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Despite our portfolio companies continuing to grow their fundamental value, the Blue Tower Global Value strategy declined -1.8% net of fees in the 3rd quarter of this year. The two big movers in our portfolio were EZCORP (EZPW) which fell 32% in this quarter and Tensho Electric Industries Co. Ltd (Tokyo: 6776) which grew 451% from the beginning of this year to our exit point this quarter[1] (more than tripling in our Q3 holding period). In my opinion, our current overall portfolio is cheaper relative to fundamental value than at any point in the last 6 years which makes today an attractive time to contribute more capital. In this letter, I will discuss what occurred with EZCORP and discuss trading strategies around momentum effects in small cap stocks using Tensho as an example.

EZPW Update

EZCORP's controlling shareholder, Phillip Cohen, has been elected by the board of the directors to be the new Executive Chairman of the company, taking a $1.5-3 million dollar per year compensation depending on performance targets. Since the previous chairman (Lachlan Givens, who is remaining with the company) has taken a pay cut and Joe Rotunda, the former head of operations, has left the company, the change in executive compensation will be offset. I previously talked about the Phillip Cohen factor in my 1Q2016 letter on EZCORP. Many in the market believe he has engaged in self-dealing behavior, and he has been accused of violating his fiduciary duty to minority shareholders in the past through his consulting agreements with EZCORP. His continued influence is depressing the share price, and is likely the main factor for the massive valuation gulf between EZPW and its competitor First Cash Financial Services (FCFS). While the optics of this are bad, and nonvoting shareholders lack the ability to change management, the controlling shareholder still has fiduciary duty to nonvoting shareholders. If the controlling shareholder violates this duty, Delaware corporate law gives an avenue for remedy.

Without going into a detailed side-by-side comparison, the valuation spread between the two public American pawn companies is large and depends on the metric used. EZCORP is trading at a price-to-sale multiple of 0.37 while FCFS trades at 2.18. EZCORP should trade at a discount because of the dual class structure, but discounting its multiples to 17% of First Cash is irrational. In the stock market, a cheery consensus is very expensive. Bargains often have highly visible issues that have been over-discounted by investors. We believe that EZCORP is such a bargain. Additionally, the counter-cyclical nature of the pawn business provides diversification against an economic recession which could hurt our other positions.

[1] We sold at an average price of ¥999.3 on September 20th

Trading Strategies around Small Cap Momentum

One of the core values of Blue Tower is to be constantly reviewing our methods and processes to find ways to improve. While one cannot back test a discretionary strategy, we can see how certain systematic changes would have affected our portfolio. During one such study of our past performance, I realized that for the first three years of our strategy, our standstill performance of holding the portfolio of January 1st constant for the year outperformed our actual performance. The main cause of this difference appears to be related to how we exited positions. Essentially, when we would exit a position at close to our estimate of fair value, the price of the stock would often overshoot our estimate of fair value in the following weeks. In some cases, the price would overshoot dramatically. Our broad mandate affords us a large opportunity set which may have been making us overly conservative in the target valuation of our portfolio holdings and therefore losing out on this extra bit of return in our investments. This appears to have occurred more with small capitalization stocks than it did with larger ones. Smaller stocks are going to have more price volatility due to their reduced liquidity. Additionally, the reduced concentration of sophisticated professional investors in these stocks may cause them to overshoot fair value in response to a big momentum shift or positive news developments about the company. As this appears to be a phenomenon that has occurred several times over the past few years, it suggests that adopting a rule to delay portfolio exits for weeks or months while high momentum is present in a position may improve our returns.

While some have presented growth investing as being opposed to value investing, this is not a correct way of viewing them. Value investors still consider the long-term organic growth prospects and the competitive advantages of stocks. Growth is part of the value investing equation. A greater antithesis of value investing is momentum investing. Momentum investing is a trading system wherein investors buy shares that have disproportionately risen over some time period while avoiding or shorting stocks which have disproportionately fallen over the same time period. Essentially, a momentum investor wants to buy high and sell higher. A considerable amount of academic research has been done on momentum investing strategies and surprisingly, back testing as shown momentum investing system to outperform the market. Three main hypotheses have been suggested to attempt to explain this surprising result which seems to fly in the face of both those who believe in the efficient market hypothesis (EMH) and traditional value investing principles. The first is that information inefficiently spreads through investors and therefore it will take the investing public time to incorporate new information into their evaluation of the stock. As this information is incorporated, the stock price changes in accordance with the new information. A second possible explanation is that stocks which have fallen are subject to tax-loss harvesting causing further declines. And a third explanation, and one that I believe is the most likely, is that investors are highly irrational and momentum takes advantage of their irrationality. Investor herding[2], overreaction to new information, disposition effects[3], and confirmation bias[4] are all cognitive biases that apply to momentum situations.

