Blue Tower Asset Management, LLC
311 Ranch Road 620 South
Suite 111
Austin, TX 78734

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I am pleased to report that in its first year of operation the Blue Tower Global Value strategy has achieved a gross composite return of 15.92% for 2014. This year has been a difficult one for many investment managers, so I am glad I was able to grow the wealth of Blue Tower's investors and reward the trust that they placed in me.

In this letter, I'd like to review the philosophy of Blue Tower and give the rationale behind two investments which were made in 2014 as a demonstration of that philosophy. Future letters will be on a quarterly basis and shorter in length.

Blue Tower Asset Management endeavors to provide above average capital appreciation over the long term while attempting to avoid large permanent impairments of capital. The two dominant approaches used on Wall Street today are quantitative investing and value investing. The philosophy of Blue Tower is to bridge the best practices of these two approaches by using recommendations generated by algorithms to create short lists of companies. These companies are then evaluated using classic value investing due diligence methods. This combined approach of machine intelligence and human understanding allows us to find hidden opportunities that most people would overlook while at the same time avoiding value traps to which a purely quantitative strategy may fall victim.

This strategy was formerly known as the Allometric Fundamental Value strategy when it was part of Allometric Research and Management LLC, a multi-strategy RIA. I found that being part of a multistrategy firm was confusing potential investors, so I created an independent RIA (Blue Tower) for the strategy. There was no change in the investment policy, management, or client base of the strategy during this transition, and the performance was linked in accordance with the GIPS portability rule.

In the attached monthly performance numbers, I compare the performance of the strategy to the CRSP Total Market index and the Russell 2000. The CRSP Total Market index is composed of nearly 100% of the public US equity market. The Russell 2000 is one of the most widely recognized small cap indexes and is composed of the 1001^{st} to 3000^{th} largest stocks by market capitalization. The Blue Tower Global Value strategy is a concentrated strategy that is not managed to any particular benchmark.

Despite the CRSP Total Market being the official benchmark for the strategy, the Global Value strategy is more correlated on a daily basis to the performance of the Russell 2000. The reason for the firm's performance being more correlated to the performance of a small-cap market index rather than the market as a whole is that the firm's holdings are currently mostly in small-cap stocks with 75.5% of the holdings in the Global Value strategy at year's end being invested in companies with a market capitalization below $1 billion. This doesn't reflect a directional view that small caps as a whole are currently a significantly better investment opportunity than larger companies, but rather due to lower market efficiency in regards to smaller companies. Small companies are the focus of far less attention from investors and sell side analysts and as a result small companies are more likely to be significantly mispriced and offer compelling valuations. I manage the portfolio in a bottom-up fashion and will continue to allow the valuations and merits of individual businesses to direct where capital is invested.

The Strategy

Blue Tower's investment philosophy is a blend of two of the most dominant strategies used on Wall Street today; quantitative analysis and value investing. Screening algorithms, that I developed by adapting and combining the best elements of quantitative investment management strategies, will identify companies which score high on a number of accounting tests and which are trading at a low valuation. These companies are then vetted for investment using the best practices of classic value investing and industry analysis.

Factors that we look for in determining if a company is high quality are high returns on tangible assets, geographic and product diversification, improving industry structure, low cyclicality, high profit margins, conservative use of debt, and a high likelihood of continued organic growth in their main product categories. The strength of a company's competitive position (their "moat") is an important aspect of investing that many other value managers overlook.

Evaluating the management of a company is an important part of the qualitative portion of the research process that Blue Tower uses for determining investment quality. We want to invest in companies with highly motivated management who are of the highest integrity and put shareholder interests at the forefront. Management should be a good steward of the capital of the business. We first determine where management is using investor capital. A company's management has four options when it comes to allocating capital: 1. Reinvest in the Business 2. Make acquisitions 3. Return capital to investors through share repurchase or paying dividends 4. Build up cash reserves/Pay down debt. Once we have determined where capital is being spent, we can evaluate the wisdom of these decisions.

A Note on Free Cash Flow

Many people focus on a company's ability to generate earnings as a measure of value. Earnings in of themselves are not the best metric as they can be manipulated through the use of accounting techniques. A better measure of a company's financial performance which has become the most important metric for many value investors is their ability to generate free cash flows. The common definition of free cash flow is:

$$\textbf{Free Cash Flow} = \textbf{Net Income} + \textbf{Depreciation} \,\&\, \textbf{Amortization} + \textbf{Interest Expense}\,(\mathbf{1} - \textbf{tax rate}) - \textbf{Change in Net Working Capital} - \textbf{Capital Expenditure}$$

However, this may not always be a fair evaluation of a company's "true" free cash flow as even free cash flow can be manipulated.

It is possible for a company to be making acquisitions that are necessary to maintain the company's competitive advantage. In this manner, these acquisitions become maintenance capital expenditure in disguise. This is particularly common for technology and pharmaceutical companies. If it appears that many of a company's acquisitions are of this nature, then a wise investor should subtract net acquisition costs from the free cash flow calculated above.

