

Dear shareholders,

Vltava Fund's NAV declined by 13.7% in 2011, marking our second negative result in the eight completed calendar years of the Fund's history. No one is happy with declines, but we must expect them sometimes. Any idea that all years will end on the upside would be unrealistic, and this is not even our goal. This would be theoretically possible, but an effort to attain a positive result each year would have a significant negative effect on total returns. Therefore, we prefer to pursue long-term objectives even at the cost of short-term decreases.

A fund's returns should be evaluated over the entire course of the market cycle, as it is easy to compose a portfolio that grows faster than the market during bull market periods but also that drops more sharply in bear market periods. Nor is it difficult to assemble a portfolio which drops less when the market goes down but that also grows more slowly in a rising market. Such portfolios say little about the skills of a portfolio manager. Rather, they indicate the amount of risk that is taken on.

Comparing a fund's returns with those of the market across the entire market cycle eliminates the influence of the portfolio's basic composition and reveals the actual result achieved by the fund's management. The current market cycle began at the turn of 2008 and 2009, when markets generally reached their low point and we at the same time adjusted the Fund's investment strategy to what it is today. The years 2009 and 2010 comprise the growth phase of the cycle, while 2011 represents the declining phase. We cannot yet say whether the entire cycle has reached its end. Only time will tell whether early October 2011, a time of great panic and low prices, will mark a return to growth and the start of another cycle.

The results of the Vltava Fund for this three-year market cycle are as follow:

Year	Return
2009	201.8%
2010	21.4%
2011	-13.7%

The total return was 216%. Through those three years, world equity markets rose by 22% as measured by the MSCI World Equity index.

The trade journal Hedge Funds Review regularly compiles a ranking of funds according to their returns for past periods. Of the 4,499 funds in the performance database, Vltava Fund ranked 21st overall and in 11th place among equity funds as measured by investment return for the years 2009–2011. Our return for that three-year period, as noted above, came to 216% overall, which is 46.8% p.a. The average return for all funds together was 7.34% p.a.

By such comparison, our results do not look bad at all; and they could have been even better had we not made two mistakes in 2011. A tennis player would call these unforced errors. We should have sold two titles earlier. The first is Chaoda. We had had growing concerns for some time about the fairness of that company's management, but we had been hesitant to sell the shares for the price at which they were trading at the time, and we were waiting for a better opportunity. This delay unnecessarily cost us money. The lesson we take from this is that once a company's managers appear not to be working primarily for the shareholders but rather to enrich themselves at the shareholders' expense, there is no advantage in waiting for a better opportunity to sell. The second error concerns the shares of the Finnish Talvivaara. During the course of the year, the company's fundamental value began to worsen due to shutdowns in mining operations. We saw it, but unfortunately our reaction came too late. We had not been able to get over a psychological barrier in our own heads quickly enough. Had it not been for these two errors, our total return for last year could have approached zero. Although we scarcely anticipate ever reaching a state where we will be making no mistakes, we do try to chronicle and describe them so that we make as few of them as possible in future.

The rest of the titles in the portfolio fared relatively well. The seemingly boring "blue chips" from developed markets did best. We drew attention to the anomaly in their valuations in our previous commentaries. This still holds true in many cases,

and during the greatest market slump at the turn of summer and autumn we increased our positions in those even more.

What can we expect this year?

Last year's market events were dominated by escalating problems of the euro zone, and, as not much has been resolved to date, that probably will be true again this year. The key to the solution is in the politicians' hands, and their behaviour is difficult to predict. It might be easier, therefore, to imagine the state towards which the euro zone is headed, as this is being driven by market forces that cannot be overcome. At the end of the decade, the euro zone could look like the following:

1. The core problem of the countries in the so-called olive belt (i.e. Greece, Italy, Spain and Portugal) relates to their payments balances. If this is to be solved, it is necessary for these countries' effective real exchange rates to drop significantly in comparison to the world around them. There are three ways to achieve that. The first is for inflation to be much higher in the surrounding countries than in those of the olive belt. So far, however, just the opposite is true. The second would be for wages and prices to decrease significantly in the countries of the olive belt. This is very difficult to achieve in practice. **Therefore, the third possibility is the most probable, which is for them to introduce their own currencies and then to devalue all of these.** The state debt will be partially written off and private debt will be reduced by its denomination. Greece will probably be the first in line.
2. In the rest of the euro zone, fiscal union will occur in larger measure, with there being a unified budget and government.
3. The European Central Bank will have the authority to print money and will be owned either by the central government or by the government of one of the euro zone countries. In choosing between a strict monetary policy and preserving the euro, they will choose the second.

4. The individual members of the euro zone will either go bankrupt or will have to subject themselves to central directives. They say capitalism without bankruptcy is like Christianity without hell. States must operate with the knowledge that the possibility of bankruptcy does exist, and investors must lend to them under conditions that reflect this risk.

This arrangement will be much more stable and much less costly in the long run than to preserve today's status quo. As to by what means and how quickly we will reach that place, this scarcely can be predicted. Perhaps today's leaders of the euro zone countries will need first to be replaced through democratic processes. The current leaders are tied too closely with constructing the EU and the common currency.

