AozoraStep

Our Performance vs. FTSE All Share Total Return

Quarterly Performance	Our Performance	FTSE All Share
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%

Annual Performance	Our Performance	FTSE All Share
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
9M 21	34%	14%

Overall Performance	Our Performance	FTSE All Share
CAGR	**22.9%**	**3.9%**
2017-21 Return	**166%**	**20%**

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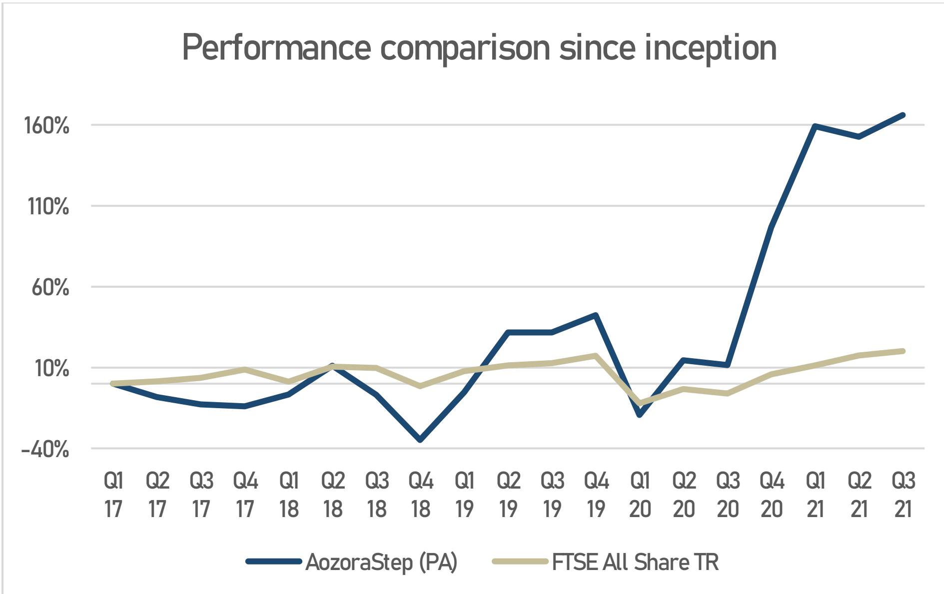

3rd October, 2021

Dear Investor,

Q3 2021 has been the first quarter where I could focus 100% on AozoraStep Capital without being subject to compliance rules of BlueCrest Capital (minimum holding periods or limited amount of trades per month). This has been an important factor during increasingly choppy markets. At the same time, I have finally finalised my application as a MiFID Investment Manager with the FCA, which is now being reviewed and expected to take around six months to conclude. Over the coming months, I'm planning to continue my focus on research and, most importantly, the performance, but will also seek to integrate a search function on the website and improve the message of what's behind AozoraStep Capital, which will help future investors understand my thinking and the investment strategy better. I have also been thinking about changing the name, as many struggle to pronounce it. Aozora is Japanese and means blue horizon/heaven. I created the name when I was studying in Tokyo one decade ago, as it translates into "step into the blue horizon", or "step into heaven". A name change is, however, quite complicated, and I will therefore likely focus on explaining the name to those in need of understanding it. I have been educated quite religiously, being Catholic Christian. However, I was much more of a believer in Capitalism since I was a kid, as for me a financially strong position always meant freedom, my most important goal in life. Catholic Christian's goal in life (similar to other religions) is to be able to "step into heaven", not into hell! In that way, I hope that AozoraStep Capital will become a vehicle that helps me and others to "step into heaven" and become financially strong, which translates into freedom.

The structure of this quarter's letter remains the same, as before drilling into the performance I will line out some important market movements that affect our positions. In Q2 2021 letter I lined out how the Fed/monetary policy is looking to follow the 2013/14 guide book by tapering asset purchases steadily and carefully, while making sure there is enough liquidity in the system. This strategy has played out correctly so far, as the reverse repo facility reached new all-time highs of over $1.6 trillion. If the Fed were to reduce asset purchases now, it should have no impact on markets, as there is a huge buffer of liquidity that sits in