Additionally, it's important to think of the fact that acquisitions are in many ways a capital expenditure and can be replacement for traditional acts of capital expenditure such as equipment purchases and R&D. This may seem like an unusual and unlikely transaction to occur in real business practices, but a very similar thing is currently happening in the technology industry. Purchases of companies such as the $3.2 billion purchase of Nest Labs by Google or the $5 billion purchase of NDS by Cisco are both examples of this. If these companies had invested their own cash into developing the intellectual property and tangible assets of these companies, they would have had to record it as an expense which would be reflected in their FCF.

An additional issue with a focus on free cash flow is off-balance sheet obligations in the form of operating leases. Companies may have an incentive to structure their purchases as operating leases rather than financial leases since operating leases are not recorded on the balance sheet and do not affect free cash flow in the initial year of the equipment acquisition. In subsequent years the company will have to recognize the lease payments on their income statement, but the accounting of these types of transactions does not adequately reflect the underlying economic realities.

The Financial Accounting Standards Board is aware of this loophole and is currently discussing making changes in FASB Topic 840 to force the capitalizing of operating leases on the balance sheet of companies. The SEC estimated in a 2005 report that the total value of the off-balance sheet lease obligations to publically traded US companies was approximately $1.25 trillion showing that this issue has become a serious distortion to reported financials in the United States.[1]

Despite these issues, I still believe that normalized free cash flow yield is a great metric to use in the analysis of companies for investment. During analysis of securities, I keep these issues in mind and make the appropriate adjustments to projections of free cash flow yield in order to get a better picture of the opportunities for client's capital.

An Active Philosophy

I believe human understanding and machine intelligence are complementary with the sum of their combination greater than its individual parts. Blue Tower is intended to be an expression of this complementary approach.

2014 was a year that saw continued flows to passive strategies from active management. Collectively, investors pulled $12.7B from active funds, while passive strategies gained $244B! A major factor fueling this is the underperformance that active managers have had this year. As more money flows to passive management, I expect the inefficiency of financial markets will increase with

[1] "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers"

correspondingly more mispriced securities. Additionally, flows to index funds will inflate asset price bubbles as overpriced securities will attract funds equal to their portion of the float-weighted benchmark. These mispricings create opportunities for truly active managers.

A significant issue with comparing performance between active and passive management is that many managers who claim to be active are really just "closet indexers." When a mutual fund owns hundreds of different positions, it is difficult to believe that the managers are closely following developments in all of the fund's holdings and not just replicating their benchmark. A paper from Martijn Cremers and Antti Petajisto of the Yale School of Management investigating the active share (measure of the degree to which holdings in a portfolio differ from the benchmark index) of actively-managed strategies has found that the amount of focus a manager places in his strategy is significant[2]. They found that the strategies with the highest active share significantly outperformed their benchmarks, even net of fees. Meanwhile, closet indexing funds (low active share) tended to underperform. They also found that strategies with a small capital base were more likely to have high active share which is to be expected considering the difficulty for a huge fund to effectively deploy capital to niche opportunities.

Nicholas Financial

The biggest position in the strategy at the close of 2014 was Nicholas Financial, making up a 13.6% position. Nicholas Financial is a specialized subprime automobile loan company which purchases and services consumer loans for automobiles and light trucks. While other subprime car loan companies use statistical models in order to decide to whom to give their loans and rely on a large pool of borrowers to balance out defaults, Nicholas focuses on truly understanding their potential borrowers. They have a distributed system of underwriting where the local branch manager determines which buyers will receive loans. This differs from the statistical and centralized model of other subprime automobile lenders. Nicholas Financial endeavors to provide loans to good customers who have had poor luck in their recent life leading to poor credit such as medical issues and avoid "credit criminals" who have poor credit due to habitually living beyond their means. They incentivize good underwriting by tying the compensation of their branch staff to the performance and recovery of the loans they approve. This has led to their employees getting a reputation for extreme vigilance in repossessing vehicles from delinquent borrowers.

Furthermore, Nicholas builds in two layers of protection for their loans. First, they make the loan for a principal amount that is cheaper than the collateral of the vehicle. Secondly, they purchase the loan at a discount to its principal when buying from the dealer. This emphasis on good underwriting has allowed them to create a pool of borrowers with far lower non-performing loans than their peers.

With such an excellent business model it may lead some people to question why it would trade at a cheap valuation. The current catalyst for this opportunity is due to a failed acquisition of the firm by Prospect Financial. The reasons for the failure were an SEC investigation of Prospect as well as pushback from Nicholas board members and shareholders against the acquisition who felt

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[2] Cremers, KJ Martijn, and Antti Petajisto. "How active is your fund manager? A new measure that predicts performance." *Review of Financial Studies* 22.9 (2009): 3329-3365.

that the $16/share price was far too low. Once the acquisition fell through, there was a forced liquidation of the stock from merger arbitrage funds who had built up large positions of the stock in anticipation of the acquisition.

