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The Global Value strategy returned 12.89% gross (12.57% net) for Q3 2017. A major change made to the portfolio this quarter was to exit our investment in Nicholas Financial. Our investment thesis that Nicholas would be capable of having superior underwriting compared to their competitors seems unlikely to work out. It appears that the regulations passed by the CFPB have made their collections more difficult in ways that we did not anticipate. In addition, the development of new technologies such as big data analytics of borrower behavior and ignition kill switches appears to have changed the dynamics of the subprime industry, thereby allowing their competitors to be more aggressive in lending. Most of the capital freed from exiting our investment in Nicholas has been redeployed towards investments in Japan.

There has been a general pessimism towards investment in Japanese equities. The bear thesis against Japan has centered around a few central themes: low birthrates and high longevity creating demographic imbalances, Japanese corporate culture not being focused on creating shareholder value, and low GDP growth since the economic bubble of the late-1980s. In this letter, I will explain why we do not share this pessimism and have invested in several Japanese stocks this year.

I should clarify that we do not take a macro approach towards investment idea generation but rather seek out individual companies. While the macro environment is something we take into account with stocks, we do not decide upon a country and then see what investments we can find there.

Demographics

Japan has one of the lowest birth rates in the world (Total Fertility Rate of 1.42) and the highest life expectancy (83.8 years).[1] There are fears that this will eventually lead to a workforce incapable of generating enough tax revenue to support the swelling ranks of pensioners. Already in Japan, adult diapers outsell those for babies. I believe that while these fears are genuine, they are not unique to Japan. The chart below depicts the total fertility rates and age dependency ratio[2] for Japan and several developed European economies[3].

	Japan	Germany	Switzerland	France	UK	Italy
Total Fertility Rate	1.42	1.39	1.52	1.99	1.83	1.39
Age Dependency Ratio	64.5%	51.8%	48.9%	60.3%	55.1%	56.5%

As we can see, the baby shortage is not specific to Japan but affects European nations as well. A counterargument can be made that these other low-birth countries have taken in large numbers of immigrants to replace the low births while Japan has not. However, this line of thinking ignores that many of these countries have been largely unsuccessful at integrating their immigrant populations. For example, in Germany, Aydan Özoğuz, the German commissioner for immigration, refugees and integration, told the Financial Times that his ministry expects that up to 75% of the 1.3 million recent refugees to the country will still be unemployed in 5 years times[4]. Therefore, it appears unrealistic to believe that immigrant populations can be used as a tax base to fund social spending on the elderly in the European Union.

While the demographic issues are real, they are not unique to Japan and afflict almost all developed economies. It should therefore not be seen as a particular reason to avoid investing in Japan.

Poor Capital Allocation

Another reason for pessimism on Japanese equity markets is the perception of poor capital allocation by corporate management. Japanese companies are seen as hoarding large amounts of cash rather than buying back stock, paying dividends, or reinvesting in growth. Western investors are therefore less likely to ascribe value to the rich balance sheets of Japanese companies as the assets are seen as "locked up" by Japanese management.

