwab Corp (NYSE:SCHW) which we discussed in our Q1 2023 letter. As interest rates have increased, fears of insolvency developed due to Schwab's unrealized losses on their fixed income investments. These fears led to a selloff in the stock out of proportion to the low probability of bank failure.

On the other extreme are the "boring" companies. These companies are boring not because their products or services are necessarily boring. Rather, this refers to them being a stable, defensible company with limited potential upside. On average, these companies tend to be undervalued and give superior returns when compared with "lottery ticket" stocks. Companies that produce consumer staples that are insensitive to the market cycle are an example of these boring, low volatility companies. Low volatility stock returns tend to be higher than high volatility stock returns even though we would expect the opposite from the efficient market hypothesis[6]. An example of a company that fits this model from our portfolio is the plastics manufacturer, Berry

[6] S&P Global. (2019, May 7). Is the Low Volatility Anomaly Universal? S&P Dow Jones Indices. https://www.spglobal.com/spdji/en/research/article/is-the-low-volatility-anomaly-universal

Global Group (NYSE:BERY). Berry is the low-cost producer of plastic packaging in the United States. As the dominant, mature company in a slow-growth industry, there is relatively little chance of a dramatic short-term growth in the company's stock. However, the company trades at a very cheap valuation and has been steadily profitable and growing over the past decade. With our expectations for its forward rate of return, we believe Berry makes a great contribution to the portfolio even if it may be "boring".

I appreciate the continued support of Blue Tower's investors. Please contact me with any questions you have.

Best regards,

Andrew Oskoui, CFA

Portfolio Manager