Dear shareholders,

The first quarter of 2011 was quite rich in significant, market-shaping events. Here is how we perceived and responded to them.

The start of the year marked the second anniversary since markets first set out on their steep climb upward from the deep bottom they had hit after the collapse in 2008. In that time, developed markets have risen by nearly 100% and some developing markets by even slightly more. (In 2008 and 2009, Vltava Fund reported growth of 267%.) Stocks bearing relatively higher risk fared best. These include, for example, shares of cyclical and commodity companies, shares of smaller companies, and shares of companies from developing markets. Early this year, most of these stocks were overpriced. Our stance can be summarised in three points.

First, caution. When I was a little boy, my grandpa and I sometimes spoke to one another in Latin proverbs and quotations, and grandpa often used to tell me "Festina lente!" (Make haste slowly!). It is precisely in this spirit that we view our investing activities. It would be quite easy to get caught up in the momentum of a growing market and to buy expensive shares in the hope that they will rise even more and that someone even greedier and more foolish will buy them from us at a higher price (this is called the greater fool theory). Investing is not a race, however, and we therefore do not want to join in such pursuits. Any attempt to chase after the results or returns of the market or of the competition over the short term is wholly alien to us and undoubtedly would come to a bad end.

Second, hold part of the portfolio in cash. Although cash in a portfolio yields no immediate return, it has great option value. This value stems from the fact that cash allows us to fully profit from those opportunities that can – and usually do – unexpectedly appear in the market. Our cash position at the start of the year was larger than usual, and it is at approximately the same level even today. We used part of the money, for example, on investments in Japan when the local market dropped sharply after the earthquake.

Third, focus on those parts of the market and individual companies that still remain inexpensive. There are always some of those to be found, and in some cases there is even bafflingly blatant opportunity. Even though markets have essentially doubled in the last two years, there are also stocks on the market which have almost not risen at all during that time, despite their being for high-quality, highly profitable and growing companies. Sometimes the market really does remain blind to evident anomalies in the valuations of some shares. Investors prefer to buy stocks that are rising in price rather than buying shares that are inexpensive. This is evidenced by the fact that 99% of investors have very short-term investment horizons. They are searching for stocks in which they will make money this month, ideally this week. Such foolish and senseless "investing" is induced by an environment that focuses upon achieving immediate results. Professional portfolio managers are under constant pressure to show good results every day, week and month. For most of them, a quarter of a year is almost an uninteresting infinity, because if they do not achieve results this month they are threatened by an outflow of investors and their positions are in jeopardy. It is crazy, but that is really how it works. For such a portfolio manager, therefore, an evidently inexpensive share yielding no immediate gain is uninteresting. They are looking for "Ideas for Today" or the "Flavour of the Month". This, then, creates on the market popular overpriced shares, on the one hand, and neglected, exceptionally inexpensive gems, on the other.

We endeavour to take a different approach. When we buy a share, it is not because we hope to sell it at a 10% higher price next month but because we can see that it is fundamentally undervalued and that its price has a chance to be at least 100% higher over the course of 3 or 5 years. This applies to every stock we have in our portfolio. It's just that the course of the price development through time from today's level to that point 100% higher tends to be unpredictable. Sometimes, the price starts to move immediately and after a year is double. At other times, nothing happens for three years before the market finally notices that stock.

We held to these basic principles – caution, holding a larger portion in cash, and investing for the long term into undervalued companies – also during the first quarter. In so doing, we were fully aware that this strategy can temporarily cause the portfolio's returns to lag the market or even to go negative if the market (our short position) rises faster than do our shares in the long position. We do not, however, see this as a shortcoming. Our targets are not short-term but long-term, and this is the best path to good long-term results. We thus refuse, as we always have, to offer our fund to the so-called hot money, which means investors seeking a quick return. Such investors would only increase the fund's management costs and thereby harm the rest of our shareholders. We have always tried to offer our fund to investors who, in our opinion, share a mentality similar to ours. I believe we are succeeding in this and that the shareholders we have in our fund provide an excellent foundation for the fund's good returns.

What specific transactions did we do? We sold three of our positions.

Canadian Natural Resources (CNQ). As unrest broke out across much of the Arab world, the price of oil shot steeply upwards. This also brought up the prices of most oil and gas companies' shares, including that for our CNQ stock. CNQ was among our oldest and at the same time largest investments. It is a company of exceedingly high quality with excellent management. The share price in February and March, however, no longer corresponded to its profitability and potential, not even with the elevated oil prices. We decided, therefore, to collect a rather large gain by selling the shares. Should the price be more favourable in future, we will gladly return to CNQ.

