AozoraStep

Q1 2022:
How ESG is the world's biggest threat and why the historic analogy of the 1970s is wrong whereas the 1920s is right

Quarterly Performance	Our Performance	FTSE All Share TR
Q1 17	0%	0%
Q2 17	-8%	1%
Q3 17	-5%	2%
Q4 17	-1%	5%
Q1 18	9%	-7%
Q2 18	19%	9%
Q3 18	-16%	-1%
Q4 18	-30%	-10%
Q1 19	45%	9%
Q2 19	39%	3%
Q3 19	0%	1%
Q4 19	8%	4%
Q1 20	-43%	-25%
Q2 20	42%	10%
Q3 20	-3%	-3%
Q4 20	76%	13%
Q1 21	32%	5%
Q2 21	-3%	6%
Q3 21	5%	2%
Q4 21	1%	4%
Q1 22	37%	1%

Annual Performance	Our Performance	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022 Q1	37%	1%

Overall Performance	Our Performance	FTSE All Share TR
CAGR	**28.3%**	**4.6%**
2017-22 Q1 Return	**270%**	**27%**

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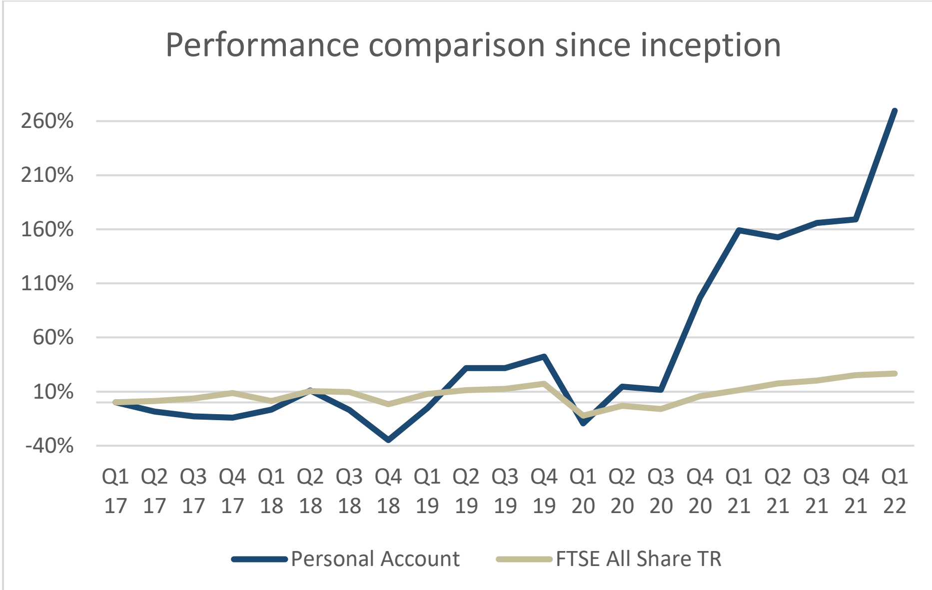

5th April, 2022

Dear Investor,

Having had to withdraw my application with the FCA has been painful, but amidst all the changes they have done this year, understandable. The tighter rules are making it a lot harder to start up the business and probably around 50% more capital is required in order to make the FCA comfortable. The biggest concern I have is regarding fulfilling the role of MLRO and Compliance Officer, which they have recently updated[1]. However, I am working with a very good partner at ComplyCraft Consulting to find ways of getting started, worst case via a financial advisor instead of portfolio manager, which is a model I am working on with Posco Capital right now. In that way I can advise clients what to buy and manage their portfolio in the same way, except not executing it myself. The step from advisor to portfolio manager is then also easier to pursue in a year's time in light of the more stringent regulation by the FCA.