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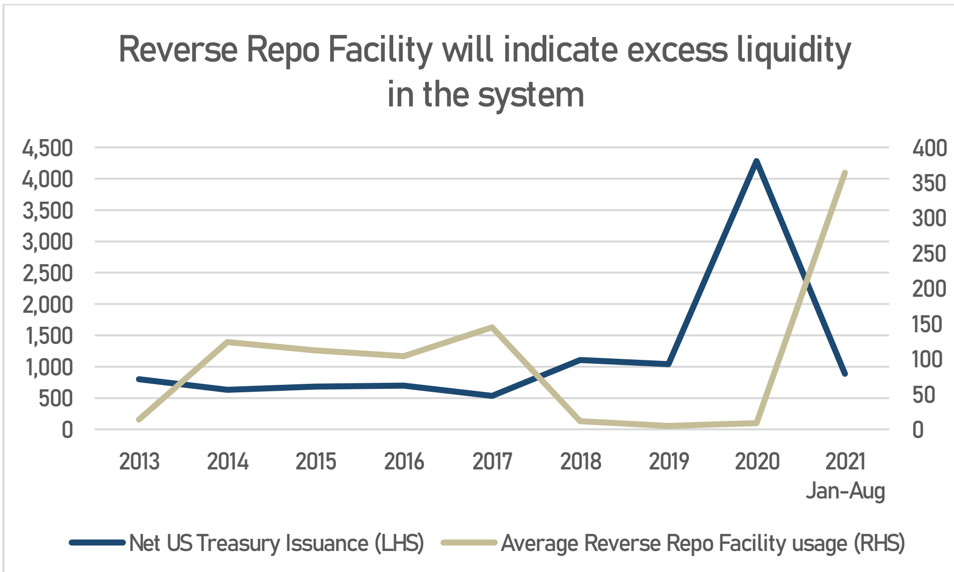
the reverse repo facility. In some ways, I think the larger the fiscal stimulus package will be, the more difficult of a job the Fed will have in tapering, as net treasury issuance will increase. Currently, the most likely stimulus package size seems to be $1.9trn, which is close enough to the $1.6trn at the reverse repo facility (which came from the drawdown of the Treasury General Account) to enable the Fed to taper, but maybe not in a 2013/14 style when the reverse repo facility remained in use all the way to the end of the taper. The imbalance between fiscal spending and resulting higher bond net issuance and monetary policy of tapering asset purchases while leaving the reverse repo facility drawn down to zero is risk number one.



Source: FRED St. Louis, SIFMA

Risk number two remains to me what I outlined in Q1 2021 letter, namely a historic comparison of the current economic environment with the Dot-com crash and the 1921 forgotten depression, and I would even add the Lehman Shock in 2008 amid the troubles of real estate developer Evergrande in China now. Economic history is an extremely important factor to identify risks, and while history repeats itself, it will never be exactly the same. The forgotten depression of 1921 remains my favourite comparison of what could happen in 2022/23, as this period was similarly to now plagued by a pandemic (influenza) and resulting economic and behavioural changes that drove inflation higher and led to imbalances in supply and demand (more here, page 3 & 4). The big question is whether the highly inflationary environment we are in now will translate into a highly deflationary environment thereafter. Therefore, inventories will be the key to watch, because it could happen that businesses order too many goods amid the strong pent-up demand in Q2 21, which will be left on the shelves when business travel reopens and consumer spending shifts more strongly back towards leisure & travel. The imbalance of business inventories and consumer spending on durable goods will be risk number two to watch out for, while the current risks of bottlenecks and higher inflation could run into its final months, which is already affecting profit margins for most retailers. This, in combination with higher taxes and tighter monetary policy could lead to a substantial correction in equity markets.

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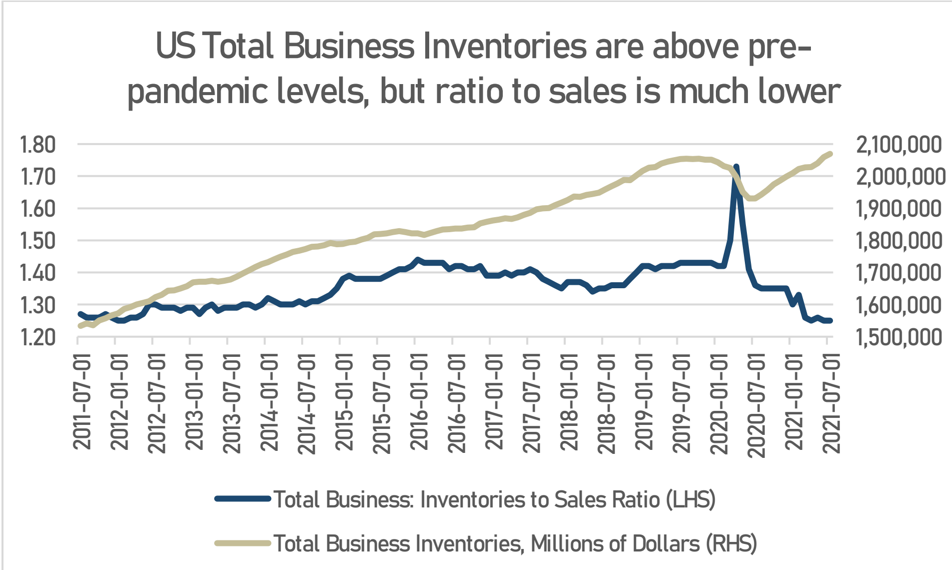