[2] Investor herding is where investors follow what they perceive other investors are doing, rather than performing independent analysis

[3] Disposition effects are related to prospect theory and describe the phenomenon of how investors tend to prematurely sell shares of a security whose price increases, while stubbornly retaining investments that have decreased in value

[4] Confirmation bias is when people place greater importance on information that confirms their preexisting beliefs and diminished importance on information that contradicts their previous beliefs.

With all of the above issues in mind, a quantitative trading guideline with a manager override is one way of improving our trading. We could delay the exit while a certain momentum level is present in the stock[5]. If there are idiosyncratic aspects of the stock which will alter the number of buyers and sellers of a stock from the typical equity trading behavior, we will abandon the momentum trading guideline and exit early. A few examples of things that could alter this price behavior would be: if a new material piece of negative news is released about the stock, if there are arbitrageurs of convertible debt who will begin shorting the stock in greater numbers as the share price approaches the conversion price[6], or if there is a massive set of expiring call options at a certain strike price near the market, creating an incentive for the option writer to short the stock before settlement.

I consider this change we undertook to be a tactical trading improvement instead of a dramatic change in overall strategy. We are still value investors even if we tactically delay exits based on momentum factors to take advantage of the behavioral biases of other market participants. This will likely assist performance more with smaller capitalization exits than with larger companies.

Tensho Electric Industries Co. Ltd.

Despite its name, the core business of Tensho Electric Industries (Tensho) is plastics injection and molding for the automotive and electronics industry. Our investment in the company had been due to the cheap valuation of the company with its relatively high free cash flow yield. While the company announced a new keiretsu[7] relationship and a factory expansion, there have not been major changes in the business in the last twelve months. The stock, however, has been parabolic as can be seen in the below chart. By following our new momentum-informed policy, we exited at close to the top of its recent price history and above our estimate of fair value.

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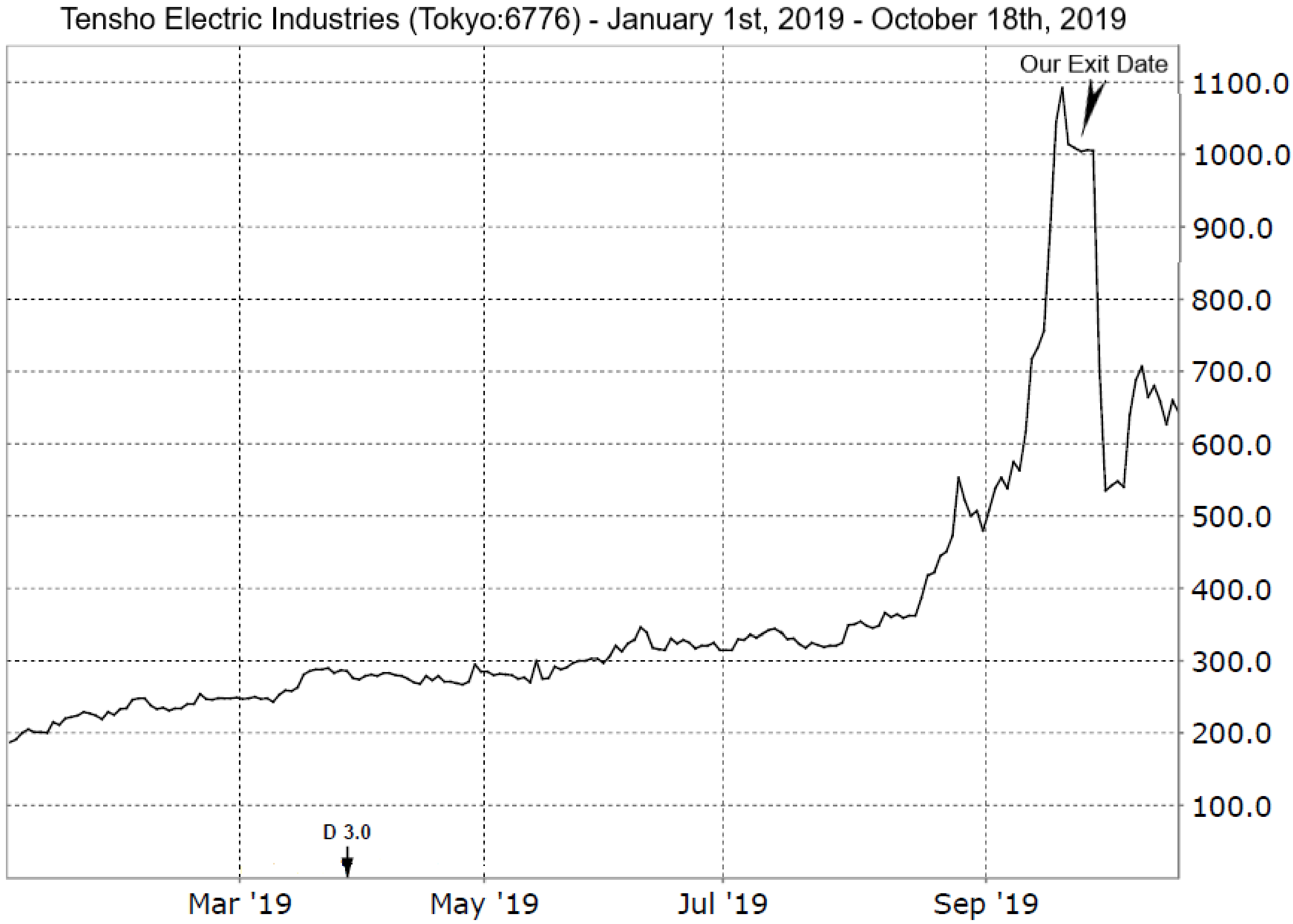
[5] The quantitative rule we will be putting in place is as follows. When the stock has reached our value target for removing the security from our portfolio, it will need a minimum percentage price increase over a set past time period to remain. As the stock moves further away from our fair value estimate, it will require a steeper momentum threshold to remain in the portfolio, either through increasing the percentage increase required or decreasing the time period length. The manager will be able to ignore the rule if there are extenuating circumstances with the stock.

