VLTAVA FUND

DNA OF EQUITY INVESTORS

Dear shareholders,

In the third quarter of 2013, the Fund's NAV increased by 1.87%. Growth since the start of the year is 10.19%.

Having things under one's control

Through the 20 years of our professional careers we have met a great many investors and potential investors. Over time, we came to recognise that they can be divided into two basic groups: those who are equity investors and those who are not equity investors.

Those who are not equity investors comprise a type of people who like having things under their own control. They are happy when they can touch their investments, and their thinking is quite concrete. There is basically no point in offering equity investments to such people. Even if they let themselves be persuaded, it usually ends with disappointment for both sides. By contrast, typical equity investors are people who do not mind that their investments are not under their direct control, or the fact that they cannot touch them, and they are accustomed to thinking about such abstractions as compound interest. They also know what they want, and there is no need to twist their arms in order to provide it to them.

The demand to have one's investments at all times under one's own control is the place at which the DNA of equity investors differs most from that of those who are not equity investors. Three conditions must be met for the requirement to have personal control over one's investment to be legitimate. First, the investor must be able to build the business oneself better than others can do so. Second, the investor must be able to manage it better than others. And third, the investor must be able to allocate the earned capital well. In our opinion, only very few people have such abilities.

Let us consider two companies in our portfolio as examples, Berkshire Hathaway and Wal-Mart. Now let us answer the aforementioned questions. Are we able to build similar businesses? No. Are we able to manage such businesses better than are the current managements? No. Are we able to allocate capital better than their current managements? No. **At least 99.9% of investors must answer three times no.** There is not the slightest doubt about that. So what is wrong with owning a minority share without the possibility to control a company when that company is unique, non-replicable, and governed by excellent management for the benefit of the shareholders?

If a genius (Warren Buffett) manages a company that is unique (Berkshire Hathaway) and moreover for the benefit of shareholders, then the DNA of equity investors says YES! The requirement to be in control in this case would be foolish. And that is not the whole story. Equity markets, due to their manic-depressive nature, sometimes offer shares in these companies for prices that would not be even considered in private transactions. Then we say twice yes.

What you can control

Investment managers must always realise which things can be controlled and which cannot, and where it makes sense to strive for control. **Three things can be controlled: the investment philosophy, the investment process, and the composition of clients.**

Investment philosophy. You would be surprised how many professional investors are unable to formulate their investment philosophies. This would be equivalent to the coach of FC Barcelona instructing his players: "Go to the pitch and play it as it comes, just go with your gut." I have never been in the team's locker room, but I am pretty sure that is not the way they do it. Even the fictitious football coach Pepík Hnátek had his strategy to "kick it long past the defence and hit the goal". There must be an investment philosophy. It can adjust over time with the development of its authors, and particularly as they learn from their mistakes, but it must be clearly formulated.

Our investment philosophy is simple.

1. We believe that equities make the best long-term investments.
2. The basis of equity investing is regular cash flow from the companies to their shareholders in the forms of dividends and buybacks of their own shares.
3. In good companies managed by high-quality management, this flow has a strong tendency to grow.
4. Share prices follow this growth over the long term.
5. Because many people view the equity market like a casino, we often can buy shares at prices markedly below their fundamental values.

Investment process. Our investment process focuses mainly on points 3 and 4 of our investment philosophy: We seek out good companies run by high-quality management teams with a strong growth tendency, and then we estimate the values of those companies. We endeavour to reach an understanding as to what share prices would make these companies attractive investments.

Investing is not a natural science, and that means there are no laws. There are only certain principles. The investor's subjective opinion will always be a crucial part of the investment process. There is no objective definition of what is a good company or high-quality management. Even the company's value does not objectively exist. It will always be in large measure an opinion based on one's own experience and ideas.

Investments should not be evaluated according to whether they made or lost money, but according to whether the investment process upon the basis of which they had been selected was correct or not. This may sound a little odd, because, after all, you are interested mostly in results. We are, too, but we think that good returns can only be achieved on the basis of a correct investment process.

If you were to pick a stock at random and made money on it, you scarcely could assert that that had been a proper investment process. It was an accident. On the other hand, sometimes even investments acquired "correctly" according to a quality process can lose money. Of course, if most investments were to yield poor results, then probably the investment process is not correct. Nevertheless, the alpha and omega of the investment managers' work is the effort to create and perfect an investment process. An investment process is something you can control.