A historic analogy recap

As pointed out multiple times in the past, if I were to compare the current period with any other historic period, I believe the 1920 Forgotten Depression is most similar to what we are going through right now,

[1] Heads of compliance and MLRO applicant competency and capability | FCA

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in particular in light of the very similar underlying economic situation of high inequality, high government debt, move towards higher taxes and shift towards new transportation technology. Given that inflation in the 1970s was triggered by two oil shocks (Arab oil embargo in 1973 and Iranian Revolution in 1979), the current Ukraine-Russia crisis is in some sense another oil (or commodity) shock that comes on top of the current supply chain crisis and hence the current world experiences somewhat of a mixture between the 1919/20 and 1973/74 & 1979/80.

Historical comparison of 1919/20, 1973/74 & 1979/80 and today

Parameter	1919/20	1973/74 & 1979/80	Now
Auto sales	High auto sales amid shift toward combustion engine (from horses)	Falling sales & strikes	Low supply has met relatively strong demand
Consumer sentiment	No data	Consumer sentiment fell to lows equivalent of 2008 in 1975 and 1980	Weakest since 2008/09
Credit spreads	20yr AAA vs. BAA rated corporate bonds yielded 6% vs. 8.2%	20yr AAA vs. BAA rated corporate bonds yielded 7.5% to 12% vs. 8.5% to 13.5%	20yr AAA vs. BAA rated corporate bonds yielded 3.5% vs. 4.5%
Geopolitics	World was split in two powers: France, UK, Russia vs. Germany, Austria-Hungary, Italy	Cold war was ongoing, Arab-Israel war led to indirect war of US vs. Soviet Union, which led to oil embargo. Iranian revolution in 1979 led to another spike in oil prices	Entering bi-polar world NATO vs. SCO
Globalisation	World was in globalisation mode, but WWI set the stage for de-globalisation	1970s were inflection point towards globalisation	Beginning of de-globalisation after strong globalisation in prior decades
Government debt/GDP	World leader (England) had excessive debt/GDP of over 130%	Below 40%	>100%
Housing market	Price hikes of as much as 14%	Mixed	Price hikes of as much as 20%
Inequality	High inequality, top 1% owning 12-19% share of total income	Inequality only started to shift from the late 70s	High inequality with top 1% owning 30% of all household wealth
Inflation	PPI was between 25-35% during WWI, then influenza kept inflation at 11%	PPI in region of 12-18% in 73/74 & 79/80	PPI in region of 10% and higher
Interest rates	Fed hiked from 4% to 7% within 8 months	73/74 Fed hiked from 5% to 12%, 78-81 Fed hiked from 8% to 18%	Fed only hiked 25bps, but more and higher hikes priced in
Inventories	Low inventories	JIT inventory approach was just taken on	Record lows
Lending	Businesses borrowed excessively in light of soaring commodity prices	Grew normally	Consumer lending is picking up, businesses reduced borrowing
Orderbook	Large orderbooks	No data	Very high
Stock market	High speculation, lots of borrowing on margin	S&P 500 halved between 1973 and 1975, stable before	High speculation, lots of borrowing on margin

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Taxation	Income tax and other taxes were introduced	UK had top rate of income tax on earned income was cut from 83% to 60% over the decade	Global minimum corporate tax to be introduced, general tax hikes
Unemployment	Low, frequent strikes for higher pay	Doubled from 4.6% to 9% and from 5.6% to 10.8% (73/73 & 79/80)	Record lows
Yield curve	No data	73/74 & 79/80 yield curve inverted for nearly 2 year, rates kept rising overall	Inverted

Source: The Forgotten Depression by James Grant, Fred St. Louis

Economic sentiment can be misleading (in this case…)

