VLTAVA FUND

Dear Shareholders,

During 2009, Vltava Fund's NAV grew by 201%. That is about 9 times greater than the rise in the world stock market. Although we realize that we still have a lot of catching up to do after an extremely disappointing 2008, we are very happy with this performance. This result puts us at the very top among global equity funds across the entire world for 2009. Let's enjoy this together now, as it is very unlikely that we ever will see such a strong rate of growth again.

How could we triple our money in one year? There is no general recipe for this, but three main factors contributed to it.

First (and foremost), the stocks that we held or bought in the beginning of 2009 were mostly absurdly cheap. It had been quite clear that, unless the world was quickly coming to its end, they must start rising rapidly. The only question had been when and how fast. Their subsequent rise surprised even us by its speed. We were not so much amazed by its magnitude, however, since all of our stocks remain undervalued today even after their share prices have substantially risen.

Secondly, the recession seems to have had a much smaller impact on our companies' profitability than the market had feared. And thirdly, we had good luck in the transactions we made during the last year. In fact, pretty much everything we touched worked out well – so far at least.

One more look back

Today, more than a year after the economic and market collapse, certain conclusions can be drawn that are relevant for our investment strategy.

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1. It hardly ever has been more clearly evident that the price of a stock and its value are two completely different things. If the price of Asian Citrus, one of our long-term holdings, drops from GBP 3 to GBP 0.77 and then rises to over GBP 5, all during one year, it hardly can be argued that it has always represented the true fundamental value of the business, which, judging from its earnings, was basically not affected at all by the recession. There were many striking examples of such mispricing in last year's markets.
2. Looking back at the development of companies' businesses and earnings, it also can be seen that, in most cases, the fundamental values of those businesses changed much less during the recession than did their stock prices.
3. Although the price of a stock can deviate very far from its fundamental value in the short run, it does tend to move towards the fundamental value in the long run. Fundamental values – however subjective and imprecise they may be – are what matter most.

We have been saying these things all along, and it was no surprise to us that they were reconfirmed during the last year.

As stated in the 2008 Annual Report, our investment strategy depends upon the following two conditions:

1. That we are able to identify stocks which in the long run perform, on average, better than the market.
2. That we are able to hold our investments for as long as we like.

Our history demonstrates that we are indeed able to identify good and outperforming stocks, and we have been able to do that consistently. While we are

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continuously working on our stock selection, we have no reason to change our basic approach, and that is to look for fundamentally undervalued stocks with a long-term view.

Our problem in 2008 had been that we were not able to hold onto all of our stocks. In order to keep the Fund's leverage in check, we had decided to liquidate part of our holdings in the last few months of 2008. We sold some of our holdings and bought back part of our short position at quite disadvantageous prices. The leverage and risk were kept under control, which was good and necessary, but part of the fundamental value of the portfolio was forever lost. If we had not had to do that, our NAV now might have been a lot higher than it is.

That whole story was described in greater detail in the 2008 Annual Report. To put it differently, it would not matter to us very much if stock prices were to drop significantly as long as their fundamental values were not impaired. They will come back up nicely later. What matters to us a lot, however, is outright loss of capital and that is what occurred in 2008.

We will never allow it to happen again. That is why we made what looks like a small – but is in fact a very important – change in our strategy at the beginning of 2009. We significantly reduced the Fund's leverage. While during the first 4 years our gross leverage was about 3, it rose to 4 during the 2008 market collapse. At the end of 2009 it was about 2.3. What does all this mean? It means that our leverage now is lower by about 25% from what it used to be in "normal times" and is only a little above half that from the autumn of 2008. The overall risk of the portfolio as measured

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by its leverage is at its historical low. It will go down further in the future.

We will still use leverage in future but to a smaller degree. That will mean much lower risk, and that is good. But what will it mean for our returns? It is probable that our returns will be a bit smaller in good times but much better in bad times. And when it is all put together and summed up, it might bring better returns with lower risk. It is worth noting that our spectacular 201% return in 2009 was achieved with much lower leverage than ever before, which is a very good sign. It might also suggest that the relationship between leverage and return is not a straightforward one.

Investing means trying to find a balance between many different things. After our dreadful 2008 experience and also as we get older (not necessarily wiser) we tend to value capital preservation and stability more highly than before. This does not mean that we have or will become feeble, unimaginative or idle. No, we will continue to work very hard, as always, in trying to find the best investments there are, but we may have shifted a bit in what we believe the best investments to be. I think that all of you who were with us through the 2008 decline know very well what we mean and are probably pleased to hear this.

Daniel Gladiš
February 2010