Source: FRED St. Louis

The UK economy is particularly vulnerable, as the effects of Brexit have worsened labour shortages and international trade caused by the pandemic. Over the coming three months, shortages will lead to a decline in profit margins for any company that is reliant on a global supply chain, from dry bulk containers to HGV drivers. This forms risk number three, a supply chain collapse, which is currently in full swing. For that reason, in the near term, I believe cash is not necessarily trash and diversification could actually increase, and not reduce risks…

Performance

After a disappointing 2Q 21, 3Q 21 was considerably better, achieving a 5% return vs. a 2% return in the FTSE All Share Total Return. Despite beating my benchmark, it was again a volatile quarter with a complete change of positions in the portfolio. I have exited Plus500, Studio Retail Group, Mulberry and by 1st October all of Photo Me. I added new positions that I held earlier this year, Centrica and Hunting, at lower prices and now have around 1/3 in cash, which I'm seeking to re-deploy when a good opportunity arrives.

Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Centrica plc	0.53	0.57	GBP	8%
Hunting	2.08	2.26	GBP	9%
Photo me	0.72	0.62	GBP	-14%
Cash	-	-	GBP	0%

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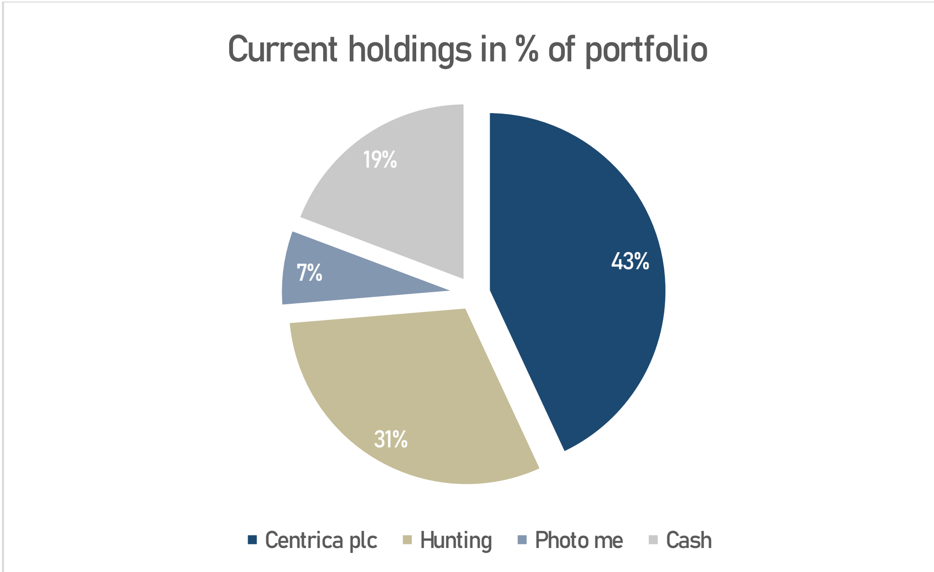

Performance explanation: Exits

Usually, I exit positions when they have reached my target price, unless I can find a better opportunity that promises higher returns or the economics have changed and risks to the downside outweighed the fair valuation of reaching my target price. All of this quarter's sale were based on downside risks increasing, while better opportunities elsewhere emerged. Nonetheless, I continue to monitor Plus500, Studio Retail Group and Photo Me, as I believe they will still succeed in their turnaround later on, maybe next year.

