

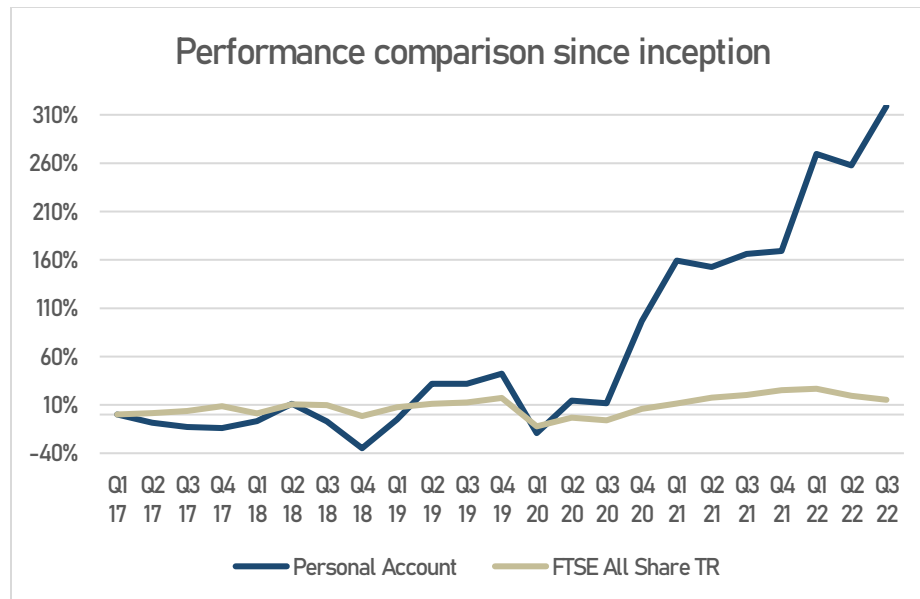
Q3 2022:

How the UK's political and economic turmoil could turn into opportunity

Quarterly Performance	Personal Account	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%
Q2 22	-3%	-6%
Q3 22	17%	-3%

Annual Performance	Personal Account	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022 9M	61%	-8%

Overall Performance	Personal Account	FTSE All Share TR
CAGR	28.3%	2.5%
2017-22 9M Return	319%	15%



17th October, 2022

Dear Investor,

First, a brief operational update. I have incorporated AozoraStep Capital on 13th April 2021. Since then, I have tried & failed to get my firm registered with the FCA, having to withdraw my application mainly as I was planning to be Chief Compliance & Chief Investment Officer. At the same time, I have not really tried too hard to raise capital and focused on the performance of my personal account instead. This has been the right choice, as a +61% in 9M 2022 and an average annual return of +66% over the last four years is beating most (if not all) other long-only, non-leveraged equity strategies. However, I still don't have institutions knocking on my door, wanting to invest millions with me... Some promising opportunities came, but everything got delayed and nothing so far has come to fruition. I have met multiple people who were interested in joining the business, but not found the ideal candidates, sometimes quite the opposite – it has not been easy! The journey continues and therefore I remain positive to bring this business into action...

For the latest one pager, factsheet, presentation, and market views, please check:

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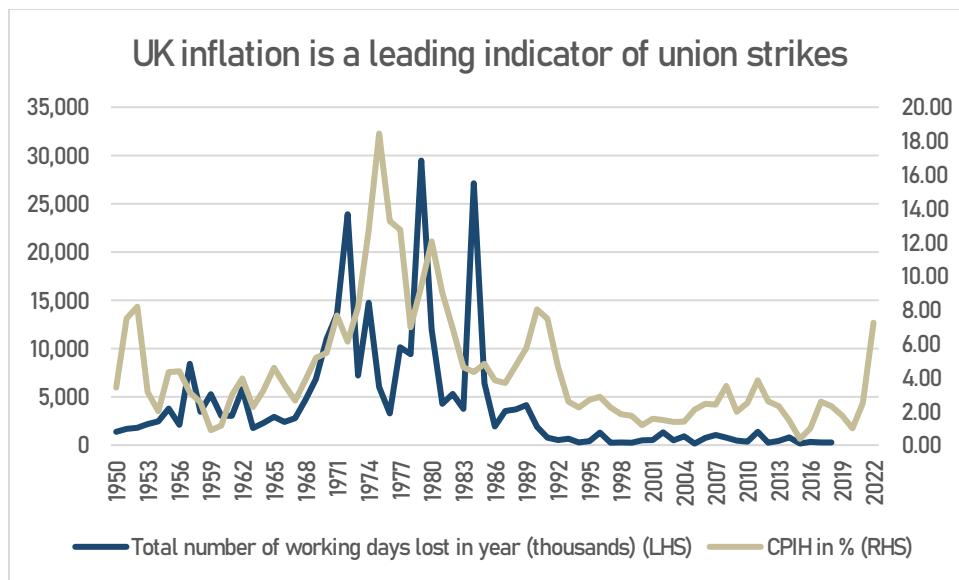
The great inflation and its aftermath

