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The Blue Tower Global Value strategy returned -2.42% gross of fees in Q4 2015 (-2.68% net) and for 2015 as a whole returned 0.31% gross of fees (-0.68% net). As always, our quarterly factsheets can be consulted to see which investments made the greatest contributions to performance for each quarter. Our performance puts our strategy in the top 1% of our Morningstar category (Small Value SMA) for 2014, and top 12%¹ for 2015.

In 2015, our investments in three small-cap financials (ENVA, EZPW, NICK) acted as a large detractor with these stocks reducing the strategy's performance by a total of -13.88%. I remain comfortable with these holdings. While market sentiment may have moved against these companies, their cash flow generation was strong during this period. Sentiment may determine short-term performance, but it is fundamentals which matter in the end. I believe the decline in these stocks is due to a negative sentiment against value which has taken hold in the market. When value strategies have historically endured a period of underperformance, they have subsequently delivered very strong absolute and relative returns.

The Market in 2015

For 2015, the market returns have been focused in a handful of growth-story technology stocks which market commentators have nicknamed the "FANG" (Facebook, Amazon, Netflix, Google). These four stocks (ending the year with a total market capitalization of \$1.184 Trillion) had an average market return of 86% last year. This has led to the unusual result where the market-cap weighted return for the S&P 500 (1.38%) far surpassed the equal-weight S&P 500 return (-2.20%) in which each stock makes up an equal .2% of the index. Since the global financial crisis, growth has significantly outperformed value as shown in the table below of value vs growth indexes of the Russell 1000 for large companies or the Russell 2000 for small.

¹ Data from Morningstar as of 1/28/2016

Annual returns on Russell Indexes

	Russell 2000 (small-cap)			Russell 1000 (large-cap)		
	Value	Standard	Growth	Value	Standard	Growth
2008	-28.92	-33.79	-38.54	-36.85	-37.60	-38.44
2009	20.58	27.17	34.47	19.69	28.43	37.21
2010	24.50	26.85	29.09	15.51	16.10	16.71
2011	-5.50	-4.18	-2.91	0.39	1.50	2.64
2012	18.05	16.35	14.59	17.51	16.42	15.26
2013	34.52	38.82	43.3	32.53	33.11	33.48
2014	4.22	4.89	5.60	13.45	13.24	13.05
2015	-7.47	-4.41	-1.38	-3.83	0.92	5.67

This runs against the long term historical trend of value outperforming growth. I believe the main factor driving this current market phenomenon is the cheap credit from zero interest rate policy. We have had 7 years of near-zero interest rates which have led to a weakening of investment discipline and a chasing of yield. Junk bond yields² have recently touched all-time lows in June 2014 when they reached 5.16% (They ended 2015 at 8.76%). This cheap credit has skewed the investment patterns of many industries and fueled asset bubbles across the globe.

An example of this is the collapse of oil prices which has been driven in part by oil project development financed by easy credit. Shale oil projects are primarily financed through bonds and to a lesser extent bank loans. The current easy credit environment has also led oil companies to change their capital structure to be financed increasingly through debt rather than equity. In 2008, the market debt to total capital of companies in the oil production and exploration industry was 27.31%. By 2015, that ratio had increased to 44.00%.³ The result is a large overinvestment into oil well development that has depressed oil prices globally. Oil inventories have built up to an all-time high, and there is little available storage remaining which could lead to a further price drop. In addition to credit-fueled over investment in oil exploration, increased production from OPEC is also a significant factor in the price decline.

The low rate environment and slow economic growth has led investors to seek exciting growth stories. Many mature, established companies will be unable to grow faster than the underlying economy. Therefore, when projections of world economic growth are muted and the cost of credit is low, growth-hungry investors will search towards more and more speculative investments. Stocks attached to stories of enormous future growth capture the imagination of investors and lead to these bubbles which will most times than not end in painful losses for them. Of the 152 companies that had IPOs in 2015, 70% are unprofitable, a significant increase from previous years.

² BofA Merrill Lynch US High Yield Master II Effective Yield

³ Source: Damodaran Online Data Library

In this current environment, investors fail to place enough value on strong balance sheets and business quality. High quality noncyclical businesses will continue to perform well in adverse conditions or recessions and should be valued at a premium. Bear markets and recessions can be a good thing for the long-term health of markets as they clear out financial excesses and speculative bubbles. It is similar to how smaller controlled burns of brushlands can prevent wild fires later. This kind of market is reminiscent of the tech bubble of the late 1990s where large, technology-based stocks dramatically outperformed small-cap and value. Eventually the bubble popped and investors rediscovered the importance of valuations.

I remain confident in the wisdom of our investment philosophy of holding quality companies at attractive prices. Thank you for your continued interest and please feel free to contact me with any questions or comments.

Sincerely,

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.