1. CFD Broker

Plus500

CFD Broker Plus500 always appeared too cheap to me. The reason why the market prices a firm that made $500mio in net income at less than $2bn is partly driven by increased regulation of leverage a broker can provide to retail clients and partly by the income volatility the firm has shown in 4Q 20. Both seemed unjustified to me, as regulatory pressure has occurred in different regions in the past without impacting profits that much, while the income volatility in 4Q 20 was down to the company not being perfectly hedged and the market went up aggressively after the vaccine news – a one off, in my opinion. One risk that remained was that day trading, as it happened during the lockdowns, will subside. Although I knew this risk was real, I did not expect it to happen so rapidly, as CMC Markets, a competitor, suddenly reduced their full year operating profits to 2019 levels. Plus500 has much lower expectations from the market and is likely to meet or beat those, however, CMC Market shares dropped around 30% since the announcement. Uncertainty outweighed the benefits and I sold the entire position at £14.15, incurring a loss of 52 pence per share (bought at £14.67 average). Nonetheless, we will still receive the dividend of around 43 pence a share in 4Q 21, which is reducing the loss to around 10 pence a share.

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2. Retail

Mulberry

British leather bag maker Mulberry has lost its creative designer (ex-Celine) to LVMH in 2020. The shares cratered amid the Covid crisis, but the popularity of its bags did not. For me the opportunity lied in pent-up demand and savings on lease renegotiations, which turned out to be correct. However, when China's economy started slowing and the Evergrande problems emerged more strongly in August, I decided to sell the position at around £3 a share, making a 55 pence a share profit. Asia has been their biggest growth market and was profitable for the first time this year. On top of the potential problems in China, the brand issued three new collections from three different designers amid their 50th year anniversary. When the Ahluwalia collection hit stores and sales apparently were muted, it seemed to me like they didn't take full advantage of their 50th anniversary, which was another reason for me to sell the position despite not having reached my target of £4 a share.

Studio Retail Group

Studio Retail Group is the Amazon for the UK market, which specializes on discounts and enables to spread out purchases via its credit facility. I bought the position at an average price of £2.88 a share in 2Q 21 as their 2Q 21 trading update suggested lockdown demand to sustain into the economy's reopening. This was also supported by data from the Office for National Statistics, which pointed to continued online shopping demand well into August 2021. After the company published its interim results, indicating a pre-tax profit expectation of £42-45mio, the share price did not move and stayed at an expected pre-tax price/earnings of below 6. When buy now, pay later company Affirm revealed a collaboration with Amazon, Studio Retail Group's market cap dropped further. When miniature train manufacturer Hornby warned of a potential delays in supply before the widely anticipated Christmas season I began reducing our position in Studio Retail Group. After having been in touch with Studio Retail Group's CFO previously, he would not return emails to my questions regarding their supply chain, which is heavily reliant on China and the Philippines. I sold the last shares when boohoo, a clothing retailer, which IR department advised me that they receive a lot of their freight via air and are hence less affected, reduced their profit margins amid supply chain issues. Boohoo shares dropped by over 20%. Studio Retail Group makes well more than half of its revenues over the Christmas holiday season. A brand manager in my building advised me earlier that they stopped looking at eCommerce companies that have supply chains in East Asia, as the supply chain crunch is set to worsen ahead of Christmas, as some supplies are set to arrive in November, which were due in the summer. I sold the entire position at an average price of £2.78, incurring a loss of 10 pence a share.

3. Automation/machinery

Photo Me International

I bought the photo booth and laundry operator Photo Me, as I expected international travel to return, leading to renewals of passports & driving licenses and increased usage of their machines. The small number of employees and machines that are standing there, ready to use, also reduced any impact of the supply chain problems that were emerging for the company. I am likely wrong on the latter. A trading

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update in August confirmed my thesis of the pent-up demand, driving increased usage for their identity machines. Their estimated pre-tax price/earnings moved down to 10/1. However, first China introduced its digital driving license, then the UK followed suit expecting its own digital driving license by 2024. The reduced demand for UK photo booths was already priced in before the pandemic, as the UK government allows you to take passport photos with your cell phone. But this is only part of the problem. The supply chain worries will probably also affect Photo Me, as they mentioned on a call with me that they already delay exchanging some older machines with newer ones amid the high shipping prices. I began selling the shares at 77 pence, but the extreme illiquidity never enabled me to sell the entire position. The share price began to fall quickly, I sold more at 70 pence and the rest at 65 pence and 60 pence. Small caps in the UK market can be extremely illiquid and the dangers of being unable to exit your position is real. On the other hand, it makes these companies often oversold. I expect Photo Me to drop further to low/mid 50 pence levels, which could prove to be an attractive re-entry level.