As usual, in the first part of my quarterly letters, I like to make historic analogies in order to understand the current economic environment better. In Robert J. Samuelson's book "The great inflation and its aftermath", Samuelson explains the different era that resulted from the high inflation in the 1970s and the subsequent decline in inflation and interest rates all the way until now and with it, or perhaps due to, capitalism going global. This movement has brought along many changes and amongst other it led away from "lifetime employment" towards "downsizing, restructuring and outsourcing". It profoundly changed the way corporations work and how much profit they make. With the decoupling of the West from Russia, China and the members of the Shanghai Cooperation Organisation (SCO) (call it the East), we are essentially de-globalizing the world economy and this bears the question, are we reversing the course of global capitalism from 1980s until today and head back into a similar economic era as the 1960-70s period, a sort of reverse Paul Volker?

High inflation always leads to union strikes and economic pain

Since the fall of the iron curtain in 1989, UK inflation has largely remained between 0% and 4%, which in turn has led to fewer workers on strike about pay. This period has clearly ended in 2022 with UK inflation to hit double digits for the first time in nearly half a century. The winter of discontent in 1979 seem to repeat itself with multiple industries announcing more strikes to come in October and November this year. Every single time inflation has hit double digits, it was always driven by an energy crisis. This time a mixture of ESG and the de-coupling of the East has led to unprecedented energy inflation in Europe. However, my estimates show that in 2022 potentially over 3mio working days could be lost (number of striking days x number of employees). This is still minor in comparison to the 29.5mio working days lost during the winter

of discontent in 1979. Partly, this has likely to do with the government stepping in and paying for people's energy bills and therefore avoiding a much worse scenario. Nonetheless, this year's strikes could still amount to the most since over 30 years and this will lower economic output. Interestingly, in 1979 the chaos led to a shift in power from Labour to Conservatives. Labour subsequently achieved their worst performance of the post-war years in 1983 with only 27.6% of the votes going to Labour¹. This time around, the opposite could happen, as polls suggest² – although the polls are narrowing³. Labour governed from 1964-1970, 1974-1979 and 1997-2010, which shows that sharply rising prices (or economic crises) have always led to a change in government.



Source: Office for National Statistics

¹ <https://commonslibrary.parliament.uk/research-briefings/cbp-7529/>

² <https://yougov.co.uk/topics/politics/articles-reports/2022/09/30/voting-intention-con-21-lab-54-28-29-sep-2022>

³ <https://yougov.co.uk/topics/politics/articles-reports/2022/10/13/voting-intention-con-23-lab-51-11-12-oct-2022>

UK striking companies in 2022

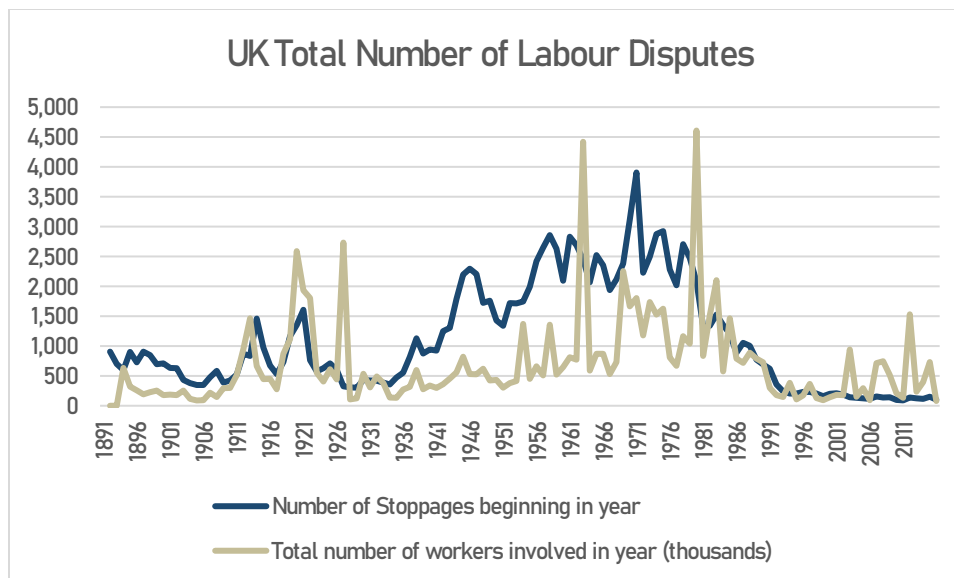
Company	Industry	Number of employees	Strike action in days
Criminal Bar Association	Barristers	3,680	30
Felixstowe Docks, Port of Liverpool	Ports	2,500	22
Several railway companies	Railway	Total 115,000 (+250,000 through supply chain - not all employees strike, companies strike on different days)	21
Royal Mail & Crown Post Offices	Logistics	115,000	14
Stagecoach, London United Busways	Bus	1,970	10
BT	Telecommunications	40,000	6
Reach	Newspaper/Media	1,150	2