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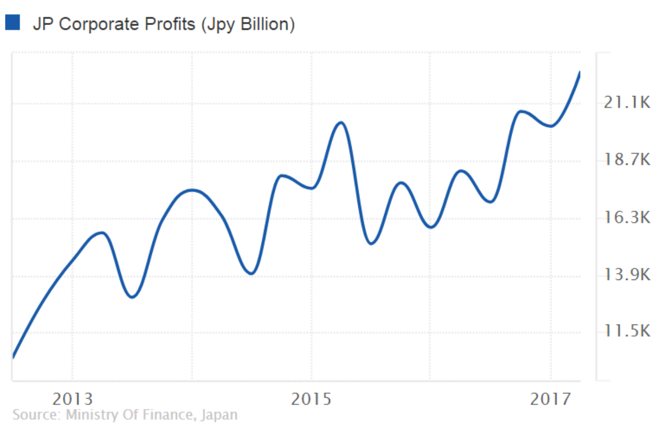
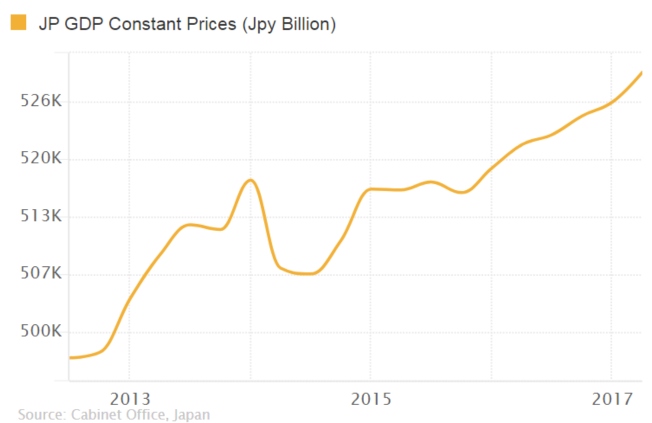
[1] World Bank statistics. http://data.worldbank.org/indicator/SP.DYN.TFRT.IN?year_high_desc=true
[2] Age dependency ratio is the ratio of dependents (younger than 15 or older than 64) to the working-age population (ages 15-64). Data are shown as the proportion of dependents per 100 working-age population.
[3] Total Fertility Rate is the number of children who would be born per woman if she were to pass through the childbearing years bearing children according to a current schedule of age-specific fertility rates
[4] "Most refugees to be jobless for years, German minister warns" June 22, 2017. Financial Times. https://www.ft.com/content/022de0a4-54f4-11e7-9fed-c19e2700005f

President Shinzō Abe began pushing a series of reforms starting in April 2014 to make Japanese companies more competitive. One of the most significant of these was the Japanese Stewardship Code which sets reforms for how institutional investors (who make up the majority of Japan's equity market) engage with the companies they are investing. The code requests that companies aim to achieve a minimum 8% return on equity. The code also calls for companies to have at least two independent board members. While the code does not advocate specific actions to take or even advocate that the investors interfere with management in the internal activities of the business, it does set out the goals for investors to justify how management's actions are aligned with good stewardship and build shareholder value. The code is voluntary for institutional investors to adhere to, but a public record is kept of which institutions are participating and which are not. These reforms and requirements to justify financial decisions in terms of stewardship will make institutional investors less able to get away with financially inexplicable moves aimed at supporting struggling Japanese companies.

There is a system of cross holdings across Japanese companies, where the companies own shares of each other. This is known as the *keiretsu* system. This creates a conflict of interest as business decisions may be made for the benefit of other companies under the ownership umbrella, rather than for the best interests of the main business. In recent years, the amount of shares held under the keiretsu system has been declining significantly, increasing the competitiveness of Japanese businesses. The ratio of holdings of Japanese stocks by listed Japanese banks and non-financial companies was 10.3 per cent at the end of the financial year that ended in 2015. At its height in 1990, the ratio was 34 per cent.[5]

Japanese corporate growth rates have been far outstripping the growth rate of the overall economy in recent years. From Q1 2012 to Q1 2017, Japanese Corporate Profits increased from 12.6 trillion JPY to 22.4 trillion JPY (12.2% annualized) while the nominal GDP change between those two quarters was 499 trillion JPY to 529 trillion JPY (1.2% annualized).





[5] "Japan Inc's silence over Toshiba sends chill across Tokyo" Financial Times. June 12, 2017 https://www.ft.com/content/cabfe9d2-4c1f-11e7-919a-1e14ce4af89b

Value Investing Works Well in Japan

In addition to an overall examination of the Japanese market, we should ask how value strategies have done in particular. We can take a look at a 2013 study of Japanese equity returns from 1975-2011 which includes Japan's post-bubble bear market (1990-2011) where Japanese stocks lost over 62% of their value.[6] What we see in this period is that not only did value investing greatly outperform during this 37-year period, but the outperformance was even more pronounced during the post-bubble bear market. Selecting low price-to-book (P/B) as our value metric and selecting the cheapest, equally-weighted quintile with monthly rebalancing gives an annual return of 19.3% for the 1975-2011 (an annual outperformance of 13.6% relative to the overall Japanese market) and 10.6% for the 1990-2011 bear market (an outperformance of 13.2% per year). Selecting low price-to-earnings (P/E) as our value metric and selecting the cheapest, equally-weighted quintile with monthly rebalancing gives an annual return of 23.6% for the 1975-2011 (an annual outperformance of 17.7% relative to the overall Japanese market) and 16.9% for the 1990-2011 bear market (an outperformance of 19.7% per year). Japanese value stocks clearly had an impressive performance in this period.