[6] Convertible arbitrage is a strategy which involves taking a long position in a convertible bond and a short position in the underlying common stock in order to take advantage of pricing inefficiencies of the bond relative to the stock. The arbitrageur will typically try to make the long-short position delta neutral (insensitive to small changes in the price of the underlying security) which will require purchasing or shorting shares if the share price is falling or increasing, respectively.

[7] A keiretsu relationship is an informal Japanese business alliance made up of different companies that have close relationships and that usually take small equity stakes in each other, while remaining operationally independent



Once the price passed ¥600, the forward rate of return[8] from holding the position was low enough that we were ready to exit once momentum had slowed sufficiently. However, we liquidated before waiting for momentum to turn as an event signaled that there would be reversal in buying pressure for shares. On September 19th, the Tokyo Stock Exchange announcing that a margin restriction was being placed on the company due to its recent upward price volatility and the degree of margin transactions being made in its shares[9]. In a margin restriction, the amount of leverage a margin investor can possess when purchasing the affected stock is reduced. It is important to note that domestic individual investors in Japan become a bigger factor the smaller the company's market capitalization as these smaller stocks tend to be ignored by large institutions. This can be seen in the market participation data for last month from the Tokyo Stock Exchange, where the ratio by total volume of domestic individual investors to domestic institutional investors in the large cap 1st section is 1.8:1 while the same ratio for the smaller-cap 2nd section was 4.8:1[10]. In this kind of parabolic increase in an illiquid microcap stock, oftentimes many of the buyers are retail or semiprofessional speculators ("day traders") who buy based on technical signals rather than fundamentals and who often use leverage for their purchases. Since their leverage requirements were about to be sharply increased, one can deduce that there will be a

[8] Forward rate of return is the combination of organic revenue growth and normalized free cash flow yield. It represents the long-term return an investor gets from holding a stable, predictable business.
[9] https://minkabu.jp/news/2485141
[10] https://www.jpx.co.jp/english/markets/statistics-equities/investor-type/b5b4pj0000033iiq-att/stock_val_1_m1909.pdf

sharp decrease in buyers for the stock. After we exited at an average price of around ¥1000, the share price quickly collapsed. The current share price of ¥641 is close to the fair value for the company. These price movements are reminders of two things: while fundamentals determine long-term price changes, short-term price movements are based on immediate sentiments which can be irrational; and secondly, securities with small-capitalization and low liquidity are far less efficiently priced. Additionally, our recent experience with Tensho demonstrates the benefit of our momentum-informed tactical exit strategy for portfolio positions. If we had exited as soon as the share price reached ¥600, we would have abandoned additional profit.

Thank you for your entrusting your capital with Blue Tower. I always enjoy the questions I receive from investors and look forward to receiving more.

Best regards,

Andrew Oskoui, CFA

Portfolio Manager