Source: Individual companies, BBC, SkyNews

UK major striking history

Year	Striking industry	Working days lost
1898	Welsh coal strike	15,257,000
1912	National coal strike	40,890,000
1919	Battle of George Square: Shipbuilding and engineering workers	34,969,000
1921	Black Friday: Coal miners	85,872,000
1926	General strike: Transport and heavy industry workers	162,233,000
1972	UK miners' strike	23,909,000
1979	Winter of discontent: Public sector workers	29,474,000
1984	Battle of Orgreave: Coal miners	27,135,000
2011	Public sector strikes	1,390,000
2022	Cost of living crisis: Railway & other industries	150,000 (June/July)

Source: Office for National Statistics, Bloomberg



Source: Office for National Statistics

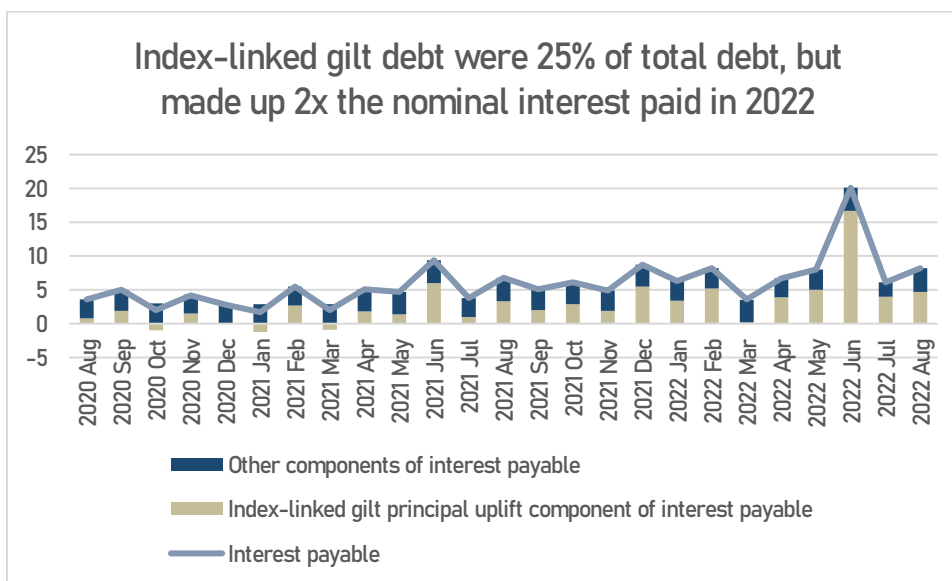
The UK budget caused havoc, rightly so?

The UK budget announced by Kwarteng in September was an absolute shocker to the market, because on top of the energy bailout, tax cuts were announced. To some degree, however, the major tax cuts (corporate tax and NIC cuts) were actually no cuts, but just a cancellation of planned tax rises. Nonetheless, there is reason for concern. At ~25%, the UK has the largest share of all nations in issued inflation/index-linked government debt. This makes the country vulnerable to high inflation. With £43.1bn the Jan-Aug 2022 index-linked government debt payments were 3x higher than the Jan-Aug 2021 index-linked government debt payments with another large increase expected by December this year. Partly for this reason, the Bank of England (BOE) was the first G7 central bank to hike interest rates in 2021, but the Federal Reserve meanwhile caught up with the BOE and raised rates faster. The result is a stronger US\$ and therefore more expensive energy imports for the UK and higher inflation. At the same time, the UK (and also Australia, Ireland, Korea and Spain⁴) has most of its mortgage debt on variable or short-term fixed rates. This puts the BOE in a tricky position, as higher interest rates could strengthen the pound and reduce index-linked government interest payments, but lead to a complete collapse in the housing market. By Q2 2022 UK's value of total outstanding residential mortgage loans was £1.65trn⁵. The average UK