It is important for us as investors to recognise that this development will bring the downfall of many companies – but also many winners. In connection with market volatility, it will continue to bring many excellent investment opportunities. Even though Europe is not very competitive as a whole, a number of European companies are very much so. One example to demonstrate the case as a whole is that of Sanofi Aventis, a global pharmaceutical company based in France and comprising one of the largest positions in our portfolio. The French market dropped by 17% last year, and, due to their exposures to southern Europe, the French banks are among the most endangered. Despite all that, the share price for Sanofi Aventis increased by 18% (plus a 5% dividend). Most of the company's sales come from areas not only outside of France but entirely outside of Europe. The problems of the euro zone affect it only marginally. Indeed, a weakening euro is even a great advantage to the company. There are many cases of this sort, and our task is to find the best of these. It is worth noting here that we are not regionally limited in our investments. We have invested 31% of the portfolio in Europe but only 12% in the euro zone countries (and in the "better" part at that). If we would so choose, we could avoid Europe altogether, but, because there are a number of very much undervalued and high-quality stocks, there is no need to do so.

Selection of individual titles is the key to achieving good returns. While this may seem obvious, the opinion has recently become popular that individual stock-picking is rather pointless due to the historically high correlation between the individual markets and shares. This view is rather misguided, but it plays into our hand. High correlation between share prices does not mean that all stocks will have the same or even similar returns. Correlation is important for speculators, whose speculative (you cannot even say investment) horizons can be counted in hours or days. Correlation means nothing for long-term investors. The fact that fewer and fewer investors seek to find the best individual opportunities creates an ideal investment environment for us. We try to make the most of it.

Price vs. value

Price and value is a favourite topic of ours. Although the price of our portfolio (expressed by its NAV) is lower than a year ago, its value is recognisably higher. The basis of our investing consists in seeking out companies whose shares are selling for significantly lower prices than are their fundamental values and on the assumption that prices will in time approach the values. We have a view as to the value for every individual stock in the portfolio, and therefore we can picture the value of the portfolio as a whole. It is higher than a year ago. Most of the stocks in the portfolio have risen in value (due to their growing profits and dividends). Moreover, we swapped certain expensive shares for others with a more favourable ratio of price to value. The reinvestment of dividends received also played its part. Therefore, all our activities focus on increasing portfolio value. We can illustrate this by the following example.

Let us presume there is one share A and one share B in our portfolio. Each costs 100. The price of the portfolio is therefore 200. Let us further presume that the stocks each have a fundamental value of 150. Therefore the portfolio's value is 300.

Should the price of share A increase to 150 and the price of share B drop to 50, the price of the portfolio will remain unchanged at 200. As share A has reached the level of its value, it is pointless to keep it and so we

sell it for 150. For the cash obtained we buy 3 shares of B for 50 each. Our portfolio now consists of 4 shares of B with a total price of 200. The price of the portfolio has therefore not changed. What has changed, however, is the value of the portfolio: the 4 shares of B have a value of 600. Therefore, the portfolio's value has doubled. You cannot see this by looking at the surface, as it were, because its price does not yet reflect the underlying value.

This is of course a simplified example, as generally such things are not so black and white, but it demonstrates our way of thinking about creating value for the shareholders and it also shows the potential disparity between price and value.

One of the Benjamin Graham's greatest insights says: ***"In the short run, the market is a voting machine but in the long run it is a weighing machine."***

In the long term, therefore, the market will weigh the prices of stocks according to their fundamental values. That has always been the case, and it always will be.

What to do with money?

There are many possibilities for how to preserve and grow one's money: stocks (both domestic and foreign), bonds, bank deposits, real estate, commodities, art, gold... Currently, people favour bonds, deposits and gold while shares have become rather unpopular. This is a good thing for us, **because only unpopular assets can be acquired at truly inexpensive prices.**

In recent years, a situation has evolved wherein many companies are considered safer entities than are most governments. Thus, we now can compare on the one hand the world's best companies, which are professionally managed, profitable and financially strong, and on the other hand the dangerously over-indebted and inefficient states managed by politicians whose only goal is to win the next election.

The financial markets are not oblivious to this situation. It is no accident that at the end of 2011 it was cheaper to insure against the bankruptcy of companies such as Coca Cola and Nestlé than against the bankruptcy of countries such as Germany, Japan and Switzerland. Moreover, in a number of cases the stocks of such companies are priced at attractively low levels. When confronted with the debt crisis in Europe, the standard response of some investors was to sell everything. With time, however, they will come to realise that the shares of strong and high-quality corporations offer a favourable combination of low price and safety.

Taking into consideration both risks and expected returns, we think money is best invested into very high-quality, professionally managed companies which are profitable, financially strong and stable and whose strength and stability are often much greater than that of the countries wherein they reside. Companies that do not cause one to worry every day about how they are being operated. Companies available at prices which implicitly indicate double-digit annual returns in the years to come. The portfolio of Vltava Fund is composed of such companies.

Daniel Gladiš
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