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I am happy to report that we have enjoyed yet another quarter of strong performance with the Global Value strategy returning 4.40% gross of fees and 4.14% net for Q2 2015 (YTD: 14.67% gross, 14.17% net). We were helped this quarter by a management change in Envirostar (EVI) which led to the stock appreciating 52.56% in Q2 and continued strength in Herbalife (HLF) and Star Gas Partners (SGU).

While the Blue Tower Global Value is a global all-cap strategy with a broad mandate, most of the investments of the strategy have been in stocks with a small market capitalization. Small caps have historically outperformed the market, but this outperformance is not the reason the Global Value strategy has focused on small cap stocks. Rather, the small cap space is subject to much greater pricing inefficiency than the market for medium and large cap stocks, and this inefficiency creates a great opportunity for diligent active investors who are performing original research to find compelling bargains. In this letter, I aim to identify some of the sources of this inefficiency and why an active strategy is key to taking advantage of it.

Liquidity

The liquidity of an asset represents the ease by which holders of that asset can convert it into cash. Markets have differing levels of liquidity between each other and also experience liquidity changes over time. I do not believe that liquidity can be accurately quantified as a single measure, but rather that liquidity has four main components:

- 1) Tightness of the bid-ask spread
- 2) Depth of market, which indicates the volume of transactions required to move prices
- 3) Diversity of opinion between market participants
- 4) Resiliency in returning to an equilibrium price after a large market-moving trade

It has been shown previously in a study by the SEC that the US small cap space has significantly wider bid-ask spreads than other segments of the market¹. Additionally, the depth of market orders on either side of the spread is much lower.

Diversity of opinion is important as it often relates to the creation of “liquidity black holes” where either all the sellers or all of the buyers of a security or asset class disappear from the market. This can lead to rapid declines or appreciations in the market price of an asset with often less trading volume than would be expected for such a large price move. One of the largest liquidity holes in financial history occurred in 1987 on “Black Monday” when the Dow

¹ Collver, Charles. “A characterization of market quality for small capitalization US equities.” The Securities and Exchange Commission (September 2014).

dropped 22.61% in a single day. A major contributor to the crash was that a large number of market participants were using the same dynamic hedging strategy (the portfolio insurance strategy developed by Hayne Leland and Mark Rubinstein) which locked them into a positive feedback loop of forced selling.

Value investors are an important source of liquidity for financial markets. Due to their reduced liquidity, small cap stocks are subject to large price swings from changes in investor sentiment. The acts of buying an underpriced security that few others wish to own and selling securities that become overpriced from market exuberance are the core principles of value investing, and this contrarian behavior supplies much needed liquidity to the market. An example of this in action was Blue Tower's investment in Ebix (EBIX). In Q2 2014, Ebix shareholders overreacted to news stories involving an acquisition and credit facility restructuring by the company resulting in a 26% price drop in less than three weeks. This drop allowed us to increase the size of our position in Ebix at a bargain price. Skilled value investors should naturally be attracted to illiquid segments of the market where their behavior creates the most value.

A recent paper also points to the fact that most of the outperformance of small cap stocks as an asset class are due to a relatively small number of extreme outliers². If a small cap manager has some ability to determine which companies which will be successful over the long term, he will be able to add significant alpha.

Asset Management Industry Dynamics that contribute to mispricing of small caps

Sell-side analyst coverage is focused on the largest and most liquid names in the market. Many small companies have only a single analyst or often times no analyst coverage at all. This lack of analyst coverage can cause stocks to trade at valuations far removed from their intrinsic value. Currently, there are three stocks in the Global Value strategy that lack any sell-side analyst coverage: Envirostar (EVI), Nicholas Financial (NICK), and Tandy Leather Factory (TLF). Nicholas has not had any analyst coverage since the aborted acquisition attempt of the company by Prospect Capital.

As investment managers are typically compensated as a percentage of assets under management, it is in a management company's financial interests to take as much capital as possible. As there is a finite amount of capital that can be deployed into any particular company, a manager whose capital exceeds the capacity of a focused small-cap portfolio either has to move up the spectrum into larger market capitalization companies or diversify their portfolio with their best ideas making up a smaller portion of their capital. For these funds that have billions of dollars of capital, small caps are simply too small to move the needle for their fund's performance. The drag of having a large capital base can be significant.