⁴ <https://twitter.com/MichaelAArouet/status/1573596383302541313/photo/1>

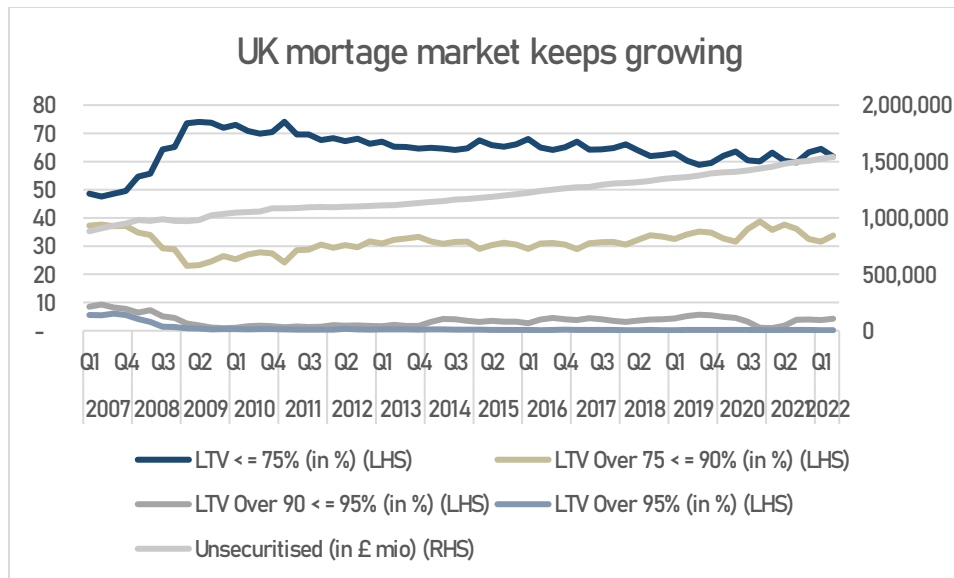
⁵ <https://www.fca.org.uk/data/mortgage-lending-statistics>

house price in July 2022 was £292,000⁶ and 1/3 of residential loans to individuals was at 75-90% loan to value (LTV). Therefore, at 85% LTV on average a mortgage of £250,000 would be taken, which would cost around £1k in monthly repayments on a 25 year mortgage at 2%. Today, 2 years later, mortgage rates have risen to 6% and are still climbing, which would make monthly repayments rise to £1.55k, taking into account repayments and 23 years left to pay. But there is another crisis brewing: Liability Driven Investments (LDIs)...



Source: Office for National Statistics

⁶ <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/july2022>



Source: Bank of England, Financial Conduct Authority

The LDI crisis could turn into opportunity

Back in 1991, a huge scandal was uncovered that changed the UK pension industry forever: Robert Maxwell, owner of the Mirror Group Newspaper (now owned by Reach plc), misappropriated the company's pension, living an extravagant lifestyle, which resulted in £450mio missing. After he fell off his yacht and died, UK companies faced more scrutiny with regards to their company pensions and had to report it on their balance sheet. Over the last 20 years, a new solution to fix pension deficits and manage pension liabilities came to fruition: Liability Driven Investments (LDI). This strategy uses leverage to hedge future pension liabilities by using repurchase agreements on the Gilts they buy or by simply buying receiver interest rate swaps and inflation linked swaps on margin. This enables additional investments into stocks and properties, helping to outperform future pension liabilities. When there are volatile movements, however, additional cash is needed to pledge for margins. This is what caused the BOE to step in and start buying Gilts, as pension trustees began liquidating them to raise cash. Now, Gilt yields, and hence discount rates that are used for calculating the net present value (NPV) of the pension liabilities, have risen, reducing the pension liabilities drastically. A 30yr inflation linked Gilt was sold at +1.55% real yield last week. With these rates, pension trustees can now sell their equity holdings and buy Gilts and index-linked Gilts, substantially reducing the liabilities, with most trustees likely ending up with a strong pension surplus, especially if de-risked and taken off their balance sheets. While liquidations in both Gilts

and equities occurred, they were mostly done to raise cash for margin payments. I expect more de-risking to happen given the much more attractive levels.