Performance explanation: Entrants

1. Energy

Centrica

Centrica is UK's largest downstream energy supplier and has been negatively affected by the Ofgem price caps as well as new small energy suppliers entering the market, undercutting competition through equity funded cash in recent years. The Ofgem price caps are set semi-annually for the periods April-September and October-March and are calculated and hedged eight months in advance, i.e. February-July for the period October-March. 2/3 of Centrica's British Gas customers are on the variable Ofgem tariff, which are in itself regulated to leave Centrica with a 3% profit margin. However, an increase in energy prices has led the Ofgem tariff to climb by £139 per household per annum. This translates into around £20mio higher profits for the period. Barclays expects the cap to rise by another £350 for the coming period amid the recent gas & electricity rise, which would lift profits for Centrica by another £50mio. Centrica confirmed to be well hedged for the winter, unlike many of its smaller challengers, more than 10 have gone bust for the last month. The reduction of future competition, means more customers for Centrica.

The company also benefits from its upstream business, which profits I estimate to move up to £800mio before £3-400mio annual capex. They plan to sell their upstream business, which I believe could fetch a £1.5bn price tag, which is equivalent to the investment to transform their Rough asset into a hydrogen gas storage facility. That's not all, amid the need of nuclear energy, Centrica is not looking to sell its stake in its nuclear power plants. The sale of Direct Energy in the US has moved their net debt position to roughly zero now. The £3-4bn in cash will likely reduce amid around £1.5 to £1.8bn in pension deficit payment reduction, which will eliminate their annual £175mio in pension deficit payments. This leaves cash to reduce their debt further, reducing their annual interest expense bill from its current £185mio. The current market cap is only around £3.4bn, lower than Octopus Energy, which has less than half as many customers and fewer assets. My target valuation is currently £4.5bn for Centrica, but it could move higher quickly, if the turnaround succeeds. I bought Centrica shares at an average of 53 pence.

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Hunting

Hunting is a global oil equipment manufacturer with assets around the world and a focus on the US shale oil patch, its Titan division. I have owned Hunting in the past and started buying again when the market cap dropped below £350mio. The company was hit hard by the reduction in capital expenditures of oil companies. Nonetheless, Hunting has maintained a $100mio net cash position throughout the Covid crisis by cutting costs and running down their $300mio+ inventories to $270mio. Their net assets are $940mio, which gives them a Price/Book value of under 0.5. Their Titan division has achieved $50mio+ in net profits during pre-pandemic times and has recently shifted back into EBITDA positive territory. On the interim results call, Hunting noted that they have started raising prices for their drilling equipment. During the crisis they have also made strategic investments into a tech/data collection company as well as a share in a 3D printing firm and previously acquired offshore drilling firms have started to see good demand as well. With the return of business travel, more oil demand is expected and I expect even larger firms to start drilling again. Many oil explorers, e.g. Enquest, have reduced their capex throughout 2020 and 2021, but noted to increase spending in 2022 again. I expect Hunting to benefit from this and achieve profits from 2022 again. Last, but not least, the company is looking at ways to bring its valuation closer to US peers. Most analysts, including myself see a current fair valuation at around 300 pence a share vs. 225 pence currently.

Review

Despite having sold most of our prior quarter's positions at a loss, I was able to turn a 5% profit in the current quarter driven by good entry points in Centrica and Hunting. I knew that a transition from lockdown into normal will be volatile, but I was surprised by the supply chain crisis and certain behavioural changes that led to a reduction in retail trading. I also somewhat underestimated the illiquidity of certain companies, such as Studio Retail Group and Photo Me. It is extremely difficult to buy/sell both very liquid and very illiquid stocks, as the approach is very different. This makes it really hard to invest in both, especially with my strategy that combines global macro with value investing, targeting a holding period of only six months. Going forward, I will be more careful in buying illiquid companies, unless the price is significantly discounted.

Outlook

For the first time in years, I have around 1/3 of the portfolio in cash. While this is naturally a drag in terms of performance, I'm looking to re-deploy this cash as soon as possible. Given the risks amid the supply chain crisis, I currently only have a strong view on oil, which should move higher amid business travel set to return when the US opens its borders to the UK and Europe in November and the UK eliminating the amber list next week. However, I already hold 2/3 of the portfolio in energy related names. I'm currently even considering Gilts as an alternative due to the number of risks highlighted in the introduction. Overall, I believe cash and a high concentration of the portfolio in oil & gas and UK downstream energy is the right thing to do, contrary to diversification.

Sincerely,

David Herrmann

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