² Arnott, Robert D., Feifei Li, and Geoffrey J. Warren. "Clairvoyant Discount Rates." *The Journal of Portfolio Management* (2013).

Currently, the most illiquid security in the Global Value strategy is the stock of microcap Envirostar which had an average daily volume of 12,289 shares in Q2 2015 and a market cap of \$33 million. Investment management is a field where the small and nimble outmaneuver the large. Due to its small capital base, Blue Tower Asset Management is in an excellent position to take advantage of smaller investment opportunities.

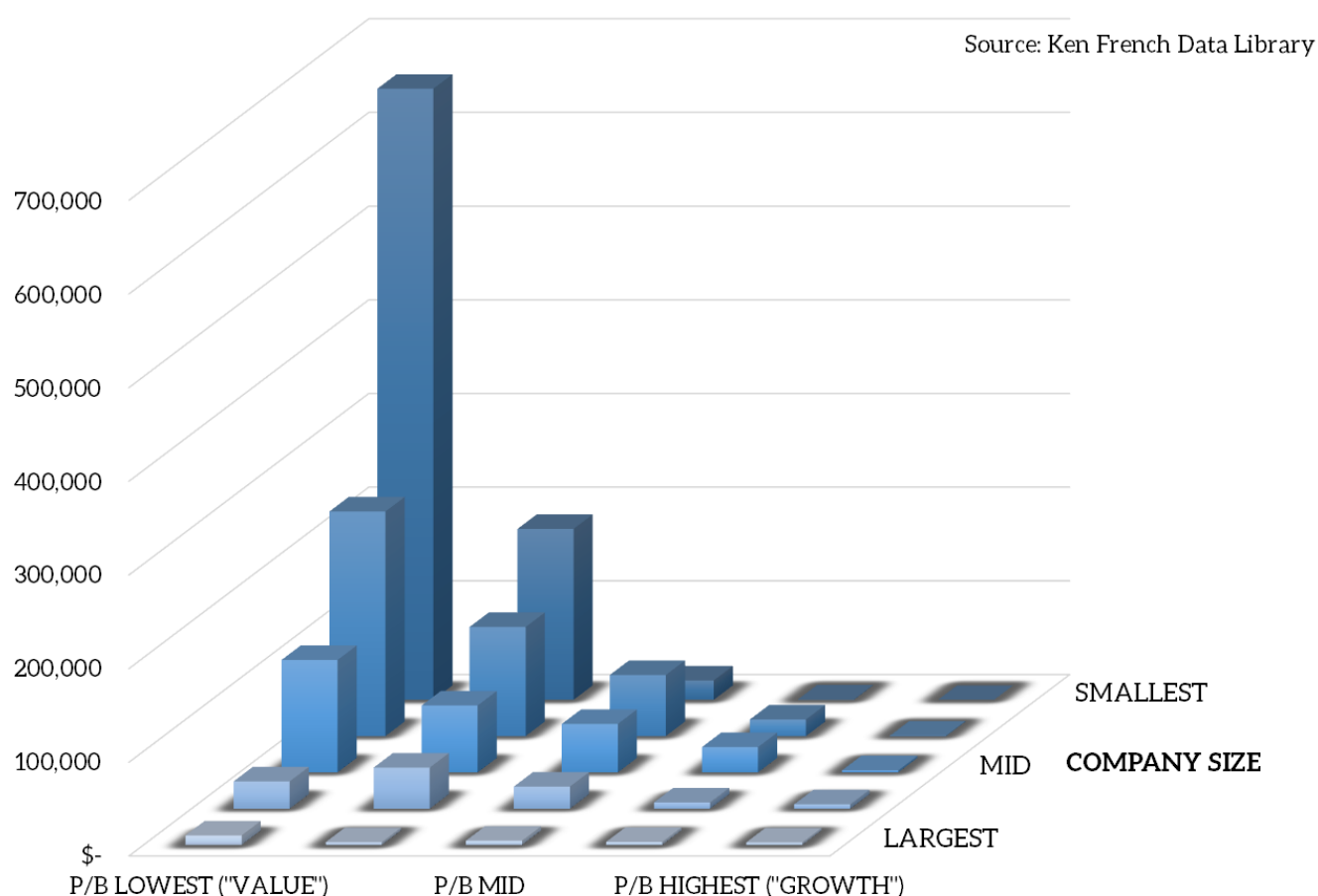
Small Caps are Both the Best and the Worst Equities