Fairfax Financial Holdings. Fairfax is a holding of insurance and reinsurance companies. It was founded in 1985 by Prem Watsa, nicknamed the "Canadian Warren Buffett". Fairfax's story is an extraordinary one, and to those of you who are interested to learn about investing in greater detail I would recommend reading Fairfax's annual reports from 1985–2010 as they offer invaluable study material. In terms of estimating intrinsic value and expected returns, Fairfax represents a relatively complicated case due especially to the transactions and hedging that it conducts in its investment portfolio. After weighing all the pros and cons, we decided to sell Fairfax especially because the expected return from holding its shares would be lower than what we could achieve with other, essentially simpler companies. Fairfax remains an interesting investment which could yield a surprisingly high return, especially under certain circumstances, but we believe we can use the money gained from its sale in a better way.

Havila Shipping. Havila is a Norwegian company operating special ships supporting offshore platforms. For us, Havila was an investment where we sought to take advantage of a low share price in comparison to the market value of the fleet that Havila owns. The market value of Havila's ships, after subtracting the debts that Havila has, is about 2.5 times greater than the amount at which Havila is traded on the stock exchange. Thus, it represents a large hidden potential which can be brought to shareholders' pockets by skilful management. Unfortunately, it is precisely Havila's management that seemed more and more of a problem to us as time went on, although initially this was not the case. The family of Havila's CEO has been in the business for several generations and also owns more than half of Havila's shares. In such a situation, one would expect that their interests would be the same as those of the other shareholders. Their actions, however, did not conform to such sentiment. Havila has ships built that it largely finances through debt and then endeavours to lease the new ships under long-term contracts that are to bring in more money than is needed to repay the debt. In our opinion, however, they have gone too far down this road. They have gradually amassed a debt so large as to endanger the company's very existence. When I met the CEO and CFO in Oslo last autumn, my impression was that instead of the shareholders' interests they are driven by the managers' testosterone. Norway is a shipbuilding country, and the larger and more modern fleet a manager operates, the higher he stands on an imaginary social ladder. Shareholders' interests have been put aside. Come the next recession, Havila will not have enough to repay its debts. If the economic boom continues, it can happen that interest rates will rise and that the higher interest costs will erase all of Havila's profit. The area in between is very narrow, and Havila's management is skating on thin ice. They recently even had to sell two of their ships to obtain cash to make the loan payments. We decided, therefore, to sell the Havila shares. For the holding period as a whole, if we include the dividends received, we came out of this investment roughly even. This is no tragedy; from time to time we certainly make worse investments, but the money could have been better used.

We received almost CZK 200 million from selling these three stocks, and we reinvested approximately the same amount during the first quarter. What did we buy?

First off, a little in Japan. The combination of the crushing tsunami on live television and the threat of invisible radiation could not have had any impact other than the panic and collapse of the Japanese market that it actually caused. At one point during the first two days after the earthquake, the Japanese market dropped by as much as 20%. In our opinion, however, this was not a systemic problem but an external shock, and so large a drop was irrational. Some stocks fell by 30% and more, and so on the Tuesday upon which the deepest slump was recorded we invested part of the money in Japan. Japan is a rich country with vast resources, and after a temporary drop in economic activity a steeper recovery will follow, driven by the very reconstruction of the devastated areas. In 1923, an earthquake in Japan wiped out roughly one-third of its GDP, and it was the reconstruction and building of railways, roads, parks and public services that helped Japan achieve its strong economic growth.

The earthquake aside, we were already focusing on Japan more and more in recent times. Japan is a classic example of a country with a stark contrast between its macroeconomic and microeconomic situations. It has debt in the range of 200% of GDP, which is approximately twice more than have some of the worst European countries. Even though Japan is being financed at extremely low rates (the 10 year government bond yields 1.24%), fully one-fifth of budgetary income is absorbed by interest alone. As soon as markets lose their willingness to lend to Japan so cheaply and the interest rates of Japanese bonds rise, it can easily happen that the majority of the budgetary revenues will go to interest and the Japanese fiscal situation will be mortally stricken. Eventually, the Japanese will have no other option than to monetise part of the debt, which means to pay it off with newly printed money. This will have a disastrous impact on the yen and its exchange rates. This will play into the hands of many the Japanese companies that are world leaders in their respective fields and are very much export-oriented. There are many interesting investment opportunities at this micro level, and it is likely that our investments in Japan will increase over time. Of the major world markets, the Japanese market is probably the most inexpensive.

We invested most of the CZK 200 million into companies of the sort we mentioned in the introduction: high-quality, highly profitable, growing companies currently overlooked by the market and therefore very inexpensive. For the most part, these were stocks that we already have in our portfolio. Only one position is new. Truth be told, in the entire 18 years I have been involved in stock markets I do not recall such quality being available at the prices it is today. We are aware that it can take some time before the market awakens and our shares' prices start to rise, but it is entirely inevitable that it will happen. The longer it takes, the more we will gradually buy. After all, we will receive more than CZK 30 million in dividends alone this year. We are gradually reinvesting those dividends, thereby contributing to the growth of our portfolio's intrinsic value.

Dan Gladiš, 31 March 2011

VLTAVA FUND