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I am happy to report that the Blue Tower Global Value returned 7.08% net of fees (7.35% gross) in Q2 2023. Our outperformance this quarter was primarily attributed to the continued strength in our Meta and Enova stock holdings.

Please review your individual account statement to see the returns in your account as it will differ from the composite return. The sanctions on Russian investments, which prevent us from buying or selling Russian stocks, caused a dramatic increase in the internal dispersion of returns for our composites. Accounts that were opened after March 2022 will not own any Russian assets and will instead have a larger weight of all the remaining positions in the strategy[1].

In this letter, we will discuss recent reforms made by the Tokyo Stock Exchange which we believe will serve to influence corporate management teams towards more shareholder aligned behavior and better capital allocation.

We previously discussed our macro thesis towards Japanese investments in our Q3 2017, Q3 2018, and Q4 2018 letters. Additionally, we have done deep dives into individual Japanese stocks since then. Therefore, I will avoid repeating my previous comments and focus on recent developments in the market.

The Japanese market has developed a reputation for poor corporate governance as management teams hoard cash and balance sheets bloat with the unnecessary cross-holdings of shares between corporations. The low returns on equity have led to a stagnation in equity returns on the Japanese stock market. Inefficient use of capital and low mobility of workers have led to a stagnation of productivity. Today, the Nikkei 225 stock index still trades below the peak value reached on December 1989. However, Japan's future trends may be very different.

Japanese market restructuring and further TSE reforms

In February 2014, the Japanese government created the new Japanese Stewardship Code which aimed to improve capital allocation within Japanese corporations by encouraging investor engagement with management. This was followed by a corporate governance code in 2015. The Ministry of Economy Trade and Industry (METI) is currently working on a new code of conduct for mergers and acquisitions aimed at encouraging more M&A activity, increasing consolidation among Japanese industries, and to discourage unreasonable takeover defenses. In addition to the work by the government agencies, the Tokyo Stock Exchange (TSE) has launched several initiatives to improve market functioning.

[1] Additionally, we will not be able to adjust the weighting of Russian stocks to account for deposits/withdrawals of existing investors. The Russian ruble weakened against the dollar in Q2 leading to investors with Russia exposure underperforming the overall composite.

All of these efforts are targeting the same underlying problem in Japan, the persistent barriers preventing the flow of human and financial resources towards fast-growing segments of the Japanese economy. This has led to a persistently low rate of productivity growth within Japan.

The Tokyo Stock Exchange has referenced[2] the fact that half of all Japanese stocks trade at price-to-book ratios below 1, and they consider this to be a major cause of concern. Therefore, much of their reform policy will focus on these stocks trading below book value and how to educate and motivate corporate management teams towards more efficient balance sheet and cash flow management. As part of this, they intend to require a disclosure policy where corporate teams acknowledge their stock trading below book value and their plans to create shareholder value through capital improvement plans:

> *"In particular, companies with a PBR consistently below 1x (i.e., not achieving capital efficiency in excess of their cost of capital, or achieving capital efficiency in excess of their cost of capital but future growth potential is not adequately expected by investors) should be required to disclose their policies and specific initiatives for improvement."*

Price-to-book has lost some relevance in the US market after the legalization of stock buybacks in 1982. When stocks are repurchased at prices above their book value, the book value per share decreases (the book value of the company declines by the total price of the repurchased shares). In extreme cases, this can cause the book value of some stocks to become negative. Therefore, high quality businesses that have consistently bought back stock may be trading at high P/B multiples without necessarily being overvalued. By contrast, repurchasing shares at prices below the book value causes the book value per share to increase. Therefore, if a Japanese company tries to correct their undervalued stock by buying back shares at P/B below 1, they will widen the gulf between share price and book value (assuming no market response). In practice though, I expect that the market will reward these companies with higher share price. Buying back shares can demonstrate corporate stewardship if the company is truly undervalued (which many of these stocks are) and will boost the earnings per share.

The TSE announced they will also encourage management teams towards greater English language disclosures as some foreign investors have cited the lack of information as a reason for avoiding Japanese stocks. They have not yet given specifics about the form of these new English language disclosure policies.

[2] Tokyo Stock Exchange memo: "Summary of Discussions on Measures to Improve the Effectiveness of the Market Restructuring" https://www.jpx.co.jp/english/news/1020/p1j4l400000014ul-att/p1j4l400000014x9.pdf

