VLTAVA FUND

Dear investors,

The second quarter was abundant in events and large price movements. The events were mostly negative, and prices generally moved in a downward direction. Everything was dominated by the unfolding crisis in connection with the market's reluctance to lend to several overly indebted countries, with Greece at the head. The European Union, European Central Bank, and International Monetary Fund bought time by pouring EUR 700 billion onto the problem. Greece's bankruptcy and the subsequent restructuring of its debt are practically certain, and the market is counting on them. Questions nevertheless remain whether several other countries will succeed in initiating reforms directed to slowing debt accumulation within the time that has been bought, whether the market will trust these reforms and continue to finance the affected countries, and how the banking sector will deal with the whole situation.

Two things are obvious. First, we need not fear that our children and grandchildren will have to repay the accumulated debt. We do not have that much time. We will have to pay it ourselves. And second, state belt-tightening is not a matter for just a couple of years. States will need to rethink their behaviour for years into the future. Just reflect on the following figures: If a state has a debt-to-GDP ratio of 100% and borrows at an interest rate of 4% per annum, then it must have a surplus of 4% of GDP in order for the debt to not grow further. It is highly likely that a number of countries will need to decrease their budget deficits in the coming years, and, in time, even move into budget surplus in order to begin cutting their debts. Most politicians will not yet own up to this, but it is evident that the market will eventually demand just that.

What does this mean for stock prices? If states start saving and lowering their deficits, then, by definition, this decrease in cash flow will manifest itself to the same extent (excluding exports) in the form of lower cash flow for households and companies. And since households are also significantly indebted in a number of countries, the greater part of the burden will be carried by companies in the form of lower profits. This will mean sailing against the wind for shares in general. But this is a macro view that looks at the markets as a whole. For us, the equity market is a market of individual shares, and our objective is to find companies that are profiting from the present situation, or companies that would do well in most any circumstances.

Where do we look for such companies? For example, an accompanying manifestation of the European crisis was a steep decline in the euro's exchange rate. This situation was a godsend for companies that have costs in euro and export revenues in dollars or other foreign currencies. This is where we are directing our attention.

We are also aware that while developed countries will be battling with debt and low growth, some states in Latin America, Asia and Eastern Europe do not have these problems, and their equity markets offer a number of attractive opportunities. Fortunately, capital knows no borders and we can invest wherever there is presently the greatest returns potential.

After last year's generally strong growth in equity markets, the markets are going through a considerable adjustment this year. The results for the first half-year of some markets are:

Greece -47%, Spain -32%, Italy -27%, France -23%, Germany -16%, UK -16%, Czech Republic -13%, China -9%, USA -8%.

All in all, these are considerable declines. We had already deemed the market expensive at the beginning of the year, which is why we had held back and always kept part of the portfolio in cash. We finished in the black, if only by a hair's breadth. What will come next? We have not the slightest idea. After dropping this year, the markets cannot be termed especially expensive. Indeed, they are more or less fairly priced. There are, however, a large number of very attractive shares within them. For the time being, we have been resisting the temptation of low prices. We still have around CZK 120 million in cash, and it is pleasant to observe the falling prices in the knowledge that we could potentially purchase more and more shares. We have a clear idea of what we want to buy, but we do not want to rush in just now. The mood on the markets is still rather negative, and we will probably hold out for a bit longer. Should a truly extraordinary opportunity arise, however, we will not hesitate!

We sold two positions in the past quarter: the American supermarket chain Supervalu and Li Heng, a Chinese producer of textile fibres. We had bought Supervalu last year at the time of the greatest decline, and it had been a short-term investment for us from the beginning. We sold Li Heng in order to reduce our exposure to China. We now have just three investments in China. All are oriented to the domestic sector, are primarily defensive and non-cyclical, and we will hold onto them.

We have two new titles in the portfolio, both in the United States. We have started buying them cautiously and expect to purchase much more over time.

Daniel Gladiš, 5 July 2010

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