Although my performance through the Russia-Ukraine crisis was very strong, as I was positioned for an energy crisis, I did throw in the towel and went into cash when my target valuations were reached and economic sentiment pointed towards a recession. The Sentix sentiment index dropped by the largest amount in a single month ever, yet equity valuations remain high. I have long been scratching my head trying to make sense of this and even bought some long dated bonds to benefit from a risk-off move. The only way I can explain the stable valuations in equity is due to the sell-off in bonds amid inflation worries. In some sense, this shows how monetary easing can sometimes cause panic, as capital allocators sell their equity and buy bonds to benefit from Central Bank actions, exacerbating the sell-off in equities and financial conditions. Historically, yield curve inversions have been a good predictor for recessions. However, in many, if not most cases, the yield curve remained inverted for nearly two years before a recession actually occurred. This is why I think the market can digest perhaps one or two 50bps rate hikes by the Fed pretty easily, especially, as the market has already priced in substantial monetary tightening. When the Fed stops hiking and the yield curve remains inverted, this is when we should worry…

Global Sentix Sentiment Index

Global	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	Comment
Overall index	17.2	15.1	16.9	17.0	1.0	-5.4	Lowest since August 2020
Headline index							
Current situation	20.1	15.1	17.1	19.5	11.3	3.6	Lowest since February 2021
Expectations	14.3	15.1	16.7	14.6	-8.8	-14.1	Lowest since March 2020

Source: Sentix

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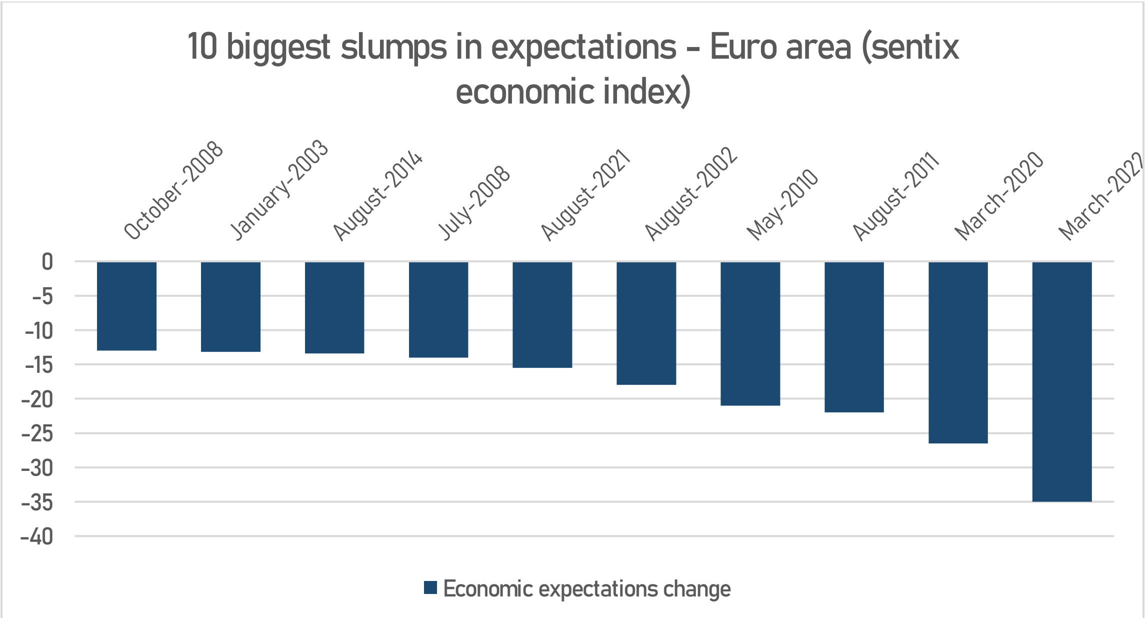
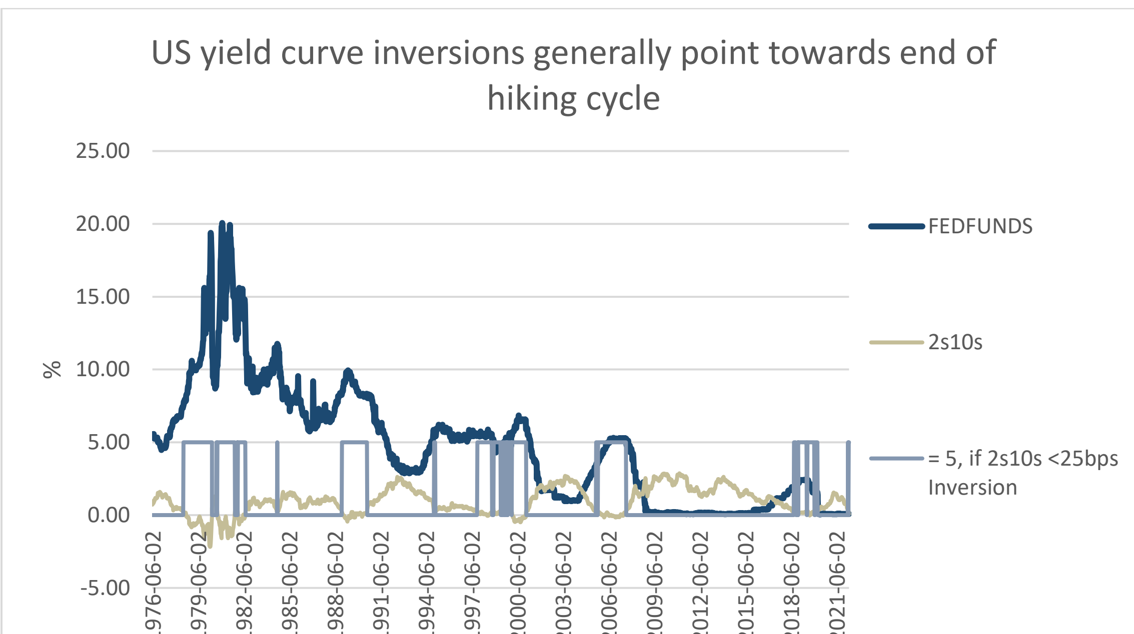