UK's 20 largest pension funds & allocation

Rank	Fund	Assets in £ mio	Fixed Income	Equity	Alternatives	Property	Cash and other
1	Universities Superannuation Scheme	£42,600	26.9%	47.7%	18.6%	6.5%	0.2%
2	BT Pension Scheme	£41,213	42.6%	28.1%	17.8%	10.8%	0.8%
3	Lloyds TSB Group	£33,916	45.2%	15.4%	17.0%	4.4%	17.9%
4	Royal Bank of Scotland	£26,843	52.7%	23.9%	10.1%	4.0%	9.3%
5	Barclays Bank	£24,575	45.5%	15.4%	9.9%	5.6%	23.6%
6	Railways Pensions Trustee	£21,147	19.3%	32.0%	28.3%	7.8%	12.6%
7	BP	£20,196	17.5%	62.3%	9.7%	7.0%	3.5%
8	HSBC Bank	£19,860	65.2%	14.7%	0.0%	4.2%	15.9%
9	British Airways	£19,739	36.3%	35.1%	6.5%	6.9%	15.2%
10	BAE Systems	£19,350	41.4%	51.7%	0.0%	6.6%	0.2%
11	National Grid	£18,234	56.7%	26.8%	4.6%	6.3%	5.7%
12	Shell International	£14,678	43.6%	35.1%	12.8%	5.7%	2.8%
13	Strathclyde Pension Fund	£14,471	12.8%	75.6%	0.0%	9.0%	2.6%
14	Greater Manchester Pension Fund	£13,509	17.3%	62.0%	4.5%	10.0%	6.2%
15	Tata Steel UK	£13,003	60.8%	25.2%	1.2%	8.3%	4.5%
16	Mineworkers' Pension Scheme	£12,793	12.1%	63.0%	15.2%	9.5%	0.2%
17	Aviva	£12,224	74.8%	7.7%	0.0%	9.2%	8.4%
18	GlaxoSmithKline	£11,838	34.3%	57.6%	0.0%	2.3%	5.8%
19	British Broadcasting Corp.	£11,101	35.1%	32.4%	18.3%	9.6%	4.6%
20	West Yorkshire Pension Fund	£10,625	15.8%	64.4%	7.7%	3.2%	8.9%