There was also a possible catalyst which was realized in December of 2014 from the low degree of leverage employed by Nicholas relative to many of its peers. Nicholas had an assets to equity ratio of 2 in an industry where many companies are employing leverage ratios of 10 or higher. This conservative accounting gave an opportunity for the business to boost its return on equity through the use of a special dividend or share buyback. On December 22, 2014, the company announced an intention to do a modified dutch auction tender offer to buyback over a third of their outstanding shares. This acted as a catalyst to greatly boost the share price and will generate a great deal of value for shareholders through increased earnings per share.

Nicholas alone boosted the composite returns of the strategy by 3.26% in the fourth quarter. I continue to have a great degree of confidence in the position and intend to maintain it as a long-term holding for Blue Tower's investors.

Sberbank of Russia

While Nicholas Financial has been a successful investment so far, I would like to also discuss the investment which was the greatest detractor to performance in 2014. I initiated a position in Sberbank of Russia for investors on March 7th, 2014 due to what I felt was an unfairly low valuation given to both Russian equities in general and Sberbank specifically.

The majority state-owned Sberbank is the largest bank in Russia and one of the largest banks in Europe with the company holding $553 billion in assets at the end of 2013, accounting for 29% of Russian banking assets. They are well-diversified with significant retail deposits, retail loans, loans to corporate customers, and public security investments.

The recent crisis with Ukraine and fears of sanctions led to capital flight across Russia and a weakening of the ruble. Russia's stock market has become the second-cheapest in the world and offers an impressive margin of safety to investors who have the fortitude to buy when others are paralyzed with panic. Furthermore, Russia has significant natural resources, very large foreign currency reserves, and minimal government debt.

When I initiated the position in Sberbank on March 7th, I thought that the fear of major sanctions on Russia were overblown due to the dependence of the German economy on Russian gas imports and the benefit the British investment management and real estate sectors gain from Russian oligarchs depositing their wealth. German business leaders had been lobbying that strong sanctions on Russia could lead to the loss of over 300,000 jobs in Germany (http://bit.ly/1p6CUBn). I thought that some limited sanctions on individuals similar to the ones enacted by the United States under the Magnitsky Act were far more likely. That part of the thesis has proved false with sanctions following after the unexpected downing of MH-17. Later in the year, the crash in global oil prices caused a currency crisis for the ruble. It is important to remember regarding the Russian ruble that the currency is tied to oil and not much else. During the last 15 years, the Brent Crude price and the real effective exchange rate of the US dollar to the ruble has had a correlation of over 90%.

Regardless of the political conflicts in Europe and the crash in oil prices, Sberbank is still a very strong company. Sberbank is critically important to the reputation of the Russian business community and Russian government officials will be hesitant to do anything that would be abusive towards minority shareholders. The company has made a major effort to improve the image of their company and transparency to investors. The company has created a committee to represent minority interests and has enacted many of the recommendations of the committee. Their financial reports are audited by Ernst & Young rather than by a domestic auditor.

The current CEO of Sberbank is Herman Gref who earlier in his career was the Minister of Economic Development and Trade for several years and earned a reputation as a liberal reformer in the Russian government. Since becoming the CEO in 2007, he has led Sberbank in a major improvement of their operational efficiency, technology, and profitability. He may be hoping to use his record of successful stewardship of Sberbank as a pivot towards future political positions. Additionally, he is close friends with President Putin which may make Putin less willing to take actions with the bank which could harm his friend.

The significant size of Sberbank has given it a "too-big-to-fail" status within the country. In 1998, during the Russian Ruble crisis, the government gave depositors the option to transfer their deposits to Sberbank with a government guarantee of deposits on Sberbank only. The government guarantee cemented Sberbank's deposit base and reputation as "the safe bank". Therefore, in times of economic crisis, I would expect Sberbank to be able to outperform its rivals as investors move their deposits in a flight to safety. In addition, Sberbank has the largest retail footprint in Russia with almost 18 thousand branches within the country. These funding advantages and large retail footprint have led to Sberbank being able to borrow money at unparalleled low rates within the country. As of the date of their last annual report, this gave Sberbank a net interest rate margin of 5.9%, a return on equity of 20.6%, and a return on assets of 2.2% which are among the highest in the global banking system.

Sberbank's revenue growth has been tremendous over the last few years with a trailing 3-year compound annual growth rate of 27.0%. Much of this growth has been due to the overall growth of the Russian banking sector which remains quite small relative to the GDP of the country. In 2012, domestic loans to the private sector as a percentage of GDP were 48%, compared to 179% for the UK and 194% for the US. Sberbank is a great company from a value perspective, growth perspective, and a quality perspective, and I'm happy to have it in our investor accounts despite the large losses it has produced in 2014. These large losses are due to macroeconomic effects caused by the decline in oil and sanctions that I failed to forsee. I believe that once oil prices return to higher levels, the ruble will regain lost ground, and Sberbank will turn profitable for our clients. Value investing often takes many years to bear fruit and that may be the case with Sberbank.

I hope this explanation of our results for 2014 and investment process has communicated the care taken by Blue Tower in the protection and investment of our clients' capital. I continue to be grateful and humbled for the trust placed in me to manage these assets and am confident that this trust will be rewarded.