Source: Sentix



Source: FRED St. Louis

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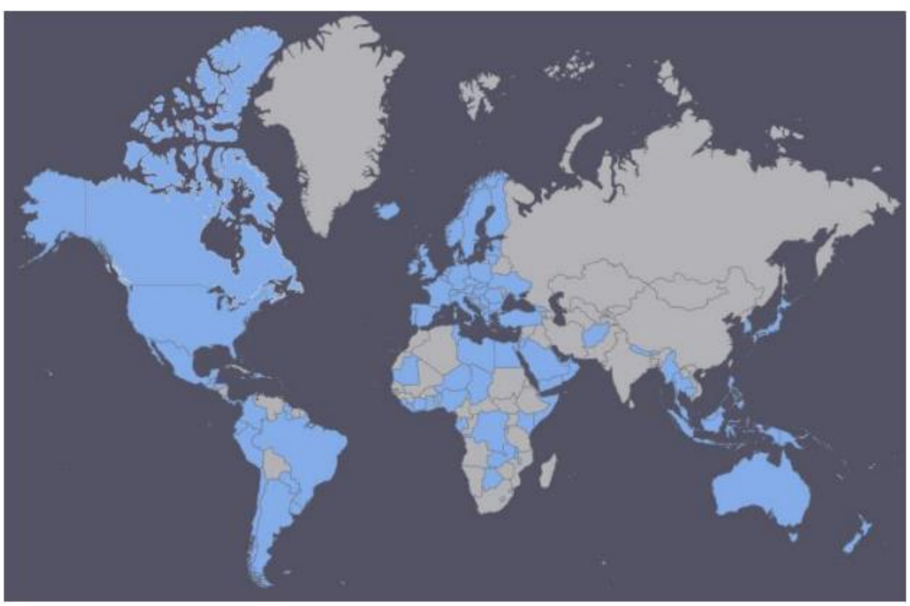
Why Russia & Ukraine matter and how ESG can become the world's biggest threat