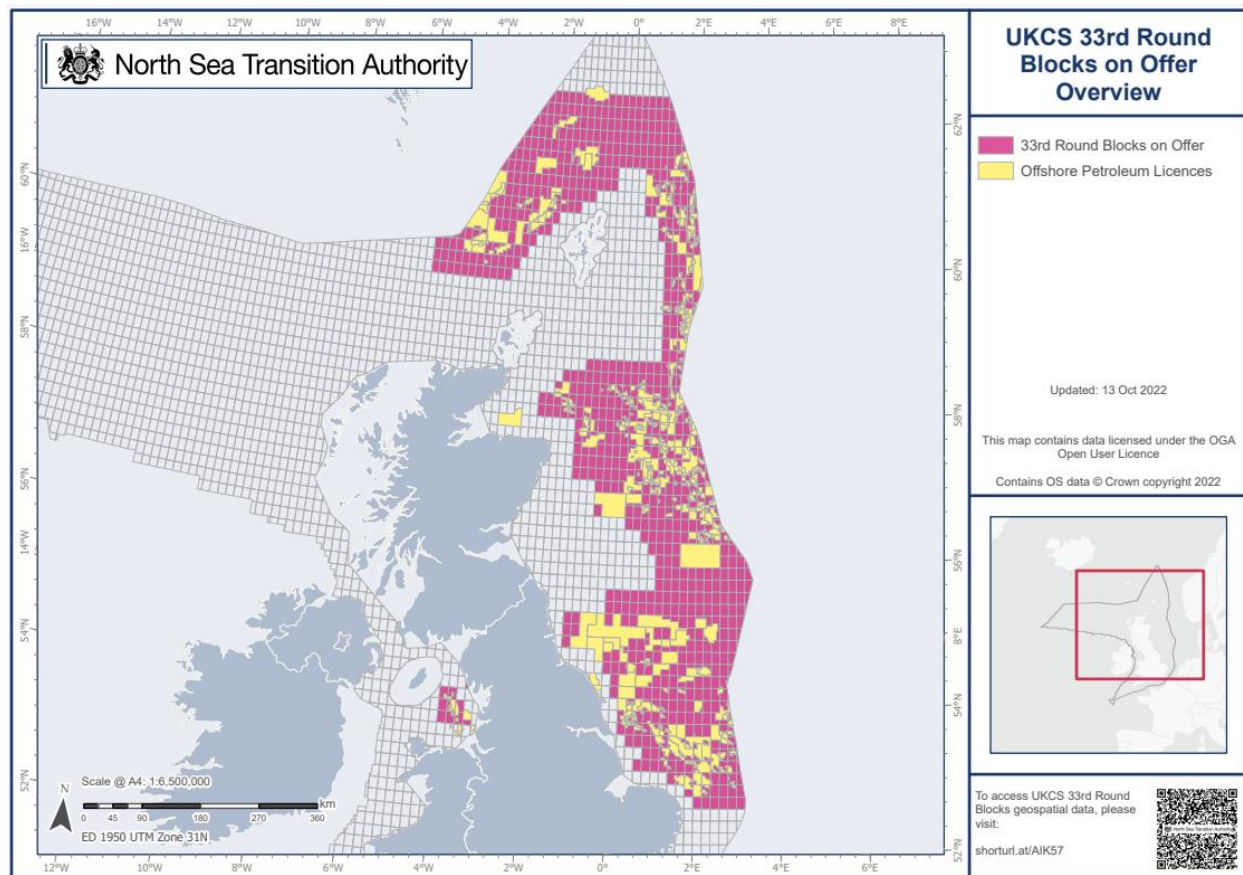
Source: pionline.com

It boils down to bringing inflation down

Ultimately, the UK needs to lower inflation as soon as possible, as it would reduce the government's liabilities to pay for average energy bills above £2,500 and the support the government provides to businesses (together ~£60bn for winter 22/23), as well as reducing the interest paid on index-linked government bonds (~+£50bn FY 22/23). While the US also struggles with high inflation, their gas prices are a lot lower than Europe's, and therefore one good way to fight inflation is to eliminate energy imports. This would, on the one hand, reduce interest on index-linked government debt, and, on the other hand, increase GDP due to a positive net export account. The current oil & gas license auction, which includes

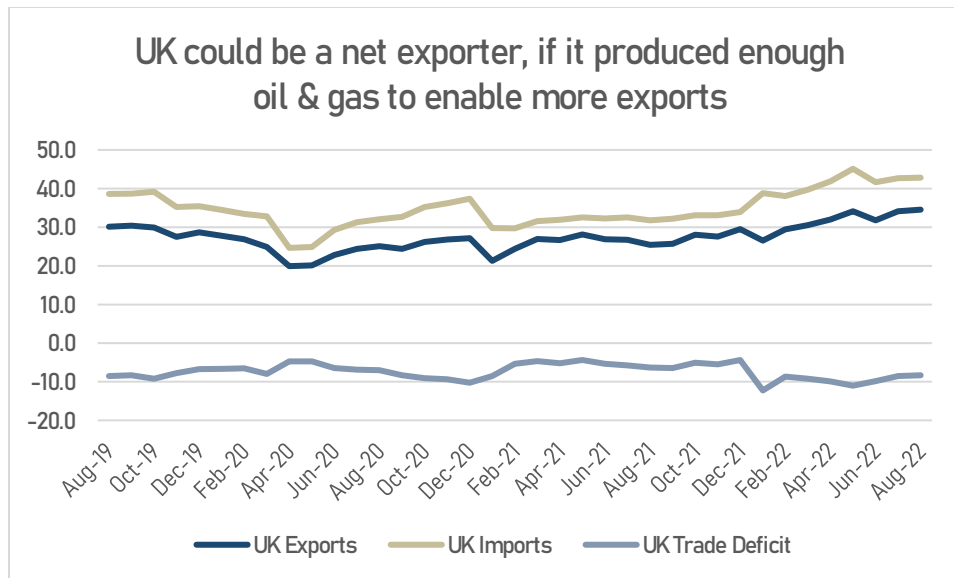
priority areas, which enable faster exploration⁷, could help in plugging the gap in GDP net exports over the long-term, as long as adequate political and tax support to the industry is given (although additional gas will likely not come before 2026 as a result of the auction). The UK will also indirectly benefit from EU's panic gas storage filling, which is close to hitting limits and has already led to lower gas prices in the day-ahead market.