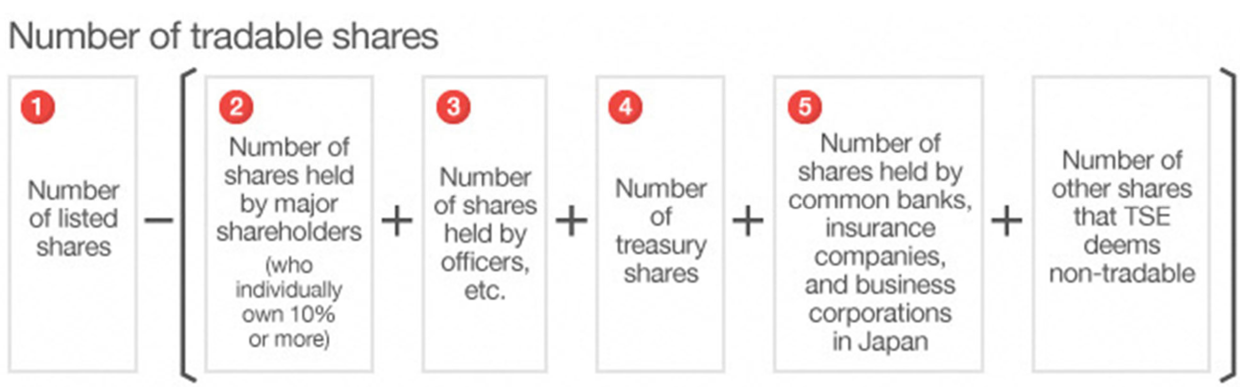
Tradable shares and keiretsu cross-holding relationships

On April 4th, 2022, the TSE replaced their historical market sections with a restructured trio of market sections that are differentiated based primarily on size of the companies, but also on corporate governance and growth prospects. The **Prime Market** is for the largest globally-facing corporations of Japan. The **Growth Market** is smaller startups that have growth potential and may not yet have achieved profitability. The **Standard Market** is for all of the other companies that meet sufficient governance and liquidity levels to be tradable in Japan, but may not fit as well in the other two categories. These sections have different requirements for maintaining stock listings which can be seen in the chart below.

	Prime Market	Standard Market	Growth Market
Number of Tradable Shares	20,000 units or more	2,000 units or more	1,000 units or more
Tradable Share Market Capitalization	JPY 10 billion or more	JPY 1 billion or more	JPY 0.5 billion or more
Tradable Share Ratio	35% or higher	25% or higher	25% or higher

Source: Japan Exchange Group[3]

An interesting requirement from the TSE for these new markets is a minimum tradable share ratio which is defined more strictly than the typical "float" metric commonly seen in other countries. The "tradable shares" exclude shares held by banks, insurance companies, and other business corporations.



Source: Japan Exchange Group[3]

In Japan, there is a system of crossholdings across Japanese corporations, where they own shares of each other, known as the *keiretsu* system. Companies will often own shares of their major customers and suppliers and try to keep their business relationships within this network. This creates a conflict of interest as management's business decisions may be made for the benefit of the other companies under the ownership umbrella of their *keiretsu* network, rather than optimizing their own business.

[3] https://www.jpx.co.jp/english/equities/listing/continue/details/02.html

This "tradable shares" requirement can be seen as an attack on this crossholding system. The delisting threat will pressure companies to either merge with their *keiretsu* partners or agree to mutually divest shares. Either of these actions will streamline the balance sheets of these corporations and encourage Japanese companies to be more competitive and nimbler. With less crossholding shares, Japanese management teams will have less incentive to keep transactions within their business alliance. This will increase the efficiencies of the Japanese economy as a whole.

Resolving the cross-holding tradable shares problem through acquisitions which will also help the acquirer deal with excess cash on their balance sheet. The revised M&A code of conduct from METI may also encourage more takeovers. These takeovers will disproportionately be small value stocks as they are the easiest for an acquirer to digest and are often the most attractive. These takeovers will be at a premium to the market price which will reward investors in these companies.

Opportunities for Japanese small value

The types of Japanese stocks we hold in our strategy tend to be small capitalization, value stocks. These stocks will disproportionately benefit from the TSE changes. They will be more likely to be acquired by another corporation or taken private. Most of our Japanese stocks trade below book value and will be encouraged to have capital improvement aimed at increasing share price. The push towards greater engagement with global investors through improved disclosure and English language financials will benefit our holdings as many of them are very much under-the-radar with no or limited English-language filings. Therefore, our portfolio is well positioned to benefit from these market improvements in Japan.

Updates on our Russian investments

There have been no significant changes in the status of our Russian investments in Q2. While Sberbank and TCS group had price increases in Q2, this was undermined by a significant weakening in the value of the Russian ruble against the dollar. The price of our GDR at Interactive Brokers remains frozen at its March 2nd, 2022 closing price on the London Stock Exchange. The USD-equivalent price of TCS Group on the Moscow Exchange and the pricing of our depository receipt at Interactive Brokers can be seen in the table below.

	London GDR price @ Interactive Brokers	MOEX Price (Rubles)	GDR price in USD based on MOEX[4]
TCS Group	$3.193	3356.5₽	$37.09

Price as of July 21st, 2023

[4] Ruble/USD exchange rate based on IBKR market close rate of July 21st, 2023: 0.011050

I look forward to receiving your questions and comments, and appreciate your continued support of our firm.

Best regards,

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.