The world is dependent on Russian, Belarusian and Ukrainian raw materials and the sanctions that target Russia/Belarus could therefore lead to a disruption in supply from energy to food commodities to semi-conductor gases and to seafarers. However, recessions occur when GDP declines, and GDP declines when either volumes or prices decline. In this sense, the rise in prices will likely outpace the decline in volume, and therefore one should fear a decline in prices, not high inflation. High inflation, on the other hand, will become problematic for developing and emerging countries, as well as low-income households of developed countries. This is why, I believe a repeat of the 2011 Arab Spring is relatively likely, and the French Presidential election on 10 April 2022 could be the beginning of a right-wing political move in Europe, which we have last seen in the 1930s, and hence the beginning of de-globalisation. As noted here & here, we could be entering a bi-polar world (NATO – West vs. SCO – East) and the danger is that the ESG movement could actually help the East in convincing countries like Turkey, Egypt, Saudi Arabia or UAE to switch sides, as these countries are either dependent on Ukrainian/Belarusian/Russian fertilizers, wheat and maize or are a major exporter of fossil fuels and simply have other worries than ESG. The UN vote could therefore be a good barometer on who has more power and controls the majority of UN votes. The countries having abstained from the vote are already home to >50% of the world's population.

Countries that voted in favour of Russian troop withdrawal from Ukraine



Source: UN

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Countries that voted against/abstained/not voted of Russian troop withdrawal from Ukraine

Source: UN

Share of world commodity supply by Russia/Belarus/Ukraine

Commodity	Russia/Ukraine/Belarus of world supply
Aluminium	6%
Barley	27%
Coal	5%
Corn	20%
Diamonds	30%
Enriched uranium	35%
Fertilizers	22%
Maize	18%
Natural gas	18%
Nickel	7%
Nickel (High quality)	17%
Oil	11%
Palladium	30%
Platinum	15%
Seafarers	15%
Semi-conductor gases	50%
Steel	10%
Sunflower	24%
Sunflower oil	73%
Uranium	6%
Wheat	34%

Source: AozoraStep Capital Market Views Episode 11

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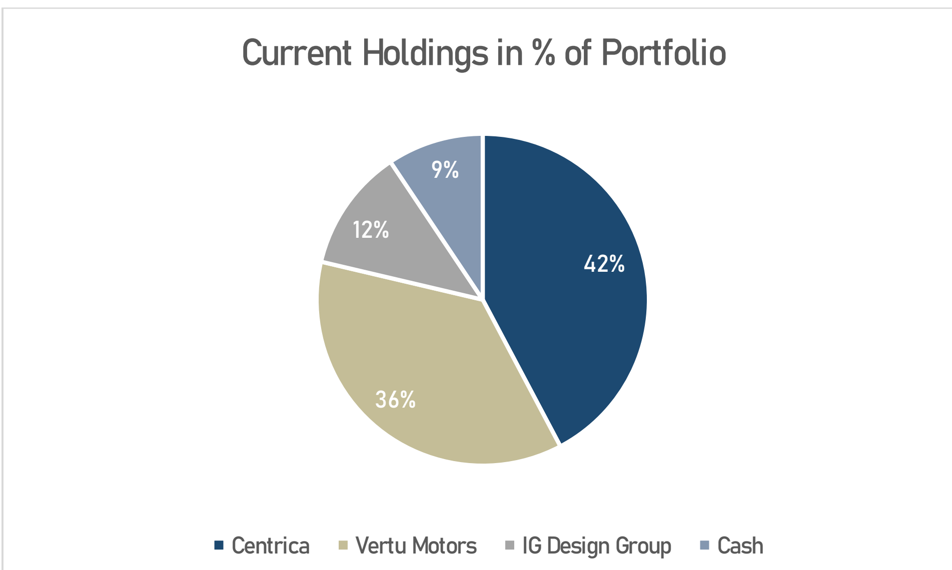
Performance

I was able to achieve a 37% return in Q1 2022, as the energy crisis led to a re-valuation of Hunting doubling its market cap from the lows in November. I have since sold the position, as it reached my fair valuation. I exited our position in James Fisher & Sons with a 16% loss, re-entered Centrica, and bought shares in Vertu Motors and in IG Design Group. More details below.

Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Centrica	0.83	0.80	GBP	-3%
Vertu Motors	0.65	0.65	GBP	0%
IG Design Group	0.60	0.67	GBP	12%

As of 31st March 2022



As of 31st March 2022

Performance explanation: Exits

I exited James Fisher & Sons, as I made a mistake in judging the management and perhaps the situation with Russian vessels and ship-to-ship (STS) transfers. I have since tried to get a call with the CEO arranged via Investec, but so far had no luck unfortunately. I continue to see value in the company and will work on getting the necessary information with regards to STS. At this moment, I believe that the CEO's dramatic focus on ESG has been a mistake for the company and would therefore like to see a softening stance in this regard first. Full exit note here. In addition, I exited Hunting, as my fair valuation was reached and politicians continue to focus on renewables rather than boosting oil & gas supply in the short-term (here).

Performance explanation: Entrants

I have re-entered Centrica, as the Ukraine-Russia conflict has caused gas prices to climb further and stay elevated for longer. Similarly, due to the Ukraine-Russia conflict supply chains for car manufacturers have been impacted further now due to electric wiring shortages that were produced in Ukraine. For this reason, I bought the car dealerships owner Vertu Motors, as the comparative valuation to competitors is around £100mio below fair value, i.e. a 40% return opportunity. Last but not least, I bought shares in IG Design Group, after the CFO was announced, which by now has appreciated by over 40% in value. More details can be found under the turnarounds section.

Review

Having lost 16% with the position in James Fisher and Sons has been disappointing. I made a mistake in not doing proper due diligence on the management team, as the CEO is a big proponent of ESG, which doesn't really fit James Fisher and Sons, and he actually had no prior experience in the industry. Going forward, I will put more emphasis on the background of the CEO, as there is substantial risk when a leader actually does not have prior industry experience.

When transportation group Go-Ahead shares tanked to below GBp 600 a share (£250mio market cap), I was eager to buy a stake in the business. However, similar to James Fisher and Sons in the prior quarter I had to clear some questions and it took them two weeks to answer. I was somewhat slow to act and did not fully understand how the business model works and how they generate revenues. This is now the 2nd time I miss an opportunity for being too slow to understand a business. Going forward I will seek to put more energy and time behind opportunities that look attractive (the company is now valued at £370mio, 40% higher).

Last but not least, on 30 March 2022, I purchased shares in IG Design Group on two different accounts after the new CFO was announced. I have monitored the company, as it generates $1bn in revenues, has

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$40mio in net cash, yet a market cap of merely £60mio due to the CEO and CFO having left the business. More details on the reasoning behind here. Sadly, the second order was not lifted by my broker HSBC, despite having traded in 4x my size and below my limit 23 minutes after my order was submitted. This has been extremely frustrating and HSBC has not recognized that they made a mistake. I have done an internship once in the Retail Equity Derivatives Sales section at UBS Investment Bank where we frequently had to deal with such cases, hence I know the procedure very well and that the broker always needs to compensate the client in such case. Life is not always fair, but the law generally is. Going forward, I will always make sure the order is actually executed and I will look at building relationships with good litigation lawyers, who can ensure justice is served.

Outlook

The outlook has rarely been more uncertain than it is today. However, there are also a lot of opportunities, although these should be enacted on with a more short-term focus. I am somewhat cautious on the position in Vertu Motors and also Centrica, as sentiment could lead to lower car buying demand (although unlikely lower than the historic low in supply) and commodity prices have slumped around six months after Russia invaded Crimea in 2014 – this risk is real this time as well, although Russia still has the upper hand when it comes to gas right now, as it can't be diverted to other countries in equal amounts. Businesses like Hostmore, Smith News, Go-Ahead and Yellow Cake are high on my watch list and I might end up shifting my portfolio before having reached my target valuation, if opportunity allows it. Meanwhile I remain hopeful in getting regulated by the FCA before the end of the year, but it might also depend on finding an anchor investor…

Sincerely,

David Herrmann

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