VLTAVA FUND SICAV

Dear investors,

During the third quarter our fund's NAV rose by 12.1%. That is a very respectable figure, both in absolute terms and in comparison to world stock markets, which fared much worse. In local currencies they grew by 8.7%, while converted to Czech koruna their value even decreased by 2.3%.

Share prices were swinging like a seesaw. They showed strong growth in July, fell back again in August and, contrary to general expectations, saw one of the strongest Septembers in history. The uncertainty about the future development of the world economy has led to a sort of tug of war between optimists and pessimists. At times the former are on top, then again the latter. We feel right in our element in this environment.

First of all, uncertainty generally leads to lower share prices. At the same time, of course, we cannot avoid this uncertainty in our own investments. The value of each investment depends upon future cash flows, and the future is by definition uncertain. However, this uncertainty appears larger at times and smaller at others. When investors agree about the future and everything seems clear and positive, investors pay for this "certainty" with higher share prices. Higher uncertainty, on the other hand, is counterbalanced by lower share prices. For long-term investors like us, lower share prices are better because they allow us to invest with the prospect of higher returns.

Secondly, uncertainty leads to greater psychological swings among investors, quicker alternations between the primary emotions of fear and greed, and less rational consideration. This causes greater short-term share price fluctuation. The more share prices fluctuate in the short term, the more favourable opportunities that arise in the markets.

For long-term investors like ourselves, this is an ideal environment when looking for good investments. We are like that notorious baseball player to whom the market pitches one ball after another. In contrast to the batter, who only has three strikes at his disposal, we have the luxury to wait as long as we want. Only when we feel the right ball is coming toward us do we try for a home run.

The market threw us a couple good pitches last quarter. For the most part, we bought additional shares of companies already in our portfolio. We have a new position in Germany, and, in the interest of narrowing down and increasing the quality of our portfolio, we sold two smaller positions, the Canadian Endeavour Financial Corporation and ASL Marine from Singapore. We had already earned enough from Endeavour in the last year and a half, it was not among our key investments, and we were beginning to doubt the further attractiveness of these shares. Reasons enough to sell.

ASL Marine is a slightly different case, so we will take a closer look at it. This is a Singaporean company with three main activities: in addition to ship construction (smaller and medium-sized tankers) and repair, it operates a fleet of relatively small ships. It is essentially a shipyard, since the first two activities are central. We know ASL Marine very well and have talked to its management many times. The company was founded by a Mr Ang, and his family still directs it today and owns a majority. The management is undoubtedly very capable, the company is regularly profitable, and it pays fine dividends. So why did we sell our ASL Marine shares?

We sold them because it became ever clearer that this type of business would bring only average results in the long term. Shipyards are a generally capital-intensive sector with low barriers to entry. Individual companies compete primarily on price, over which they have scarcely any influence, and the returns on equity across the full business cycle are merely average. In other words, the characteristics of the sector in and of themselves do not promise above-average long-term returns.

Even with excellent management, a company with below-average characteristics will in all likelihood have poorer results than a company with average management operating in a sector that is in and of itself predisposed to above-average returns. As the saying goes, a horse that can count to ten is a remarkable horse but a lousy mathematician.

We are endeavouring in our portfolio to give greater preference to companies from sectors that are less capital-intensive, have high barriers to entry, have high returns on equity and free cash flow, and are able to some extent to influence the price of their products on the market. These characteristics provide such companies the prerequisites for long-term high expected returns. We have found several dozen such companies across the entire world, and the best and lowest priced among them now form the core of our portfolio.

This is connected to a market anomaly that plays to our hand. At the end of the 1990s, the most expensive shares on the markets were those of growth companies with high market capitalisations. Investors were so focused on the top 25–30 companies that their shares became overpriced and were in effect more expensive than the market as a whole. The situation has changed completely since then, however, and today, companies we term “high-quality” are much cheaper than the rest of the market. As a rule, high-quality companies have the same characteristic described in the preceding paragraph. In addition, they predominantly have strong to dominant positions in their markets, strong brands, and little or no debt. In all respects, they truly are companies of high quality.

For some inexplicable reason a number of these are available at truly affordable prices. We aim to exploit this situation to its fullest. One might think that especially in times of uncertainty one would have to pay more for high quality than for average quality, but precisely the opposite is true. Today, high quality is cheaper than average. These “high-quality” companies now constitute 40% of our portfolio and presumably will further gain in importance. I would like to emphasise that we do not buy quality to the detriment of returns. On the contrary, a number of these companies have years and years of strong growth ahead of them.

Of course, we are not alone in this view. Perhaps you remember how we had a detailed discussion of Johnson & Johnson shares, our new investment at the time, at our yearly investor meeting in April. We had bought the majority of our shares in April, and when it transpired in July that Warren Buffett had bought a substantial number of shares himself (for an estimated $1.2 billion), we were pleased. Buffett is part of a group of investors whose world view we share and which we monitor closely. Of course, that does not mean that we copy them. For instance, we know of some 40 publicly traded stocks that Buffett holds at present, about three of which we are in agreement (in all we have 25 various titles in the portfolio).

As I was writing the preceding paragraph, one of our investors called me to offer his congratulations for our 10.95% NAV growth in September. Literally, he said: "Good work this month, boys."

This sentence calls for a short reflection. Of course we are pleased that our portfolio is on the rise, but it is important to realise that the result of a month does not reflect our work in that month.

First of all, share price movements in a time period as short as a month are entirely unforeseeable, to a large extent random, and at the same time not all too substantial. Our portfolio had almost the same composition at the beginning of September as at the end. If the September result was to be a reflection of our work, it would be the work of the preceding two years rather than that of one month.

Secondly, the transactions that we do are not aimed to bring results in the span of some few short months. We neither know how to achieve this, nor is it the proper way to procceed. When we buy some stock, we do so because, on the basis of our own analyses, we believe that its price will rise by at least 100% in a time horizon of 3–5 years. We are essentially unable to say anything, however, about what the price curve for that share will look like from today to that future point in time.

Investing is a lot about patience, mainly because the results of one's day-to-day work only rarely manifest themselves immediately. For the most part, one must wait for months or even years. Hence, while September was nice, in and of itself the month says nothing about our present work or the new investments we made this year. We see great value in them, and we believe that the future will prove us right.

Daniel Gladiš, 4 October 2010

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Before subscribing, prospective investors are urged to seek independent professional advice as regards both Maltese and any foreign legislation applicable to the acquisition, holding and repurchase of shares in the fund as well as payments to the shareholders.

The shares of the fund have not been and will not be registered under the United States Securities Act of 1933, as amended (the "1933 Act") or under any state securities law. The fund is not a registered investment company under the United States Investment Company Act of 1940 (the "1940 Act").

The shares in the fund shall not be offered to investors in the Czech Republic on the basis of a public offer (veřejná nabídka) as defined in Section 34 (1) of Act No. 256/2004 Coll., on Capital Market Undertakings.

Historical performance over any particular period will not necessarily be indicative of the results that may be expected in future periods.