While it has been appreciated in the investment community that there has been a historical performance advantage enjoyed by small caps, it has been less appreciated that this premium exists primarily in the cheapest stocks. This ties in with the liquidity effects that I mentioned above. Small caps have less liquidity which causes more price volatility when market participants want to exit or enter a position in the stocks. Therefore, investors who are buying these small cap stocks at low valuations are being rewarded for providing much needed liquidity to the market

Interestingly, this makes small caps both the best and the worst investments in the US equity market. On the chart below, I've taken data from the French Data Library to separate the market into five deciles based on price-to-book and five deciles based on market capitalization, producing 25 portfolios. Each of these portfolios starts with \$1 of investment and is compounded over the 88 year period of 1927-2014. Small-value is the best performing of these portfolios with \$1 growing into \$652,382.77. Small-growth is the worst performing with the \$1 turning into \$7.53.

In the same way that negative sentiment can push small caps to extremely compelling bargains, exuberant sentiment can cause small cap stocks to become highly overvalued. These expensive small caps have historically been the worst investment in the market. In fact, the rate of return of these high price-to-book small caps has not even been able to keep up with inflation!

88 Years: The difference in growth of \$1 from the beginning of 1927 to the end of 2014 on the basis of size & value



Here are the same market quintile portfolios presented in the form of annualized rates of return for the period of 1927-2014:

Annualized Total Return, 1927-2014

		Lowest “Value”	Price-to-Book			Highest “Growth”
Company Size	SMALLEST	16.43%	14.76%	11.96%	6.93%	2.32%
		15.12%	14.18%	13.43%	11.76%	7.36%
	MID	14.21%	13.54%	13.13%	12.29%	9.17%
		12.39%	12.91%	12.12%	10.54%	10.08%
	LARGEST	11.06%	9.53%	10.04%	9.62%	9.41%

Some may question whether the same pattern holds true for a more recent time period. Perhaps, the outperformance of small-value was due information inefficiency which has disappeared after the creation of improved information communication in the form of the internet. Here is the same annualized return chart for the 15-year period of the beginning of 2000 to the end of 2014 which shows that small-value outperformance is still going strong (even though mid-value had slightly better performance):

Annualized Total Return, 2000-2014

Company Size		Price-to-Book				Highest “Growth”
		Lowest P/B “Value”				
SMALLEST		14.18%	13.41%	10.71%	9.65%	-1.43%
		10.87%	11.53%	13.31%	9.77%	4.46%
MID		15.52%	12.87%	12.29%	10.96%	4.09%
		8.77%	11.51%	9.52%	10.57%	7.18%
LARGEST		5.80%	5.60%	6.11%	7.26%	3.43%

Qualitative differences between small cap stocks are underappreciated

Obviously, there is more to evaluating a stock than simply looking at the price of its stock relative to the book value of its equity. Companies can have important qualitative differences including the skill of management, future growth opportunities, maintenance capital intensity, competitive advantages, risk of obsolescence or disintermediation, and pricing power for their goods and services. A recent paper from AQR³ developed a quantitative measure to serve as a proxy for business quality and came to the conclusion that the small cap sector of the market fails to sufficiently discriminate between high quality and low quality companies thereby creating an opportunity for investors. While I agree with the conclusion that there are high quality businesses in small caps trading at bargain valuations due to the dearth of analyst coverage for small companies, I don't believe one can truly make a quantitative measure of business quality. On this matter, I agree with the sociologist William Bruce Cameron who once wrote (in reference to research in his field), “not everything that can be counted counts, and not everything that counts can be counted.” Careful research by active investors can differentiate between these qualitative, nonquantifiable factors in ways that passive and purely algorithmic investors simply cannot.

³ Asness, Clifford S. and Frazzini, Andrea and Israel, Ronen and Moskowitz, Tobias J. and Pedersen, Lasse Heje, Size Matters, If You Control Your Junk (January 22, 2015). Fama-Miller Working Paper.

There are an exceptionally high number of attractive opportunities among smaller companies, and I believe we are well-positioned to take advantage of them.

Sincerely,

Andrew Oskoui
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.