Composition of clients. Having a big fund has never been our main goal. Our priority is to do work that we enjoy and to do it for pleasant people who try to understand what we do and who think in a similar way. We have full control over the composition of our clients. We see our investors as partners. We choose (or refuse) them on this basis while endeavouring to build long-term relationships. We strive to explain what we do, as well as why and how we do it. That is also why we write these commentaries.

We want to have a stable, long-term coterie of investors founded on trust in what we do. Sometimes we feel like we succeed in this very well, and at other times we may feel less so. The truth is that 98% of our shareholders at the end of each year had been our shareholders also at the start of the year. This makes us very happy.

Changes in the portfolio

Over the past three months, we mainly added to existing positions in our portfolio. We have two new positions. The first is a British company operating in a sector where we have not invested before. We think it is a very attractive opportunity with a double-digit expected annual yield for a number of years into the future. Nevertheless, because it is new for us, we are building the position gradually.

The second company is American, and we have been following it for many years. We almost bought it last autumn. We had our finger on the trigger, and all we had to do was to pull. The shares were fantastically cheap, but we were lacking a little in courage. Today's price is somewhat higher, but it still provides a very attractive opportunity.

We sold AIG. AIG was one of the synonyms for collapse of the financial sector five years ago. The government had to spend an incredible USD 180 billion to rescue it. Then something unexpected happened. Not only did AIG survive, but it paid the entire USD 180 billion back to the government. The repayment process was completed last year. At the same time, the government sold all of its shares, a significant part of which AIG itself bought back. AIG sold off some of its marginal businesses, dealt with most of the bad investments from the pre-crisis period, and under new management began to rise again. For many investors, however, AIG still bore the stigma of 2008, and professional managers did not want to be seen having it in their portfolios. The market simply had not taken into consideration the standing and quality of the "new AIG". This allowed us to buy shares for almost half of their book value. In summer, we sold them with a 33% gain, because we felt we had already made the easy money, and we did not view the further expected returns as very attractive.

AIG was a rather atypical investment for us. We held it for a very short time – only about 9 months. It represented more an effort to exploit a manifestly transitory error in the market's valuation of its shares. We are not opposed to engaging in such opportunistic transactions as a complement to our core investments.

Current state of equity markets

This year, the US market is repeatedly pushing to new historic highs. Is this a good or a bad thing? Well, we do not regard the mere fact that the market is at a historic high as big news. Over the past 100 years, the US market reached new highs more than 1,000 times. And essentially we might say that we invest in equities because we expect the market to go higher and higher over the long term, just as it has in the past.

The level of the market must be compared to the level of profits in the companies. This, too, is at a historic high, so it is quite logical that the market behaves accordingly. If we follow this line of reasoning still further, we must ask whether the current level of corporate profitability is sustainable. This is not so unambiguous, as the profit margins of US companies are also at historically high levels. In such case, we should expect to see so-called "regression to the mean," which is to say that profit margins should be expected to trend somewhat downward to their long-term average. A narrowing of margins does not automatically mean a decrease in profits, however. Companies' profits should be expected to decline relative to the size of GDP, but, as GDP is growing nominally, it is not necessary that nominal profits of companies must diminish as well. Moreover, this process of regression to the mean margins can sometimes occur very gradually and may extend over many years.

We also must not forget that the equity market is a market of individual titles. And practically always there are concurrently titles that are exceptionally expensive and others that are exceptionally cheap. The US market is today in a peculiar state. On the one hand, there are lots of absurdly overpriced titles. One could buy shares of companies without profits (sometimes even almost without sales) or shares of over-indebted companies of inferior quality. These are frequently stocks which investors feel embody some sort of "story", and they forget the fact that the value of each investment depends on future cash flow.

On the other hand, there can be found a number of companies with no "sexy story" but which offer profits, quality, financial strength, and, above all, a good share price. The situation is somewhat similar to that in the markets in 1999 and 2007. In 1999, while the so-called dotcom bubble was inflating, entire sectors of shares were absurdly overpriced. Everything related to the internet, telecoms, technology – which is to say the "story" of the time – was crazily expensive. In 2007, the "story" was commodity and financial companies. In such periods, investors completely disregarded a large part of the market where many attractive opportunities could be found among strong and established companies. In the following years, these were the companies that provided clever investors with handy returns, while a number of those companies through which speculators chased the "story" do not even exist anymore.

We see the situation somewhat similarly today, and I probably need not mention in which market segments attractive investments can be found. The contrast between low-priced and expensive market segments is really clear-cut today. **We are conservatively holding high-quality and low-cost shares, even with full knowledge that for a certain time (and especially as the market climbs further) it may seem that our results are only average.** Carefully forward.

Daniel Gladiš, October 2013