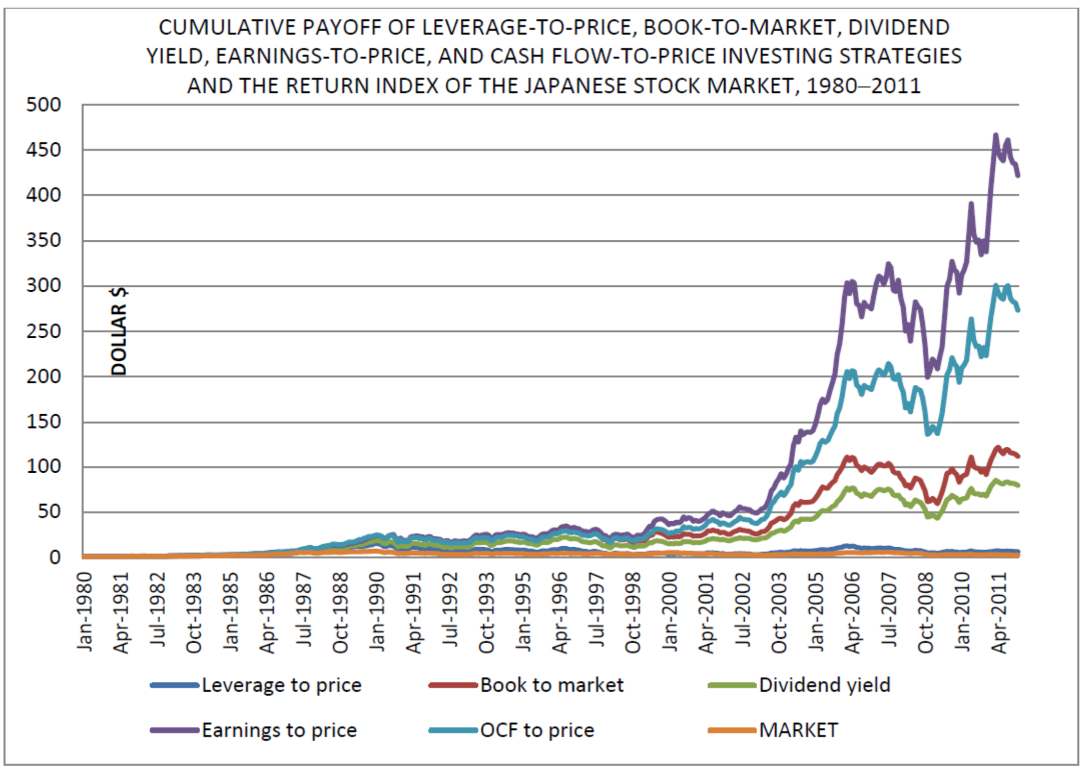


Figure 1. Cumulative Payoff of $1 Invested in Japan's Total Market Index and in Portfolios with the Highest Book-to-Market, Dividend Yield, Earnings-to-Price, Cash Flow-to-Price, and Leverage-to-Price with Monthly Portfolio Rebalancing in the Japanese Stock Market.

Source: "Performance of Value Investing Strategies in Japan's Stock Market", Hong Kong University of Science and Technology Value Partners Center for Investing

[6] "Performance of Value Investing Strategies in Japan's Stock Market", June 28, 2013, Hong Kong University of Science and Technology Value Partners Center for Investing.

Valuations of Japanese Small Caps Depressed

The aggregate valuations of Japanese small cap stocks make it clear that this is currently a target rich environment for value investors. At the end of September, the forward P/E of Japanese small caps was 70% of the average for small caps globally and 58% of the US small cap average. Additionally, price-to-book is 65% of the world small cap average and 54% of US small cap price-to-book.

I hope that after reading this letter, our clients understand Blue Tower's view on the Japanese equity markets and why Japanese equities have been a growing portion of the portfolio.

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.