33rd North Sea Oil & Gas License Auction

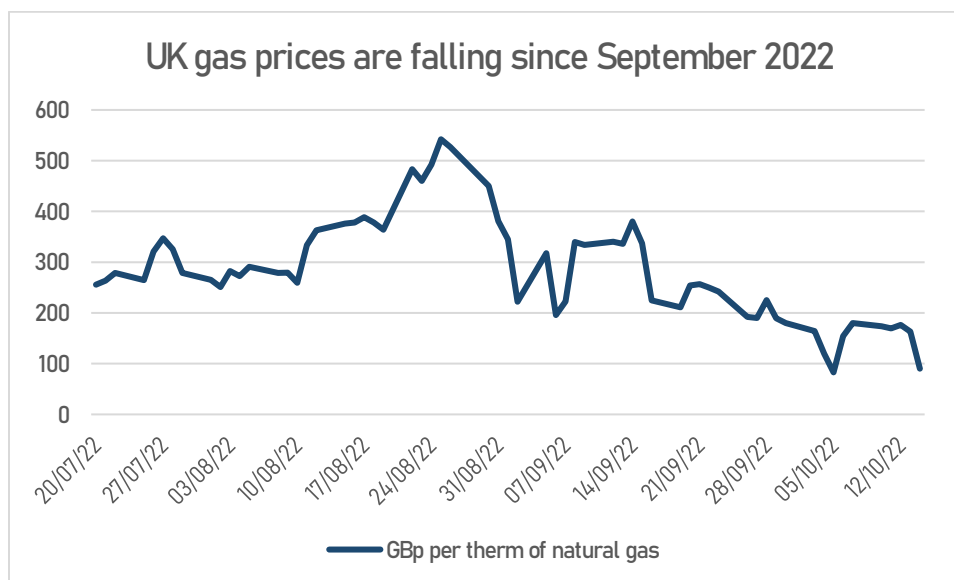


Source: North Sea Transition Authority

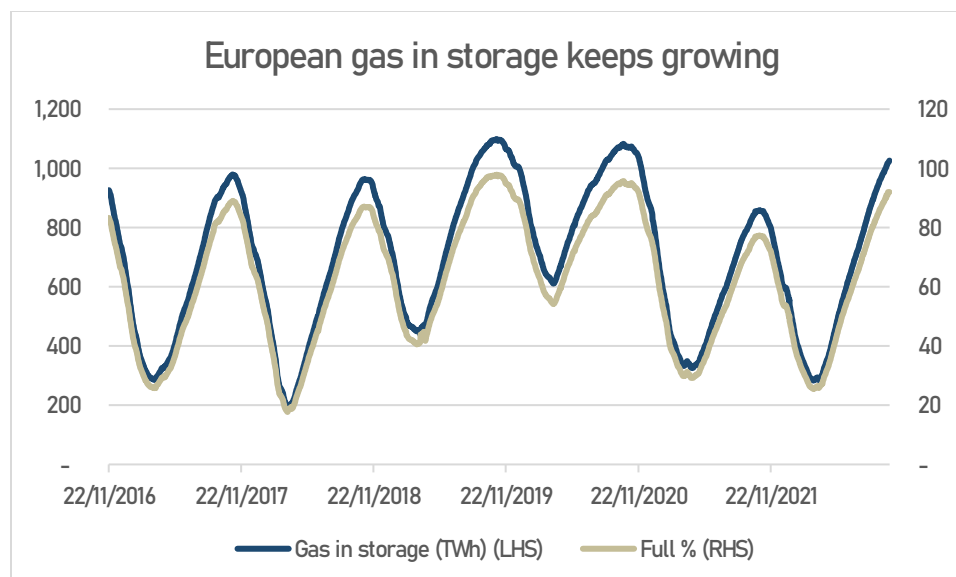
⁷ <https://www.nstauthority.co.uk/news-publications/news/2022/nsta-launches-33rd-offshore-oil-and-gas-licensing-round/>



Source: Office for National Statistics



Source: Marex



Source: AGSI

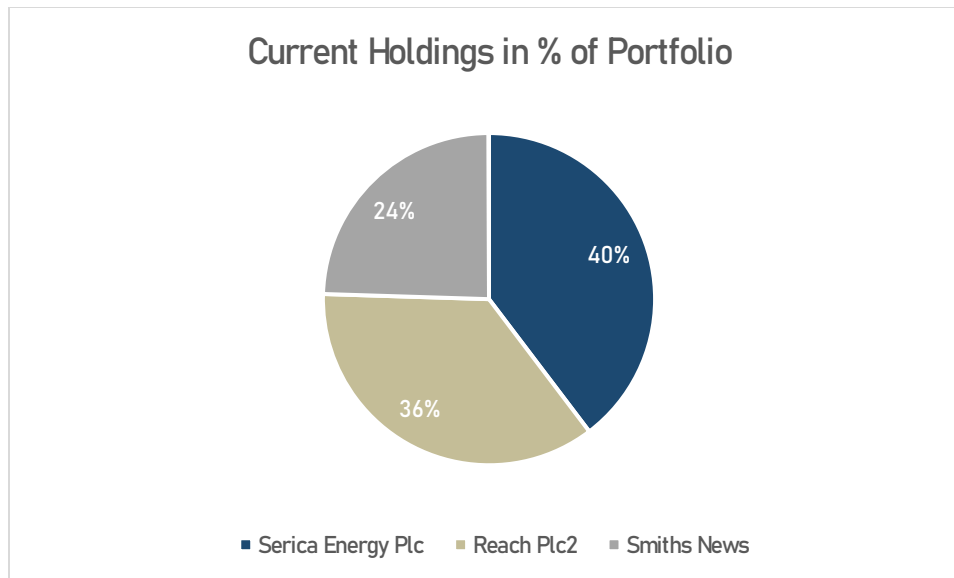
Performance

The 3rd quarter was a strong performance, up 17% vs. FTSE All Share TR down -3%, mostly due to the position in Serica Energy, which I sold end of August with a 46% return. I have also sold Centrica incurring a -7% loss due to fear of falling gas prices, while the UK government would start hiking taxes, limiting Centrica's profits. By the end of August, I was 100% in cash. This usually has only happened 2-3 months before a big crash in the market, and each time, I could not sit on the cash long enough and bought into a declining market – way too early. This time I also made some mistakes in re-entering the market when risk/reward was unfavorable for some positions...

Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Serica Energy Plc	3.84	3.75	GBP	-2%
Reach Plc2	0.81	0.70	GBP	-14%
Smiths News	0.29	0.32	GBP	10%

As of 30th September 2022



As of 30th September 2022

Performance explanation: Exits

I sold Serica Energy with a 46% gain when it hit my price target and it became clear that the EU will be able to meet their gas in storage targets, with German economy minister Habeck indicating faster storage tanks filling than planned⁸. For similar reasons, but also due to high UK government scrutiny on excess profits of the likes of Centrica, which could eventually lead to higher taxation of nuclear power output, I have exited Centrica with a disappointing -7% loss⁹.

Performance explanation: Entrants

After a sell-off in Serica Energy I re-entered the position, but soon felt that it was a mistake. In the 2nd week of October when EU gas in storage hit new highs, I exited Serica Energy again with a -11% loss. While I viewed the position as a hedge in case gas prices spike again, I should have really avoided it, especially as it was no real turnaround anymore and risks for gas prices to decline are rising by the day¹⁰ - exit note to come. Smiths News posted a strong trading update and advised to pay a large dividend, equivalent to

⁸ <https://www.aozorastep.com/Serica%20Energy%20Exit.pdf>

⁹ <https://www.aozorastep.com/Centrica%20Exit2.pdf>

¹⁰ <https://www.aozorastep.com/Re-Entry%20Serica%20Energy.pdf>

an annual yield of +14% at the beginning of next year. I have bought a position, but quickly sold after a 10% return due to liquidity concerns and a concentration in newspapers due to also owning shares of Reach plc¹¹. As of 17th October, I only remain a position in Reach Plc¹². While the trading update did not reveal any news on the pension deficit and the collapse in advertising outweighed the increase in newspaper circulation in light of the Queen's death, I believe the market valuation is still wrong and could double in six months. Due to the history of the Daily Mirror's pension scandal in the 1990s, Reach plc is very transparent when it comes to their pension deficit. By the end of June, their pension deficit was £69.1mio, however, since then the discount rate (long end Gilt yields) has increased by 200bps. This means, their deficit should now be a surplus of nearly £400mio, all else equal. This could improve their cash flows by over £50mio annually! Compare this to a £200mio enterprise value...

Reach plc impacts on pension deficit

Movement	Effect on liabilities £mio	Effect on deficit £mio
Discount rate +/- 0.5% p.a.	-130/145	-115/+125
Retail price inflation rate +/- 0.5% p.a.	+29/-29	+20/-19
Consumer price inflation rate +/- 0.5% p.a.	+33/-30	+31/-28
Life expectancy at age 65 +/- 1 year	+100/-100	+80/-80

Source: Reach plc HY 22

Review

It was certainly a mistake to buy back Serica Energy shares due to high risk, low reward mechanics. Like Vertu Motors, where I lost -16% last quarter, it was not a turnaround company anymore. While it makes sense to break rules sometimes, this has now led to a 2nd loss in a row and strengthens my commitment towards real turnaround candidates only. Although not mentioned, I have also bought ultra-long duration Gilt linkers (0.125% UKTI 68) and nominals (0.5% UKT 61) a day after 30yr yields hit 5% for a 2nd time and sold after Kwarteng handed in his forced resignation. The positions were combined around ¼ of the portfolio and while I made some money on the nominals, the linkers had a massive bid/offer spread worth 5-10% and I ended up losing a bit on the linkers (overall tiny profit when combined), as real yields strangely

¹¹ <https://www.aozorastep.com/Smiths%20News.pdf>

¹² <https://www.aozorastep.com/Reach.pdf>

didn't move. It was only after new Chancellor Hunt reassured markets by walking back almost the entire "Mini Budget" that real yields fell, leading to a +10% rally in the 0.125% UKTI 68.

Outlook

Despite the gloomy outlook that persisted now for nearly a year, valuations are becoming very attractive. Airlines have posted strong results recently and some companies in the retail space are also attractively valued. The consumer is a lot stronger than some people might think, and I believe these are sectors where turnarounds can be found. Advertising (& perhaps gambling) could also show strong results in Q4, especially due to the FIFA Football World Cup. My flight schedule is pretty much back to 2019 levels, yet Easyjet is trading at 2009-2011 levels and IAG will likely benefit from a return of the New York – London business route.

I'm hoping with the strong, consistent returns, high transparency and a clear path of building and scaling up the business that we can get regulated and attract & manage capital. Until then, I'll continue to follow my passion, solely focus on the track record and working on a solid understanding of what is going on the world. I hope it continues to benefit you & always feel free to reach out to me.

Sincerely,

A handwritten signature in black ink that reads "Herrmann".

David Herrmann



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